



Grantor Retained Annuity Trusts ("GRATs") and Rolling GRATs

Producer Guide

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Introduction to GRATs and Rolling GRATs

The Grantor Retained Annuity Trust (“GRAT”) is a flexible planning tool which can be used by wealthy clients to:

- Reduce estate and gift taxes through an estate “freeze;”
- Reduce gift taxes that could be incurred when funding an irrevocable life insurance trust (“ILIT”); or
- As an “exit strategy” for other estate planning techniques such as premium financing or private split dollar.

GRATs come in several varieties including fixed-term GRATs, Rolling GRATs, Walton GRATs, Zeroed-Out GRATs, and Ramp-Up GRATs. Each of these various types of GRATs are defined and explained in the materials which follow.

When Does a GRAT Make Sense?

The GRAT technique is especially appropriate for high net-worth clients (individuals with \$3 million or more in assets or married couples with \$5 million or more in assets) who:

- Have highly appreciating assets (such as closely-held stock or real estate);
- Are funding life insurance that requires premiums which exceed the amounts available to the Grantor(s) for annual gifting; or
- Are involved in or considering premium financing, split dollar, private split dollar, or similar financing techniques where an “exit strategy” may be appropriate.

What is a GRAT?

A GRAT is a wealth transfer technique where an individual (the “Grantor”) transfers assets to an irrevocable trust (the “GRAT”) in exchange for a stream of payments (an “annuity”) and designates remainder beneficiaries who will receive any assets left over in the trust at the end of the annuity term. In essence, a transfer to a GRAT is like a sale, only the payments for the property are characterized as an annuity that lasts either for the lifetime of the Grantor(s) or for a fixed term of years. The estate and gift tax treatment of the transfer of assets to a GRAT depends on the value of the annuity payments retained by the Grantor. If the payment stream to the Grantor is equal to the value of the asset contributed to the GRAT, then there are no gift taxes on the transfer (and any remainder passing to the GRAT beneficiaries will also pass free of gift taxes).¹

While the payments from a GRAT are described as an annuity stream and can be scheduled to last for the lifetime of the Grantor(s), it is more typical to structure a GRAT for a term of years. Such a GRAT may be referred to as a “fixed GRAT” or a “fixed-term GRAT.” The maximum term allowed for a GRAT under the Internal Revenue Code (“IRC”) is currently 20 years.

What Are “Rolling” GRATs?

Rolling GRATs are a series of short-term GRATs strung together to increase efficiency and reduce risk. Rather than having a single GRAT which returns payments for the asset for a period of years, the Grantor places the asset in a 2-year GRAT, and then reinvests the payments received from the GRAT into new 2-year GRATs until the original trust term has been reached.

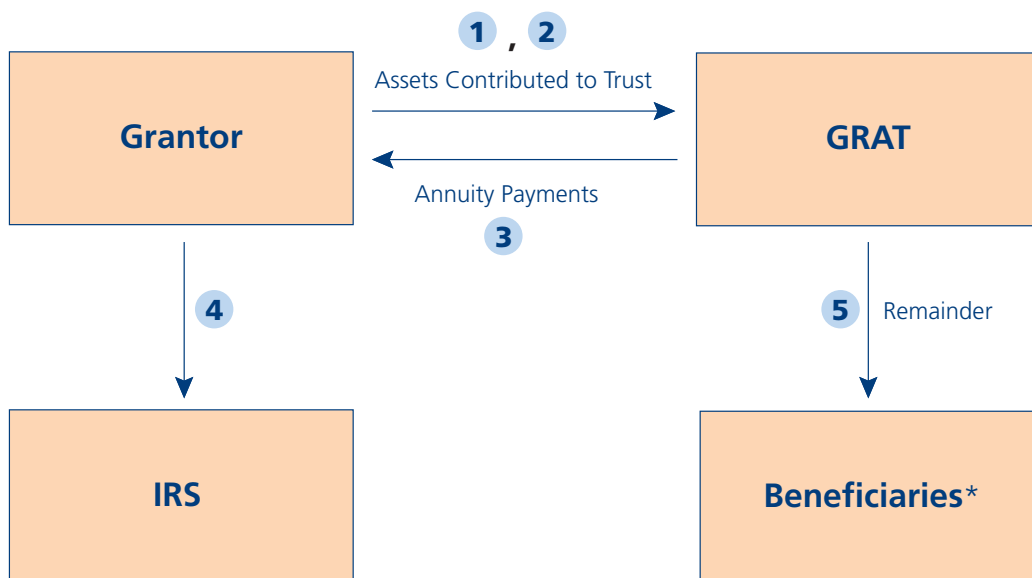
The Rolling GRAT technique came to prominence in the Walton case [Audrey J. Walton v. Commissioner; 115 T.C. No. 41; No. 3824-99 (December 22, 2000)] which featured a series of 2-year Rolling GRATs. While the focus of the Walton GRAT case was on whether a GRAT could be “zeroed out” for gift tax purposes, it also had the effect of publicizing the use of a series of short-term GRATs to reduce risk rather than relying on a single long-term GRAT to remove assets from an estate.

¹ Review Internal Revenue Code §§ 2071-2074 for a full discussion of the tax treatment of GRATs.

How Does a Typical GRAT Work?

Implementing a GRAT typically involves five steps:

- 1. Client creates a grantor trust.** The first step is to have the client's attorney draft a grantor trust. This is an irrevocable trust which is specially designed so that the trust assets are excluded from the Grantor's estate for estate and gift tax purposes, but the assets are treated as belonging to the Grantor for income tax purposes. This allows the Grantor (your client) to buy and sell from the trust without incurring income taxes on the sales. At the same time, the Grantor has removed the trust assets from his or her estate.
- 2. Transfer assets to trust in exchange for an annuity.** The second step is to transfer assets into the trust in exchange for an annuity. The annuity must be for a "fixed amount" and be for either a term of years or for the life or lives of the Grantor(s). Once inside the trust, the assets can be used to purchase life insurance. Or, if there is already life insurance, the assets can be used for an exit strategy: to pay-off the loan for premium financing or buy out a policy funded through private split dollar.
- 3. Trust makes annuity payments.** The third step is to have the trust make scheduled annual payments to the Grantor. As already mentioned, the IRS requires GRATs to make "fixed" annuity payments. The payments must be based on either a stated dollar amount or a stated percentage of the initial value of the assets contributed to the trust. Although the IRS calls the payments "fixed," it does allow the scheduled payments to systematically increase or decrease by as much as 20% a year.
- 4. Grantor pays income taxes for the trust.** Step four is for the Grantor to pay income taxes on the trust's income. This is a tax-free gifting opportunity for the Grantor. If he or she had kept the assets, he/she would pay these taxes. If he or she had given the assets away to his/her children, they would have to pay the taxes. If he or she wanted to pay the taxes for the children, he/she would have to pay gift taxes, too. By paying taxes for the trust, he or she makes a tax-free gift and allows the trust assets to grow for his/her children or other remainder beneficiaries designated in the GRAT.
- 5. At end of GRAT term, remaining assets pass to beneficiaries tax free.** Finally, if the Grantor outlives the term of the GRAT, the trust assets will pass to his or her beneficiaries free of any estate taxes. If the trust owns a life insurance policy, the death benefits will pass to the beneficiaries free of income taxes as well. If the Grantor dies before the GRAT term has expired, then all of the trust assets are brought back into the Grantor's estate. So clients should try to limit the length of a GRAT and may even want to purchase life insurance to provide protection against premature death during the GRAT term.



*Beneficiaries can be individuals or an ILIT

Advantages of the GRAT

The GRAT technique offers clients the following potential benefits:

- **Estate “Freeze”** – Future asset growth is removed from the Grantor’s estate.
- **No “Pre-Funding” Required** – Unlike an installment sale to a grantor trust, a GRAT does not require the Grantor to gift money into the trust prior to the transaction.
- **“Exit Strategy”** – A GRAT can be used to provide an ILIT with funds to repay loans and terminate premium financing or private split dollar arrangements.

Disadvantages of the GRAT

Of course, the GRAT technique also has some possible disadvantages:

- **Estate Inclusion** – If the client dies before the GRAT term has finished, all of the assets may be brought back into his or her estate.²
- **Performance Risk** – The GRAT technique only works if the assets contributed to the trust grow at a higher rate than the § 7520 rate used by the IRS to value the annuity payments.

The interest rate used to compute the amount of a taxable gift to a GRAT is called the IRC § 7520 rate.

How Do “Rolling” GRATs Work?

Instead of relying on a single long-term GRAT, Rolling GRATs use a series of short-term GRATs. The same original contribution amount is used to fund the Rolling GRATs as would have been used to fund a long-term GRAT, but the GRAT term is limited to two years. As payments come out of each 2-year GRAT, the Grantor contributes these amounts to successive 2-year GRATs.

Thus, for example, if the Grantor originally considers funding a 10-year GRAT, the Rolling GRAT strategy would replace this with a series of eight 2-year GRATs as follows:

(Year 1)	GRAT 1	2-year GRAT funded with original contribution amount.
(Year 2)	GRAT 2	2-year GRAT funded with 1st payment from GRAT 1; Remainder from GRAT 1 paid to beneficiary.
(Year 3)	GRAT 3	2-year GRAT funded with 2nd payment from GRAT 1 and 1st payment from GRAT 2. Remainder from GRAT 2 paid to beneficiary.
(Year 4)	GRAT 4	2-year GRAT funded with 2nd payment from GRAT 2 and 1st payment from GRAT 3. Remainder from GRAT 3 paid to beneficiary.
(Year 5)	GRAT 5	2-year GRAT funded with 2nd payment from GRAT 3 and 1st payment from GRAT 4. Remainder from GRAT 4 paid to beneficiary.
(Year 6)	GRAT 6	2-year GRAT funded with 2nd payment from GRAT 4 and 1st payment from GRAT 5. Remainder from GRAT 5 paid to beneficiary.
(Year 7)	GRAT 7	2-year GRAT funded with 2nd payment from GRAT 5 and 1st payment from GRAT 6. Remainder from GRAT 6 paid to beneficiary.
(Year 8)	GRAT 8	2-year GRAT funded with 2nd payment from GRAT 6 and 1st payment from GRAT 7. Remainder from GRAT 7 paid to beneficiary.
(Year 9)	GRAT 9	2-year GRAT funded with 2nd payment from GRAT 7 and 1st payment from GRAT 8. Remainder from GRAT 8 paid to beneficiary.
(Year 10)		Remainder from GRAT 9 paid to beneficiary.

² If the Grantor fails to survive the term, the GRAT corpus is includible in the estate of the grantor under IRC § 2039.

What Are the Advantages of Rolling GRATs?

Rolling GRATs offer clients several potential advantages over the use of a single long-term GRAT. The most significant advantage is the reduction of the risk for estate inclusion. If a Grantor dies before the end of a GRAT term, some or all of the assets remaining in the GRAT may be included in the Grantor's estate. By using a series of short-term GRATs, the Grantor is assured of moving at least some assets out of his or her estate as each short-term GRAT reaches maturity.

Additionally, using a series of short-term GRATs and re-contributing payments received from the GRATs into successive Rolling GRATs may also be more efficient over the long run than relying on a single GRAT. Even if the Grantor outlives the term of a long-term GRAT, he or she may have been able to remove more assets from the estate by using a series of short-term GRATs over the same period. This will be true if the discount rate applied to the short-term GRATs is the same as the rate applied to the long-term GRAT.

On the other hand, if the IRS discount rate prescribed under § 7520 increases after the year of initial funding, Rolling GRATs may prove less efficient than a long-term GRAT. But even with this risk, Rolling GRATs have the advantage of starting to get assets out of the estate earlier than long-term GRATs and reducing the "all-or-nothing" potential for estate inclusion that comes with long-term GRATs.

The interest rate used to compute the amount of a taxable gift to a GRAT is called the IRC § 7520 rate.

Uses of GRATs & Rolling GRATs

GRATs and Rolling GRATs have several applications in estate planning and life insurance. GRATs can be used for an "estate freeze," as a way to reduce gifting needs for irrevocable life insurance trusts ("ILITs"), and as an exit strategy for techniques such as premium financing.

What Is an "Estate Freeze"?

One of the primary uses for GRATs is to help wealthy clients create an "estate freeze." Planners use the term "freeze" to describe an attempt to move all future asset growth outside of an individual's estate. Generally, an "estate freeze" is any technique that allows a person to fix or "freeze" an asset's value for estate and gift tax purposes at a given time, so that any future appreciation in value of the asset can pass to selected recipients at no additional tax cost. The goal of an "estate freeze" is to limit the date-of-death value of an asset or an estate to the value the asset or estate has today.

GRATs contribute to an estate freeze by leveraging the difference between anticipated growth on estate assets and the standard growth expectation used by the IRS to value gift transfers. For any given month, the IRS publishes a table of rates to be used to measure the value of gifts, loans, and annuities. The rates published include short-term, mid-term, and long-term rates for valuing loans, and the § 7520 rate for valuing annuity payments. These rates reflect the IRS' view on what growth rates a typical asset should experience in future years. The rate applied to measure the value of the remainder interest in a GRAT is the § 7520 rate.

A GRAT can create an estate freeze to the extent assets contributed to the trust out-perform the rate established by the IRS. For example, if a GRAT is established at a time when the § 7520 rate is 5.0%, and assets contributed to the GRAT actually grow at an annual rate of 8.0%, then the extra 3.0% of growth is removed from the Grantor's estate free of any gift or estate taxes (assuming the Grantor survives for the entire term of the GRAT). Thus, GRATs work best with assets that are expected to experience high growth during the GRAT's term.

The interest rate used to compute the amount of a taxable gift to a GRAT is called the IRC § 7520 rate.

How Can GRATs Be Used to Reduce Gift Taxes for ILITs?

In addition to being used as a stand-alone technique for reducing estate and gift taxes through estate freezes, GRATs can be used in conjunction with irrevocable life insurance trusts (“ILITs”) to reduce the gift taxes that may be incurred when funding large ongoing life insurance premiums.

Planners use ILITs to help clients create a source of funds to pay anticipated estate taxes without subjecting those funds to taxation by helping the insured avoid any incidents of ownership in the life insurance policy. The trustee of the ILIT purchases life insurance on the Grantor and the trust agreement provides direction on how the death benefit should be applied. The Grantor (and his or her spouse) must make contributions to the ILIT so that the trustee will have funds to pay the insurance premiums. The ILIT may include withdrawal rights (often called “Crummey Powers”) for trust beneficiaries which allow the Grantor’s contributions to qualify as “present interest” gifts meaning that the Grantor can use his or her annual gift exclusion rather than using up a portion of his or her available lifetime exclusion.

A problem arises for wealthier clients who decide to purchase larger life insurance policies to meet estate liquidity needs. As of 2009, an individual’s annual gift exclusion is limited to \$13,000 per beneficiary (or \$26,000 if married and the spouse consents to gift-splitting). If the life insurance policy purchased by the ILIT calls for annual premiums that are greater than \$13,000/\$26,000 per trust beneficiary, the Grantor will have to use some of his or her lifetime gift exclusion each year premiums are due.

To avoid this problem, clients can use a GRAT to fund the ILIT. Rather than naming children or other family members as the remainder beneficiary of the GRAT, the Grantor names the ILIT as the beneficiary. A series of short-term GRATs (2-year or 3-year terms) can be used to create an ongoing source of gift-tax free contributions to the ILIT which will provide funds for the ILIT trustee to pay insurance premiums.

What Is an “Exit Strategy”?

GRATs can be especially useful as an “exit strategy” for other wealth transfer techniques. All wealth transfer strategies include some element of risk. The level of risk is higher for some strategies than others. And for some strategies—such as premium financing, split dollar, and private split dollar—the level of risk increases with time.

An “exit strategy” is a technique clients can use to reduce risk by providing the funds needed to terminate wealth transfer strategies that become too expensive. Premium financing, for example, carries an interest rate risk—i.e., there is a risk that interest rates will increase over time. Similarly, split dollar and private split dollar become more expensive over time because the measure of the gift—the “economic benefit” or “term costs” of life insurance coverage—increases as the insured becomes older. For each technique, the client can choose to accept this risk, avoid this risk, or plan for this risk by having an exit strategy.

The GRAT works as an exit strategy for premium financing, private split dollar, and similar techniques, by creating a set of funds which can be used to terminate a transaction when it is no longer producing economic advantages to the client. In the case of premium financing, for example, if interest rates are fixed for a period of time the client can fund a GRAT that will provide a remainder benefit to the ILIT at the end of the fixed interest rate period. If interest rates increase, the ILIT trustee can use the funds received from the GRAT to pay off the loan. When GRATs are used as part of an exit strategy for a premium financed loan, if any part of the assumed GRAT remainder payments are not received by the ILIT or not used to repay the lender loan, the loan will need to be repaid from outside sources. If interest rates do not increase, the trustee can hold onto the funds for use in terminating the financing arrangement in the future. Meanwhile, the assets passed to the ILIT from the GRAT are also moved outside of the Grantor’s estate.

Gift and Estate Tax Consequences of GRATs

The purpose of the GRAT transaction is to move assets out of the Grantor's estate and into the hands of children and heirs with little or no gift or estate taxes. To accomplish this goal, the Grantor sets the annuity payments from the trust at a level that is high enough that no gift results upon the contribution of assets to the trust. Whether the GRAT results in a gift depends on the value of the remainder interest in the trust determined on the date the GRAT is created. To determine the value of the remainder interest, the present value of the annuity stream to be paid to the Grantor is subtracted from the fair market value of the assets contributed to the trust.

The IRS characterizes a GRAT as a transfer to a trust with a "retained interest"—i.e., the right to receive annuity payments from the trust is an interest retained by the Grantor. For gift tax purposes, transfers to trusts with retained interests are subject to "special valuation" rules outlined in IRC § 2702.

Under the special valuation rules, the value of the gift to the remainder beneficiaries is determined by taking the total value of the assets transferred to the trust and subtracting the value of the interest retained by the Grantor. But if the retained interest of the Grantor does not meet the requirements of a "qualified interest," the value of the retained interest will "be treated as being zero." IRC § 2702(a)(2)(A) This means that if a transfer does not meet the requirements of § 2702, the full value of the transferred assets will be treated as a gift even though the Grantor is receiving payments for the assets.

To be a "qualified interest," the interest retained upon the transfer of property to a trust must be either the right to receive payments of a fixed amount no less than annually (GRAT), or the right to receive payments no less than annually of a fixed percentage of the value (determined annually) of the trust assets (Grantor retained unitrust or "GRUT"). In the case of a GRAT, the fixed amount may be expressed in terms of dollars or as a percentage of the initial total value of the assets contributed. GRATs may provide payments for a term of years or for the life of the Grantor.

Where the retained interest meets the requirements of a "qualified interest," the value of the income stream is determined by using the discount factor published by the IRS under IRC § 7520. The § 7520 rate is published monthly and is 120% of the mid-term applicable federal rate ("AFR") for the month rounded to the nearest two-tenths of a percent.

The interest rate used to compute the amount of a taxable gift to a GRAT is called the IRC § 7520 rate.

Income Tax Consequences of a Grantor Trust

As indicated above, a GRAT is a grantor trust that, in exchange for the Grantor's contribution of assets, makes annuity payments to the Grantor which qualify as a "retained interest" under IRC § 2702. This raises two questions: (i) What is a grantor trust?; and (ii) What are the income tax consequences of using a grantor trust?

What Is a Grantor Trust?

"Grantor trust" is a term used in the Internal Revenue Code to describe any trust over which the Grantor or other owner retains the power to control or direct the trust's income or assets. In essence, a grantor trust is a trust that is not recognized as a separate entity for income tax purposes, but which may be a distinct entity for estate and gift tax purposes. The Grantor (also known as trustor, settlor, or creator) is the creator of the trust relationship and is the owner of the assets initially contributed to the trust. The Grantor establishes in the trust instrument the terms and provisions of the trust relationship between the Grantor, the trustee, and the beneficiary.

If a Grantor retains certain powers over or benefits in a trust, the income of the trust will be taxed to the Grantor, rather than to the trust. Examples of such powers include: the power to decide who receives income, the power to vote or to direct the vote of the stock held by the trust or to control the investment of the trust funds, and the power to revoke the trust, etc. All "revocable trusts" are by definition grantor trusts. An "irrevocable trust" can be treated as a grantor trust if any of the grantor trust definitions contained in IRC §§ 671, 673, 674, 675, 676, or 677 are met. If a trust is a grantor trust, then, for income tax purposes, the Grantor is treated as the owner of the assets, the trust is disregarded as a separate tax entity, and all income is taxed to the Grantor.

Income Tax Consequences

There are a number of income tax consequences to having a trust structured as a “grantor trust:”

- 1. Trust income is taxed to the Grantor.** The first, and most obvious, consequence is that any income generated inside the trust is taxed to the Grantor. This applies both to ordinary income from receipt of dividends and to capital gains generated from the sale of trust assets. Although it may be permissible for the trust to reimburse the Grantor for payment of income taxes, there should be no requirement, agreement, or understanding that the trust will automatically do so. If such an agreement or understanding exists, the IRS has ruled that the trust assets will be included in the Grantor’s estate under IRC § 2036. See Rev. Rul. 2004-64.
 - The fact that the Grantor is responsible for income taxes of a grantor trust should not necessarily be viewed negatively. Many planners consider the Grantor’s responsibility for income taxes as an advantage of the grantor trust arrangement. This is because, in essence, the payment of such taxes is a tax-free gift to the trust beneficiaries. If the trust were required to pay the income taxes, this would reduce the amount of assets ultimately passing to the trust beneficiaries. In fact, if the Grantor wanted to add funds to the trust to pay taxes and prevent this loss of benefits, he or she would have to make a taxable gift. Moreover, the fact that taxes are being paid by an outside source increases the likelihood that trust assets will grow at a rate higher than the rate prescribed by the IRS to value the initial transfer to the trust.
- 2. Transfers between Grantor and trust ignored.** A second tax consequence to grantor trust status is that transfers between the Grantor and the trust will be ignored for income tax purposes. Whether the Grantor contributes assets to the trust in exchange for annuity payments or sells assets to the trust in exchange for a note requiring payments of principal and interest, there is no transfer for income tax purposes. This means that the contribution or sale does not trigger any recognition of capital gains by the Grantor. It also means that payments from the trust, whether in the form of annuity payments or principal and income payments, do not create income for the Grantor. For all income tax purposes, the grantor trust is treated as if it doesn’t exist—the Grantor is responsible for the same income taxes as if he or she continued to own the assets outright and no new income is created by payments from the trust.
- 3. No basis adjustment for contributed assets.** A third tax consequence to grantor trust treatment is that the basis of assets transferred to a grantor trust is unaffected by the transfer, regardless of how the assets are transferred into the trust. Because transfers between a Grantor and a grantor trust are ignored for income tax purposes, there is no adjustment to the basis of assets that are sold to the trust. This is consistent with the fact that the Grantor does not recognize any gain on such transactions. It also means that trust beneficiaries will not benefit from a step-up in basis at the Grantor’s death.
- 4. Transfer for value problems avoided.** A final set of tax consequences from grantor trust status has to do with life insurance. Life insurance is a unique asset under the Internal Revenue Code with specialized tax treatment. In particular, death benefits received from a life insurance policy are not ordinarily subject to income taxes. The income tax-free nature of such benefits, however, can be lost if, during the insured’s life, the policy is subject to a “transfer for value” and the transfer does not fall into one of several exceptions to the transfer for value rules as outlined in IRC § 101(a)(2). Because a grantor trust is ignored for income tax purposes, a transfer of a life insurance policy between the Grantor and the trust will not be characterized as a “transfer for value.” Moreover, if the Grantor is the person insured under the policy, transfers to the grantor trust will qualify as a “transfer to the insured” which is an exception under the transfer for value rules.

Conclusion

GRATs and Rolling GRATs are powerful planning tools which can be used to help transfer assets out of an estate with little or no gift tax consequences. GRATs are especially useful for creating “estate freezes,” reducing gifts to ILITs, and as an exit strategy for premium financing. Rolling GRATs can be used to reduce the risk of estate inclusion that would be caused by a Grantor’s early death.

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