Transferring Wealth to Your Family With Grantor Retained Annuity Trusts

One of the hardest things for executives, business owners and other wealthy families to do, is to ensure that their hard earned wealth gets transferred to their children. The reason is taxes – more specifically, gift and estate taxes. Most people understand that estate taxes may be imposed when a person dies with an estate that exceeds a certain size. And, if you were going to try to transfer your assets to family members during your lifetime, gift taxes may apply, making the gifting strategy unattractive. Are there ways to transfer some of your wealth to your children, thereby reducing your estate for estate tax purposes, and minimizing gift taxes?

One Solution – Using a Grantor Retained Annuity Trust

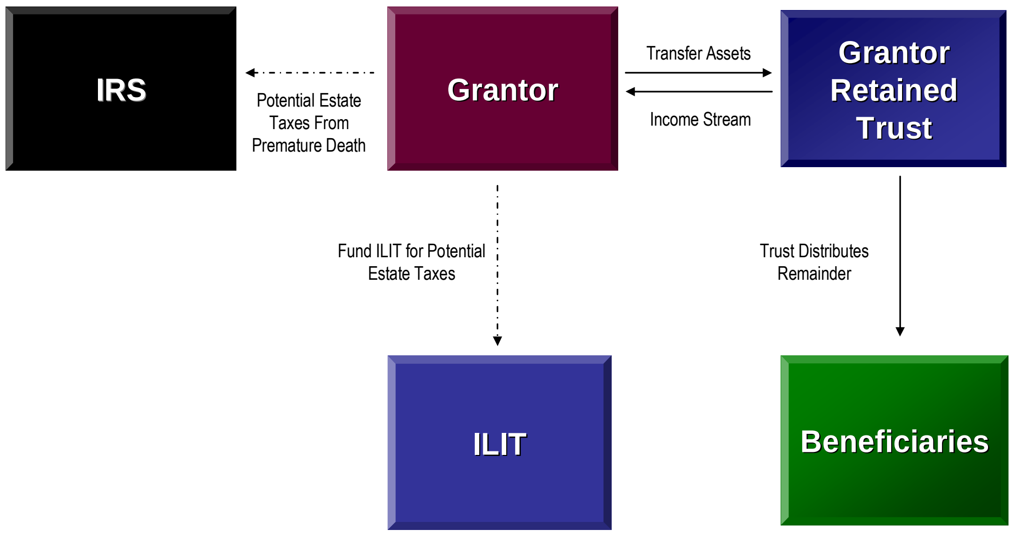
Fortunately, there are some ways to transfer wealth to your children, helping you to reduce the size of your estate for estate tax purposes, and minimizing the gift taxes that may normally apply to large gifts. One of the most common ways is a wealth transfer technique known as the Grantor Retained Annuity Trust (GRAT). The GRAT is an irrevocable trust where you (the grantor) transfer assets to the trust in return for an annuity stream for a certain period of years. This is known as the "income interest." At the end of the term, the assets remaining in the trust are either passed to your beneficiaries (e.g., your children), or held in trust for their benefit. This is known as the "remainder interest." At that time, the assets are also no longer in your estate, reducing your potential estate tax burden.

As you can see, the GRAT serves a dual purpose and is one of several wealth transfer techniques that are known as "split interest" trusts. In effect, you are making a gift to your beneficiaries with strings attached, and those strings are the return of an annuity stream for a certain period of time. As a result of those conditions, the "gift", for gift tax purposes, is not the amount that you transferred into the trust, but something less.

The gift tax value of your gift is actuarially determined at the time the GRAT is established, using discount rates published by the IRS on a monthly basis known as the "7520 rate." The calculations depend upon the amount transferred into the trust, the amount of the annuity, the time period for the trust, and the discount rate in effect.

The end result of a GRAT is that the asset and/or the growth of the asset that was transferred into the trust, has now been transferred out of your estate at a reduced gift tax cost.

How Does it Work?



1. You work with your estate planning attorney and your financial representative to decide on the structure and design of your GRAT. You also decide on the assets that will be used to fund the GRAT. Your attorney will draft the legal documents required to implement this.
2. With the help of your financial representative, you will transfer the assets to the GRAT. The trustee of the GRAT will pay the annuity stream to you for the time period selected.
3. At the end of that term, the assets that remain in the trust will be transferred to your beneficiaries. You have now effectively transferred wealth to your beneficiaries, during your lifetime, at a reduced or minimal gift tax cost.
4. In the event you do not survive the term of the GRAT, the assets will be recaptured in your estate for estate tax purposes. You may wish to create an irrevocable life insurance trust (ILIT) to own life insurance on your life as a hedge against this possibility. The life insurance proceeds in the ILIT will help to pay the estate taxes due or to replace the wealth lost to taxes.

Note that the GRAT is typically designed to qualify as a “grantor trust.” What this means is that for income tax purposes only, the assets held in the trust are deemed to be owned by you, as the grantor, even though you are trying to give them away. Hence, if the assets generate any income in the trust, the taxes on that income will be paid by you. From an estate planning point-of-view this is actually good because your payment of the income taxes will further reduce the size of your estate and leave the trust assets free to continue growing undiminished by income taxes. If you had held on to those assets, you would have had to pay income taxes on any income generated by those assets anyway.

Summary of Advantages

1. The GRAT provides tremendous leverage of your gift tax exemption amount by allowing you to transfer assets to family members at a discounted value for gift tax purposes.
2. The best assets for a GRAT are those that are expected to appreciate rapidly in value and/or those that generate significant income.
3. Although the GRAT allows you to shift wealth to family members, it still provides you with a stream of income from the annuity interest for the term of the trust.
4. As a grantor trust, additional wealth is transferred to family members because the assets in the trust are not reduced in value by the income taxes imposed on the income generated by those assets.
5. GRATs work best in low interest rate environments (i.e., when a low 7520 rate is dictated by IRC §7520) where the growth of the asset is expected to exceed the 7520 rate. If the asset does not grow at a rate faster than the 7520 rate, the GRAT technique, while ineffective, will not result in any adverse consequences other than the expenditure of legal and accounting fees.
6. The longer the term of the trust, or the greater the annuity stream, the lower the value of the gift.
7. The GRAT technique is statutorily approved and codified in existing laws.
8. In some situations, gift taxes can be almost entirely eliminated (through a technique known as a “Walton GRAT” or “Zero’d Out GRAT”).

Summary of Disadvantages

a. Gifts to a GRAT do not qualify for the annual gift tax exclusion amount.
b. GRATs do not generally allow for the leverage of your generation skipping transfer tax exemption.
c. If you die prior to the end of the GRAT term, the value of the assets will be recaptured into your estate for estate tax purposes but life insurance can be used to help pay the estate taxes or replace the wealth lost to taxes.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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Guardian Financial Representatives may call the Business Resource Center for Advanced Markets, at 1.800.871.7780, Option 3, for additional information.