Grantor Retained Annuity Trust (GRAT)

A Grantor Retained Annuity Trust (GRAT) is an estate planning tool generally used to transfer future appreciation of assets to beneficiaries at a reduced gift or estate tax cost.

DESCRIPTION OF STRATEGY

The grantor contributes assets, often those expected to appreciate substantially or have significant yield, into the GRAT in exchange for an annuity payment back to the grantor (or to others, but most often to the grantor) over a specified term. The gift is calculated by subtracting the value of the annuity from the initial value of the assets transferred to the GRAT. The value of the annuity is calculated using the IRS Section 7520 rate, the length of the term, and the annuity payment. Due to this subtraction method, it's possible to have the value of the annuity equal the initial value of the assets contributed to the GRAT resulting in a zero gift, commonly referred to as a zeroed-out GRAT. Ultimately, if the grantor survives the term and the assets in the GRAT appreciate at a rate higher than the 7520 rate, the excess appreciation passes to the beneficiaries free of income, gift or estate taxes at the end of the GRAT term. If the grantor doesn't survive the term, the GRAT assets are typically included in the grantor's estate. During the term of the GRAT, the trust is taxed as a grantor trust, so the grantor pays the income tax on the GRAT assets and there is no recognition of income by the grantor upon receipt of the annuity.

KEY BENEFITS

Tax-Free Transfer

Any asset income and appreciation above the Section 7520 rate passes to beneficiaries free of income, gift or estate taxes at the end of the GRAT term.

Limited Use of Exemption

The value of the annuity is subtracted from the value of the assets for determining the initial amount of gift tax exemption being used, so the GRAT can be (and often is) designed to use nearly zero exemption.

Estate Freeze

The growth on the GRAT assets are essentially frozen at a growth rate equal to the 7520 rate.

Asset Retention

The grantor retains the right to receive an annuity payment, allowing him or her to benefit from the assets and cashflows during the term of the GRAT.

RISKS/DRAWBACKS

Mortality Risk

If the grantor dies during the term of the GRAT, the assets in the trust are included in the grantor's estate for tax purposes, potentially negating the benefits of the GRAT.

Performance Risk

If the assets in the GRAT do not appreciate at a rate higher than the Section 7520 rate, the tax benefits are reduced, as nothing will pass to the remainder beneficiaries. In this instance, the client is in the same position as having not done the GRAT but has paid attorney's fees to create it.

GST Inefficiency

GST exemption is not allowed to be allocated to the gift amount at the creation of the GRAT but must be allocated to the property passing to the beneficiaries at the end of the term. So, a GRAT is less efficient than an IDGT for GST tax purposes.

OPPORTUNITIES TO UTILIZE

Appreciating Assets

GRATs are most effective with assets expected to appreciate significantly, such as publicly traded stocks, closely held business interests, real estate or pre-IPO stock, among others.

Estate Freezing

GRATs can be an effective tool for a client who wants to maintain the current value of their assets but share income and appreciation with their beneficiaries. GRATs allow the for "freezing" of the value of an estate's growth to the 7520 rate. Creating a series of GRATs can allow a grantor to keep the current value of the GRAT assets "frozen" over a long period of time at the 7520 rate (through the annuity being paid back to the grantor) while transferring future appreciation.

Low Interest Rate Environment

GRATs are most efficient when interest rates are low. A low interest rate will generally result in more assets passing to the remainder beneficiaries at the end of the GRAT term without further estate or gift tax. However, at higher interest rates, GRATs can still be effective to shift appreciation in asset values above the 7520 rate.

Client Has Limited Exemption

Because GRATs can be designed to use almost zero gift tax exemption, they can be useful for clients who have already used most of their exemption.

Volatility

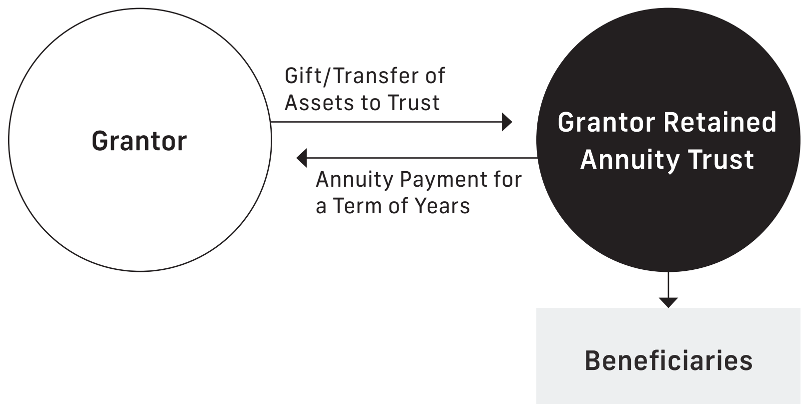
Creating a series of GRATs or rolling GRATs can be effective in volatile markets as the GRAT may not payout as asset values decline, but GRATs created at the low point of asset values can produce significant payouts and “freeze” the grantor’s estate value at the low point. Actively administering a series of GRATs can shift assets to GRAT beneficiaries despite market volatility.

What’s a Grantor Retained Annuity Trust?

“Heads I Win, Tails I Tie” proposition

GIFT CALCULATION

Amount Gifted	$5,000,000
Less: Annuity Retained	$5,000,000
Value of Gift	**$0**



Grantor Retained Annuity Trust

Assumptions

- Gift of $5,000,000
- Annual Annuity Payment for Two Years: $2,628,259
- 7520 Rate = 3.4%

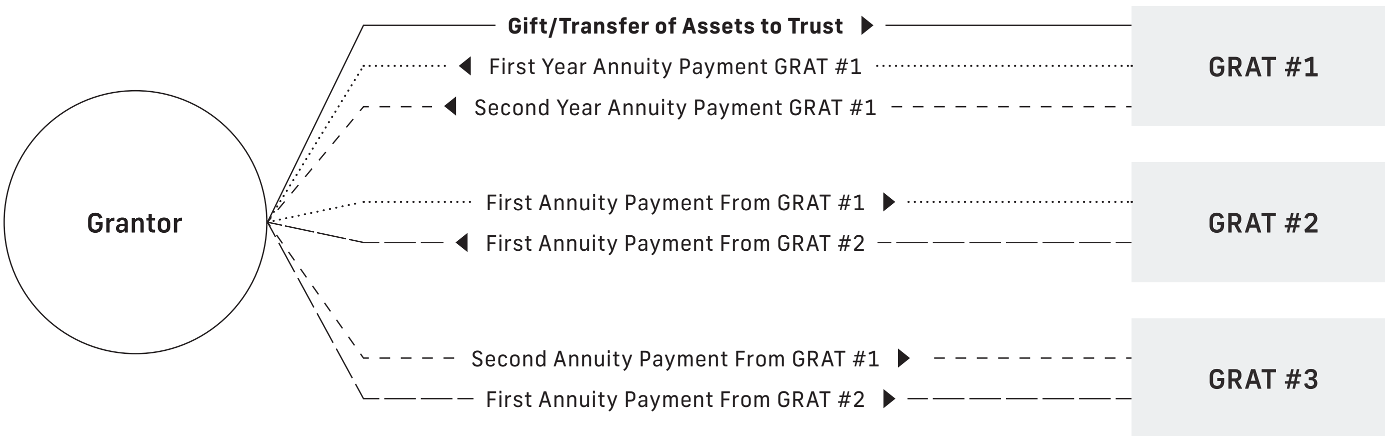
Financial Results

- $0.08 Taxable Gift
- Assuming a 8% Growth Rate:

YEAR	BEGINNING VALUE	GROWTH 8%	ANNUITY PAYMENT	ENDING VALUE
1	$5,000,000	$400,000	($2,628,259)	$2,771,741
2	$2,771,741	$221,739	($2,628,259)	$365,221
Summary	**$5,000,000**	**$621,739**	**($5,256,518)**	**$365,221**

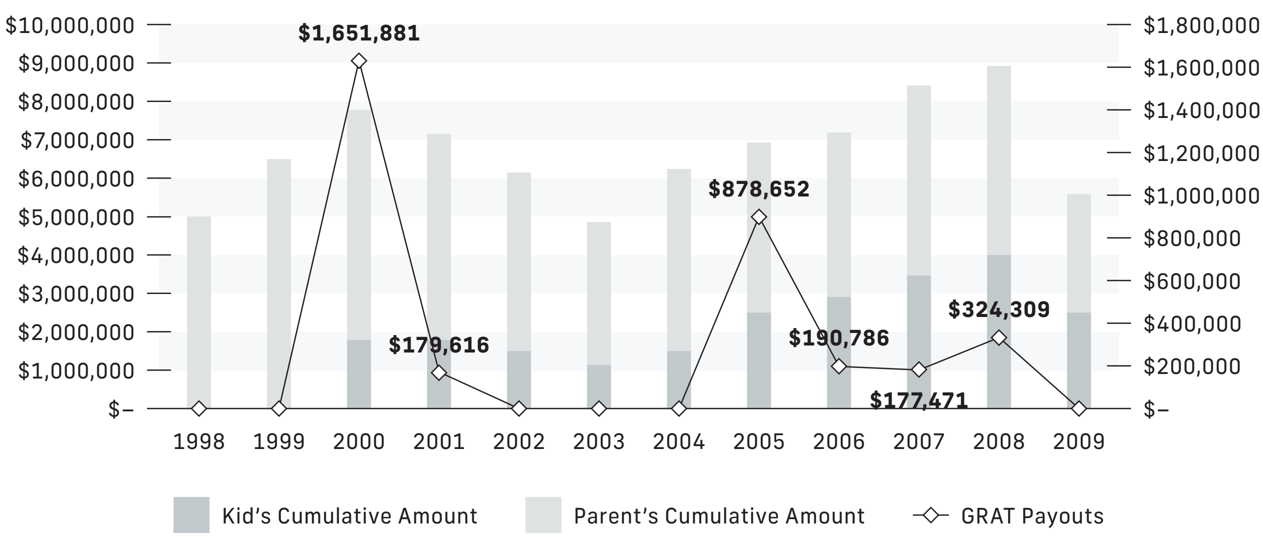
Example above is for illustrative purposes only. It does not reflect any actual situation. Growth rate is illustrative and does not reflect performance of any investments. Information is subject to change without notice. This information is provided for educational purposes only and should not be considered specific investment, legal, or tax advice. Each individuals situation is unique. We encourage you to discuss these strategies with your personal tax, legal and accounting experts.

Rolling GRATs



Key Drivers of a GRAT – Volatility

10 Rolling GRATs from 1998–2009



45% of the portfolio value is transferred to the kids!

This illustration is designed to show the benefits of volatility in the utilization of GRATs. This timeframe was chosen as a $5M portfolio performing consistent with the S&P 500 beginning in 1998 didn't experience significant overall growth through 2009, despite experience significant volatility. The illustration assumes that parents contribute a $5M portfolio to ten 2-year rolling GRATs beginning in 1998 and ending in 2007. The light shaded bar graph tracks the value of the parent's share of the original $5M portfolio and the darker shaded bar graph tracks the kid's share of the original $5M portfolio due to a GRAT payout after a 2-year term. The entire bar indicates the value of the original $5M portfolio. The line graph indicates the amount of each GRAT payout. For example, the original 1998 GRAT, due to an increase in portfolio value, pays out $1.65M two-years later in 2000. The 2001 GRAT, due to market decline, pays out zero in 2003. The cumulative effect is that approximately 45% of the original $5M portfolio is transferred to the kids through 2009.

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