



Giving to a family member?

Act now with a specialized trust to minimize your tax burden

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Remove assets from an estate while minimizing use of the gift tax exemption.

We all know that low interest rates make it an excellent time to refinance or purchase a home. What many don't know is that low rates can also make it a good time for making gifts to family members.

By using a grantor retained annuity trust (GRAT), individuals can make gifts to family and friends in today's low rate environment with minimal impact on use of the gift tax exemption amount. A GRAT may make sense for you, but don't wait too long before deciding: Steps could be taken in Washington that would materially impact the attractiveness of GRATs.

Gifts and taxes

Under current federal law, any person can make unlimited gifts to a spouse without incurring a federal gift tax. For gifts to non-spouses, the annual exemption is \$15,000 per person per year.¹ Gifts in excess of that amount are considered taxable gifts, which cuts into the unified gift and estate tax exemption amount.² Anyone who wants to make larger gifts in any one year to the same individual must use a portion of their exemption amount. For some, however, a GRAT may provide a way around that.

What is a GRAT?

A GRAT is a split-interest planning technique that allows the grantor to leverage the amount that can pass to remainder beneficiaries with a reduced gift tax. It is an irrevocable trust into which a grantor makes a one-time transfer of property, reserving for themselves a fixed annual payment percentage. The annuity period can be for a term of years or the grantor's life expectancy. At the end of the annuity term, payments to the grantor stop, and any property remaining in the trust passes to the remainder beneficiaries (e.g., the children) as named in the trust document. Alternatively, the property can remain in the trust for the future benefit of the beneficiaries.

The most significant advantage of a GRAT is that it provides the grantor's ability to remove assets from an estate without using as much of the gift tax exemption. If

properly drafted, the beneficiaries can receive assets with none of the grantor's gift tax exemption being used. And a GRAT can be a particularly effective way to transfer rapidly appreciating property.

How a GRAT works

A GRAT is composed of the lead interest (the payments to the grantor) and the remainder interest (assets passing at the end of the trust term to the remainder beneficiaries, i.e., the gift). The amount of the gift passing to the remainder beneficiaries is calculated based upon what is deemed to be returned to the grantor during the trust term.

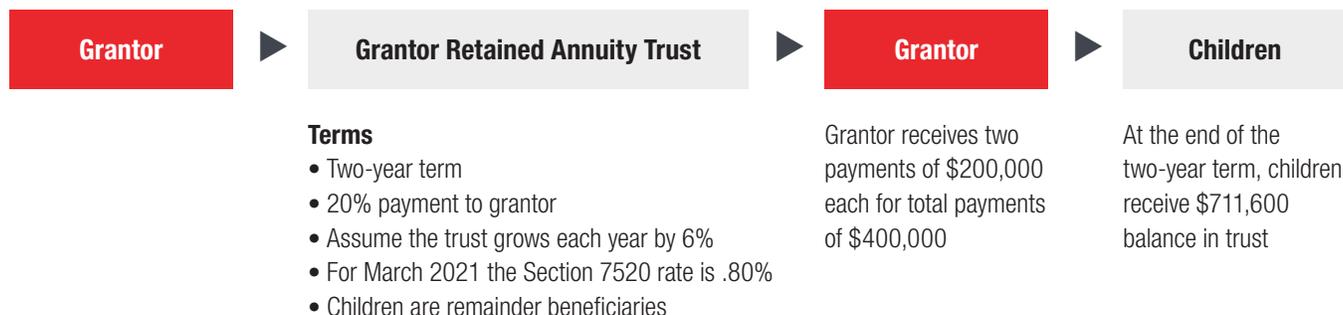
The present value of the grantor's income stream is calculated, which determines the value of the GRAT passing back to the grantor. This is done using a calculation based upon the Section 7520 rate of the Internal Revenue Code. The Section 7520 rate, updated monthly, is used to discount the value of annuities, life estates, and remainder interests to determine present value.

In a GRAT, the amount deemed to be the gift passing to the remainder beneficiaries – and hence the basis for computing the gift tax payable – is based on the funding value of the trust reduced by the present value of the income stream paid to the grantor. The lower the Section 7520 rate, the lower the value of the gift transferred to the remainder beneficiaries.

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Transfers \$1 million cash

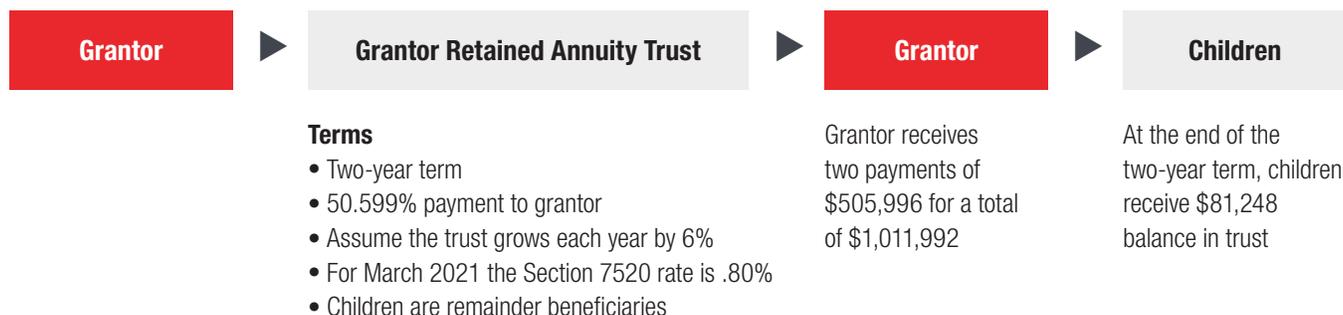
Example one:



To gain an appreciation of the value of this type of trust, consider the above example of a grantor transferring \$1 million to a GRAT.

Although the children receive over \$700,000 at the end of the two-year term, the value of the taxable gift at the time of creation is \$604,740 because the value of the remainder interest was calculated in the month the trust was established. However, since the trust earned a much higher return (6%) than the Section 7520 rate (0.80%) deemed at the time of funding, the grantor could pass \$106,860 to the children free of gift taxes.

Example two:



The appeal of the GRAT is even more apparent if a zeroed-out GRAT is utilized. With this technique, the value of the remainder interest passing to beneficiaries is deemed to be zero at the time of funding. As a result, no gift tax exemption amount is used at all.

Although the children receive over \$81,000 at the end of the two-year term, the value of the taxable gift at the time of creation is zero since the value of the remainder interest was calculated in the month the trust was established. The grantor could pass \$81,248 to the beneficiaries without using any of the estate tax exemption.

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Why timing matters

As mentioned previously, GRATs work best when the Section 7520 rate is low. So long as the underlying performance of the GRAT is better than the Section 7520 rate, the GRAT will be a success. But even if the GRAT underperforms the Section 7520 rate and isn't a success, the only real cost to the grantor is the expense of drafting and administering the trust.

The Section 7520 rate has been rising in 2021, providing an incentive to establish a GRAT now. However, the prospect of increasing rates is only one reason to create a GRAT today. The Biden administration is seeking to pick up on an unmet objective under President Obama's White House to mandate a minimum ten-year term for

GRATs. Since the grantor must survive the GRAT term to be effective, a longer period can adversely impact the probability that the GRAT will be successful. The value remaining in the trust is included in the taxable estate of a grantor who does not survive the term. Also, the current administration may consider introducing a requirement that a GRAT must consist of a minimum taxable gift to the remainder beneficiaries, effectively eliminating the zeroed-out GRAT.

With the prospects of rising interest rates and the potential for legislation that would diminish the utility of a GRAT, the message is clear: Now is the time to act.

If you have any questions or need more information, please contact your Key Private Bank advisor.



¹The spouse must be a US citizen; the limit is \$159,000 annually for a resident non-US citizen spouse.

²Currently, only Connecticut imposes a stand-alone gift tax for annual gifts more than \$15,000. Other states may bring back lifetime gifts at death or enact legislation to impose a gift tax.

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