



All in the family

A GRAT can help transfer ownership in your business to your heirs

You've spent most of your life building a profitable company. And now that you're approaching retirement, you want to establish a tax efficient way to transfer ownership in your business to your children while maintaining a significant income stream for yourself. A grantor retained annuity trust (GRAT) could be the answer.

How GRATs work

A GRAT can transfer all or part of the value of your business to your heirs — and typically without the burden of estate taxes. As grantor, you transfer stock or other assets to this irrevocable trust.

In return for your contribution, the trust pays you annual payments for a specified term, allowing you to enjoy a cash stream while giving up control of the trust assets. At the end of the trust term, the assets' value and all future appreciation are no longer in your taxable estate. With a GRAT, the annuity payments are a fixed percentage of your initial contribution's value. (Note that, with a grantor retained unitrust (GRUT), the annuity payment is a fixed percentage of the trust's assets recalculated on a periodic basis.)

The payment amounts, the term of the trust and an IRS-determined interest rate determine how much of a taxable gift has been made. You can cancel out any gift by setting up the trust so that the value of the annual annuity payments is equal to the value of the shares contributed to the GRAT, often referred to as a "zeroed-out" GRAT.

At the GRAT term's end, the remaining assets are transferred free of gift or estate taxes to your heirs, the trust's beneficiaries. How can there be assets remaining if the value of the annuity is equal to the value of the contributed shares? Because the value of your business can grow at a higher rate than the IRS-determined rate.

Keep in mind that, because a GRAT is a "grantor trust," you pay any income taxes on the trust's earnings. But you should look at this as an additional tax-free gift to your heirs.

GRAT in action

An important caveat, however, is that you must survive the trust's term. If you don't, the GRAT assets will be included in your taxable estate. Let's say your closely held

business is valued at \$5 million. Your company is on track to double its revenues and profits within five years, which will cause its value to appreciate significantly.

Because you're approaching retirement, you want to gift your company stock to your son, Jack, who's the vice president. If you make direct transfers during the next five years, your tax-free gifts will be limited to the annual exclusion amount of \$12,000 (\$24,000 if married and consent to a joint gift) and the \$1 million gift tax exemption (\$2 million if married and consent to a joint gift).

If you create a GRAT instead, you can direct the future appreciation in your stock to your son with little or no gift tax. You can contribute your stock to a five-year GRAT and receive the annuity payments during the next five years.

If the stock in the GRAT doesn't garner adequate income to fund the annuity payments, the principal of the trust will be distributed back to you to satisfy the payments. Exercise caution if you gift non-income-producing assets without a readily ascertainable market value to a GRAT.

At the end of the five-year period, Jack will receive the remainder of the trust — the stock. In addition, the GRAT can help transfer your stock's appreciation in value during the term of your annuity — passing gift-tax free.

Is a GRAT great for you?

With research and planning, a GRAT can help reduce the size of your taxable estate, maintain a cash flow for your retirement and transfer interests in your business to your heirs in a tax efficient manner. And because a creditor typically can make a claim only against a grantor's retained income interest and not the trust's assets, a GRAT can stave off creditors.

An estate planning professional can help you determine if a GRAT is the right option for your estate plan.

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