

Patti Spencer's Taxing Matters Column for June 02, 2008

GRATs (not GRITs) - More on estate planning

Last week's column discussed the Charitable Lead Annuity Trust as an estate planning opportunity that is particularly attractive in the low interest rate environment that is a product of the credit and the disruption in the U.S. and world markets. A Grantor Retained Annuity Trust is an estate planning technique particularly attractive in a low interest rate environment, such as we are experiencing. It allows an individual to make large gifts without paying gift tax or using any unified credit.

The IRS §7520 rate for May, which is used for the valuation of interests in GRATs, is 3.2 percent — historically very low. For June, the rate is 3.8 percent. The May 3.2 percent rate can be used for valuations of property interests transferred in May, June and July 2008. The June rate of 3.8 percent, which is still very low, can be used until the end of August 2008.

A GRAT is an irrevocable trust. The creator of the trust, the grantor, transfers assets to the trust. For a specified term of years, the GRAT must pay an annuity to the grantor (hence, the "retained annuity"). At the end of the term, the balance remaining in the trust is paid to the beneficiaries. The term of the trust and the amount of the annuity are chosen to make the actuarial value of this gift to the beneficiaries very small. Here is an example:

Grantor transfers \$1 million to a 5-year GRAT. To "zero out the GRAT," each year the GRAT is required to pay \$219,601.60 to the grantor. Since the Grantor can't make a gift to himself, the only gift made is the actuarial value of the remainder interest which is valued at zero. If we assume that the asset contributed to the GRAT grows at the rate of 3.2 percent per year, then at the end of the 5 year term, the grantor would have received back all of the trust's property as annuity payments. The remaindermen would get nothing. The value of the gift that the grantor made is thus zero. However, if the asset in fact appreciated or earned income at the rate of 12 percent per year, then there would still be \$367,246.23 remaining in the trust. This \$367,246.23 is distributed to the beneficiaries at the end of the five-year term free of gift and estate tax. Since the effective rate of the gift and estate tax is 45 percent this represents a tax savings of 165,260.80. The greater the growth of the assets inside the trust, the bigger the tax savings. In effect, all growth in excess of the IRS stated rate of 3.2 percent passes to the beneficiaries estate and gift tax free. If the grantor can put \$10 million in the GRAT the beneficiaries receive \$3,672,623 estate tax free.

For this tax saving technique to work, the grantor must survive the chosen term of years. If the grantor dies during the term, the trust is included in his or her

estate. That is why it is preferable to do shorter term GRATs. You can do more than one; one each year if you like.

If the GRAT asset does not outperform the IRS §7520 interest rate (now 3.2 percent), then there will be no tax savings. What is the downside? Only the transaction costs of setting the GRAT up and maintaining it (Translation: attorney fees).

It is not necessary for the annuity to be paid in cash. Let's say the grantor transfers stock to the GRAT, perhaps even stock in his or her closely-held business. The annuity obligation can be satisfied by transferring shares of stock back to the grantor, valued at the time of the payment.

The grantor can be the trustee of the GRAT. (Caution: The grantor should not be the trustee if stock in a closely-held corporation is transferred to the GRAT.) Payment at the end of the term of years need not be outright to the beneficiaries. There could be a continuing trust for beneficiaries. With limited trustee powers, the grantor could even be the trustee of the trust after the expiration of the term.

There is an additional income tax advantage. Since all of the GRAT's income is paid to the grantor, the GRAT is a grantor trust for income tax purposes. The grantor pays the income tax on any income earned by the trust. This is an additional estate planning advantage because this tax payment is really for the benefit of the remainder beneficiaries and, yet, it is not treated as a gift.

Because the GRAT allows the remainder beneficiaries to receive the appreciation on all of the trust property, it produces a much better tax result than an outright gift. Other gifts either use up the exemption or cause the payment of gift tax. A properly structured GRAT can shift very significant value to beneficiaries for no tax cost at all