

# Grab a GRAT Before It's Too Late

An estate planning tool that is particularly valuable when rates are low is coming under political pressure.

BY ROBERT GORDON

## Grantor retained annuity trusts

are a popular estate planning tool whose future might be a little shaky. Therefore, before the terms of such trusts become less generous, advisors should seriously consider making use of them for clients who are ideal candidates.

GRATs are employed to move money to heirs without being hit with one of the federal taxes on the transfer of money from one generation to the next: the estate tax and the gift tax. These taxes are now at 40%.

The typical GRAT is set up and funded by a patriarch. The grantor agrees to receive back from the trust the principal plus a return on that principal.

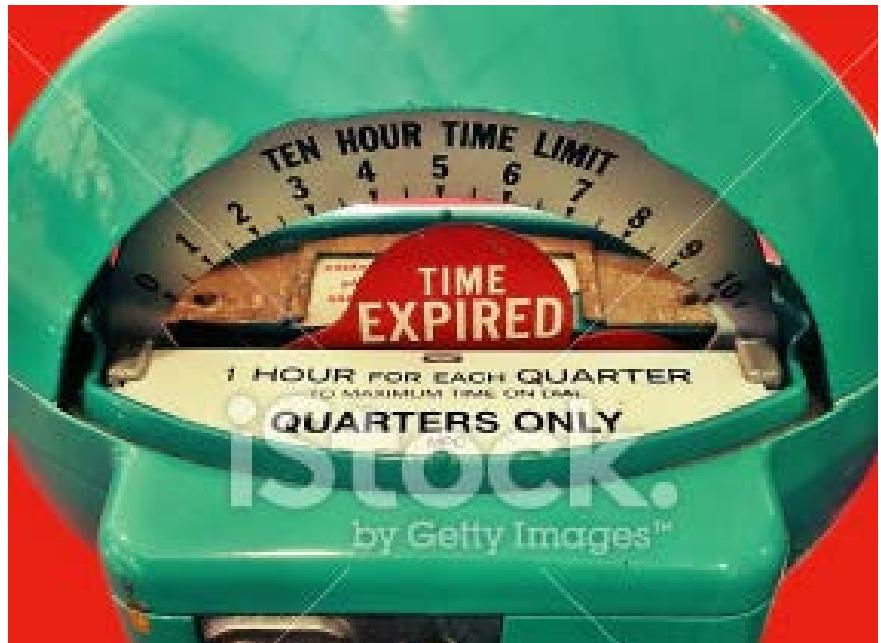
If the trust has money left after fulfilling its obligations to the grantor, any remaining amount in the trust belongs to the children. There is no estate or gift tax levied on the excess amounts that may pass from the grantor to the next generation at the end of the trust.

## Clearing a Hurdle

Investments in a GRAT must outperform a hurdle rate demanded by the grantor in order for the maneuver to be considered a successful GRAT. In other words, a successful GRAT is one that moves some money intergenerationally.

If the GRAT's investments underperform the stated rate, then there is nothing left in the GRAT for the next generation, and it is considered a failed GRAT.

Interestingly, there are no negative tax ramifications if you have a failed



GRAT. Of course, there are legal and administrative costs that will have been spent to no avail.

The lower the return demanded by the grantor, the more money that may be left in the pot at the end of the trust.

To ensure that grantors are not too generous to the heirs by demanding an artificially low rate, the government sets the minimum rate monthly. A hurdle rate is locked in for the life of the GRAT when the trust is established.

By setting up a GRAT when interest rates are low, it becomes much easier to move money to the children. This government-established rate is referred to as the Section 7520 rate, and it currently stands at 2%. By comparison, the

rate was 3% in 2011, 6% in 2007 and 8% in the year 2000.

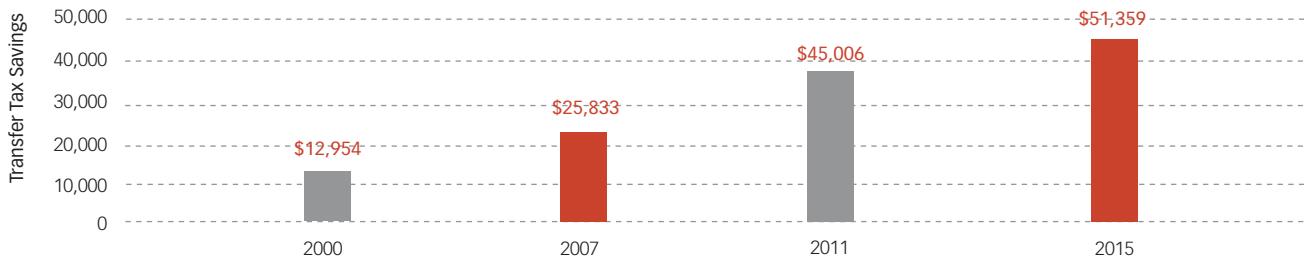
The chart illustrates the differences that are made possible when one establishes a GRAT at a lower rate. The example assumes that the GRAT earns a 10% annual return; the grantor gets the stated rate and the kids get the rest. You can see that when you start can impact how much money can be moved.

## Living to Maturity

It should be noted that the grantor must live through the term of the GRAT for the process to be successful. If the grantor dies before the trust matures, there will be no wealth transfer. This is one reason that many people like their GRATs to be

## How Low Rates Help GRATs

Transfer taxes saved at the termination of a two-year GRAT started in each of the years illustrated.\*



\*Assuming 10% annual returns and a 40% estate tax.

as short as possible.

Currently, it is accepted wisdom that a GRAT should be at least two years long to make the government happy. It is not uncommon to see clients participating in a series of rolling two-year GRATs.

Note that President Obama has proposed to make GRATs less attractive. His proposals have not focused on killing GRATs but only on extending the minimum life for such trusts to 10 years. The proposals, if enacted, would apply only to GRATs established after any new law is signed.

### Asset Location

Jean Brunel, the managing principal of Brunel Associates, has opened our eyes to the power of asset location. Wealthy families have many pockets where they can house assets; where one places those assets can have dramatic after-tax wealth effects.

One possible location that Brunel identifies for housing assets is a GRAT. If a wealthy family is buying a portfolio of high-yield bonds paying 7%, why not stick those bonds in a GRAT? The difference between today's Section 7520 rate (2%) and the bond's 7% yield would

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pass to the next generation without any transfer tax.

Traditionally, GRATs have been used for assets that are seen as possible home runs. But GRATs can be very powerful even for singles and doubles.

As advisors, we hedge stocks for clients; those hedges usually entail having the client buy a put option on their shares.

Why not throw the put in a GRAT? If the put expires worthless: no harm, no foul. If the underlying shares tank, not only does the put give you counterbalancing value, it would also be doing double duty in moving money to the kids.

We would suggest that you do not put multiple assets in a GRAT, but rather that you put multiple assets in multiple GRATs. Diversification smooths results and those looking to maximize the transfer of assets want each GRAT to stand on its own.

You would not want losses on one asset to deplete the gains from another asset in the same GRAT. If those two assets were each in its own GRAT, one GRAT would fail and the other would be much more successful.

### Political Pressure

If you have a client who is ever going to use a GRAT, now might be the time to act. In every one of his budgets, the president has tried to limit GRATs.

In addition, there is a growing sense in Washington that income inequality may have to be dealt with politically. Between the political environment and the current level of interest rates, we would have to conclude that if you are contemplating the use of a GRAT, the time is now. **OWS**

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