GRATs: A Planning Tool for Business Succession

Reducing your family's tax burden while keeping your business intact

For today's business owner, continuation and estate planning go hand-in-hand. Without proper tax strategies, the time, hard work, and money you've invested in your business could yield little more than a significant tax bill for your heirs. Fortunately, with careful planning, there are numerous ways of reducing your family's tax burden while keeping your business intact.

Gifting Review

You are annually allowed to give assets valued up to $15,000 in 2020 to each of your children or grandchildren (or anyone else, for that matter) without incurring a tax penalty. A married couple can transfer assets worth $30,000 in 2020 – $15,000 per adult.

Making gifts qualifying for this annual gift tax exclusion can help lower your estate's taxable value and minimize estate taxes. In 2020, the federal estate tax generally applies when a person's assets exceed $11.58 million at the time of death and can be as high as 40%. Further, some states also assess estate tax.

Accordingly, above and beyond the annual gift tax exclusion, every individual has a lifetime gift tax exemption of $11.58 million in 2020, almost $180,000 more than it was in 2019. Most taxpayers will not reach the gift tax limit of $11.58 million over their lifetimes, but for some business owners, this amount is not enough to transfer an entire business. Furthermore, using the lifetime gift tax exemption will reduce what you can transfer tax free at death. So in order to substantially reduce your tax liabilities, further planning options should be explored.

Is a GRAT for You?

For many estates, a trust is a cost-effective method of making gifts, which can often facilitate intergenerational transfers. In particular, the **grantor retained annuity trust (GRAT)** enables you to gift a substantial amount while retaining an income interest for a specified period of time. This significantly minimizes your gift tax liability or entirely eliminates your exposure. GRATs are especially useful if a business or estate assets will appreciate in value.

With a GRAT, you can put all or part of your company's stock into an irrevocable trust that pays you (the business owner) a fixed income for a specified number of years.

Since the trust is irrevocable, once you place stock or other assets into the trust, they are there for good, or until the GRAT terminates and the assets pass to your designated beneficiaries.

Assets transferred to the trust are considered a gift for gift tax purposes. GRAT gifts do not qualify for the annual exclusion because the beneficiaries have a future interest, not a present interest, in the gift. Since you retain an income interest, the gift's value is discounted, reducing your total gift tax liability. However, any income is taxed to you as the grantor.

An applicable Federal interest rate determines your annuity (the income you receive as a percentage of assets transferred) value. GRATs are generally most attractive when interest rates are low because you may receive substantial transfer tax savings if the growth rate of assets transferred to the trust exceeds the federal interest rate. Your beneficiaries will receive any appreciation free of estate and gift tax, provided you survive the trust term. It is important to keep in mind that while reducing your transfer tax liability and possibly building wealth for your heirs, a GRAT also locks in a guaranteed income stream for yourself for a fixed time period.

A Word of Caution

It is important to emphasize one major drawback to using a GRAT: If the grantor dies before the trust term expires, then the trust's full value falls back into the grantor's estate. It is important to plan for a trust term you expect to outlive. Given this risk, older grantors may wish to specify shorter terms, or set up several trusts of varying durations, known as "laddering."

Business owner estate planning is a multifaceted endeavor. Advance planning and carefully considered tax-efficient strategies may help maximize the transfer of wealth to your heirs.

Be sure to consult your financial advisor about your unique circumstances.