Planning opportunities during market volatility: Finding the silver lining

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The currently depressed market and low interest rates present a once in a lifetime planning opportunity to transfer significant wealth to your family and other loved ones without the imposition of gift taxes. The vehicle to achieve this goal is a zeroed out Grantor Retained Annuity Trust, or "GRAT."

You create a GRAT by transferring assets into a special type of irrevocable trust and retaining the right to annuity payments from the trust for a specific term of years. The amount of the annuity payment retained by you, the grantor, is a function of: (i) the value of the property contributed to the GRAT, (ii) the GRAT's term, and (iii) a fixed interest rate set by the IRS for the month of contribution. In most cases, the GRAT term we will suggest will be a relatively short 2 to 4 years.

So why is now a good time to consider a GRAT?

One of the key drivers determining the annuity payment is the initial value of the property contributed to the GRAT. Assets that have temporarily declined in value, but which you believe will dramatically rebound, will generate a higher gift tax free remainder for your children or other loved ones who you wish to benefit.

Low asset values combined with low interest rates result in higher tax free remainders, even when the trust is designed to "zero out" (i.e., returning the contribution value of the property contributed, plus the IRS determined interest rate, to you over the term of the trust). But why would someone want to create an irrevocable trust, only to receive back annuity payments equal to the contribution value of the property contributed plus interest?

This is where the current historically low interest rates and depressed asset values are key. As long as the property contributed to the GRAT appreciates at a rate higher than the IRS rate on the date of contribution, the remainder interest in the GRAT will be worth more than zero and will result in a gift tax free transfer to your loved ones. For example, if a stock appreciates by 20% from its contribution date to the end of the GRAT term, nearly all of the increase will pass gift tax free.

The IRS interest rate is only 1.2% in April and with the Federal Reserve slashing interest rates to zero, the IRS rate is expected to be significantly lower in May. Sophisticated structuring of the GRAT can enhance the tax free transfer generated by appreciating assets in a number of ways. Annuity payments to the grantor are income tax free and can be made "in kind."

GRATs have other advantages. One is that GRATs are grantor trusts for income tax purposes, which means that the grantor of the trust is responsible for the GRAT's income taxes. While this might not sound like an advantage at first, it actually increases a GRAT's ability to transfer family wealth in a tax efficient manner. The grantor, through the payment of the GRAT's income taxes, is effectively making tax-free gifts to the trust. A second advantage is that GRATs are statutory vehicles under federal tax law. For individuals concerned with being too close to the cutting edge with their planning, this provides additional comfort.

For people who want to do something other than simply outlast the current crisis in the markets, a GRAT may be worth a calculated bet. If you would like to discuss how you could put this information to use for you and your family, please consult your Withers Bergman attorney.

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