RUSHFORTH FIRM LTD. NEVADA TRUST ADVICE	**GRANTOR RETAINED ANNUITY TRUST** *Overview of the GRAT*

A. OVERVIEW

A.1 Historical Evolution. Grantor retained interest trusts ("GRITs") have existed for many years, but the rules have gradually changed, and the most common GRITs that are used today are the "qualified personal residence trust" ("QPRT") and the "grantor retained annuity trust" ("GRAT"). This memo focuses on the GRAT.

A.2 Just One Tool of Many. The GRAT is not for everyone. It is common for an individual to consider various tax planning techniques, such as tax-saving provisions in their revocable trusts, creating one or more life insurance trusts, and/or implementing an estate-reducing gift-giving program. For some people, a GRAT might be an appropriate tax-reduction tool, but it must be compared to other options.

B. Grantor Retained Annuity Trust (GRAT)

B.1 GRAT Overview. A "grantor retained annuity trust" is an irrevocable trust into which you, the settlor (the trust's creator), make a gift of income-producing property and retain the right to receive regular annuity payments during a term of years ("the settlor's term").

B.1.1 Initially, the settlor of the trust transfers assets to the trust. Unless the assets are cash and/or marketable securities, an experienced, licensed appraiser should be retained to provide asset values.

B.1.2 In most cases, the settlor can be the trustee during the settlor's term, but there are exceptions. The settlor should not be the trustee after the settlor's term.

B.1.3 The settlor is the only beneficiary of the trust during the settlor's term, and nothing but the annuity payment can be paid to the settlor during that term. Annuity payments are mandatory.

B.1.4 A GRAT is typically designed as a "grantor trust" for federal income tax purposes, which means that the settlor pays all income taxes on the trust's income during the settlor's term, and possibly during the settlor's lifetime. Although the settlor's payment of income tax is a benefit to the trust's beneficiaries, it is not a gift for federal gift-tax purposes because the tax obligation is mandated by law for all grantor trusts.

B.1.5 After the settlor's term, the trust can continue for the benefit of designated "remainder beneficiaries", such as the settlor's children, or it can terminate with an outright distribution of the trust's assets to one or more designated beneficiaries or to one or more trusts for specified beneficiaries.

B.2 Tax-Reduction Goal. The objective of a GRAT is to transfer assets with a reduced transfer-tax cost. If you retain the assets until your death, the value will be subject to the federal estate tax, and if the assets are expected to increase in value during your life expectancy, the estate tax due at the time of your death would potentially be higher than a gift tax paid now.

B.2.1 For federal gift-tax purposes, the transfer of assets into a GRAT is a taxable gift, but it represents a gift of a future interest to the remainder beneficiaries. For valuation purposes, the market value of the assets is "discounted" or reduced by the actuarial value of the settlor's right to receive the annuity payments during the settlor's term. The IRS-prescribed valuation formula takes into consideration the "7520 rate" [which is based upon the current applicable federal rate ("AFR")][1], the annuity payment rate, and the length of the term annuity payments will be made to the settlor. The longer the settlor's term and the higher the annuity payment rate, the lower the gift-tax value will be; however, that also means that more will end up back in the estate of the settlor for estate taxation upon the settlor's death.

B.2.2 While designating a longer settlor's term may reduce the tax, a GRAT only partially works if the settlor dies during that term. If the settlor dies during the term, the annuity payments must be paid to the settlor's estate during the balance of the settlor's term, and the actuarial value of the remaining payments will be subject to the federal estate tax.

B.2.3 Increasing the annuity payment can reduce the gift tax value, but it also increases what you are getting back into your taxable estate as the annuity payments are made.

B.3 Cash Required. It is important to fund a GRAT with cash or income-producing assets because a GRAT must have enough cash to pay the required annuity payments. If the assets in the trust do not produce income that is sufficient to pay the annuity payments, then the assets themselves will have to be distributed. A GRAT can ultimately implode if all of its assets have to be distributed to make the annuity payments. ***To trigger any transfer-tax savings, the rate of return (including income and appreciation) on the property must exceed the 7520 rate.***[2]

B.4 Irrevocable Gift. At the end of the settlor's term, you cannot have any interest in the GRAT or its assets. The trust can be designed so that the trust does or does not continues as a grantor trust so that you can pay the income tax on trust income without triggering a gift tax.

B.5 Illustrations:

B.5.1 *Assumptions*. Assume that:

(a) JONATHAN DOUGH, age 75, owns an office building that is valued at $1,000,000. The building generates net rent of 5% a year, and it appreciates 3% a year in value.

[1] Under federal tax law, present-value calculations are based on current interest rates. Pursuant to Internal Revenue Code 7520, the interest rate (or "7520 rate") for a particular month is the rate that is 120 percent of the applicable federal midterm rate (compounded annually) for the month in which the valuation date falls.

[2] See footnote **Error! Bookmark not defined.**.

(b) Jon will live to age 85. The office building will have appreciated to $1,434,597. In addition, during that period, Jon's estate will have received $724,328 in rental income (assuming the 5% rent keeps up with the appreciating value of the property).

(c) At Jon's death, the estate tax rate is 40%.

(d) Jon has already used up his exclusion, and so all transfers will be subject to either the gift or the estate tax.

B.5.2 *Do-Nothing Scenario*. If Jon does nothing, his estate will include the office building and accumulated income for a total of $1,460,288. The estate tax on that will be $863,570, leaving $1,295,355 for Jon's family.

B.5.3 *5-Year GRAT*. If Jon establishes a GRAT when the 7520 rate is 0.4%, and he selects a 5-year term and a 5% annual payout, the gift-tax value of the trust will be $752,970, and the gift tax will be $301,188, which generates $562,382 less in transfer taxes over the do-nothing scenario.

B.5.4 *9-Year GRAT*. If Jon selects a 9-year term with the same 5% payout, the gift-tax value would be $558,870, and the gift tax would be $223,548 or $640,022 less than the do-nothing scenario.

B.5.5 *15-Year GRAT*. If Jon selects a 15-year term with the same 5% payout, the gift-tax value would be $273,465, triggering a gift tax of $109,386, but since he is only going to live 10 years, there will be five years of payments remaining, and the actuarial value of those payments (based on the applicable federal rate at the time of his death) will be subject to the estate tax. It is impossible to predict the AFR in ten years, but the five remaining payments of $50,000 might have a present value of around $200,000, resulting in an estate tax of $80,000 and a total transfer tax amount of $223,548, which is the same result as a 9-year GRAT.

B.6 Near-Zero GRAT. A "near-zero" GRAT is a GRAT that has a gift tax value of near zero. For example, if we use the same assumptions given in paragraph 2.5(c) except to change the payout to 20.240456%, the gift-tax value of the 5-year GRAT is three cents. A near-zero GRAT is often used with a term as short as two years in situations where the actual return on an asset is significantly higher than the 7520 rate. It also requires enough cash to be able to make the high annuity payments. On a contribution of $1,000,000, the annuity payable to the settlor on a five-year GRAT would be $202,405 each year, which would return $1,012,022 to the settlor over five years, which is more than originally contributed. This is most effectively used when there is an anticipated event that will make the trust assets mushroom in value. A near-zero GRAT has worked with highly appreciating securities, business interests, and even racehorses (before they win a big race, of course).

B.7 Rolling GRATs. A "rolling GRAT" strategy involves using a series of near-zero GRATs with a settlor's term of two years. In some years, the annuity payments will result in having nothing left in the GRAT, but in other years, there is substantial wealth for the remainder beneficiaries even after the annuity payments are made. It is a strategy that allows for some significant wealth transfers in appropriate situations. Congress has threatened to prohibit by requiring a minimum term of 10 years, but that has not yet been enacted.

C. CONCLUSION.

If you have a taxable estate that includes income-producing investment assets that you are willing to part with during your lifetime after a term of years, a GRAT may be a tool that can help you do that with a lower net tax than would apply if you were to retain those assets until your death.

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