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Grantor Retained Annuity Trusts: Tax-Efficient Estate Planning Techniques

Leveraging GRATs to Preserve and Transfer Assets

TUESDAY, JANUARY 31, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Grantor Retained Annuity Trusts:

Tax Efficient Estate Planning Techniques

Leveraging GRATs to Preserve and Protect Assets

GRAT: Tax Efficient Estate Planning

Presented by:

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WEALTH MANAGEMENT

2012 – A Window of Opportunity Is Open

- Great time for estate freeze techniques
 - Estate, Gift, and GST tax exemptions at \$5,000,000
 - A top tax rate of 35%
 - Asset values still depressed
 - Historic low interest rate environment

2012 – A Window of Opportunity Is Open

- January 1, 2013 scheduled to change
 - \$1,000,000 exemption for estate, gift and GST
 - Top tax rate moves to 55%
 - Portability no longer available
 - Markets recovering
 - Congressional action against techniques?

GRAT Defined

- An irrevocable trust
- Grantor places income producing assets inside
- Retains the right to fixed payments, usually for a term of years
- The GRAT assets remaining pass to beneficiaries upon termination.

Overview of a GRAT

- Estate Freeze technique
 - The donor/grantor transfers all future appreciation on the asset
 - Gift and estate tax free.

Overview of a GRAT, cont'd

- How do we do it?
 - In exchange for annuity payment [IRC 2702(b)(1)]
 - Assets are transferred to the GRAT
 - Payment returns contribution
 - Plus statutory interest (the 7520 rate)
 - No gift – the grantor is getting everything back plus interest

Overview of GRAT cont'd

- Effect of Interest Rates
 - Low interest rate environment
 - More likely to succeed
 - Expect assets to grow quicker than 7520 rate
- Beneficiary receives
 - Difference between 7520 rate and
 - Actual appreciation
 - Tax free

Overview of GRAT cont'd

- Downside risks
 - Mortality risk
 - Grantor must survive the term
 - Investment risk
 - Assets don't perform as expected

Overview of GRAT cont'd

- Gift tax
 - Grantor gift calculated as
 - Fair market value of asset transferred
 - Less, present value of the annuity
 - Determined under the 7520 rate

GRAT – Creature of Statute

- A statutory exception to the general rule on value of remainder interests
 - See Treas. Reg. 25.2702-3.
 - See also IRC 2702(a)
- Unlike IDGT planning – statutory status makes them safe
 - What will Congress do next?

GRAT – Statutory Creature cont'd

- Must be for a fixed term of years or life, or the shorter of either
 - Term of years is preferred
 - Can zero out the GRAT gift value

GRAT – Statutory Creature cont'd

- Annuity amount must be fixed
 - Can be a dollar amount, or
 - Percentage of assets.
 - Paid at least annually.
- Annuity payment from income
 - If insufficient, can be from principal of the GRAT

GRAT – Statutory Creature cont'd

- Annuity payment may increase over time
 - No more than 120% of the prior year
 - Allows assets to grow inside the GRAT
 - No limitation on DECREASING the annuity payment.

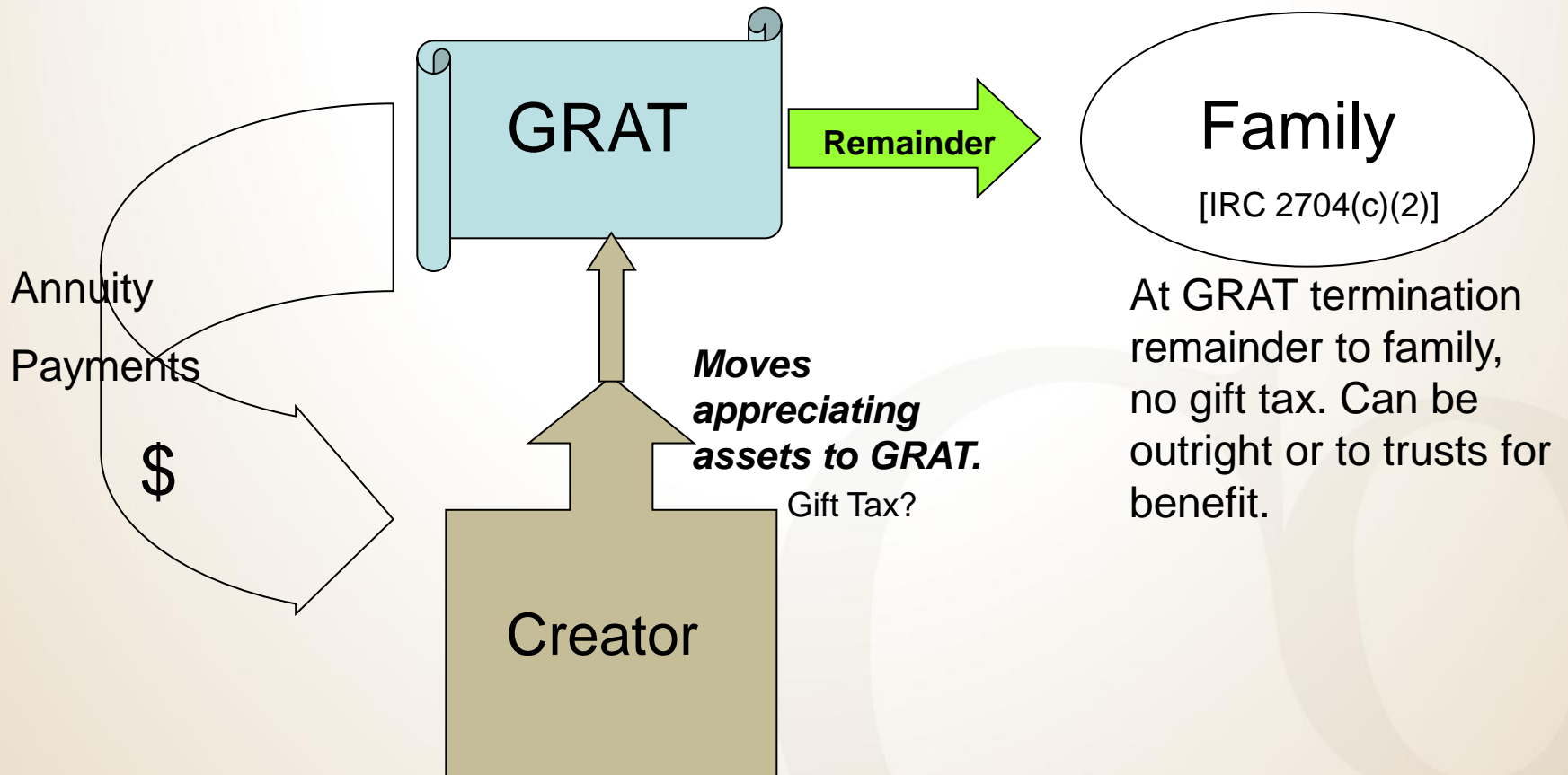
GRAT – Statutory Creature cont'd

- What if the IRS disagrees with asset value upon creation?
 - If annuity is based upon percentage, will not fail.
 - Need trust provision requiring correction by trustee
 - Undervaluation – send more
 - Overvaluation – grantor to pay back (no other post creation funding)
 - Must be within reasonable time after discovery.
 - Limits or eliminates unexpected taxable gift

GRAT – Statutory Creature cont'd

- File a 709 gift tax return on creation
 - Report GRAT as zero or near zero remainder
 - Start 3 year SOL running

The GRAT



At GRAT termination remainder to family, no gift tax. Can be outright or to trusts for benefit.

Impact of the 7520 Rate

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Why do we care about the 7520 rate?

- Different techniques are better suited to high 7520 rates, others benefit from low rates.
 - GRAT and CLAT does better with a low rate
 - QPRT, CRT we prefer a high rate.
- Monthly revenue rulings give us the rates
 - RR 2012-2 January rate is 1.4%
 - December 2011 was 1.6%
 - November 2011 was 1.4%

7520 Rate

- Used for valuing
 - Annuities
 - Life estates
 - Interests for a term of years
 - Remainder or reversionary interests
- Source for current and historical rates:
 - <http://pmstax.com/afr/index.shtml>

What Difference Does the 7520 Rate Make?

- Examples – January 2006 @ 5.4%

January 2006 - 7520 rate of 5.4%, \$1,000,000 5 year GRAT funded				
Growth projected at 5%				
Year	Beginning Principal	5.00% Growth	Annual Payment	Remainder
1	\$1,000,000.00	\$50,000.00	\$233,535.60	\$816,464.40
2	\$816,464.40	\$40,823.22	\$233,535.60	\$623,752.02
3	\$623,752.02	\$31,187.60	\$233,535.60	\$421,404.02
4	\$421,404.02	\$21,070.20	\$233,535.60	\$208,938.62
5	\$208,938.62	\$10,446.93	\$219,385.55	\$0.00
	\$1,000,000.00	\$153,527.95	\$1,153,527.95	\$0.00

January 2006 - 7520 rate of 5.4%, \$1,000,000 5 year GRAT funded				
If we can beat market at 8% growth				
Year	Beginning Principal	8.00% Growth	Annual Payment	Remainder
1	\$1,000,000.00	\$80,000.00	\$233,535.60	\$846,464.40
2	\$846,464.40	\$67,717.15	\$233,535.60	\$680,645.95
3	\$680,645.95	\$54,451.68	\$233,535.60	\$501,562.03
4	\$501,562.03	\$40,124.96	\$233,535.60	\$308,151.39
5	\$308,151.39	\$24,652.11	\$233,535.60	\$99,267.90
	\$1,000,000.00	\$266,945.90	\$1,167,678.00	\$99,267.90

What Difference Does the 7520 Rate Make?

- Examples – January 2012 @ 1.4%

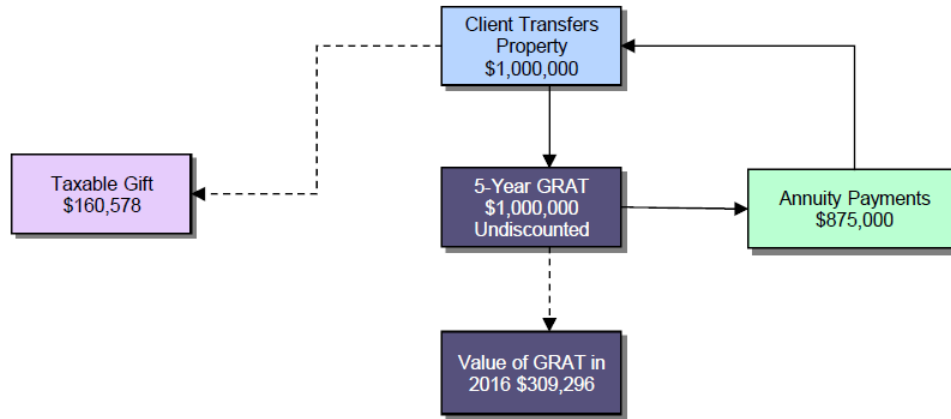
Year	Beginning Value	5% Growth	Annuity Payments	Ending Value
2012	\$1,000,000	\$50,000	\$208,477	\$841,523
2013	\$841,523	\$42,076	\$208,477	\$675,123
2014	\$675,123	\$33,756	\$208,477	\$500,402
2015	\$500,402	\$25,020	\$208,477	\$316,946
2016	\$316,946	\$15,847	\$208,477	\$124,316
		\$166,700	\$1,042,384	

Year	Beginning Value	8% Growth	Annuity Payments	Ending Value
2012	\$1,000,000	\$80,000	\$208,477	\$871,523
2013	\$871,523	\$69,722	\$208,477	\$732,768
2014	\$732,768	\$58,621	\$208,477	\$582,913
2015	\$582,913	\$46,633	\$208,477	\$421,070
2016	\$421,070	\$33,686	\$208,477	\$246,278
		\$288,662	\$1,042,384	

Predetermined 17.5% 5% Growth

Grantor Retained Annuity Trust Flow Illustration

Property Transferred in 2012 in Exchange for an Annual Payment of \$175,000.



This illustration assumes that trust assets earn an annual pretax total return of 5.0%.

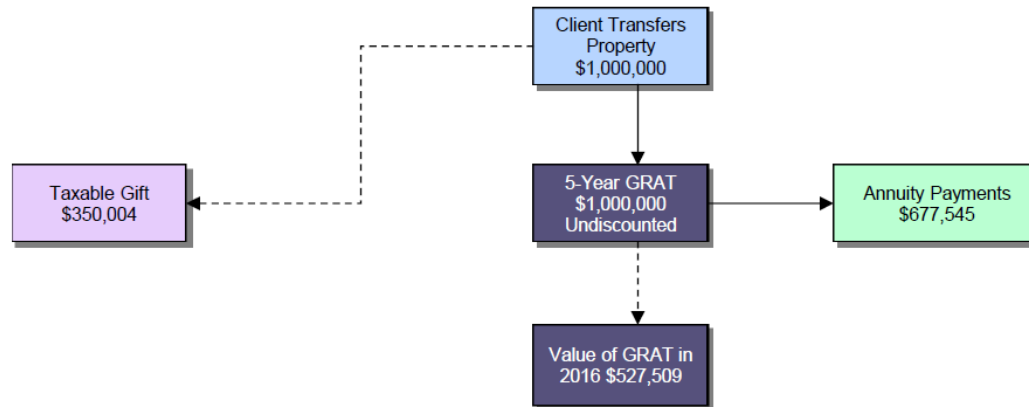
Grantor Retained Annuity Trust Illustration

Year	Beginning Value	5% Growth	Annuity Payments		Ending Value
			Annuity Rate	Annuity Payments	
2012	1,000,000	50,000	17.50000%	175,000	875,000
2013	875,000	43,750	17.50000%	175,000	743,750
2014	743,750	37,188	17.50000%	175,000	605,938
2015	605,938	30,297	17.50000%	175,000	461,234
2016	461,234	23,062	17.50000%	175,000	309,296

Remainder 35% 5% Growth

Grantor Retained Annuity Trust Flow Illustration

Property Transferred in 2012 in Exchange for an Annual Payment of \$135,509.



This illustration assumes that trust assets earn an annual pretax total return of 5.0%.

Grantor Retained Annuity Trust Illustration

Year	Beginning Value	5% Growth	Annuity Payments		Ending Value
			Annuity Rate	Annuity Payments	
2012	1,000,000	50,000	13.55090%	135,509	914,491
2013	914,491	45,725	13.55090%	135,509	824,707
2014	824,707	41,235	13.55090%	135,509	730,433
2015	730,433	36,522	13.55090%	135,509	631,446
2016	631,446	31,572	13.55090%	135,509	527,509

7520 Rate and Estate Planning

- January 2012 – rate is 1.4%, one of the lowest in history
- Low rate is good for:
 - GRAT
 - CLT
 - Intra-family loan (bank of mom and dad)
 - Sales to IDGT

7520 Rate and Estate Planning

- High rates are good for:
 - CRT
 - QPRT
- The rate does not affect planning with
 - FLP
 - ILIT
 - Annual exclusion gifts
 - IDGT
 - Dynasty trusts

Drafting considerations for your GRAT

- Flexible payment schedule (see Treas Reg 25.2702-3(b) the 105 day rule)
- Spendthrift clause for the annuity interest?
 - Will not be able to use as loan collateral
 - How does that fit with the client's overall goals and portfolio?

Drafting considerations for your GRAT

- Most important element in drafting
 - Meet the 2702 requirements
 - Otherwise retained interest is valued at zero
 - Results in taxable gift of the FMV of assets transferred
- “Qualified interest” - IRC 2702(b)



Statutory Change

What will Congress do next?

Status of Legislation Heading into 2012

- No man's life, liberty, or happiness is safe while Congress is in Session
 - **Mark Twain**
 - *US humorist, author & lecturer (1835 – 1910)*
- Series of bills, see 2010 H.R. 4849
 - Required no less than 10 year GRAT term
 - Remainder greater than \$0 at time of transfer
 - No decrease in fixed amount
- Passed House March 24, 2010
- Never taken up by Senate

Status of Legislation Heading into 2012

- H.R. 5486
 - Introduced June 9, 2010
 - Small Business Jobs Tax Relief Act of 2010
- Looks to GRATs as revenue generation for tax incentives (like H.R. 4849)
- Senate passed its own version
 - Eliminated provisions restricting GRAT planning
 - Passed by House
 - Signed by President Obama

Status of Legislation Heading into 2012

- No new legislation addressing short term GRAT planning
 - 2012 election cycle
 - President signed the last legislation without the restriction
- This country has come to feel the same when Congress is in session as when the baby gets hold of a hammer.
 - **Wil Rogers**
US humorist & showman (1879 - 1935)



WEALTH MANAGEMENT

Mortality Risk

Addressing the Mortality Risk

- To succeed the creator of the GRAT must outlive the term
- Elderly or ill client – how do we address the mortality risk?

Addressing the Mortality Risk

- Rolling GRAT
 - Series of GRATs
 - Short term (2 years typically)
 - Longer term = greater mortality risk for failure
 - Use payment from GRAT 1 to fund GRAT 2
 - Transfer wealth in stages exposing only portion to mortality risk

Addressing the Mortality Risk

- Rolling GRAT
 - Also addresses the investment risk
 - 10 year GRAT created in 2000 with Lehman stock
 - Fails in 2008 with collapse of asset
 - Series of 2 year GRAT for 10 years
 - Growth of 1 – 6 transferred gift tax free
 - 2008 collapse only affects part of the transfer

Addressing the Mortality Risk

- Risk using rolling GRAT
 - 7520 rate may increase
 - Potential tax law changes
 - Additional fees

Addressing the Mortality Risk

- Discounted sale
 - Advantage
 - Immediate, no waiting for end of trust
 - No worry of client “not cooperating”
 - If no IDGT then recognize gain on sale
 - Step up in basis for children
 - With multiple children IDGTs can get minority discount
 - no capital gain on sale
 - no interest reporting on the note
 - no rental income to report

Addressing the Mortality Risk

- Discounted sale

			Florida Condo
		\$590,000	Appraised value
		\$413,000	Discounted value
		\$42,000	Down payment
		\$369,000	Note (total)
		\$11,070	interest at 3% (annual)
		\$67,278	Note payment (yearly) for 6 years
		\$16,800	Rent (yearly)
		\$177,000	gift reduction

Tax Treatment of GRAT Plans

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Tax Treatment of GRAT Plans

Gift Tax

GRAT and Tax (Gift)

- Transfer constitutes a taxable gift to the donor
- Amount of gift:
 - Excess of
 - Value of property transferred
 - Over the value of retained interest
- 7520 rate important

GRAT and Tax (Gift)

- Gift of a future interest
 - No annual exclusion
- IRS “coupon”
- Or Zeroed Out GRAT

GRAT and Tax (Gift)

- Walton v Commissioner, 115 T.C. 589 (2000)
 - If Audrey died during the term annuity paid to her estate
- The IRS decided not to fight the decision (26 CFR 25.2702-3)
 - Agreed to ignore the example 5 as invalid

GRAT and Tax (Gift, income, estate, GSTT)

- “Walton GRAT”
 - Court recognized 2702 formula
 - Value of property transferred
 - Minus value of qualified interest retained by grantor
 - Equals = value of the gift
- Is a GRAT that
 - Lasts for a term of years
 - Annuity will pay to grantor estate

GRAT and Tax (Gift)

- Zeroed out GRAT
 - Retained interest value
 - Equals value of property transferred
 - Remainder interest equals zero
 - Fixed annuity term not reduce by estate contingent interest

GRAT and Tax (Gift)

- Calculation of the gift
 - For difficult to value assets or discount calculation
 - Consider percentage distribution
- No gift tax at termination
 - Gift was complete at time of creation
 - Even if not a zeroed out GRAT

Tax Treatment of GRAT Plans

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Estate Tax

GRAT and Tax (Estate)

- Mortality risk
 - Must be alive at end of term
 - Remainder to beneficiaries
- If donor doesn't cooperate
 - Estate inclusion
 - Lost estate tax savings
 - Some or all included in gross estate

GRAT and Tax (Estate)

- Treas. Reg. 20.2036-1(c)(2) and 20.2039-1(e)(1) [changed effect of IRC 2039 and prior rulings applicable to 2036] (July 11, 2008)
 - Amount needed to produce income satisfying remaining annuity payment included in gross estate.
 - Entire GRAT may be included under 2036 if
 - 7520 rate decreased during the term
 - Assets did not perform well

GRAT and Tax (Estate)

- Treas. Reg. 20.2036-1(c)(2) and 20.2039-1(e)(1) (July 11, 2008)
 - Amount to include in estate:
 - Annual annuity payment
 - Divided by the current 7520 at grantor death

GRAT and Tax (Estate)

- If donor cooperates and outlives the GRAT term
 - All growth is removed from the estate
 - Estate value freeze process
 - Future earnings and growth of the assets exceeding 7520 rate no longer in estate



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Tax Treatment of GRAT Plans

Generation
Skipping Tax

GRAT and Tax (GSTT)

- Unfortunately not a great tool for GSTT planning
- Can't allocate GST until termination
- Upon creation the transfer is to a trust
- Transfer of future interest (contingent)
- Possible reversion in grantor

GRAT and Tax (GSTT)

- GST planning using sale of remainder interest
 - Avoiding the ETIP rules
- Grantor children as remainder beneficiaries
- Sell to an existing GST exempt trust
 - Shift benefit to the GST
 - FMV of remainder interest sales price
 - Zeroed out GRAT?



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Tax Treatment of GRAT Plans

Income Tax

GRAT and Tax (Income)

- GRANTOR trust treatment, no separate return
- Income, deductions, credits, etc. as if owned
- Reported on donor 1040
- No added income tax liability
- Remainder growth transfers essentially tax free

When Should We Recommend a GRAT to Our Clients?

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Who Is A Good Candidate?

- Has already used up much or all unified credit
- Client with portfolio expected to outperform 7520
 - And wants to minimize transfer taxes
- Client holds stock options in growing company or pre-IPO
- Client who wants to gift while leveraging “IRS coupon”

What types of assets are good for a GRAT?

- Non-qualified stock options
- Concentrated stock positions in portfolio
- Income producing assets

Grantor Retained Annuity Trusts

- **PROS**

- You receive periodic distributions
- Removes all future gains on assets from your estate
- A strategy of rolling GRATs alleviates “all or nothing”
- If the growth of the assets exceeds the IRS interest rate, you can pass appreciation without gift tax or utilizing your lifetime exemption

Grantor Retained Annuity Trusts

- **CONS**

- Control of assets limited to terms of trust
- Lose income from the assets
- You are taxed on the trust income
- If you do not live beyond the specified term of years of the trust, the assets will revert back into your estate
- Your cost basis is transferred to the trust
- Trust must have sufficient liquidity to make payments



WEALTH MANAGEMENT

Thank You!

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