The Doctors' GRAT

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Did you know that a grantor retained annuity trust (GRAT) can help you maintain control over your property and other financial assets, while simultaneously transferring their ownership to your heirs and removing them from your taxable estate? Essentially, the GRAT enables a donor to remove highly-appreciating assets from his estate to transfer to designated beneficiaries at a low gift tax cost. When conditions are right, GRATs are an unbeatable wealth management and asset protection tool.

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Let me simplify the definition of a GRAT. A trust is simply a vehicle, an entity to own assets, and in this case it pays out an annuity. An annuity is a predetermined income stream for a specific period of years. In a GRAT, the grantor or donor retains control of assets put into the trust and receives annuity payments each year. GRATs have a definitive timeline, and most are structured for a three- to ten-year period.

A GRAT is an excellent tool in today's low interest rate environment, wherein real estate and investment assets have depreciated in value. When a GRAT is established, the assets transferred into it are appraised and it is assumed that their value will increase by at least as much as the interest rate set by the IRS for that month (Section 7520 rate). If the value of the assets inside a GRAT does not increase at rate equal to or greater than the Section 7520 rate by the end of the GRAT, the assets may revert back to the grantor's taxable estate. However, if the assets' value increases beyond the Section 7520 interest rate, the beneficiaries of the trust reap the rewards of the excess investment growth tax-free. On the whole, assets that are likely to substantially outperform the Section 7520 Rate are best suited for a GRAT.

Recently, I suggested to a client that a GRAT would be an excellent vehicle to transfer his interest of a real estate partnership to his children. Three conditions make the GRAT particularly appealing: current low interest rates, the depressed real estate market (and therefore low appraisal value of assets going into the GRAT) and the ability to discount when gifting. The real estate partnership produces income that the retired doctor needs, so the trust will pay out the income as an annuity. The doctor pays tax on the income, just as if he continued to own the assets. Assuming that the trust does go to its full term, the appreciation of the property escapes estate tax.

GRATs also create an added asset exchange opportunity. This exchange opportunity allows you to swap a non-GRAT asset into the trust in exchange for the asset already in the trust—for example, high growth stocks for non-appreciating stock. Swapping assets allows the grantor (the person forming the trust) a corrective means to replace the wrong assets put in the trust. Think of a GRAT as a second chance to get appreciation out of your estate.

Real Life Case Scenario

Orthopod: Age 55, retiring in five years
Office Building: $1 million (recently reduced valuation due to real estate debacle)
Cash Flow from Building: $70,000 per year

This Orthopod puts the office building into a GRAT and designates her children as beneficiaries. The future appraisal value of the building is estimated to be $1.6 million in five years, when the market turns around. The $70,000 is paid from the GRAT to the doctor each year for the next five years, at which time the kids will own the building. Normally, the doctor would hold the building and gift it in five years, making a gift of $1.6 million. By utilizing the GRAT structure, she can:

1. Gift the building into the trust today.
2. Take a current gift of $686,000.
3. Receive the $70,000 each year.
4. At the end of the term, have the office building out of her estate, not subject to tax.

5. Effectively gift an additional $914,000 without tax.

Even if the property does not appreciate as hoped for, it is still a good deal. Remember, the GRAT also provides the opportunity to exchange another low basis asset for a higher basis asset.

Establishing a GRAT

A GRAT is not something you can set up on your own. You need a professional tax attorney who can get a proper appraisal of the asset. Overall, the process is not difficult for the trained professional; however, every detail is critical, especially calculating the proper payout and time period. Once the GRAT is established, you will have to file a gift tax return with your next income tax filing and have the IRS on notice.

Estate planning should not be left until your later years. The old adage, "Failing to plan is planning to fail," definitely applies here.

All physicians need to be made aware of tax-efficient strategies such as a GRAT as a means to minimize the tax consequences of being successful and transferring assets to family. There is no doubt in my mind that taxes will be increasing soon. What has worked in the past may or may not hold success in the future. A proper and thorough analysis is essential to plan the most appropriate strategies to accomplish your specific objectives.

Many investors – even those who realize the importance of estate planning – do not feel comfortable with planning strategies that they view as too complex or sophisticated. But strategies like GRATs should not be reserved for the ultra-wealthy. Investors should have an advisor evaluate estate planning options, including but not limited to:

- Grantor Retained Annuity Trusts (GRATs)
- Family Trusts
- Irrevocable Life Insurance Trusts (ILITs)
- Qualified Personal Residence Trusts (QPRTs)
- Installment Sale to an Intentionally Defective Grantor Trust
- Qualified Terminal Interest Property Trusts
- Dynasty Trusts
- Limited Liability Companies (LLCs)

Estate planning is often the most neglected element of wealth management. Investors focus on growth, education funds and retirement planning, but frequently minimize the importance of estate planning. Estate planning should not be left until your later years. The old adage, "Failing to plan is planning to fail," definitely applies here. Properly executed estate planning and vehicles, such as the GRAT, can save the family millions of dollars in taxes.

GRATs are a good example of a tool that cannot be implemented at the last minute. GRATs must be in place for a minimum of two years, or all of the assets revert back to the grantor's taxable estate. Therefore, the grantor must survive the length of the GRAT. Our advice is take the time to plan now, meet with your advisor and be sure to consider every strategy available.

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Mark Germain, CFP™, MBA, is the founder and Chief Executive Officer of Beacon Wealth Management and has over 30 years of experience in giving advice to high net-worth individuals and organizations. His career highlights started with the "Big Eight" accounting firm of Touche Ross and Company (Deloitte and Touche). After completing his Bachelor of Science in economics and accounting, Mark completed his Master of Business Administration and graduate work in finance at Northeastern University and taught accounting. He keeps contemporary as an adjunct professor at Fairleigh Dickinson University teaching future CFP candidates the financial planning process. For more than 20 of the last 25 years, Mark Germain has provided financial guidance on investments, estate planning, insurance protection and ad hoc financial advice. He can be reached at mark@bwmllc.com.

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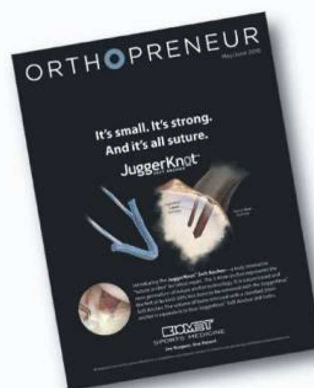

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