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## GRANTOR RETAINED ANNUITY TRUSTS (GRATS)

Grantor Retained Annuity Trusts, commonly referred to as "GRATs," are an excellent tool to transfer wealth outside of your taxable estate while using a minimal amount of gift tax exemption in the process. GRATs are great estate planning vehicles for clients with appreciating assets, clients who are risk averse and clients who have used up a majority of their exemption and who wish to do more gifting.

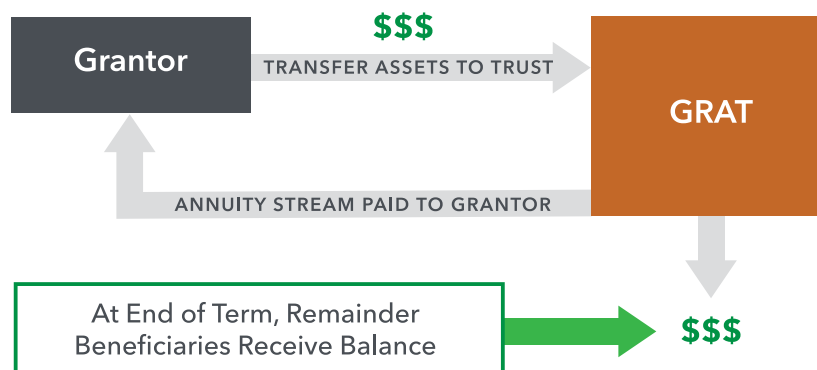
Several years ago, with low IRS interest rates, GRATs were an especially popular strategy. While IRS interest rates are rising, now is still an appropriate time to explore a GRAT, especially for assets valued at artificial lows and with appreciation opportunities.

Please review the following for an overview of the basic GRAT strategy, additional GRAT strategies, and potential risks and issues.

### BASIC GRAT STRATEGY

**1. Description.** A GRAT is a strategy that freezes the value of an asset in your estate and transfers the appreciation of the asset to your beneficiaries. In a typical GRAT, you transfer property to a trust and retain an annuity payment for a fixed term. The annuity payment is designed to roughly equal the value of the property transferred to the trust and create a nominal taxable gift (a "zeroed-out" GRAT). The annuity is calculated by using the IRS interest rates at that time. For a GRAT to successfully transfer assets gift-tax-free to the remainder beneficiaries, the transferred asset must grow at a higher rate than the IRS interest rates, hence why lower IRS interest rates are preferable. At the end of the term, any appreciation in the transferred property in excess of the annuity payments passes to your children or other family members (called the "remainder beneficiaries") gift-tax free. *See illustration below.*

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With IRS interest rates (the rate used to determine the annuity payment) that are low but rising and asset values that are declining, GRATs are especially attractive right now.

**Example.** In a month when the applicable discount rate is 3.6%, Gwen transfers publicly traded securities worth \$1,000,000 to a GRAT, receiving in return a \$120,848 annuity for 10 years. Under the 3.6% discount rate then in effect, the value of Gwen's retained annuity stream is \$999,993. The value of her taxable gift is \$7, which is the difference between the fair market value of the securities transferred and the value of her annuity stream. If the transferred property produces an average annual return of 3.6% or less, nothing will be transferred to the remainder beneficiaries at the end of 10 years. On the other hand, if the property produces an average annual return of greater than 0.6% and Gwen survives the 10-year term, property will be transferred to the remainder beneficiaries free of gift tax, as shown in the following chart:

| Average Return for 10 Years: | Amount Passing Gift Tax-Free to Remainder Beneficiaries |
|------------------------------|---------------------------------------------------------|
| 3.6%                         | \$ 0                                                    |
| 5.0%                         | \$ 108,881                                              |
| 7.0%                         | \$ 297,461                                              |
| 10.0%                        | \$ 667,736                                              |
| 15.0%                        | \$ 1,591,894                                            |

**2. Suitable Property for a GRAT.** The ideal assets to place in a GRAT are those with high-growth or income-producing

potential. In the current economic environment, this means that most individuals could consider a GRAT for marketable securities. As in the past, a GRAT is also particularly useful as a repository for hard-to-value assets such as closely held stock, real estate or family partnership units – especially if discounts are available to lower the fair market value of the property.

### 3. One Unique Benefit of a GRAT.

During a period of uncertainty when asset values are fluctuating wildly, GRATs offer a unique “no lose” feature. In the example above, Gwen would assume a downside risk if she instead made an outright gift of her \$1,000,000 portfolio because if the market value of the portfolio were to decline to \$600,000, she would have wasted \$400,000 of her federal gift tax exemption. With a GRAT, however, the \$600,000 of assets would simply be returned to Gwen, and, if she chose to do so, she could create another GRAT using the lower values. Her total cost would be any legal and accounting fees incurred, plus the *de minimis* amount of federal gift tax exemption used.

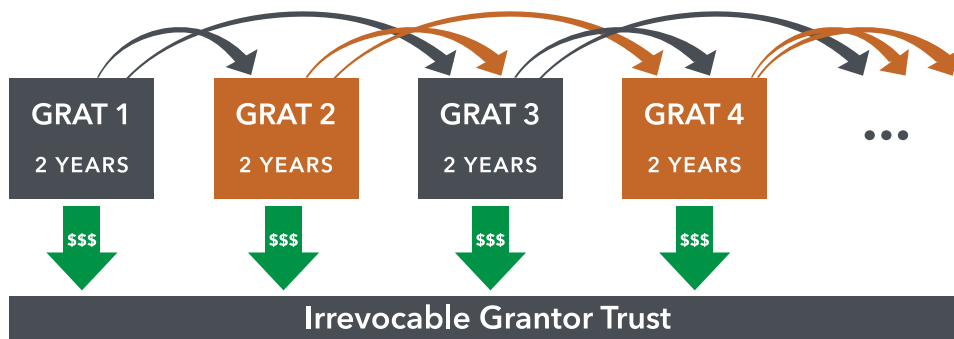
## ADDITIONAL GRAT STRATEGIES

**1. Rolling GRATs.** Generally, the minimum initial term for a GRAT is 2 years. A major benefit of a short term GRAT is that any failed GRATs are simply discarded and any successful GRATs produce excellent tax benefits without being encumbered by down years in the economy. One technique for maximizing value to the beneficiaries, therefore, is to create a series of short-term “rolling GRATs” – every year that the individual receives the annuity payment, the annuity payment is used to create a new GRAT. *See illustration on next page.*

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*This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.*

## GRANTOR RETAINED ANNUITY TRUSTS (GRATS)



**2. End-Loaded GRATs.** The tax regulations specifically authorize the use of a GRAT with smaller annuity payments in the beginning and larger annuity payments as the term continues. By “end-loading” the annuity payments, the grantor leaves more assets in the trust in the early years which may result in a greater return for the remainder beneficiaries.

there may be additional legal fees associated with preparing a separate trust agreement.

**3. Filing a Gift Tax Return.** You must file a Federal gift tax return for the year a GRAT is created reporting the future gift to the remainder beneficiaries, however small.

**4. Allocation of Generation-Skipping Transfer (“GST”) Tax Exemption.** A GRAT is not an effective vehicle for transferring wealth to grandchildren and later descendants through GST tax planning.

### GRAT RISKS AND ISSUES

**1. Mortality.** If you die during the term of your GRAT, the GRAT property is brought back into your estate. Of course, you are in no worse position than if you had not created the GRAT in the first place, other than the legal and other fees associated with preparing the GRAT.

**2. Continuing Trusts After Initial Term of GRAT.** Many clients, especially those with younger children, create continuing trusts (set forth in the GRAT itself or in a separate trust agreement) to hold the assets for the remainder beneficiaries until later ages. For “rolling GRATs,” for example, you could create an irrevocable trust for the benefit of your family that would always receive the remainder assets at the end of every successful GRAT. Although there is no downside to this approach,

### SUMMARY

In short, GRATs remain a great estate planning vehicle for clients with appreciating assets, clients who are risk adverse and clients who have used up a majority of their exemption and who wish to do more gifting. If a GRAT fails, you incur only a minimal tax cost and the professional fees associated with the project. If they succeed, you can transfer significant wealth to your beneficiaries, essentially gift-tax free.

Please reach out to your Wiggin and Dana attorney to explore your wealth transfer options and discuss GRATs as a possible strategy.