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Grantor Retained Annuity Trusts…A Timely Wealth Transfer Tactic

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With low interest rates and a stock market that remains well off its peak, the economy today provides a unique opportunity to pass substantial wealth to family via a ***Grantor Retained Annuity Trust ("GRAT")***.

GRATs are particularly appealing for those who continue to be concerned with estate taxes (generally, those owning assets greater than $3,500,000 for an individual, or $7,000,000 for a married couple) and are looking for ways to transfer assets to family without paying gift or estate taxes.

A typical GRAT is an irrevocable trust that makes fixed annual distributions to the grantor (usually a parent) for a term of years, after which the trust assets are distributed to the grantor's children. By establishing a GRAT, the grantor divides the ownership of the assets into a current interest of annual distributions, which they retain for themselves, and a future remainder interest, which the grantor gifts to children.

The gift to children may be subject to gift taxes. But, if the grantor is living at the end of the GRAT term, the assets remaining in the GRAT that pass to children will not be taxed in the grantor's estate.

The taxable gift to the children is calculated as follows:

Taxable Gift = Trust Assets – Present Value of Annual Distributions to Grantor

Note that a GRAT can be structured so that the present value of the distributions to the grantor are equal to the value of the GRAT assets, resulting in a zero taxable gift. These trusts are often called "Zeroed-out" GRATs.

The present value of the annual distributions to the grantor is calculated using an IRS discount rate that varies monthly and is based on mid-term interest rates. For August, the IRS discount rate is 3.4%, reduced from 4.2% a year ago, and 6.2% in August, 2007.

Essentially, the discount rate is the rate of return the IRS assumes the taxpayer will earn on the GRAT assets. However, if the GRAT assets appreciate at a rate of return greater than the IRS discount rate, the remaining assets will pass to the children free of gift or estate taxes (if the grantor survives the GRAT term).

And, when the IRS discount rate is historically low, and decent stock returns are expected, the spread between the IRS' discount rate and actual returns can be substantial, resulting in significantly greater tax-free transfers to children from the GRAT than when interest rates and stock values are higher.

For example, if a grantor transfers $1,000,000 to a 3-year GRAT which makes annual distributions to the grantor of $356,000, the 3.4% IRS discount rate will result in a zero taxable gift. However, if the GRAT averages annual investment return of 8%, $103,000 will be distributed tax-free to children at the end of the GRAT term. If the GRAT averages a 10% annual return, $152,000 will pass to the children tax-free.

Zeroed-out GRATs can be very appealing for people who have already used their lifetime gift tax exclusion ($1,000,000 per person), but are interested in making additional tax-free gifts to family.

Also, in difficult markets where the grantor may not be feeling as financially secure, GRATs are appealing because the trust will return the original assets to the grantor, plus the IRS discount rate, which may alleviate concerns with giving substantial assets away to family.

To consider whether a GRAT could be helpful to your situation, please call your portfolio manager or Michael D. Barnes for more information.

Michael D. Barnes is President of Johnson Trust Company, a subsidiary of Johnson Investment Counsel, Inc., Cincinnati's largest independent wealth management firm with over $4 billion under management. Michael is also President of the Johnson Charitable Gift Fund, a public charity providing donor advised accounts and endowment funds. He is an attorney with over 20 years experience assisting clients in preserving wealth through wise estate and charitable gift planning.