

## *Idea of the Month*

### **Grantor Retained Annuity Trusts**

Estate and gift planning is an area where you can make today's lower valuations work to your benefit. We'd like to revisit our discussion of grantor retained annuity trusts (GRATs).

A GRAT is a gift of a remainder interest in a trust. Because you retain an annuity interest for a term of years, the remainder interest has a reduced value for gift tax purposes. Thus, you can give away the remainder interest with a zero or significantly reduced gift tax cost, or you can use some of your \$1,000,000 lifetime exemption.

GRATs are the "no harm, no foul" way to transfer the future appreciation of an asset without transfer-tax liability. A GRAT created today could be used to transfer all future appreciation on portfolio assets, thus protecting that appreciation from estate or gift taxes.

Windows of opportunity in life open and close, and this window may close early this year. Some members of Congress and the IRS are concerned that with market valuations down, many wealthy individuals will take advantage of GRATs to transfer future appreciation. GRATs would not be entirely prohibited because that would cause many other problems. To prevent government revenue loss, however, Congress may impose a requirement that at least 10% of the appreciation remain with you, the grantor, reducing the benefit of GRATs.

The possibility that this window might close has prompted advisors to encourage their clients to consider using long-term GRATs now as part of their investment and estate planning program.

A GRAT is created by transferring assets to an irrevocable trust and retaining an annuity interest for a specified number of years. The annuity interest is a fixed percentage of the trust's initial value, determined according to the actuarial tables published by the IRS. (For transfers in February 2009, the required IRS rate is 2.0%.) Your retained annuity interest terminates after the stated number of years, and the trust assets are then made available to your beneficiaries.

Let's say that you have an asset that had been worth \$1,300,000 in 2007, but by February 2009 is worth only \$1,000,000. If you transfer it into a 15-year GRAT, you will take back approximately \$77,825 in value each year. By the end of Year 15, we'll assume that the asset grew at a compound annual rate of 7%, net of annuity distributions. The growth of \$2,765,000 would then be transferred to your family with no use of your gift tax exemption or out-of-pocket cost.

If the asset soars in value after the transfer, then this strategy works very well. If the asset becomes worthless, the grantor is still in the same position as he would have been without the strategy. In other words, "no harm, no foul." Other than the value of the asset, all the grantor loses are the costs associated with creating the trust along with some accounting fees. The key benefit is that this approach can conserve your \$1,000,000 lifetime gift-tax exemption.

With the possibility of change on the horizon, however, financial advisors are looking much more favorably at longer-term GRATs. (In an example included with your December statement, we had demonstrated the savings you could realize by using a three-year GRAT.)

A big risk associated with GRATs is that if a grantor dies before the GRAT ends, the full value of the asset, including its appreciation, is pulled back into your estate. This is one reason why short-term GRATs had been widely used in the past. A common strategy was to “roll,” or “cascade,” short-term GRATs. You may currently be employing this strategy, but the potential new laws would make this obsolete. While longer-term GRATs present a greater risk of premature death, you can manage that risk through life insurance that would pay any applicable estate taxes.

The key to a successful GRAT is selecting the assets that you expect will grow in value the most, such as your business, stocks, or real property. Of course, you must have a desire to pass on some of your wealth to the next generation.

We do not know how long this window will remain open, so we urge you to speak with your Contango advisor about GRATs today. You may find that a GRAT is the right tool, at the right time, to bring about a tax-efficient transfer of your wealth.

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