

## GRANTOR RETAINED ANNUITY TRUSTS CAN REDUCE GIFT AND ESTATE TAXES

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*Trusts have long been a favored vehicle for estate planning, and can be valuable tools in transferring wealth to succeeding generations with the lowest possible tax liability. Reducing the tax burden on intergenerational transfers is an important goal of estate planning, but recent changes in tax laws have reduced or eliminated the advantage of many tax minimization strategies. However, the Grantor Retained Annuity Trust (GRAT) remains a viable structure for transferring wealth to heirs while retaining the current value of assets and paying sharply reduced gift and estate taxes.*

### INVESTMENT-DRIVEN ESTATE PLANNING

In order to take advantage of this estate planning technique, an individual, hereafter known as the Grantor establishes an irrevocable trust (*a trust that cannot be terminated by the Grantor once it is established*) for a specified number of years. The Grantor places a certain amount of assets in the trust and, in turn, will receive an annuity payment at the end of each year that the trust exists. The assets held in the GRAT (which can be shares or other non-cash assets) may be used to make the annuity payment. The annual payment may be level or graduated, although increases cannot exceed 120% of the prior years' payment. The payment can be specified in dollar terms, or as a percentage of the assets held in trust. At the end of the trust term, the assets remaining in the GRAT are passed on the trust beneficiary free from tax liability.

Upon creation of the GRAT, the Grantor is considered to make a taxable gift to the beneficiary, and the Grantor pays the tax at that time. The value of this gift is calculated by subtracting the present value of the total annuity payments from the fair market value of the assets contributed to the GRAT. The present value of the annuity is calculated using an interest rate provided by the Internal Revenue Service. By maximizing the present value of the annuity, the taxable value of the gift can be drastically reduced, in some cases to zero. However, for the trust to have transferable value, the total rate of return generated by trust assets must exceed the Internal Revenue Service designated interest rate used to value the annuity. Investment performance therefore drives the value of this estate planning technique.

### WHAT HAPPENS IF THE GRANTOR DIES DURING THE TRUST PERIOD?

If the Grantor does not survive the trust period, the trust assets will be considered part of the Grantor's taxable estate. However, the estate will not bear any additional tax liability. It will be as though the trust were never created.

### WHO PAYS THE TAX ON INCOME GENERATED BY THE TRUST?

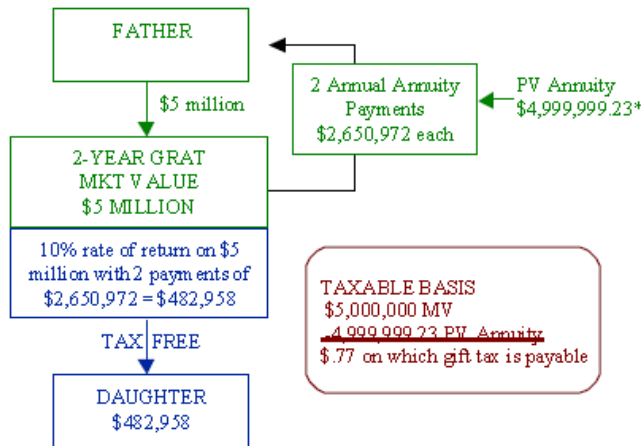
For income tax purposes, the trust is treated as a Grantor Trust for the entire term of the trust. The Grantor will be responsible for the income tax payable on all income earned by the trust during that period, whether or not the income is distributed. The Grantor must have other assets available to meet this tax liability.

Note once more that in order for the GRAT to be an effective estate planning technique, the trust assets **MUST** generate a total return that exceeds the IRS-designated return. If the assets do not generate an adequate return, there will not be sufficient appreciation on the trust assets to pass on

to the beneficiary. With no assets to pass on, the Grantor will fail to realize any value from the trust and will have paid the fees associated with creating and administering the trust for no benefit.

## HOW DOES A GRAT WORK?

For illustrative purposes, imagine that a father transfers \$5 million of assets into a GRAT with a term of two years. At the end of the trust period, any remaining assets will be paid out to his daughter. According to the trust agreement, an annuity payment of 53%, or \$2,660,972, will be paid to the father at the end of each of the two years. Assume that the rate of return on the trust assets will be 10% annually. The IRS designated rate<sup>1</sup> is 4%.



The market value of the trust assets is \$5 million at the trust's inception. The present value of the annuity is \$4,999,999.23, based on the IRS designated interest rate.

Subtracting this present value from the market value of the trust assets, a taxable gift valued at 77 cents by the IRS remains. The gift tax liability will effectively be zero. At a 10% rate of return, the assets will generate \$482,958 that will pass tax-free to the daughter at the end of the trust period.

Note that the terms of the trust allow the annuity payments to be made using the trust assets themselves. Therefore, each annual annuity payment to the father will be made using \$2,650,972 worth of the shares held in the trust. At the end of the trust term, the father will have recouped the assets used to establish the trust.

## AN ATTRACTIVE ESTATE PLANNING TECHNIQUE FOR CLIENTS WITH UNDERVALUED ASSETS

Today, many assets including equities, venture capital and property subject to valuation discounts (e.g., closely-held business interests or limited partnership interests may be at very low valuations for various reasons. If undervalued assets are expected to appreciate significantly, this appreciation can be transferred on a tax-advantaged basis while the current value of the asset is retained for the individual desiring to make a gift.

A GRAT may be a wealth transfer planning tool you should consider.

<sup>1</sup> IRC § 7520 Rate

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