

The Gift of GRAT:

Estate Freezing Strategy Utilizing Underperforming Markets

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There is little to be excited about in our current economic situation. The simultaneous struggles of housing market, credit and liquidity markets, and the performance of the stock market has lead to a stagnant U.S. economy. However, interest rates have remained low. This combination of slumping markets and low interest rates creates a good opportunity to utilize an estate freezing strategy called a Grantor Retained Annuity Trust or GRAT.

A GRAT works by the grantor (or donor) transferring property into a trust (a GRAT) that provides the grantor with a yearly, fixed annuity for a term of years. At the end of the term, the beneficiaries (who must be family members of the grantor) receive whatever is left with no tax consequence.

A GRAT is used to ensure that any gains realized by a gift to family members of an underperforming asset- such as a stock- will occur outside of the grantor's taxable estate. In order to effectively utilize the GRAT two things must occur: (1) grantor must survive the term of years, and (2) the transferred asset must outperform the hurdle rate.

The "hurdle rate" or 7520 rate is an interest rate set by the IRS that estimates what a trust will earn for tax purposes. As of April 2008, the hurdle rate was 3.4%. As such, the underperforming asset transferred into the GRAT has to outperform 3.4% in order to leave a non-taxable gift to the beneficiaries of the GRAT.

This technique is especially desirable for wealthy families to transfer wealth down a generation or two while avoiding the #1 family wealth killer- the Federal Estate tax! Currently, the Federal Estate tax rate is 45% of anything over \$2 million.

Example of using a GRAT:

Dad holds 100,000 shares of stock that is worth \$5M (\$50 a share) which is down 15% due to market conditions. As such, the current value of his stock is \$4.25M. Dad creates a GRAT in which he transfers this underperforming stock leaving his three children as beneficiaries or remaindermen. The term is set for 5 years. A yearly fixed annuity is set in the amount of \$878,900 (1/5 of the value of the initial transfer plus the hurdle rate of 3.4%).

Value of stock prior to market slump: \$5M

Current value of stock (down 15%) transferred into GRAT:	\$4,250,000
Hurdle rate:	3.4%
Term of years:	5 years
Yearly fixed annuity formula:	1/5 of transfer value + hurdle rate of 3.4%
Value of fixed annuity:	\$878,900 per year for 5 years
Assumption:	Stock regains pre-slump value and grows 10% over term of GRAT
End of term money back to grantor:	\$4,394,500
Tax-free gift to children:	\$1,105,500

Assuming the stock regains its value and grows another 10% over the next five years, Dad gets his initial transfer back (plus hurdle rate interest) and his three children will get a tax-free gift of over \$1 million!

Although typically, underperforming stocks are used in setting up GRATs, another interesting concept is utilizing bonds. If you can lock-in a high yield rate for the bond for the term of the GRAT- a rate in excess of the hurdle rate- you can avoid the volatility of the stock market while ensuring a tax-free gift to your children or grandchildren.

The key is to do whatever it takes, within the boundaries of the law, to avoid estate taxes. A great time to do so is by taking advantage of a slumping market by using a GRAT.