What Is a Grantor Retained Annuity Trust (GRAT) ?

A grantor retained annuity trust (GRAT) is a financial instrument used in estate planning to minimize taxes on large financial gifts to family members. Under these plans, an irrevocable trust is created for a certain term or period of time. The individual establishing the trust pays a tax when the trust is established. Assets are placed under the trust and then an annuity is paid out every year. When the trust expires the beneficiary receives the assets tax-free.

Understanding Grantor Retained Annuity Trusts (GRAT)

A grantor retained annuity trust is a type of irrevocable gifting trust that allows a grantor or trustmaker to potentially pass a significant amount of wealth to the next generation with little or no gift tax cost.
GRATs are established for a specific number of years.

When creating a GRAT, a grantor contributes assets in trust but retains a right to receive (over the term of the GRAT) the original value of the assets contributed to the trust while earning a rate of return as specified by the IRS (known as the 7520 rate). When the GRAT's term expires, the leftover assets (based on any appreciation and the IRS-assumed return rate) are given to the grantor's beneficiaries.

Under a grantor retained annuity trust, the annuity payments come from interest earned on the assets underlying the trust or as a percentage of the total value of the assets. If the individual who establishes the trust dies before the trust expires the assets become part of the taxable estate of the individual, and the beneficiary receives nothing.

Grantor Retained Annuity Trust Use

GRATs are most useful to wealthy individuals who face significant estate tax liability at death. In such a case, a GRAT may be used to freeze the value of their estate by shifting a portion or all of the appreciation on to their heirs. For example, if a person had an asset worth $10 million but expected it to grow to $12 million over the next two years, they could transfer the difference to their children tax-free.

GRATs are especially popular with individuals who own shares in startup companies, as stock price appreciation for IPO shares will usually far outpace the IRS assumed rate of return. That means more money can be passed to children while not eating into the grantor's lifetime exemption from estate and gift taxes.