John Hancock
LIFE INSURANCE

Success Strategy
Estate Equalization and Grantor Retained Annuity Trusts (GRATS)

WEALTH TRANSFER AT A DISCOUNTED GIFT TAX COST

Funding Grantor Retained Annuity Trusts (GRATs) with appreciating assets such as stock or real estate can be an excellent way to transfer wealth to the next generation at a low gift tax cost.[1] A Grantor Retained Annuity Trust (GRAT) is an irrevocable trust in which a person can transfer property to the trust and retain the right to receive an income stream for a fixed period of time. At the end of the GRAT term, the property will transfer to the remainder beneficiaries named in the trust (or to a trust for their benefit) and will be out of the grantor's taxable estate. Using a GRAT in conjunction with an Irrevocable Life Insurance Trust (ILIT) can help you equalize the distribution of your estate among your heirs.

HOW DOES A GRANTOR RETAINED ANNUITY TRUST (GRAT) WORK?

The grantor will typically make a gift to the GRAT of assets such as stock or real estate. The value of the gift to the GRAT is "discounted," i.e., for gift tax purposes the value of the remainder interest is based upon a formula that factors in the Section 7520 rate, the length of the trust term and the amount of the annuity payout. If the Section 7520 rate goes down, the annuity interest increases and the remainder interest decreases, causing the initial gift amount to be even lower.[2]

The GRAT technique can be used to "freeze" the value of an asset after the initial valuation, and any additional appreciation will generally pass to the GRAT beneficiaries. A GRAT must last for a specified term of years. If the grantor predeceases the term of the trust, some or all of the property inside of the GRAT will be included in the grantor's taxable estate.[3]

WHAT IS A ZEROED OUT GRAT?

There are several different types of GRATs that are used for estate planning purposes. A "zeroed out" GRAT (also known as a Walton GRAT) is a popular trust in which the present value of the annuity interest retained by the grantor equals the fair market value of the assets transferred to the GRAT, causing the gift to the GRAT to be valued at zero.[4] A zeroed out GRAT usually results in a large annual annuity payout to the grantor and can be done only if the annuity payments from the trust can be paid over a fixed period of time.[5] A "gift GRAT" is a GRAT in which the remainder value would be valued greater than zero, which generally results in a "future interest" gift by the grantor; such a gift can generally be covered by the $1,000,000 lifetime gift exemption.

HOW DOES ESTATE EQUALIZATION WITH A GRAT WORK?

In this approach, you can fund a GRAT (usually a zeroed out GRAT) with business or investment assets, and the annuity payments from the GRAT can be used to fund an ILIT with annual exclusion gifts and/or the lifetime gift exemption. At the end of the GRAT term, the asset can transfer either directly to one or more family members or to an ILIT, but in either case the asset will be outside of the taxable estate. In order for this strategy to be successful, the asset transferred to the GRAT must generate a sufficient amount of income to make the annuity payments. This approach can be particularly useful if you have assets such as rental real estate or S corporations, which produce large amounts of cash annually.

CASE STUDY: TOM AND ANGELA EVANS

Clients:	Tom and Angela Evans, both age 68, three children, $20 million estate
Asset:	$15 million S corporation
Asset Transfer:	Transfer $10 million of stock in their business to a GRAT for their two children who are involved in the business and fund life insurance to provide liquidity and wealth replacement for all of their children, including one child who is not in the business.
Product:	$18,000,000 John Hancock Protection SUL-G policy with annual premiums of $241,254

CASE STUDY: TOM AND ANGELA EVANS (continued)

The ILIT is the beneficiary of the GRAT, and will receive the remainder interest of the GRAT ($10,091,159) in year 10 when the GRAT terminates. In this case, because of the size of the premium, Tom and Angela will make a loan to the ILIT (private financing), rather than make gifts, then the ILIT will pay off the loan, including principal and deferred interest, to Tom and Angela in year 11. Following year 11, the ILIT will have sufficient assets and cash to pay the annual premium on the life insurance policy. The trustee of the ILIT will be able to make distributions of assets and cash to each of Tom and Angela's children. The chart below is a "snaphot" of how the numbers for the transaction would look in years 1–22.

YEAR	LOAN PRINCIPAL AMOUNT TO ILIT	LOAN INTEREST AT 4.46% (DEFERRED)	GRAT ANNUITY PAYMENT TO TOM AND ANGELA	DEATH BENEFIT FROM ILIT	NET TO HEIRS FROM ILIT[6]
1	$241,254	$10,760	$1,295,051	$18,000,000	$17,907,988
10	$241,254	$131,974	$1,295,051	$18,000,000	$26,472,478
11	($3,091,044)	$0	$0	$18,000,000	$25,299,571
22	$0	$0	$0	$18,000,000	$30,682,909

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In this case, Tom and Angela were able to transfer a large chunk of stock to their children through the GRAT at a zero gift tax value. They were also able to fund a large life insurance policy using the GRAT income and private financing, to provide both estate equalization and liquidity at death. Using private financing with deferred interest for ten years and loan repayment occurring in year 11 (after the ILIT received the GRAT remainder interest), enabled Tom and Angela to fund their ILIT with no gifts and transfer over $30 million to their heirs free of estate tax. Since the ILIT is the beneficiary of the GRAT remainder interest, the trustee of the ILIT can then make distributions to each of their children, using the business assets as well as the cash within the trust.

1. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.
2. The projected value of a GRAT remainder interest is inversely related to the Section 7520 rate; the performance of GRATs improves with lower interest rates and declines with higher interest rates.
3. In June 2007, the IRS issued REG-119097-05, a proposed regulation that provides new guidance on valuing the portion of a GRAT that is includible in the grantor's taxable estate if the grantor has a retained interest in the trust and has deceased before the end of the trust term. Under the proposed regulation, the formula for determining the inclusion amount of a GRAT at the grantor's death is the annual annuity amount divided by the Section 7520 rate on the date of death. As a result, if a grantor dies during the term of a long-term GRAT, under the proposed regulations, some of the GRAT assets will be outside of the taxable estate. However, for many short-term zeroed out GRATs, the formula under the proposed regulations will still result in 100% inclusion of the GRAT assets in the grantor's taxable estate.
4. Walton v. Commissioner, 115 T.C. 589 (2000). Even if the gift to the GRAT is zero, a gift tax return (Form 709) should still be filed when a GRAT is funded. A gift to a GRAT is a future interest gift, so the $1,000,000 applicable exclusion amount (but not the annual exclusion) can be applied towards the gift (the annual exclusion amount can only be used with present interest gifts).
5. In 2005, the IRS issued final regulations to modify the special valuation regulations under Section 2702 of the Code. The new regulations under Section 2702 confirm that zeroed out GRATs can be used to eliminate or minimize gift taxes on transfers of appreciating property to the next generation and are effective for trusts created on or after July 26, 2004.
6. In this chart, the Net to Heirs in Years 1–10 represents the ILIT proceeds less the loan repayment net of estate taxes on the loan to the ILIT. In year 10, the ILIT is projected to receive $10,091,159 from the GRAT and in year 11 the ILIT will use $3,091,044 to repay the loan to Tom and Angela. From year 11 on, the ILIT includes the GRAT assets, which will be distributed to their children in the form of assets and cash. This example assumes a Section 7520 rate of 4.4% for the GRAT and an interest rate of 4.46% for the private financing loan (both are published rates for January 2008). Year 22 is the joint life expectancy.

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