

GRITs, GRATs, and GRUTs Trusts

What Are GRITs, GRATs and GRUTs?

IRC Section 2702 is generally intended to prevent the use of trusts to reduce artificially the value of interests passing to younger generations. This is generally accomplished by not recognizing for tax purposes the value of a parent-grantor's intervening income or life estate interest, so that the full value of the transfer in trust becomes a gift to the ultimate beneficiaries. But certain qualifying interests in trust--GRITs, GRATs and GRUTs--will not be valued at zero, and may serve to reduce the taxable gift to trust beneficiaries.

After 1990 the use of the Grantor Retained Interest Trust (GRIT) is generally limited to those trusts which either pay the Grantor a fixed payment, at least annually (an annuity), or pay a fixed percentage of the trust assets as revalued annually (unitrust).

The intrafamily GRIT allowed under pre-1990 law currently has only a limited usefulness in the areas of tangible property (e.g., artwork) and personal residences which are exempt from the special valuation rules. To avoid confusion between the GRIT prior to the 1990 law change and the type of trusts which are now permitted, the two authorized forms of GRITs are now called GRATs and GRUTs. The GRAT is a Grantor Retained Annuity

Grantor Retained Interest Trust (GRIT)

The "House GRIT"

A House GRIT is an irrevocable trust into which the grantor places a personally owned home while retaining an income right or the use of the property for a fixed period of years. The home, at the end of the specified period of years, will pass to non-charitable beneficiaries, such as a child or grandchild of the grantor. Generally, the grantor is making a gift of the future right to trust assets to the remainderman (family members). If the grantor survives the term of years selected, so that the home is not included in his gross estate, significant estate tax as well as other transfer cost reductions may be realized.

Requirements for a "House GRIT"

First, an irrevocable trust must be established. The trust must provide that the grantor retains the right to enjoy trust income or possess trust property for a specified number of years. The longer the specified term of the trust, the greater the value of the retained income interest, and therefore, the lower the taxable gift the grantor is making to the ultimate remainder beneficiaries. The "principal residence" of the grantor and/or one "other residence" of the grantor are candidates for transfer to the trust. Under the Internal Revenue Code rental-use rules, if the grantor uses the residence for the greater of (1) 10% of the number of days during which the house is rented at a fair rental, or (2) two weeks, and rents the property for the balance of the year, it will qualify.

One or more qualified appraisers should value the property shortly before it is placed into trust. If the grantor resides in the home at the expiration of the trust term, a written lease should be entered into requiring the grantor to pay a fair market rental to the remaindermen (family members). The IRS has taken the position that the home may not be transferred out of the trust (as, for example, by sale to the grantor) during the life of the trust.

The trustee generally should be someone other than the grantor or the grantor's spouse. Third-party-owned life insurance could replace the value of the gifted personal residence without adding to the grantor's taxable estate.

Grantor Retained Annuity Trust (GRAT)

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The cost of the transfer would be the gift tax on the value of the remainder interest. The gift is of a "future interest" and does not qualify for the annual gift tax exclusion. Therefore, part of the applicable credit amount (formerly, unified credit) must be consumed.

Grantor Retained Unit Trust (GRUT)

Grantor Retained Unitrust (GRUT)

The GRUT may be used by an estate owner to transfer assets to his or her children. The value of the transferred asset minus the value of the retained unitrust interest will equal the value of the remainder interest which is potentially subject to gift taxation. For example, if the payout rate is 6%, the trustee will pay the grantor 6% of the value of the trust assets as revalued each year. Thus, if the trust assets earn more than 6%, the excess earnings will be added to principal and there will be a higher dollar payment the following year.

For this reason, the GRUT is not as effective as the GRAT in shifting asset appreciation to younger generations. However, for persons desiring to transfer assets to children while retaining an increasing annual return of income, the GRUT may be considered. The cost of the transfer would be the gift tax on the value of the remainder interest. The gift is of a "future interest" and does not qualify for the gift tax annual exclusion. Therefore, either the gift tax must be paid or part of the applicable credit amount must be consumed.