Waiter, There's a REIT in my GRAT!

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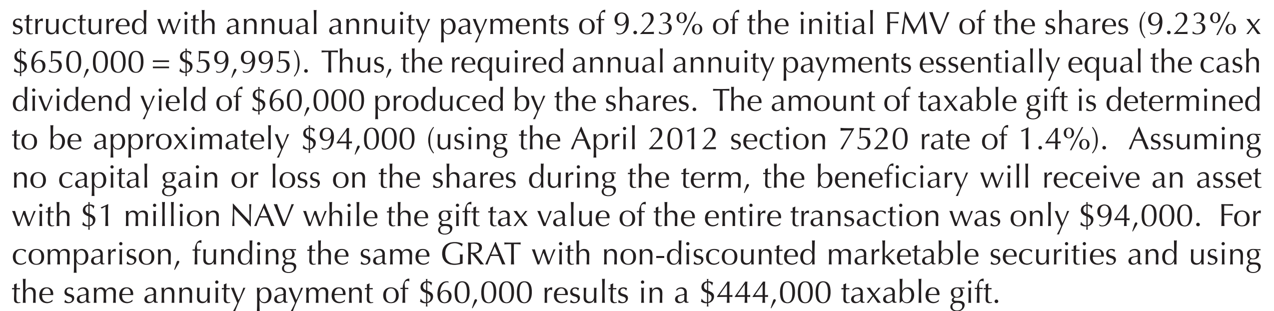
The next line in the old joke about a fly in the soup has the offended patron asking the waiter: "what is he doing in there?!" To which the clever waiter replies: "it looks like the backstroke, sir." Please excuse my bad take off on the joke, however, some estate planners might react similarly upon the suggestion of a REIT in a GRAT. That is, until they discover how much "flavor" this combination really has.

Non-traded REITs are popular and widely held alternative investments with billions of dollars flowing into them annually. It's an oxymoron to call a widely held asset "alternative," but so it goes in the industry. They are typically sold on the basis of portfolio diversification into commercial real estate and relatively high yields in the form of dividends. It's not uncommon to find non-traded REITs yielding between 5% - 7% even in the early stages. But what do they have to do with GRATs?

Grantor retained annuity trusts (GRATs) are widely used vehicles for transferring wealth from one generation to the next with little or no transfer tax consequence. The grantor establishes the trust which is required to make annuity payments back to the grantor during the trust term. The principal remaining at the end of the term goes to the remainder beneficiary. This assumes the grantor survives the term of the trust because adverse effects apply if the grantor dies prior to the end of the term. A significant benefit of GRATs is that any income and growth in excess of the required annuity payment remains in the trust and passes to the beneficiary. Assets that produce high yields or high growth are favored since the excess yield and growth passes free of gift tax.

Another standard technique is to initially fund the GRAT with discounted assets. Assets such as family limited partnerships, closely held stock, minority interests and others are often subject to valuation adjustments between net asset value (NAV) and fair market value (FMV). The FMV is often much less than NAV due to discounting factors such as lack of control (minority interest), lack of marketability and so on. The annuity payment is generally based on a percentage of the FMV at the time the asset is transferred into the trust. When the trust terminates, the entire NAV which includes any accumulated interest and capital appreciation is transferred to the beneficiary. The net result is the ability to transfer significantly more assets into the GRAT at the outset (NAV) while using a much lower value in the calculation to determine the amount of gift subject to tax upon funding (FMV).

This is where non-traded REITs become attractive assets for funding GRATs. Non-traded REITs are subject to similar discounting principles as outlined above such as lack of control, lack of marketability, etc. For example, assume a client holds $1 million NAV shares of a non-traded REIT with a current cash yield of six percent ($60,000 annually). The FMV is determined to be $650,000, representing a thirty-five percent discount which is the average discount applied to several non-traded REITS by a large US brokerage firm in 2011. The client establishes a GRAT with a ten-year term funding it with the REIT shares. The GRAT is



structured with annual annuity payments of 9.23% of the initial FMV of the shares (9.23% x $650,000 = $59,995). Thus, the required annual annuity payments essentially equal the cash dividend yield of $60,000 produced by the shares. The amount of taxable gift is determined to be approximately $94,000 (using the April 2012 section 7520 rate of 1.4%). Assuming no capital gain or loss on the shares during the term, the beneficiary will receive an asset with $1 million NAV while the gift tax value of the entire transaction was only $94,000. For comparison, funding the same GRAT with non-discounted marketable securities and using the same annuity payment of $60,000 results in a $444,000 taxable gift.

The same advantages apply to the two-year rolling GRAT technique as well as other shorter term GRAT structures. Non-traded REITs are often overlooked as an attractive GRAT asset because many advisors do not realize they are subject to valuation adjustments. Understanding this opportunity opens up many more avenues to help clients in their planning scenarios. Taking advantage of discount valuation opportunities inherent in alternative assets many clients already own can bring significant tax savings that may not otherwise be available. Many clients are not perfect FLP/FLLC candidates but may already hold significant assets subject to discounting that can be used with GRAT-type planning techniques instead.

Now you know the proper response to: "Waiter, there's a REIT in my GRAT! What is it doing in there?" Advisors should respond: "Excellent - it's saving you tax money, sir!"