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GRANTOR RETAINED ANNUITY TRUSTS

With the increase of the net worth of many clients resulting from significant appreciation in the value of common stocks and equity mutual funds, more and more clients have been inquiring as to what strategies are available to minimize the imposition of estate taxes at death. One such strategy, which is relatively new and somewhat sophisticated, is the establishment of a Grantor Retained Annuity Trust ("GRAT").

A GRAT is an irrevocable trust which is established by a written trust agreement. The creator of the trust (the "Grantor") transfers assets to the GRAT while retaining the right to receive fixed annuity payments, payable at least annually, for a specified term of years. After the expiration of the term, the Grantor will no longer receive any further benefits from the GRAT. The remaining trust principal comprising the GRAT at the end of the term interest, if any, can be either distributed to specified beneficiaries (such as the children of the Grantor), or held in further trust for the benefit of one or more individuals. If the Grantor survives the initial term of the trust, that is, the term during which the Grantor is to receive annuity payments from the GRAT, the remaining principal of the GRAT will be excluded from the Grantor's gross estate for federal estate tax purposes.

The GRAT provides a unique opportunity for the Grantor to receive an economic benefit in the GRAT for a specified term, which is different from what would otherwise occur if an outright gift was made by the Grantor to one or more individuals. The primary advantage in establishing a GRAT is that the assets transferred by the Grantor to the GRAT are valued for federal gift tax purposes at a discount. This is because the value of the gift will equal the fair market value of the assets initially transferred to the GRAT reduced by the present value, determined actuarially, of the future annuity payments that the Grantor will receive during the initial term. Just how significant the discount will be is dependent upon the length of the initial term of the GRAT, the amount of the fixed annuity payments that will be made from the GRAT to the Grantor during the initial term, and the applicable federal rate of interest in the month that the assets are transferred by the Grantor to the GRAT as announced by the Internal Revenue Service. In other words, the transfer of property to a GRAT constitutes a gift equal to the total value of the property transferred to the GRAT, less the present value of the retained annuity interest held by the Grantor.

If the Grantor survives the initial term during which the Grantor is to receive a fixed annuity, the property comprising the GRAT will pass to or be retained in trust for the benefit of the designated remainder beneficiaries (such as the Grantor's children) at a reduced gift tax value. For example, assume that an individual, age 60, transfers $1,000,000 of assets to a GRAT which provides the Grantor with the right to receive an annuity of $70,000 per year (7% of the value of the assets initially transferred to the GRAT), payable annually, for a fifteen year period. Assume also that the applicable federal rate announced by the Internal Revenue Service in the month that the property is initially transferred to the GRAT is 6.0 percent. Based on applicable Internal Revenue Service tables, the value of the retained interest is $600,565, so the value of the gift being made by the Grantor to the GRAT upon creating the GRAT is $399,435. At the end of the term, if the Grantor is still living, the remainder beneficiaries (or a trust to be administered for the benefit of the remainder beneficiaries) receive the balance of the assets comprising the GRAT, which may exceed $1,000,000, depending on whether the GRAT

is able to earn (in terms of income or appreciation) an amount in excess of the annuity payments that will be made by the GRAT to the Grantor annually over the fifteen year term.

For federal income tax purposes, it appears that a GRAT will be treated as a grantor-type trust. In other words, during the initial term of the GRAT (the term that the Grantor is to receive the annuity payments) the Grantor will be taxed on all of the income earned by the GRAT during each such year, including capital gains. This results in an even greater benefit from the gift being made by the Grantor because the income taxes that the Grantor will pay will reduce the estate of the Grantor for federal estate tax purposes, rather than reducing the economic value of the assets being gifted to the Grantor's beneficiaries.

One of the disadvantages of a GRAT is the fact that it is irrevocable, that is, it cannot be changed by the Grantor. The trust agreement can provide for ***limited*** flexibility, but any time a trust is created that cannot be amended by the Grantor, there is always the risk that a change in individual circumstances may make the trust less desirable in the future; not for tax reasons, but for personal reasons. This disadvantage, however, is no different than the risks inherent when making outright gifts, because then the recipients of the gifts are free to dispose of the gifts in any manner the recipients desire.

An additional disadvantage of establishing a GRAT is that a portion, if not all, of the assets comprising the GRAT will be includible in the gross estate of the Grantor for federal and state estate tax purposes if the Grantor dies prior to the expiration of the initial term of the GRAT. However, other than the transaction costs of establishing and administering the GRAT, the Grantor is really no worse off than if the GRAT was never established. Furthermore, the Grantor can mitigate against the potential for the inclusion of the assets comprising the GRAT in his or her gross estate for estate tax purposes by establishing an irrevocable trust that could purchase and maintain a policy insuring the life of the Grantor for the initial term of the GRAT.

In conclusion, although there are certainly some complexities surrounding the establishment of a GRAT, the GRAT can prove to be an extremely viable tool to reduce the size of a potentially taxable estate by allowing for a substantial reduction of the underlying assets for valuation purposes under federal gift tax laws. This allows individuals to leverage their unified credit exclusion equivalency. As with all estate planning tools, a GRAT has some disadvantages, but those disadvantages are minimal when compared to the potential estate tax savings that can be obtained.

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