# A Time for Giving

## *Why now is a great opportunity to pass on some of your wealth*

By Nate Hardcastle

It may be tough expanding your wealth in an economy that is teetering, but giving it away to heirs is getting a whole lot easier, thanks to rock-bottom interest rates.

Some estate-planning professionals are urging clients to take advantage of the situation by setting up grantor-retained annuity trusts, vehicles designed to minimize or eliminate gift taxes on wealth transferred out of an investor's estate during his or her lifetime.

The reason: Low Treasury rates have pulled down the rate the Internal Revenue Service uses to calculate tax on these trust assets. The lower this rate—known as the "hurdle" rate—the more a grantor-retained annuity trust, or GRAT, can potentially pass to beneficiaries free of gift tax.

In March, the hurdle rate stood at 2.4%, less than half of what it was a year earlier, after falling to 2% in February, its lowest level ever.

"We believe Treasury rates are lower than the fundamentals justify," says Paul Palazzo, managing director of wealth management for L.J. Altfest & Co. in New York. "The hurdle rate is unusually low as a result—which makes now a good time to set up a GRAT."

The person who establishes a GRAT (the grantor) places investments in the trust, and receives annuity payments from those assets over the trust's term—usually two to five years, but sometimes longer. The grantor pays taxes on investment gains and income, but any investment growth in excess of the hurdle rate passes to the trust's beneficiary free of gift tax.

So say a grantor in March placed $1 million worth of stock in a GRAT with a three-year term, and he or she took annuity payments that would leave the trust with no assets—thus no taxable gift—at the term's end if the investment grew at the 2.4% hurdle rate. (This technique is known as "zeroing out" a GRAT.) If the stock actually gained 10% annually, the trust would finish its three-year term with more than $174,000—all of which would pass to the beneficiary tax-free.

There's one important catch: The grantor must outlive the term of the GRAT, or assets in the trust revert to his estate. That provision may make it impractical to zero out a GRAT, especially when it is funded with illiquid assets such as real estate or a business. In such cases, the annuity payments are made up of whatever cash flow the asset is likely to generate, and the amount may not be sufficient to zero out the GRAT within a time period the grantor believes he or she will outlive. In that event, the difference between the IRS's projected value for the trust at the end of the its term (the current value of the asset plus appreciation at the hurdle rate) and the scheduled annuity payments becomes the taxable gift.

### Clearing the Hurdle

A GRAT is ineffective if the investments within it don't outpace the hurdle rate. In that case the grantor receives no benefit for either the expense of setting up the trust—typically between $3,000 and $15,000—or the inconvenience of forgoing access to the assets (apart from annuity payments) during the GRAT's term.

Today's lower hurdle rate makes such a scenario less likely, however. "You set up a GRAT because you think your investment growth will be higher than the applicable federal rate," says Helen Modly, a financial adviser who specializes in estate planning for Focus Wealth Management Ltd. in Middleburg, Va. "These days that doesn't take much."

A smaller hurdle rate not only lowers the bar for sufficient investment growth, it also increases a GRAT's potential tax benefit. For instance, a three-year GRAT funded with $1 million and producing a 6% annual investment return would leave $78,476 tax free to a beneficiary at the current 2.4% hurdle rate, compared with just $4,405 at the March 2008 hurdle rate of 5.8%.

Because greater investment growth results in a greater tax benefit, grantors traditionally use GRATs to hold investments they expect will leap in value—for example, shares of a closely held firm that will go public. But the low hurdle rate and the financial markets' declines have led wealth advisers, estate attorneys and grantors to reconsider the types of investments that are appropriate for these trusts.

Planners are increasingly funding GRATs with corporate bonds—a once-unthinkable move that becomes worth considering when yields are in double-digits. Stock declines could make equities more or less attractive for GRATs, depending on the investor's perspective. They would be more attractive if

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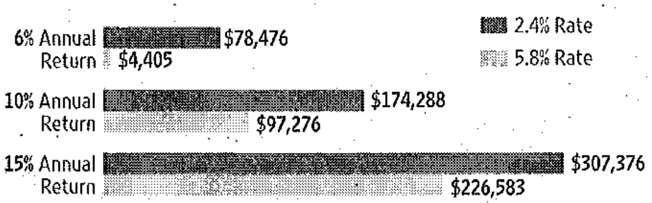
### You Can Trust in Lower Rates

Historically low interest rates are increasing the appeal of grantor-retained annuity trusts. Here are the amounts left tax-free to a beneficiary under a three-year GRAT funded with $1 million, assuming three different rates of return. In March, the IRS used a 2.4% "hurdle rate" to calculate tax on trust assets, down from 5.8% in March 2008. The lower the hurdle rate, the more money a trust can pass to beneficiaries tax-free.




Source: L.J. Altfest & Co.

# Giving

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the grantor considers the securities drastically undervalued, but less attractive if he thinks they will stay depressed for some time. Meanwhile, the cloudy outlook for the real-estate market and the economy may give grantors pause before funding the trusts with property or a small business, two traditional GRAT mainstays.

## Staging a Rescue

Asset declines have undermined some GRATs that were established in the past several years, many of which are lagging behind the hurdle rate by a wide margin. Estate planners have a solution they call a GRAT rescue, which effectively swaps an old GRAT for a new one.

"Say you set up a two-year GRAT in late 2007, and you know it won't meet the hurdle rate," says John Dedon, an estate attorney with Odin, Feldman & Pittleman in Fairfax, Va. "You throw in the towel on that GRAT: You buy out its assets with cash, which remains in the trust and pays your annuity. Then you put your investments in a new GRAT, taking advantage of the current low hurdle rate and your assets' low values."

There are a few caveats associated with GRATs. The trusts generally make sense only for people whose estates exceed the estate-tax exemption: $3.5 million per person in 2009, or $7 million for a couple that takes full advantage of the spousal exemption. (Most observers expect Congress to extend the current exemption, rather than allowing it to drop to $1 million in 2011 as scheduled.) And the trusts don't prevent generation-skipping tax, so they aren't ideal for leaving assets to grandchildren.

Some estate planners worry that Congress and the new administration will change the rules that govern the trusts, perhaps prohibiting grantors from zeroing them out. So they're urging people who are considering funding or rescuing a GRAT to act quickly. "There is a buzz in the field that this technique is in legislators' target zone," says Richard Franklin, an attorney with Pillsbury Winthrop Shaw Pittman, LLP in McLean, Va.