A Hot Idea for Summer by Pam Howard, CLU, ChFC

Want a sure-fire way to avoid paying taxes on gifts and still receive income on your asset? There are methods to reduce or eliminate the tax and today's economic climate, with depressed business and real estate values, is very favorable for one of them – the Grantor Retained Annuity Trust (GRAT).

With a GRAT, you gift income-producing assets with the potential for significant appreciation to an irrevocable trust. (Stock, real estate, or shares of family limited partnerships are examples of appropriate assets to use.) The trust pays you income (the retained annuity) at least annually for a set period of years, usually two to 20. At the end of the term, the balance of the trust assets (the remainder) is distributed to the beneficiaries you have selected – perhaps your children.

When the value of the taxable gift is calculated, the income stream you retain is not included. Only the difference between the total asset value and the value of the payments to you will be subject to gift taxes.

Here's how it works. When the trust is established, you select a percentage of the initial value to be paid to you each year. This can be from 5% to 50% of the initial value. Then, the present value of the annuity payments is calculated using the IRC §7520 rate as the discount rate. The higher the present value of the annuity payments to you, the lower the taxable remainder interest to the children will be. Properly structured, a GRAT may even produce a remainder with zero value. Confused yet? Let's look at an example in the chart below.

Suppose that you gift assets worth $1 million to your GRAT and specify that the GRAT will pay you 8% of the initial value of the assets ($80,000) each year for 10 years. At the end of the 10 years, whatever is left in the trust will be distributed to your children. At the July 2008 7520 rate of 4.2%, the present value of the annuity to you is $642,456. That leaves $357,544 subject to gift tax. So, you've gifted $1 million from your estate, but the value of the taxable gift has been discounted significantly.

An additional advantage is realized because the asset you gave to the trust is appreciating and producing income. Using the example above, assume that the trust assets are growing at 6% per year and produce an annual income of 3%. At the end of 10 years and after the trust has paid $800,000 to you, the trust assets payable to your children are worth $1,166,316.

Year	Beginning Principal	6% Growth	3% Annual Income	Annual Payment	Remainder
1	1,000,000	60,000	30,900	80,000	1,010,900
2	1,010,900	60,654	31,237	80,000	1,022,791
3	1,022,791	61,367	31,604	80,000	1,035,763
4	1,035,763	62,146	32,005	80,000	1,049,913
5	1,049,913	62,995	32,422	80,000	1,065,350
6	1,065,350	63,921	32,919	80,000	1,082,191
7	1,082,191	64,931	33,440	80,000	1,100,562
8	1,100,562	66,034	34,007	80,000	1,120,603
9	1,120,603	67,236	34,627	80,000	1,142,466
10	1,142,466	68,548	35,302	80,000	1,166,316
Summary	1,000,000	637,832	328,484	800,000	1,166,316

What have you accomplished?

- You've transferred property to your children at a greatly discounted gift tax rate. In our example, you've given your children $1,166,316 of which only $357,544 is subject to taxation. You may be able to use a portion of your $1 million lifetime gift tax exclusion to avoid paying any gift tax at all.
- You've provided yourself with a guaranteed income stream for the next ten years of $800,000.
- Since the GRAT is an irrevocable trust, you may provide some protection from creditors and certainly assure that the assets go to the person you want to have them.

Of course, there are caveats.

- If you die before the end of the trust term, the value of trust assets is brought back into your taxable estate.
- Because this is a future-interest gift, you can't use your annual gift tax exclusion ($12,000 in 2008) to mitigate the gift tax.
- The GRAT ***must*** make the annual payments to you. If trust income is insufficient, assets may have to be sold in order to make the payments.
- You lose control of the assets. A GRAT is an irrevocable trust – you may not change your mind down the road.
- There are significant setup costs as well as continuing annual administrative costs.

That said, however, a GRAT can be one of the best estate planning tools around and it is particularly good now. Interest rates are low which increases the value of the annuity portion and decreases the taxable gift. Stock and real estate values are depressed, but if they rebound, the value of the assets you've transferred to your heirs is increased. With the exception of setup and administrative costs- if you do not survive the term of the GRAT, you are in no worse shape than if you had done nothing. As a wealth-shifting and tax-reducing vehicle, a GRAT is surely a Win-Win proposition. Rosenbaum Financial has the software to discuss these planning opportunities with you, your CPA and attorney. Please let us know if you would like to see a specific scenario illustrated for your review.