



Gift-Tax Free Planning with GRATs in this Dismal Stock Market

March 2008 from James M. Kane, Attorney

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This is a significant estate-gift tax planning opportunity centering on both the current low interest rates and the dismal stock market.

As you read this summary, keep in mind two preliminary points. First, the low interest rates are the key to this technique. Interest rates may possibly get even lower over the next several months.

Second, the depressed stock market significantly enhances the potential for increases in the GRAT asset values in excess of the Section 7520 rate if the market begins to rebound over the next few years.

I explain these two points in more detail as follows.

The term GRAT is a written trust document based on an acronym under the tax law for "grantor retained annuity trust".

The central feature of this GRAT allows a client to carve out the investment returns from the GRAT assets, with the client getting back the underlying assets when the GRAT ends. The carved-out returns end up as gift-tax free transfers.

The gift-tax free transfer can either pass directly to the client's beneficiaries, typically the children and grandchildren. Or, the transfer can pass into a recipient trust for their benefit.

This GRAT technique fits also with the notion that clients like the idea of reducing their exposure to estate tax by making gift-tax free transfers. These tax-free transfers reduce the client's estate value that otherwise will ultimately be subject to estate tax.

A key component of the GRAT is the IRS's monthly interest rate, called the Section 7520 rate. It is currently 3.6 percent (for March 2008) and will be 3.4 percent for April 2008. The rate may likely continue to drop even

further over the next few months.

The following point is very important: The IRS rate for the month when the GRAT begins is fixed and applies unchanged for the entire duration of the GRAT trust. Thus, a low rate when the GRAT starts is the key to a successful GRAT.

The investment return on the GRAT assets over and above the (fixed) Section 7520 rate ends up as the gift-tax free transfer.

The duration of the GRAT is stated in the trust document and can be two or more years. A 2-year term is typical for many clients.

The client receives yearly distributions back from the GRAT. These are technically annuity payments from the GRAT to give back to the client the value of his or her initial funding of the GRAT.

What the client does not get back are the GRAT investment returns that exceed the Section 7520 rate. [These excess returns end up gift-tax free for the children and grandchildren.]

The investment returns on the GRAT assets consist of interest, dividends, and any market increase in the value of the assets. The potential market increase in the asset values, again, is a reason the current dismal stock market may produce significant investment returns for a GRAT.

The client, as trustee, can continue to buy and sell the assets within the GRAT for managing the investment portfolio, and so forth.

From a tax law perspective, this GRAT technique centers on a "zeroed-out GRAT". It is well-grounded under the tax law and a product of the Internal Revenue Code, tax regulations, and the IRS's loss and acquiescence in a well-publicized U. S. tax case in *Audrey J.*

Walton v. Commissioner, 115 T.C. 589 (2000).

The administration of the GRAT is streamlined. No new tax identification number is necessary for the GRAT trust and no separate trust income tax return is required. The trust will use the client's SSN; all income, losses, gains, and deductions are reportable on the client's personal income tax return Form 1040. The GRAT trust ends after its stated term.

Failed GRATs:

What if the asset portfolio in the GRAT does not achieve a return greater than the Section 7520 rate, or falls in value below the initial value when the GRAT started? In this case the client still gets back the assets with no obligation for the GRAT trust to make up the loss. And, in this situation there is no excess investment return for a gift-tax free transfer.

However, if this failed GRAT occurs, it is essentially no different than if the client otherwise had held the portfolio of assets in his or her individual name outside the GRAT for the same time period.

In essence, there are no adverse tax consequences if the assets do not achieve the threshold Section 7520 return.

Using Multiple GRATs:

Some clients funnel multiple, mirror-image GRATs into a single recipient trust. The recipient trust is designed typically for the client's children and grandchildren and continues after the GRATs terminate.

The multiple GRATs are for the purpose of segregating specific stocks or classes of assets among different GRATs. This segregation of the assets can be an investment hedge, for example, to help prevent losses, if any, on one stock from offsetting gains on other stocks.

The multiple GRATs also can run concurrently and consecutively (called rolling GRATs).

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