

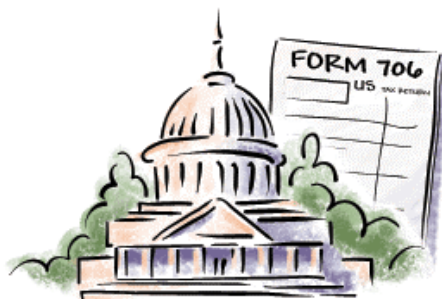
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# Estate Freezing Generally

When an estate reaches \$2,000,000, it enters the top estate tax bracket.

When 45% of each additional dollar of estate growth is earmarked for estate taxes, many estate owners look for methods of freezing the growth of their present estate.



Techniques developed over the years can be classified in three categories.

- **Gifts of assets**

- Lifetime gifts to children of \$12,000<sup>1</sup> or less per year are generally free of gift taxes.
- Gifts to an irrevocable life insurance trust can create very large amounts of capital which are not subject to estate or income tax.
- Gifts to charities can produce both income and estate tax savings.

- **Intrafamily sales of assets**

- An installment sale of an asset to a child in exchange for secured promissory notes will put future growth of the asset in the child's estate.
- A private annuity is the sale of an asset for an unsecured promise to pay annual amounts for the seller's lifetime.

- **Changes in business organizations**

- Corporate recapitalizations
- Personal holding company
- Multi-tier family partnerships

The Revenue Reconciliation Act of 1990 repealed the so-called antifreeze provision of the IRC Sec. 2036(c) and replaced it with a new Chapter 14 entitled "Special Valuation Rules." See IRC Secs. 2701 – 2704.

The purpose of this new chapter is to impose a gift tax at the time an estate-freezing transaction occurs rather than waiting until the taxpayer dies.

IRC Sec. 2701 establishes a valuation rule for estate-freezing techniques involving interests in corporations and partnerships; e.g., recapitalizations.

**Note:** Under the Tax Act of 2001, the federal estate tax is gradually phased out until its final repeal in the year 2010. If Congress does not act at that time to repeal it for the years following, it will automatically revert back to the rates in effect during the year 2001, with an exemption for the first \$1,000,000 of assets.

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<sup>1</sup> The annual gift tax exclusion (\$12,000 in 2007) is indexed for inflation in increments of \$1,000.

# Family General Partnership

Family partnerships are often used as a method of dividing business income with children in lower tax brackets and shifting future appreciation out of one's estate.



The rules set forth in IRC Sec. 704(e) deal with partnerships where capital is a material income-producing factor, as opposed to businesses which earn income by providing services.

Family members can either purchase an interest in the business or receive it by gift. If the value exceeds the annual gift tax exclusion amount, currently \$12,000,<sup>1</sup> there may be gift taxes due. The donor parent may use his or her applicable credit amount to eliminate or reduce gift taxes on amounts exceeding the annual gift tax exclusion.

A trust for minors can be a partner if the trust is administered solely for the beneficiaries' best interests. See Treas. Reg. Sec. 1.704-1(e)(2)(vii).

## Why Consider a Family Partnership?

What is the effect of shifting estate growth to a younger generation? Assume a sole proprietorship currently valued at \$200,000 which has a growth potential of 10%.

	Retain as Sole Proprietorship	Set Up a Family Partnership
1. Current value of business	\$200,000	\$200,000
2. Amount transferred to children	0	100,000
3. Amount remaining in the estate	200,000	100,000
4. Growth of business (10 years at 10%)	518,748	259,374
5. Federal estate tax at 45%	233,436	116,718
<b>Potential estate tax savings</b>		<b>\$116,718</b>
6. Growth of business (20 years at 10%)	\$1,345,500	\$672,750
7. Federal estate tax at 45%	605,475	302,737
<b>Potential estate tax savings</b>		<b>\$302,737</b>

## Family Partnerships Are Not for Everyone

Before proceeding with a family partnership arrangement, business owners must ask if they really want to have a child involved in their business. What effect will the reduced income have on their lifestyle? Will there be a gift tax due and payable when the transfer is made? Will the tax savings compensate for the increased complexity?

<sup>1</sup> The annual gift tax exclusion (\$12,000 in 2007) is indexed for inflation in increments of \$1,000.

# Family Limited Partnership

Family limited partnerships (FLP) can be used with business, personal or investment assets. Their traditional purpose has been to divide investment income with children in lower income tax brackets and increase the family's net spendable income.



They have also been used for long-range estate planning. Closely held businesses, along with other assets, are subject to Federal estate and generation skipping transfer taxes. These taxes can effectively prevent the transfer of a family business from one generation to the next. The FLP provides a valuable estate planning tool to lessen these tax burdens.<sup>1</sup>

In recent years, such partnerships have also been employed as a method of protecting family assets from creditors.

IRC Sec. 704(e) effectively limits FLPs to business/investment activities where capital is a material income-producing factor, as contrasted with activities which earn income by providing services.

## How It Works

The parents set up an FLP and transfer capital assets into the partnership. Within the partnership structure, the parents act as the general partners; the children (or grandchildren) are the limited partners.

In a limited partnership, the general partners often own only a small proportion of the partnership (for example 5%), while the limited partners own the majority interest. The general partners have complete responsibility and control of partnership activities, as well as the liability for partnership debts and losses.

The limited partners have no control or management rights. Their liability is limited to the amount of their contribution to the partnership.

One of the most attractive features of the FLP is its flexibility. Some estate planning strategies must be irrevocable in order to be effective. Once set up, these irrevocable tools cannot be changed or undone. By contrast, the FLP document can be modified to respond to changes in the family or business structure.

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*Continued...*

# Family Limited Partnership

## Reasons to Consider a Family Limited Partnership

There are three primary reasons for creating an FLP.

- **Income tax benefits:** Income generated by a limited partnership is often allocated according to ownership. With the limited partners (the children or grandchildren) owning the majority interest, most of the income generated could flow through to them and be taxed at their lower marginal tax rate.
- **Estate planning benefits:** When the parents contribute assets to the partnership, they are transferring asset value and shifting asset growth from themselves to a younger generation.

Consider the following hypothetical example in which an asset has a current value of \$200,000 and is expected to grow by 10% per year. Over time, the parents transfer 90% of the business to the children.

	Retain for Parents	Contribute to FLP
Current value	\$200,000	\$200,000
Amount transferred to children	\$0	\$180,000
Amount remaining in estate	\$200,000	\$20,000
Asset value in 20 years	\$1,345,500	\$134,550
Federal estate tax assumed at 45%	\$605,475	\$60,548
<b>Potential estate tax savings</b>	<b>\$544,928</b>	

Often a gifted ownership interest can receive a discounted value because the interest is either a minority interest or lacks marketability. This minority interest issue should be carefully reviewed with your legal advisor.

- **Protecting assets from lawsuits:** Most state limited partnership statutes prevent the creditors of a limited partner from attaching partnership assets. While the creditors may get a charging order against the debtor's partnership interest, as a practical matter it is very difficult to collect the debt. The FLP may provide one of the most effective asset protection structures available today.

## Family Limited Partnerships Are Not for Everyone

Before considering an FLP, there are a number of questions that the parent or parents must answer. Do they really want to have a child involved in their business? Will the income shared with the child affect the parents' lifestyle? Will a gift tax be due and payable when the transfer is made to the child? Will the income tax savings compensate for the increased complexity?

Additionally, legal counsel must be obtained. Because of the complexity involved, FLPs are not appropriate for every situation. The documentation for such a partnership must be carefully designed to avoid problems with both federal law and the law of the state under which the limited partnership is being created.

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*Continued...*

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- **Estate planning benefits:** When the parents contribute assets to the partnership, they are transferring asset value and shifting asset growth from themselves to a younger generation.

Consider the following hypothetical example in which an asset has a current value of \$0 and is expected to grow by 0.00% per year. Over time, the parents transfer 0% of the business to the children.

	Retain for Parents	Contribute to FLP
Current value	\$0	\$0
Amount transferred to children	\$0	\$0
Amount remaining in estate	\$0	\$0
Asset value in 0 years	\$0	\$0
Federal estate tax assumed at 0.00%	\$0	\$0
<b>Potential estate tax savings</b>	<b>\$0</b>	

Often a gifted ownership interest can receive a discounted value because the interest is either a minority interest or lacks marketability. This minority interest issue should be carefully reviewed with your legal advisor.

- **Protecting assets from lawsuits:** Most state limited partnership statutes prevent the creditors of a limited partner from attaching partnership assets. While the creditors may get a charging order against the debtor's partnership interest, as a practical matter it is very difficult to collect the debt. The FLP may provide one of the most effective asset protection structures available today.

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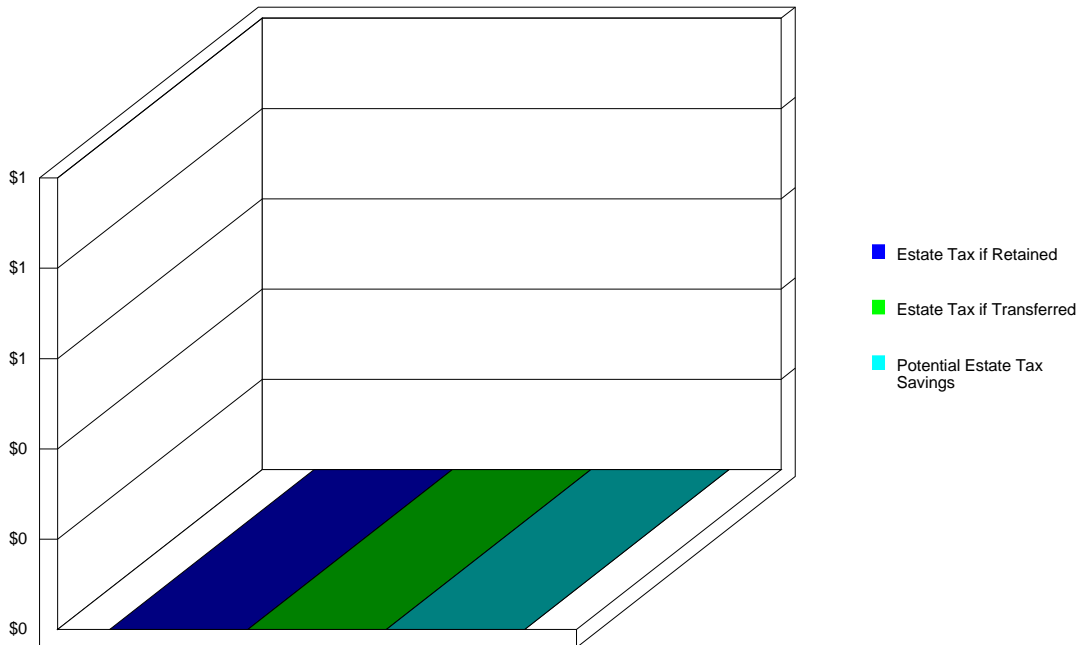
Before considering a FLP, there are a number of questions that the parent or parents must answer. Do they really want to have a child involved in their business? Will the income shared with the child affect the parents' lifestyle? Will a gift tax be due and payable when the transfer is made to the child? Will the income tax savings compensate for the increased complexity?

Additionally, legal counsel must be obtained. Because of the complexity involved, FLPs are not appropriate for every situation. The documentation for such a partnership must be carefully designed to avoid problems with both federal law and the law of the state under which the limited partnership is being created.

# Family Limited Partnership

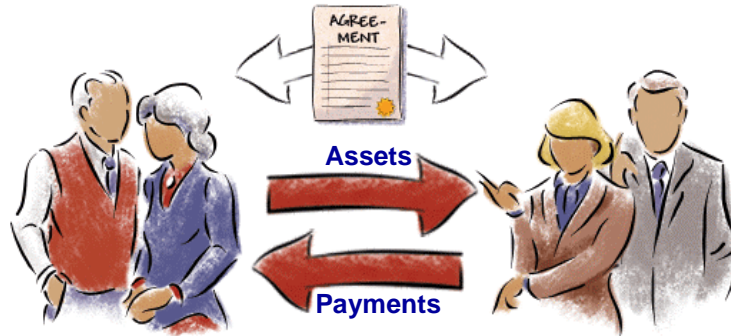
Consider the following hypothetical example in which an asset has a current value of \$0 and is expected to grow by 0.00% per year. Over time, the parents transfer 0% of the business to the children.

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Current value	\$0	\$0
Amount transferred to children	\$0	\$0
Amount remaining in estate	\$0	\$0
Asset value in 0 years	\$0	\$0
Federal estate tax assumed at 0.00%	\$0	\$0
<b>Potential estate tax savings</b>	<b>\$0</b>	



# Installment Sale

The installment sale method allows a taxpayer to spread the profit on a sale over the entire period during which the payments are received. Each payment received is treated as part return of investment and part profit and interest. This relieves the seller of paying tax on income not yet received.



The seller must either use the installment method or elect not to use it and include all of the gain in the current year.

## Imputed Interest

If no interest is charged under the terms of the agreement, the IRS imputes interest to the transaction. This means that even if the seller does not collect any interest on the transaction, the IRS will pretend that he or she does and require him or her to include the imputed interest in his or her annual income.

## Depreciable Property

If the property sold has been subject to excess depreciation (i.e., greater than straight-line depreciation), any recapture of the excess depreciation must be reported in the year of the sale. Any gain in excess of the recaptured amount may be eligible for installment treatment. When the parties are related, installment sale treatment is only available for sales of depreciated property if it can be demonstrated that tax avoidance was not a principal purpose for the installment sale.

## Sales to Related Parties

Any installment sale to a related party<sup>1</sup> who then sells (or otherwise disposes of) the property may cancel the installment reporting of the first sale unless at least two years have passed since the first sale and the property is not marketable securities. See IRC Sec. 453(e).

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<sup>1</sup> Related parties generally include one's spouse, ancestors, descendants, brothers, sisters and business entities or trusts controlled by any of them. See IRC Sec. 453(f)(1).

*Continued...*

# Installment Sale

## Sales by Dealers

Sales of real or personal property by a dealer or anyone who regularly sells property on the installment plan cannot be reported on the installment method. Neither can sales of personal property that would have to be included in business inventory if it were on hand at the end of the tax year.

## Advantages of Installment Sales

If installment-sale reporting is available, it has several important advantages.

- By spreading income over two or more tax years, it may allow the gain to be taxed in lower tax brackets.
- Even if no taxes are saved, if the payment can be postponed for one or more years, the deferred tax dollars can earn income until they become due.
- Potential future appreciation of the asset may be removed from the seller's estate.
- One may be able to shift high-income-producing assets to a family member in a lower tax bracket.

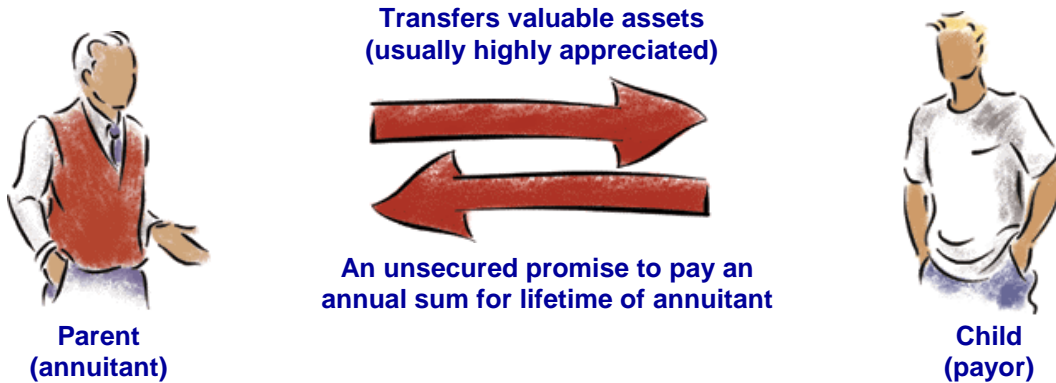
**Notes:** An installment sale of an interest in a corporation or partnership should not be regulated by the special valuation rules of IRC Sec. 2701.

In some situations there may be interest due on deferred tax liabilities. See IRC Sec. 453A.

# Private Annuity

A private annuity is a contract between two individuals to exchange a valuable asset for a lifetime income.

## A Typical Example



## Formula

$$\frac{\text{Fair Market Value of Asset}}{\text{Annuity Factor for Age and Sex of Annuitant (See IRC Sec. 7520.)}} = \text{Annual Payment Necessary to Avoid Gift Tax}$$

- If the annuity payment is large enough, there will be no gift tax.
- The annuity factor is dependent upon the parent's age.
- Parent can make annual gifts to child to assist in meeting the annual payments.
- Payments to annuitant are partially income tax-free with the remainder taxed as ordinary income, but they are not deductible to the payer.<sup>1</sup>

## Estate Planning Considerations

### Advantages

- The asset and future appreciation may be removed from the annuitant's estate without gift tax or estate tax liability.
- The annuitant gets a lifetime income.
- Some of the payments will be considered a return of capital and not taxable.

### Disadvantages

- Annuitant may live too long with the payer paying too much for the asset, thus increasing the size of annuitant's estate.
- Payments are not tax deductible.
- If payer dies, it may be difficult to collect the payments. A life policy could guarantee funds.

<sup>1</sup> On 10/17/06, the IRS issued proposed regulations (NPRM REG-141901-5) on the exchange of appreciated property for an annuity contract. These proposed regulations treat the transaction as if the transferor had sold the property for cash and then used the proceeds to purchase an annuity contract. The proposed regulations are generally effective for transactions occurring after 10/18/06, with a six-month delay until 04/18/07 for certain types of transactions.

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# Corporate Recapitalization

Recapitalization is a reorganization of the corporation's capital structure by readjusting the amount and type of stock outstanding. Typically, the corporation issues both voting preferred stock and common stock in exchange for the owner's currently held common stock.

Prior to 1987, most of the value of the company at the time of the recapitalization was assigned to the preferred stock. The common stock, therefore, had very little value and could be gifted to or sold to the children with very little, if any, gift tax consequence. Since the future appreciation of the business would be reflected in the common stock, the parents could transfer all of the future appreciation while still effectively retaining control of the business until their deaths.



In 1987, Congress effectively eliminated recapitalizations as an estate freezing device by enacting IRC Sec. 2036(c).

## Rules Under IRC Sec. 2701

The Revenue Reconciliation Act of 1990 repealed IRC Sec. 2036(c) and enacted IRC Sec. 2701, which specifically deals with valuation in the transfer of business interests. Recapitalization freezes may be beneficial under this law if all the rules are carefully followed.

First, the business must be valued using appraisal standards acceptable to the IRS.

Second, the preferred stock, which the owner will retain, must be valued.

- Some privileges are assigned a zero value; e.g., voting rights, conversion rights, etc.
- At least 10% of the business value must be allocated to the common stock (if the family owns 50% or more of the business).
- The value is based on the dividends which must be paid to the preferred stockholders. Higher dividends will increase the value of the preferred stock, but they also drain the working capital of the business.

Finally, the value of the preferred stock is subtracted from the appraised value of the entire business, and the difference will be the value of the common stock.

If dividends are missed, they will be added back into the value of the preferred stock when the owner dies. If dividends are not paid for four consecutive years, interest will accrue and will also be added onto the value of the preferred stock.

**Note:** Under the Tax Act of 2001, the federal estate tax is gradually phased out until its final repeal in the year 2010. If Congress does not act at that time to repeal it for the years following, it will automatically revert back to the rates in effect during the year 2001, with an exemption for the first \$1,000,000 of assets.

## Joint Purchase of Assets

The technique of a joint purchase of certain assets by a parent and child brought some very attractive tax results; however, in most cases it has been eliminated as a family wealth-transfer technique. Here's how it might still work.



- A parent and child find a qualified property. Joint purchases by family members must be limited to a personal residence or tangible property, such as artwork.<sup>1</sup>
- The parent purchases the life income interest and the child purchases the remainder interest. The IRS Table S gives the following percentages at an 8% rate. This rate varies from month to month as provided under IRC Sec. 7520.

Values	Age of Parents					
	50	55	60	65	70	75
Value of Remainder	18%	23%	28%	35%	42%	50%
Value of Life Income	82%	77%	72%	65%	58%	50%

**Note:** Numbers have been rounded to the nearest percent. See Reg. Sec. 25.2512-5.

Assume a father aged 55 wants to purchase a personal residence with his son under this type of arrangement. The father must invest 77% and the son only 23%. At the father's demise, his life income expires and the asset is not included in his estate—the entire 77% that he paid into the property, plus any appreciation, would be excluded.

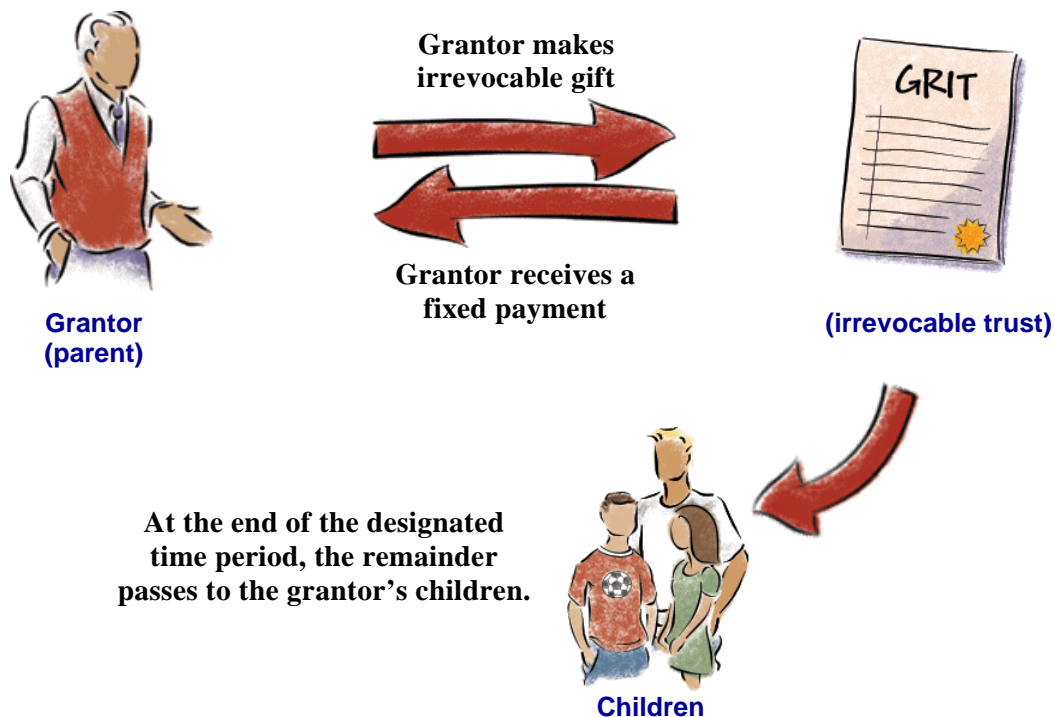
### Potential Problems

- The return on the child's investment may not be very high if the parent lives beyond life expectancy.
- If the parent gives the money to the child to make the initial purchase, there will be estate and gift tax problems. The IRS will likely treat the transaction as a purchase by the father with a gift of a future interest (the remainder) to the child. Future interests do not qualify for the annual gift tax exclusion. Furthermore, since the father retained a life income, the IRS may attempt to include the asset in his estate.

**Note:** Under the Tax Act of 2001, the federal estate tax is gradually phased out until its final repeal in the year 2010. If Congress does not act at that time to repeal it for the years following, it will automatically revert back to the rates in effect during the year 2001, with an exemption for the first \$1,000,000 of assets.

<sup>1</sup> Some analysts feel the IRS will include the asset in the parent's estate under IRC Sec. 2702.

# Grantor-Retained Interest Trust (GRIT)



The use of the grantor-retained interest trust (GRIT) under the Revenue Reconciliation Act of 1990 is limited to those trusts which either pay the grantor a fixed payment at least annually (an annuity) or pay a fixed percentage of the trust assets as computed annually (a unitrust).

The intrafamily GRIT allowed under the prior law currently has only a limited usefulness in the areas of tangible property (e.g., art work) and personal residences which are exempt from the special valuation rules. Such a GRIT is still usable in situations involving unrelated individuals, as well as those including non-lineal descendants such as nieces, nephews and cousins.

To avoid confusion between the GRIT prior to the change in law and the type of trusts which are now permitted, we have two new forms of GRITs called GRATs and GRUTs.

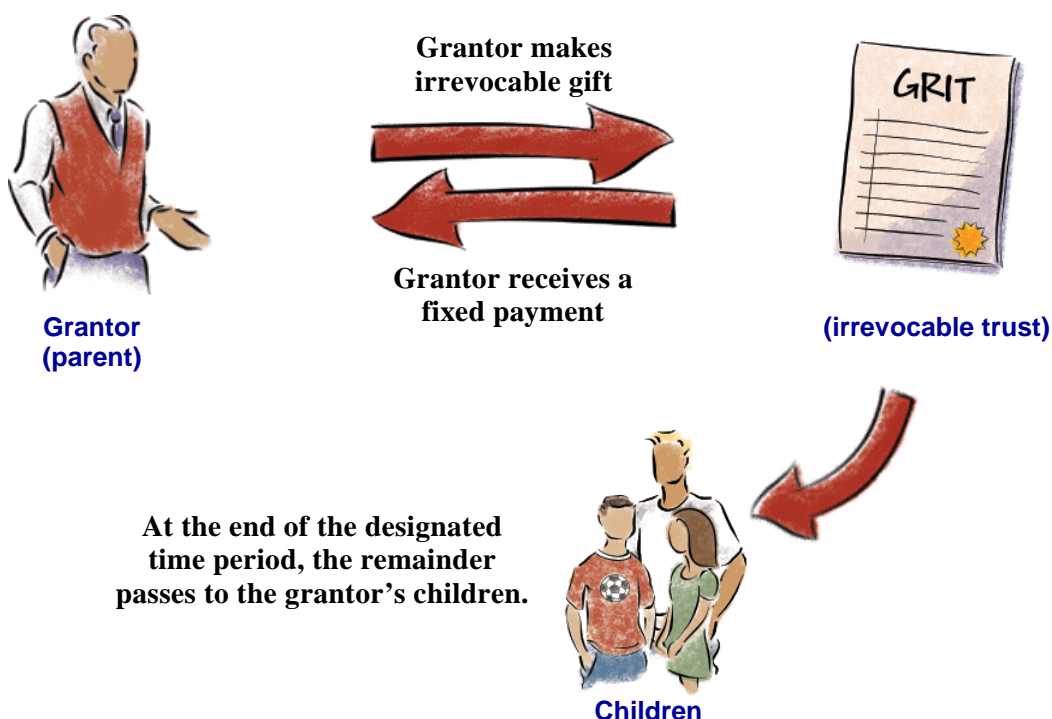
The GRAT is a grantor-retained annuity trust and the GRUT is a grantor-retained unitrust.

By following the new rules, senior family members may transfer assets with growth potential to junior family members with minimal payment of gift taxes.

In localities where real estate values are depressed, a personal residence GRIT may be very useful in transferring future appreciation potential to one's children.

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# Grantor-Retained Interest Trust (GRIT)



The value of the transferred asset minus the value of the retained income interest will equal the value of the remainder interest which is subject to gift taxation.

The example below illustrates the potential tax benefits of a term trust for 0 years.

**Assumptions:**

- Value of asset: \$0
- Age of grantor at beginning of trust: 0
- Term of the trust:<sup>1</sup> 0 years
- Federal discount rate:<sup>2</sup> 5.80%

Value of remainder interest	\$0
Probability of living 0 years	100.00
<b>Amount of taxable gift: \$0</b>	

Assuming the grantor lives beyond the 0 -year period, he or she will have removed a \$0 asset (plus its growth potential during the 0 years) from the taxable estate.

The cost of the transfer would be the gift tax on the value of the taxable gift. The gift is of a future interest and does not qualify for the annual gift tax exclusion. The gift tax on assets up to \$1,000,000 is first offset by an individual's applicable credit amount. The tax on gifts which exceed the \$1,000,000 must be paid in cash in the year the gift is made.

<sup>1</sup> If death occurs before 0 years, the value of the trust assets is includable in the grantor's gross taxable estate.

<sup>2</sup> This rate generally changes monthly.

# Grantor-Retained Interest Trust (GRIT)

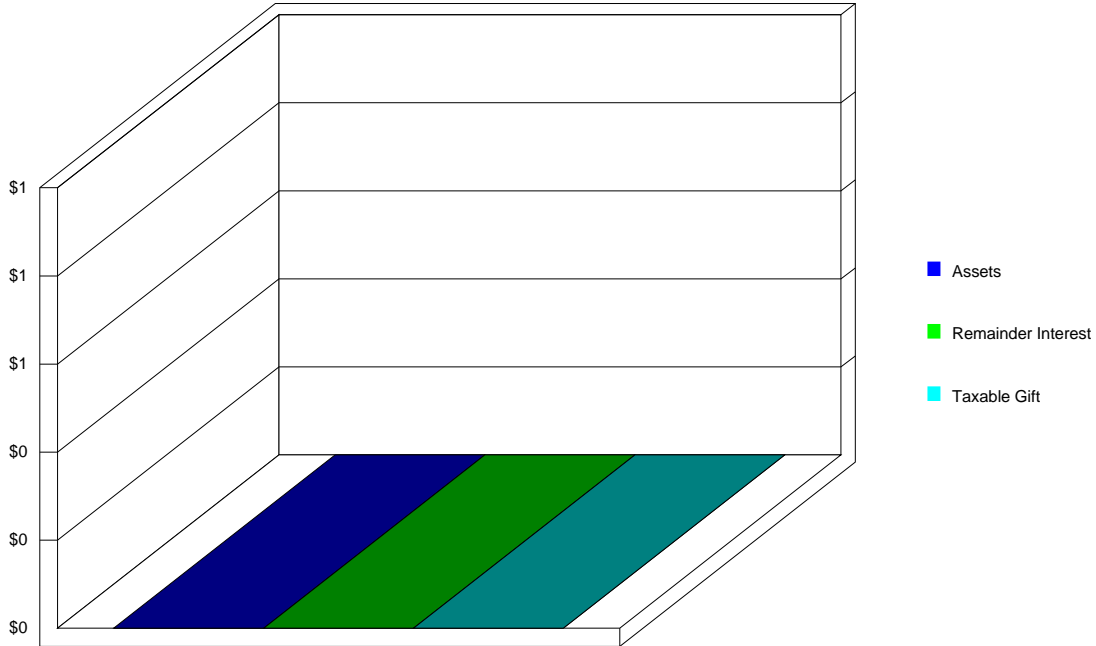
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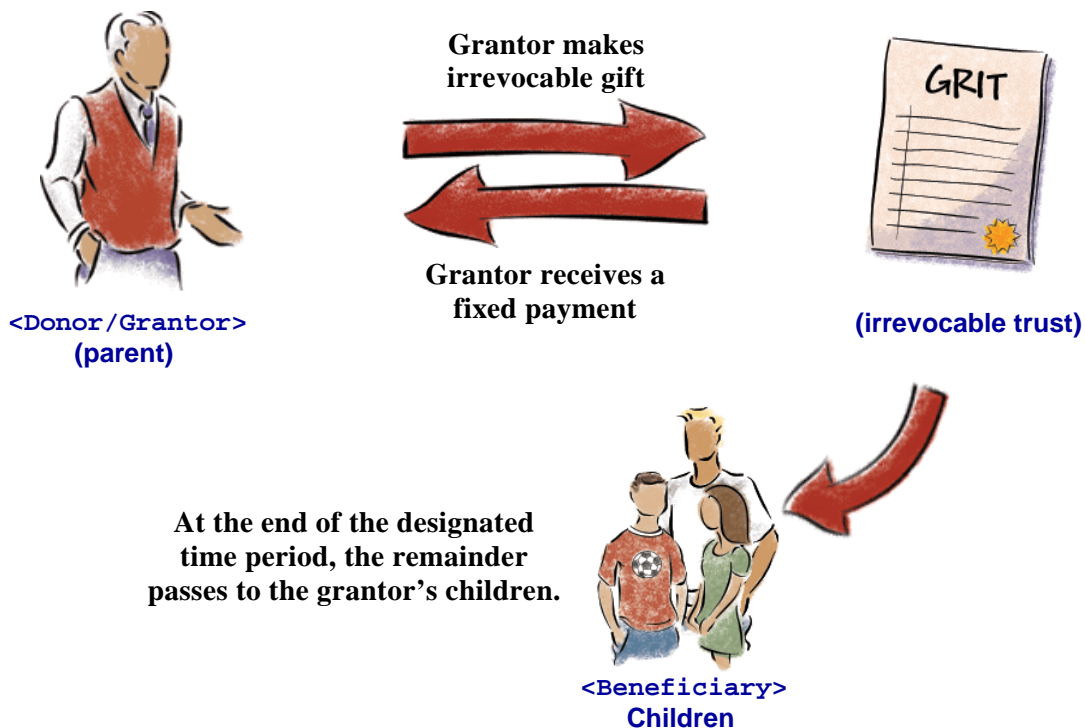
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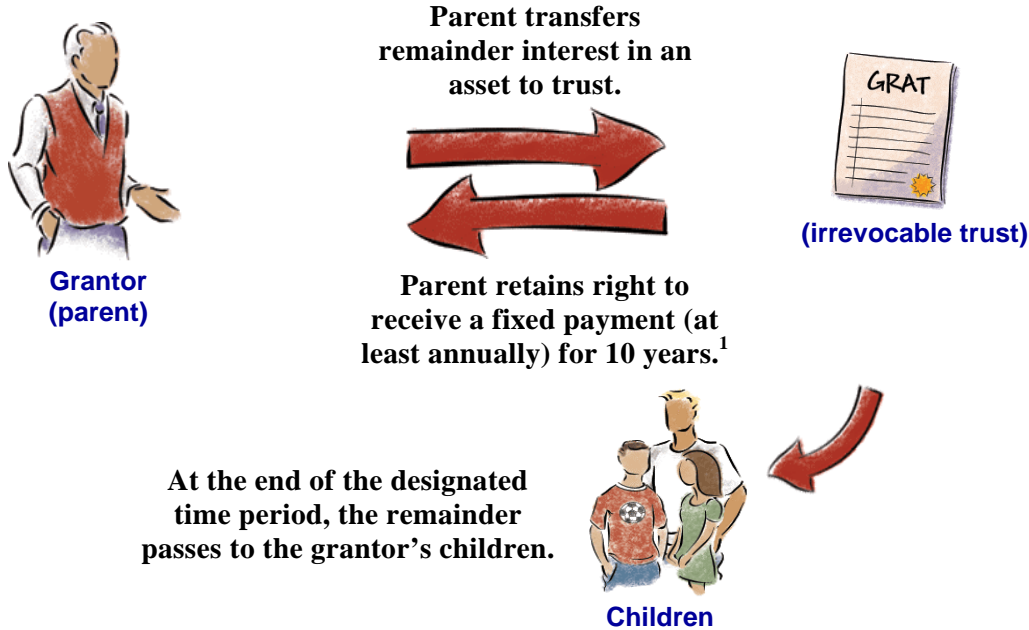
In localities where real estate values are depressed, a personal residence GRIT may be very useful in transferring future appreciation potential to one's children.

**Note:** Under the Tax Act of 2001, the federal estate tax is gradually phased out until its final repeal in the year 2010. If Congress does not act at that time to repeal it for the years following, it will automatically revert back to the rates in effect during the year 2001, with an exemption for the first \$1,000,000 of assets.

# Grantor-Retained Annuity Trust

## GRAT

An estate owner may use the GRAT to transfer assets and future appreciation to his or her children.



The value of the transferred asset minus the value of the retained annuity interest will equal the value of the remainder interest that is subject to gift taxation.

### Assumptions:

- Value of asset placed in GRAT: \$500,000
- Age of grantor: 65
- Type of payment: End of year
- Term of payment: 10 years
- Federal discount rate (changes monthly): 4.0%

Annual Payment to the Grantor	First-Year Payment as a Percentage of the Asset <sup>2</sup>	Value of the Retained Interest	Gift Tax Value of the Remainder Interest
\$30,000	6%	\$243,327	\$256,673
\$40,000	8%	\$324,436	\$175,564
\$50,000	10%	\$405,545	\$94,455
\$60,000	12%	\$486,654	\$13,346

The cost of the transfer would be the gift tax on the value of the remainder interest. The gift is of a future interest and does not qualify for the annual gift tax exclusion. The gift tax on assets up to \$1,000,000 is first offset by an individual's applicable credit amount. The tax on gifts that exceed \$1,000,000 must be paid in cash in the year the gift is made.

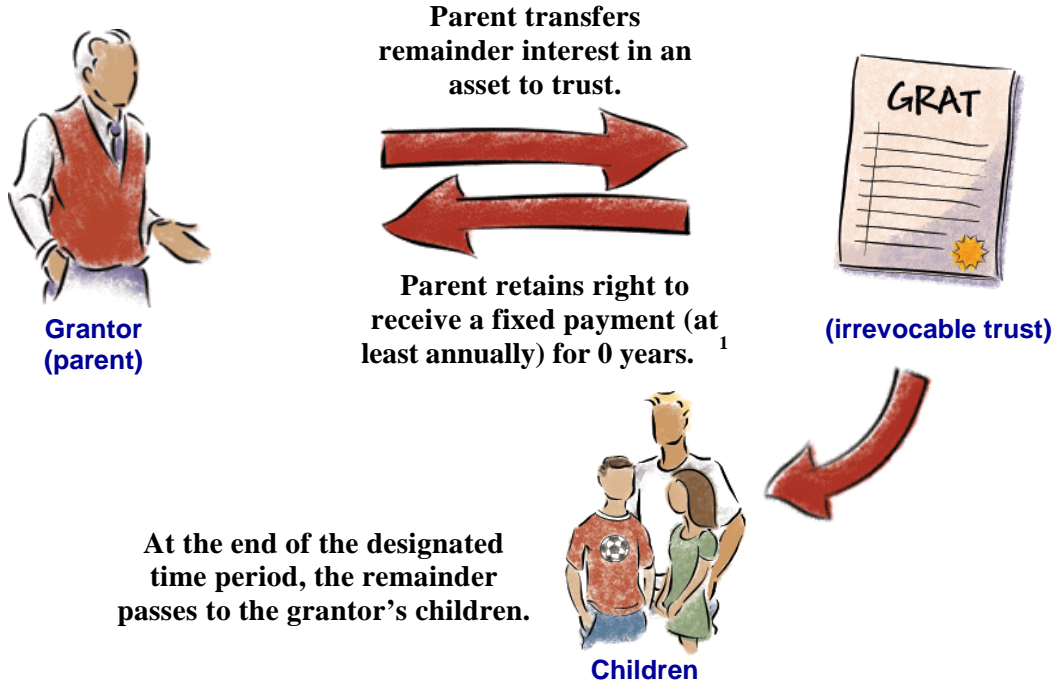
<sup>1</sup> The payment period can be for the life of the grantor, for two or more joint lives or for a set number of years.

<sup>2</sup> In subsequent years the dollar amount of annual payment would remain the same but the percentage of trust assets distributed would vary.

# Grantor-Retained Annuity Trust

## GRAT

An estate owner may use the GRAT to transfer assets and future appreciation to his or her children.



The value of the transferred asset minus the value of the retained annuity interest will equal the value of the remainder interest which is subject to gift taxation.

### Assumptions:

- Value of asset placed in GRAT: \$0
- Type of payment: End of year
- Term of payment: 0 years
- Federal discount rate (changes monthly): 5.80%

Annual Payment to the Grantor	First-Year Payment as a Percentage of the Asset <sup>2</sup>	Value of the Retained Annuity Interest	Gift Tax Value of the Remainder Interest
\$0	0.00%	\$0	\$0
\$0	2.00%	\$0	\$0
\$0	4.00%	\$0	\$0
\$0	6.00%	\$0	\$0

The cost of the transfer would be the gift tax on the value of the remainder interest. The gift is of a future interest and does not qualify for the annual gift tax exclusion. The gift tax on assets up to \$1,000,000 is first offset by the applicable credit amount. The tax on gifts which exceed \$1,000,000 must be paid in cash in the year the gift is made.

<sup>1</sup> The payment period can be for the life of the grantor, for two or more joint lives or for a set number of years.

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# Grantor-Retained Annuity Trust

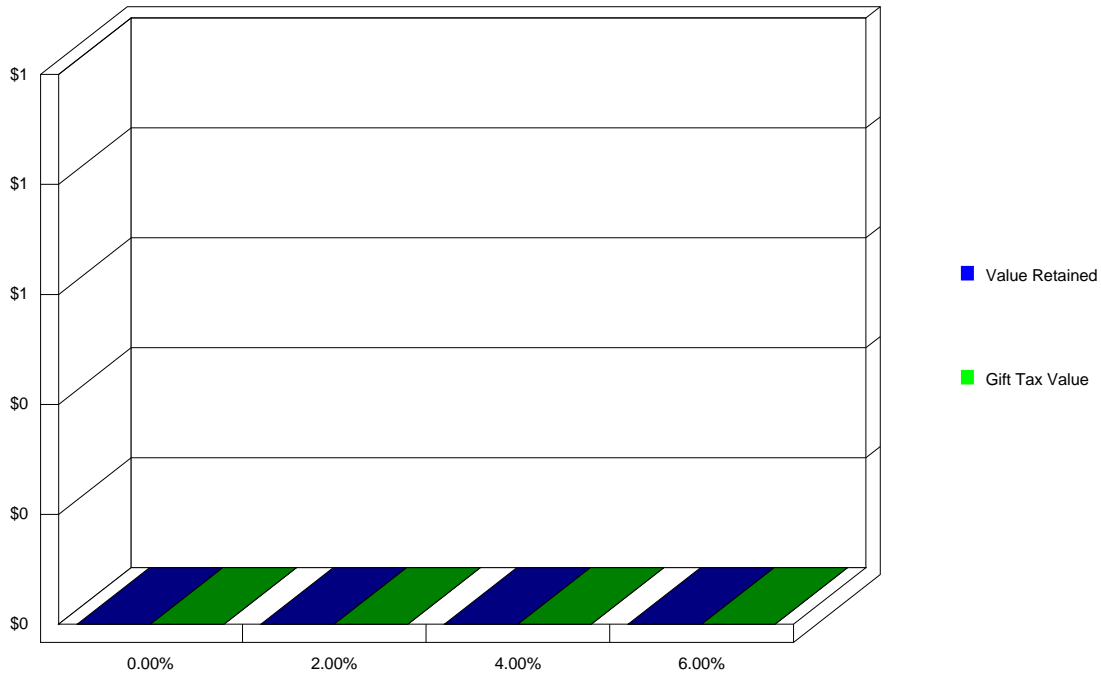
## GRAT

The GRAT may be used by an estate owner to transfer assets and future appreciation to his or her children.

**Assumptions:**

- Value of asset placed in GRAT: \$0
- Type of payment: End of year
- Term of payment: 0 years
- Federal discount rate (changes monthly): 5.80%

Annual Payment to the Grantor	First-Year Payment as a Percentage of the Asset <sup>1</sup>	Value of the Retained Annuity Interest	Gift Tax Value of the Remainder Interest
\$0	0.00%	\$0	\$0
\$0	2.00%	\$0	\$0
\$0	4.00%	\$0	\$0
\$0	6.00%	\$0	\$0

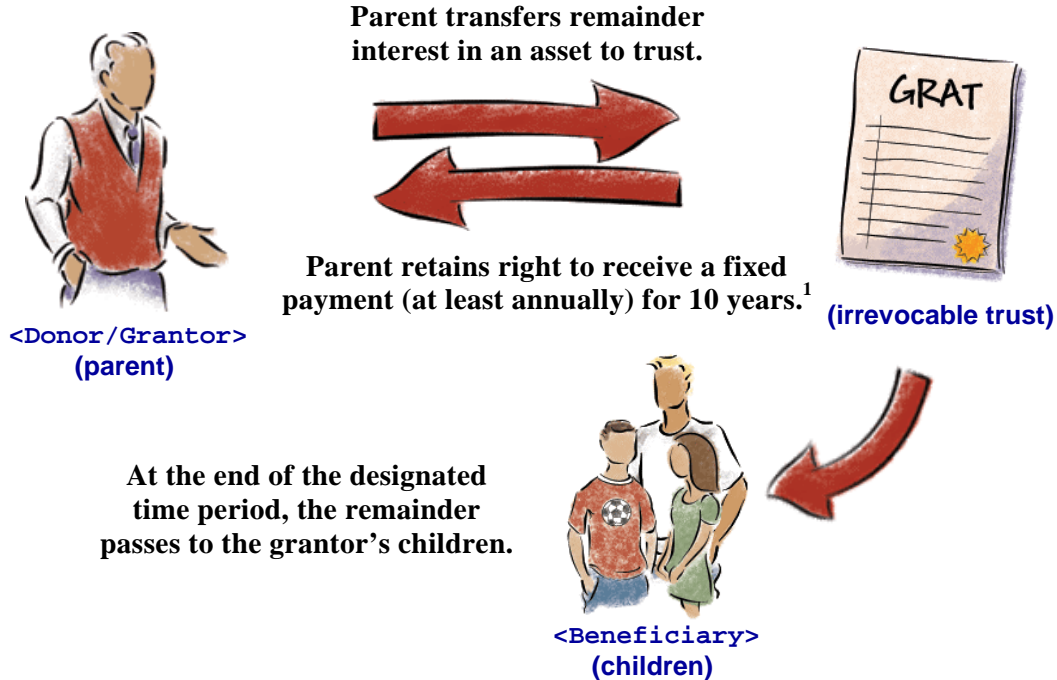


<sup>1</sup> In subsequent years the dollar amount of annual payment would remain the same but the percentage of trust assets distributed would vary.

# Grantor-Retained Annuity Trust

## GRAT

The GRAT may be used by an estate owner to transfer assets and future appreciation to his or her children.



The value of the transferred asset minus the value of the retained annuity interest will equal the value of the remainder interest that is subject to gift taxation.

### Assumptions:

- Value of asset (gift) placed in GRAT: \$500,000
- Age of grantor: 65
- Type of payment: End of year
- Term of payment: 10 years
- Federal discount rate (changes monthly): 4.0%

Annual Year-End Payment to the Grantor	First-Year Payment as a Percentage of the Asset <sup>2</sup>	Value of the Retained Annuity Interest	Gift Tax Value of the Remainder Interest
\$30,000	6%	\$243,327	\$256,673
\$40,000	8%	\$324,436	\$175,564
\$50,000	10%	\$405,545	\$94,455
\$60,000	12%	\$486,654	\$13,346

The cost of the transfer would be the gift tax on the value of the remainder interest. The gift is of a future interest and does not qualify for the annual gift tax exclusion. The gift tax on assets up to \$1,000,000 is first offset by the applicable credit amount. The tax on gifts that exceed \$1,000,000 must be paid in cash in the year the gift is made.

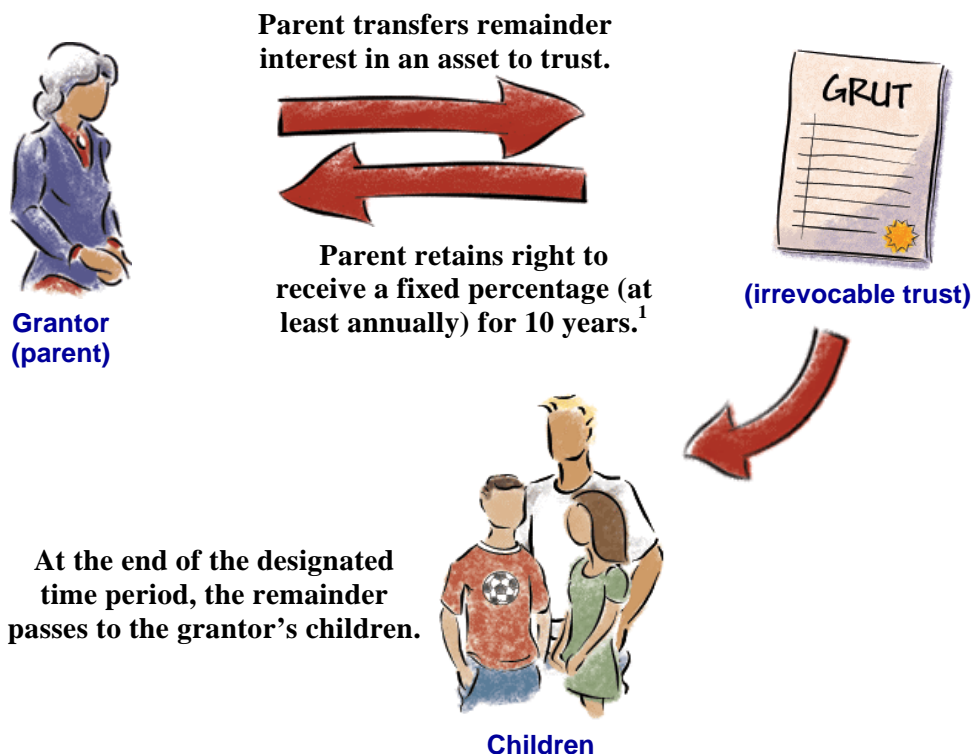
<sup>1</sup> The payment period can be for the life of the grantor, or two or more joint lives, or a set number of years.

<sup>2</sup> In subsequent years the dollar amount of annual payment would remain the same but the percentage of trust assets distributed would vary.

# Grantor-Retained Unitrust

## GRUT

An estate owner may use the GRUT to transfer assets to his or her children.



The value of the transferred asset minus the value of the retained unitrust interest will equal the value of the remainder interest that is subject to gift taxation.

For example, if the payout rate is 6%, the trustee will pay the grantor 6% of the value of the trust assets each year. If the trust assets earn more than the 6% payout, there will be a higher payment the following year.

For this reason, the GRUT is not as effective as the grantor-retained annuity trust (GRAT) in shifting asset appreciation to younger generations.

However, for persons desiring to transfer assets to children while retaining an increasing annual return of income, the GRUT should be considered.

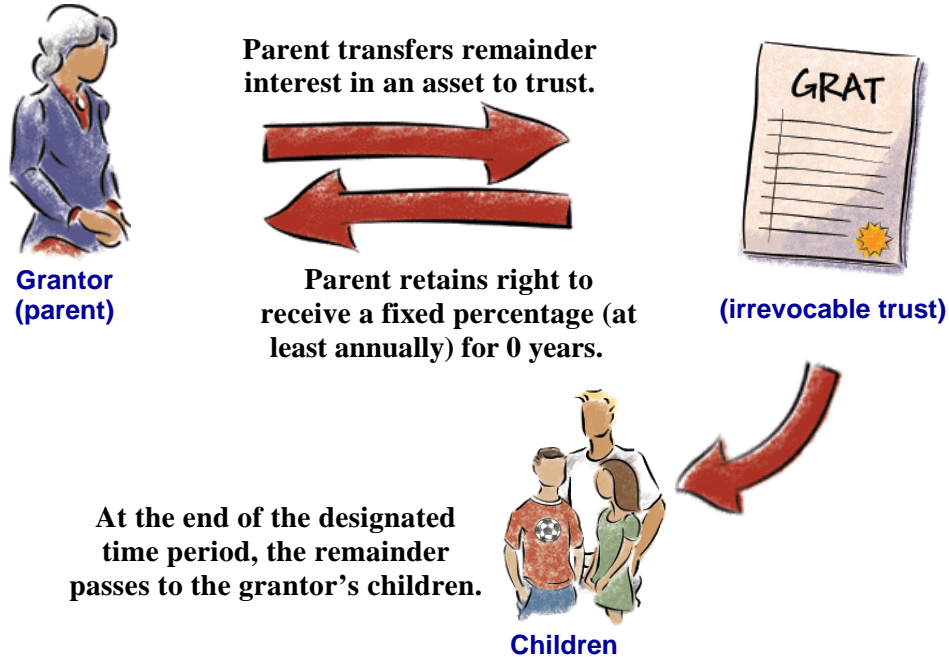
The cost of the transfer would be the gift tax on the value of the remainder interest. The gift is of a future interest and does not qualify for the annual gift tax exclusion. The gift tax on assets up to \$1,000,000 is first offset by the applicable credit amount. The tax on gifts which exceed \$1,000,000 must be paid in cash in the year the gift is made.

<sup>1</sup> The payment period can be for the life of the grantor or a set number of years.

# Grantor-Retained Unitrust

## GRUT

An estate owner may use the GRUT to transfer assets to his or her children.



The value of the transferred asset minus the value of the retained unitrust interest will equal the value of the remainder interest that is subject to gift taxation.

### Assumptions:

Value of asset placed in grantor-retained unitrust: \$0  
 Type of payment: End of year  
 Term of payment:<sup>1</sup> 0 years  
 Federal discount rate (changes monthly): 5.80%

First-Year Payment to the Grantor	First-Year Payment as a Percentage of the Asset <sup>2</sup>	Value of the Retained Interest	Gift Tax Value of the Remainder Interest
\$0	0.00%	\$0	\$0
\$0	2.00%	\$0	\$0
\$0	4.00%	\$0	\$0
\$0	6.00%	\$0	\$0

The cost of the transfer would be the gift tax on the value of the remainder interest. The gift is of a future interest and does not qualify for the annual gift tax exclusion. The gift tax on assets up to \$1,000,000 is first offset by the applicable credit amount. The tax on gifts that exceed \$1,000,000 must be paid in cash in the year the gift is made.

<sup>1</sup> Although the payment period for a GRUT can be for the life of the grantor, or a set number of years, this example assumes a set number of years.

<sup>2</sup> In subsequent years the dollar amount of annual payment would vary but the percentage of trust assets distributed would remain the same.

# Grantor-Retained Unitrust

## *GRUT*

The GRUT may be used by an estate owner to transfer assets to his or her children.

**Assumptions:**

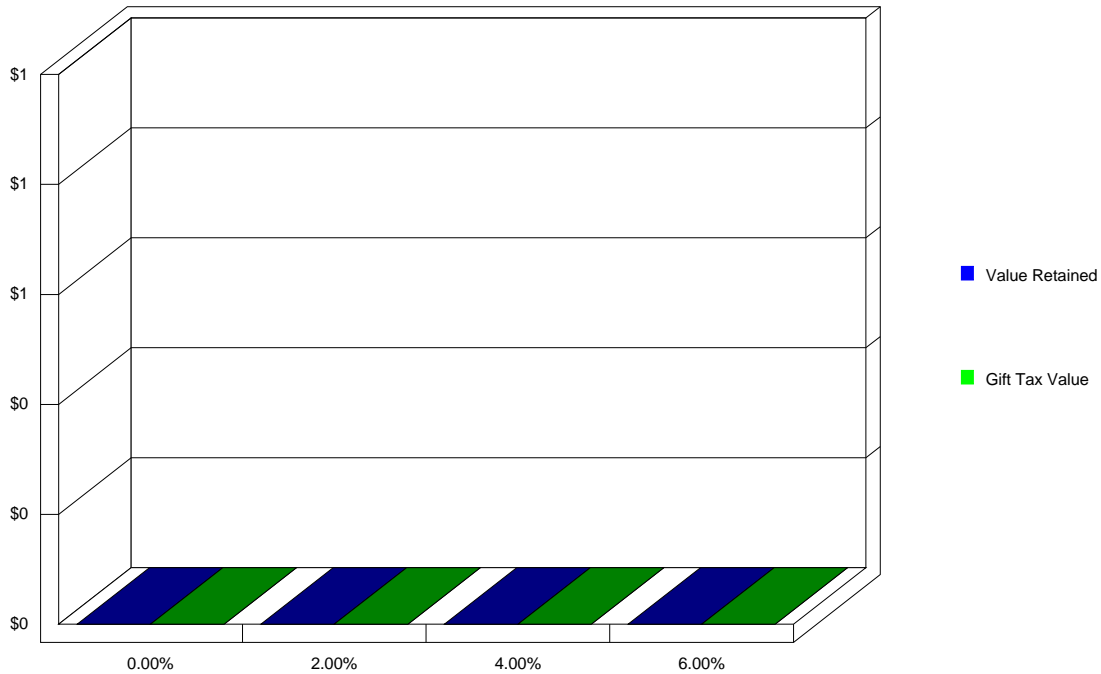
Value of asset placed in grantor-retained unitrust: \$0

Type of payment: End of year

Term of payment: 0 years

Federal discount rate (changes monthly): 5.80%

First-Year Payment to the Grantor	First-Year Payment as a Percentage of the Asset <sup>1</sup>	Value of the Retained Interest	Gift Tax Value of the Remainder Interest
\$0	0.00%	\$0	\$0
\$0	2.00%	\$0	\$0
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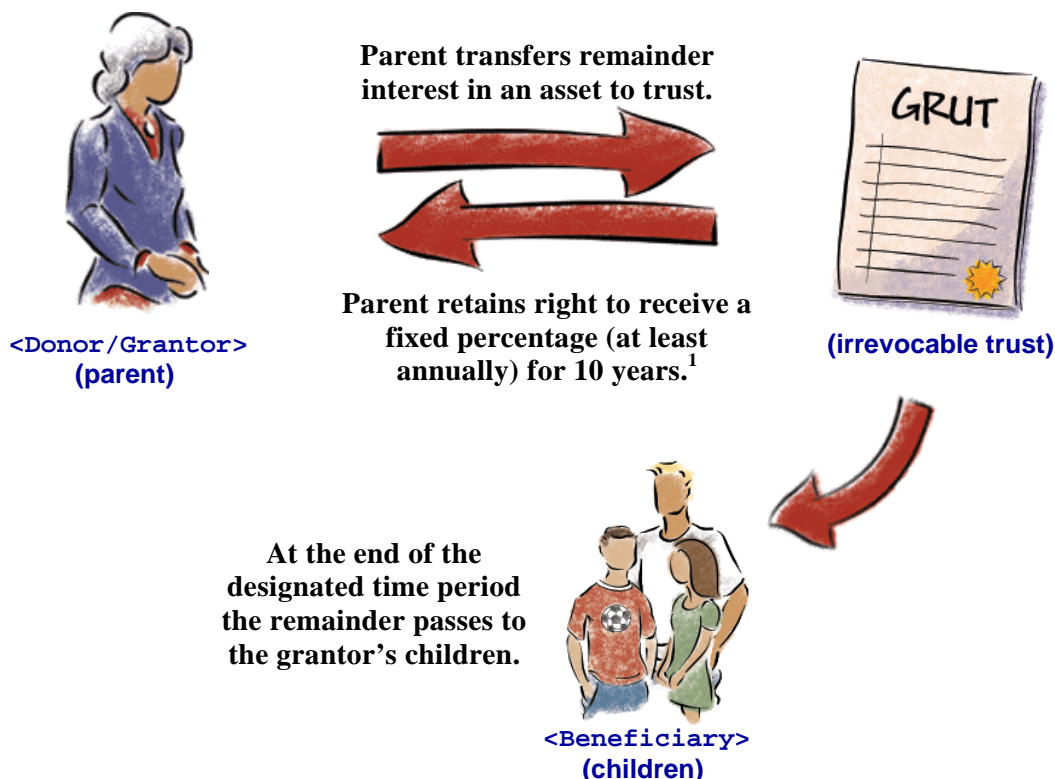


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# Grantor-Retained Unitrust

## GRUT

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<sup>1</sup> Although the payment period for a GRUT can be for the life of the grantor, or a set number of years, this example assumes a set number of years.

# Personal Residence GRIT

The GRIT is a grantor-retained income trust. This planning technique allows a person (the grantor) to transfer assets to a trust and retain the income for a number of years, after which the remaining trust assets pass to others; e.g., children, grandchildren, etc.



By retaining the rights to the income, the value of the remaining interest is reduced, along with the potential gift tax. If the grantor lives beyond the term of years selected to receive the income, the asset will be totally removed from his or her taxable estate.

Although the use of this device was limited by the Tax Act of 1990, it is still useful when used with a personal residence of the grantor.

## Qualified Personal Residence Trust

The following example illustrates the potential tax benefits of this type of trust, with a term of 10 years or the death of the grantor, should it occur earlier:

### **Assumptions:**

- Value of residence: \$500,000
- Age of grantor at beginning of trust: 65
- Term of the trust: 10 years
- Gov't. rate for valuing remainder interest: 7.4%<sup>1</sup>

Value of remainder interest	\$244,865
Probability of living 10 years	76.02%
<b>Amount of taxable gift = \$186,142</b>	

Assuming the grantor lives beyond the 10-year period, he or she will have removed a \$500,000 asset (plus its growth potential during the 10 years) from the taxable estate.<sup>2</sup>

The trust instrument should be drafted so that it is a grantor trust. This makes the trust income taxable to the grantor but also allows him or her to deduct mortgage interest and property tax payments made by the trustee.

**Note:** The grantor's applicable credit amount may be used to avoid paying a gift tax on the taxable portion.

<sup>1</sup> This rate generally changes monthly.

<sup>2</sup> If death occurs before 10 years, the value of the trust assets is includable in the grantor's gross taxable estate.

# Personal Residence GRIT

The GRIT is a grantor-retained income trust. This planning technique allows a person (the grantor) to transfer assets to a trust and retain the income for a number of years, after which the remaining trust assets pass to others; e.g., children, grandchildren, etc.



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Although the use of this device was limited by the Tax Act of 1990, it is still useful when used with a personal residence of the grantor.

## Qualified Personal Residence Trust

The following example illustrates the potential tax benefits of this type of trust, with a term of 0 years or the death of the grantor, should it occur earlier.

### **Assumptions:**

Value of residence: \$0  
Age of grantor at beginning of trust: 0  
Term of the trust:<sup>1</sup> 0 years  
Federal discount rate:<sup>2</sup> 5.80%

Value of remainder interest	\$0
Probability of living 0 years	100.00%
<b>Amount of taxable gift: \$0</b>	

Assuming the grantor lives beyond the 0 -year period, he or she will have removed a \$0 asset (plus its growth potential during the 0 years) from the taxable estate.

The trust instrument should be drafted so that it is a grantor trust. This makes the trust income taxable to the grantor but also allows him or her to deduct mortgage interest and property tax payments made by the trustee.

**Note:** The grantor's applicable credit amount may be used to avoid paying a gift tax on the taxable portion.

<sup>1</sup> If death occurs before 0 years, the value of the trust assets is includable in the grantor's gross taxable estate. Under the Tax Act of 2001, the federal estate tax is gradually phased out until its final repeal in the year 2010. If Congress does not act at that time to repeal it for the years following, it will automatically revert back to the rates in effect during the year 2001, with an exemption for the first \$1,000,000 of assets.

<sup>2</sup> This rate generally changes monthly.

# Personal Residence GRIT

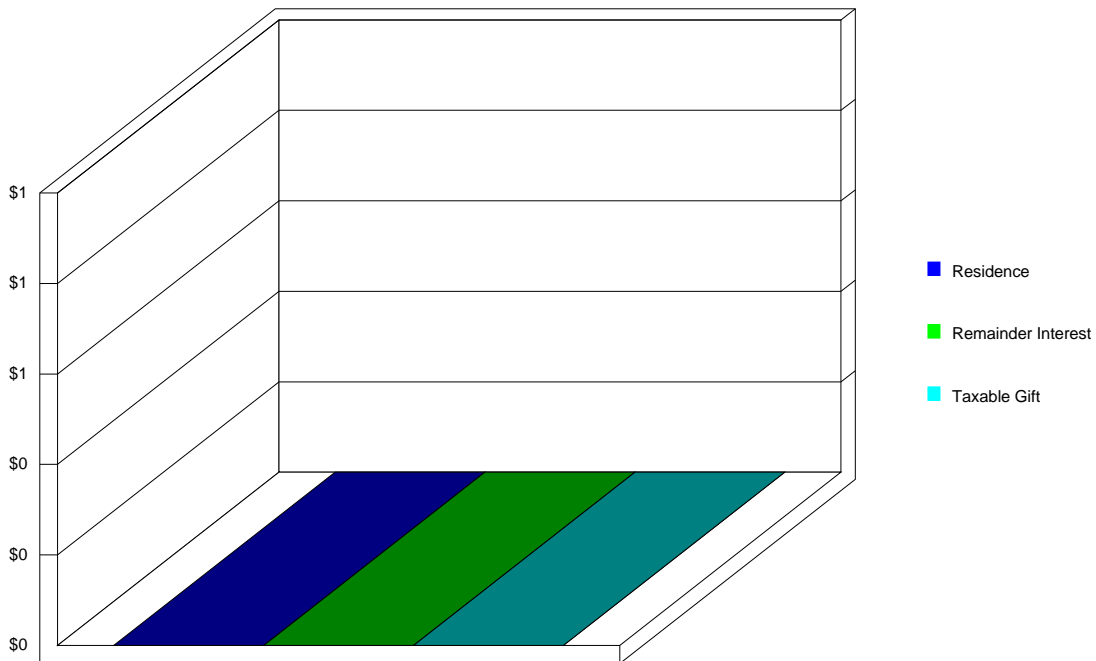
The following example illustrates the potential tax benefits of this type of trust, with a term of 0 years or the death of the grantor, should it occur earlier.

**Assumptions:**

- Value of residence: \$0
- Age of grantor at beginning of trust: 0
- Term of the trust:<sup>1</sup> 0 years
- Federal discount rate:<sup>2</sup> 5.80%

Value of remainder interest	\$0
Probability of living 0 years	100.00%
<b>Amount of taxable gift: \$0</b>	

Assuming the grantor lives beyond the 0 -year period, he or she will have removed a \$0 asset (plus its growth potential during the 0 years) from the taxable estate.



<sup>1</sup> If death occurs before 0 years, the value of the trust assets is includable in the gross taxable estate of the grantor. Under the Tax Act of 2001, the federal estate tax is gradually phased out until its final repeal in the year 2010. If Congress does not act at that time to repeal it for the years following, it will automatically revert back to the rates in effect during the year 2001, with an exemption for the first \$1,000,000 of assets.

<sup>2</sup> This rate generally changes monthly.