

# *the* Estate PLANNER

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# Roll with it

## Keep wealth in the family using rolling GRATs

A grantor retained annuity trust (GRAT) can be a powerful tool for transferring wealth to family members with minimal gift and estate tax consequences. But GRATs also have some disadvantages.

Perhaps the most significant drawback is the “mortality risk.” Generally, the longer a GRAT’s term, the better it performs. But if you, as the grantor, fail to survive the term, the GRAT’s benefits are lost. Thus, designing a GRAT involves striking a balance between maximizing performance and minimizing mortality risk. One technique that may offer the best of both worlds (maximizing the GRAT’s term while minimizing the risk of dying during its term) is the use of rolling GRATs.

### How a GRAT works

To take advantage of a GRAT’s benefits, you make a one-time contribution of assets to an irrevocable trust. In return for your contribution, the trust pays you an annuity for a specified term, and at the term’s end, any remaining assets are transferred tax-free to the trust’s beneficiaries. The annuity payments are either a fixed percentage of your initial contribution’s value or a fixed percentage of the trust’s assets recalculated on a periodic — generally annual — basis. A GRAT is considered

a “grantor trust,” so you pay any income taxes on the trust’s earnings.

A GRAT can reduce your estate tax exposure because the assets you contribute are removed from your estate — as long as you outlive the trust’s term. When you create a GRAT, however, you make a taxable gift to the trust’s beneficiaries equal to the present value of their remainder interest. The amount of the gift is calculated by subtracting the present value of your annuity payments from the value of the assets you transfer to the trust.

**A GRAT avoids estate taxes because the assets you contribute are removed from your estate — so long as you outlive the trust.**

Increasing the GRAT’s term and the size of the annual payments increases your annuity’s present value and, therefore, decreases the size of the taxable gift. If you set the term long enough and the annuity payments large enough, the gift disappears altogether (a so-called zeroed-out GRAT).

### GRATifying results

Now here’s the secret to taking advantage of a GRAT: Your annuity’s present value for tax purposes is based on an assumed rate of return — the Section 7520 rate — published monthly by the IRS. The applicable rate is the Sec. 7520 rate in effect during the month you create your GRAT. If you design the GRAT so the present value of your annuity payments is equal to the value of the assets you contribute to the trust, the present value of the remainder interest is zero. Therefore, there’s no taxable gift, but any appreciation of the GRAT assets *above* the Sec. 7520 rate passes to your beneficiaries gift-tax free.



## Rolling GRATs in a volatile market

Rolling GRATs can be effective because of their ability to capture the upside of a volatile market. To illustrate this concept, consider the period from 1965 to 1974. The S&P 500's compound return for that 10-year period was about 1.2%. And though the IRS didn't establish the Sec. 7520 rate until 1989, analysts have estimated that the hurdle rate at the beginning of 1965, based on IRS methodology, would have been 5.2%.

According to a 2005 study by Bernstein Investment Research and Management, if you'd created a 10-year GRAT in 1965 funded with \$5 million and invested in a diversified portfolio of U.S. equity securities, at the end of the term nothing would have been transferred to your beneficiaries.

If, on the other hand, you'd used that \$5 million to create a series of two-year rolling GRATs, about \$1.5 million would have been transferred to your beneficiaries gift-tax free. Why? Because, despite the stock market's dismal overall performance between 1965 and 1974, there were a couple of very good years. Although most of the two-year GRATs would have failed — that is, not transferred wealth to your beneficiaries — strong performance by the GRATs established in 1967 and 1971 would have been enough to produce a windfall transfer.

So, the key to a successful GRAT is for the trust assets to generate returns that exceed the assumed rate of return. The Sec. 7520 rate often is referred to as the “hurdle rate,” because your GRAT's growth rate (appreciation and earnings) must top that rate to pay off. This is one reason longer-term GRATs tend to perform better. Historically, longer-term investments have yielded higher average returns: the longer your GRAT's term, the greater your chances of clearing the hurdle rate. GRATs also typically do well in a low-interest-rate environment because you can lock in a low hurdle rate, increasing your chances of success.

### GRATs on a roll

As interest rates continue to increase, GRATs become riskier. After dropping to a historical low of 3% in July 2003, the Sec. 7520 rate has inched back up to the 5% to 6% range. Although you can improve your chances of outperforming the hurdle rate by choosing a long trust term, this increases your mortality risk.

Rolling GRATs are an alternative to traditional GRATs that may allow you to enhance performance without increasing the mortality risk. The technique involves creating a series of short-term GRATs (typically two or three years) with each successive GRAT funded by annuity payments from the previous ones. By using short trust terms, you can minimize the mortality risk. But over the longer term, rolling GRATs stand a good chance

of successfully transferring wealth, and in many cases outperform single, longer-term GRATs.

### Improving your odds

With a single, longer-term GRAT, poor market performance in the early years can make it difficult for the trust to recover. Rolling GRATs, on the other hand, thrive on volatility. And unlike the success of a single, longer-term GRAT, which usually performs better when interest rates are low at inception, the success of a series of rolling GRATs is less dependent on a lower initial interest rate.

Rolling GRATs offer other advantages as well. They may allow you to transfer wealth to your beneficiaries sooner. And you can stop creating GRATs if your assets' growth rates drop too low, you feel you've transferred enough wealth or you need the income from the trust assets.

### Rolling out a strategy

Like most investments, rolling GRATs offer no guarantees of success. But under the right circumstances, they can greatly improve your chances. And remember, when a GRAT “fails” — either because you don't outlive the trust or because the trust doesn't outperform the hurdle rate — the money isn't lost. It simply goes back into your estate and you're no worse off than if you hadn't created the GRAT in the first place. ■

# Administrative checklist for after a family member passes away

When a loved one dies, business and legal matters likely will be the furthest thing from your mind, and rightly so. Your first priority should be to take care of yourself and your family, and to make any necessary funeral arrangements. In most cases, there's no reason to worry about business and legal matters before the memorial service.

After the funeral and an appropriate grieving period, you'll need to attend to important administrative matters. Here's a checklist to help you get started:

- Locate your loved one's will or living trust, and other important legal papers. Places to look for estate planning documents include safe deposit boxes, safes or strong boxes, or filing cabinets. In addition to a will or living trust, attempt to locate:
  - Life and other insurance policies,
  - Bank records,
  - Retirement plan and other employee benefit documents,
  - Deeds and other real estate documents,
  - Automobile registrations,
  - Income tax returns, W-2 forms and other tax records,
  - Notes receivable and payable,
  - Marriage certificate, and
  - Birth certificates for all family members.
- Contact the lawyer who drafted your loved one's will or living trust and make an appointment. If he or she can't be identified or the decedent didn't have one, the personal representative named in the will or the trustee of the living trust should retain a lawyer.
- If assets pass under a will, the decedent's personal representative should consult legal counsel about initiating probate proceedings. If you're named as the personal representative, remember that you have no authority to act on behalf of the estate until a court accepts the will as valid and appoints you to act in that capacity. If your loved one died without a will, consult legal counsel about steps you should take to initiate court administration of the estate.
- If the decedent had a living trust, the trustee can begin managing his or her affairs immediately, without the need for court proceedings.
- Conduct an inventory of your loved one's assets and liabilities, paying particular attention to assets that may require immediate attention, such as life insurance policies, stock options and retirement plans. If probate is required, be sure your lawyer moves quickly so the court can address the disposition of stock options and other time-sensitive assets. Don't pay any outstanding bills until you've inventoried all of the decedent's assets and debts and compiled a complete list of his or her creditors.
- Contact the decedent's employer or business associates to get information about:
  - Group life, accidental death or disability insurance,
  - Contributions to pension funds or other retirement plans,
  - Accrued vacation and sick pay,



- Unpaid commissions, and
  - Health insurance covering you or other dependents.
- If the decedent was a business owner, determine the obligations of the trustee or personal representative to continue the business's operations. Consult legal counsel to review any succession planning documents prepared by the business and arrange for a qualified appraisal if necessary.
- Contact the decedent's insurance agent to file a life insurance claim. You'll need to furnish the following to the life insurance company:
- Death certificate,
  - Insurance policy numbers and amounts,
  - Decedent's full name, address, and date and place of birth,
  - Decedent's occupation and last place of employment, and
  - Claimant's name, address, age and Social Security number.

- Contact your local Social Security office to apply for spousal and dependent benefits. You'll need to furnish the following:
- Certified copy of death certificate,
  - Decedent's Social Security number, proof of age and marriage certificate,
  - Decedent's employer information, approximate earnings in the year of death and earnings records for the previous year, and
  - Social Security numbers and proof of age for the deceased's spouse and dependents.

Keep in mind that this list is by no means exhaustive, but it gives you an idea of the financial and legal steps you'll need to take when a family member dies. Losing a loved one is extremely stressful, but you can ease some of the strain by organizing the documents you'll need well in advance and consulting experienced advisors to guide you. ■

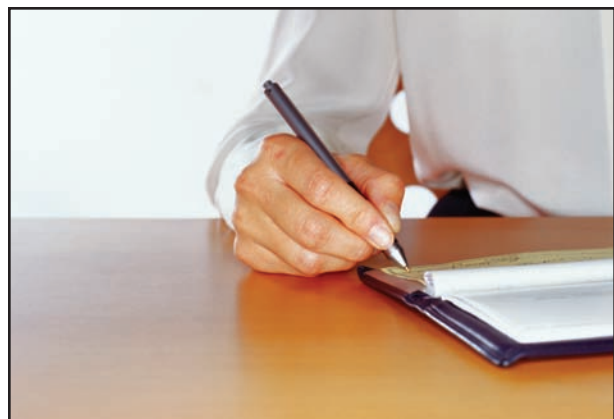
## Tips for tax-wise charitable giving

For many people, estate planning isn't just about reducing taxes and providing for their loved ones. You also may want to share your estate with one or more of your favorite charities. Charitable giving can satisfy several important goals, including leaving a legacy and instilling a sense of social responsibility in your heirs.

As you ponder your philanthropic strategies, saving taxes may not be your biggest priority. But it makes sense to consider the tax implications of various approaches to charitable giving.

### **Souping up lifetime charitable donations**

Tax planning allows you to benefit the organizations you care about at a lower cost to you and



your family. It also may enable you to leverage your charitable dollars by providing greater benefits to charity without increasing your cost.

Say, for example, you're in the 35% tax bracket and plan to donate \$100,000 to your favorite

charity. If you donate cash, the “cost” of your gift is \$65,000 — \$100,000 less the tax-savings you would enjoy by taking a \$100,000 deduction on your income tax return (assuming your write-off isn’t reduced by charitable deduction limitations).

Suppose, instead, you donate \$100,000 worth of publicly traded stock you bought five years ago for \$50,000. In this case, the cost of your gift is \$57,500 because, in addition to getting the income tax deduction, you avoid the 15% capital gains tax on the stock’s \$50,000 in appreciation. The charity still receives the full \$100,000 value, but, by donating stock instead of cash, you save an additional \$7,500.

### Tax-smart charitable bequests

It’s not unusual for people to name charities in their wills, either by making outright bequests to charitable organizations or by contributing assets to a charitable trust. One of the benefits of making charitable gifts at death is that your estate can claim a charitable deduction for estate tax purposes.

But what if the value of your estate is within the federal estate tax exemption (currently, \$2 million) so that you have no federal estate tax liability? In that case, you may be better off leaving the money to your kids and asking them to make the donation. These lifetime gifts may qualify for income and gift tax deductions.



Let’s suppose Allen wants to share \$100,000 of his \$2 million estate with a charity. If he names the charity in his will, he won’t generate any estate tax savings, because he has no

estate tax liability (assuming the exemption is still \$2 million or more when he dies). Now, suppose Allen leaves the \$100,000 outright to his daughter, who’s in the 33% income tax bracket, and asks her to donate the money to the charity. By making the donation and taking a charitable deduction, Allen’s daughter enjoys \$33,000 in income tax savings.

This strategy allows Allen to make the same gift to charity, but also provides a significant benefit to his daughter. Bear in mind that his daughter has no legal obligation to carry out his request, but a donor’s wishes typically are respected.

### Potential state tax savings

The examples above show just a few of the many ways that tax planning can help you achieve your charitable giving goals in a cost-efficient manner. It’s also important to consider the potential impact of state income and death tax savings on your planning, because lifetime gifts reduce the value of your estate. ■

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## Too much information?

Consider disclosure rules when designing trusts

Trusts are an integral part of many estate plans, and often there are advantages to keeping the trust’s terms — or even its existence — confidential. Why? Perhaps your beneficiary is immature or reckless. Or you may be concerned that knowledge of the trust would cause your beneficiary to become dependent on it and fail to pursue his or her own ambitions.

There are many legitimate reasons for keeping a trust quiet. But in many cases, state law interferes with this goal by requiring a trustee to disclose information about the trust to its beneficiaries.

### ABCs of UTC

The Uniform Trust Code (UTC), which has been adopted in many states, requires the trustee of certain trusts to disclose detailed information about

a trust to any “qualified beneficiary” who requests it. Qualified beneficiaries include not only those who may receive a distribution under the trust (your children, for example), but also those who might benefit if a “first-in-line” beneficiary’s interest terminates (your grandchildren, for example).

The UTC also requires you to notify each qualified beneficiary of his or her rights to information, making it nearly impossible to keep the trust a secret from your beneficiaries.

The purpose of the UTC’s disclosure provisions is to help avoid fraud or mismanagement on the part of trustees by allowing beneficiaries to monitor the trust’s financial activities and performance. Some states that have adopted the UTC allow you to waive the trustee’s duty to disclose. Others allow you to name one or more third parties to receive required disclosures and protect the beneficiaries’ interests.

### **An alternative strategy**

If applicable law doesn’t provide a mechanism for avoiding disclosure to your child or other beneficiary, an alternative strategy is to grant your spouse or someone else a power of appointment over the trust. The person who holds the power of appointment can then redirect trust assets to your child if needed.

This solves the disclosure problem, because you don’t have to name your child as a trust beneficiary. The primary disadvantage of this approach is that the power holder has no legal obligation to honor your intentions.

### **Put your trust in trusts**

Trusts are commonplace in estate plans. Before you create a trust or if you’re concerned about the confidentiality of your trusts, be sure to consider the law in your state. ■

## **Estate planning red flag**

### **Newly acquired property isn’t titled to your living trust**

A living trust is one of the most flexible, effective estate planning tools available. It contains instructions for managing and distributing your assets in the event you become incapacitated and when you die. It also avoids probate — an expensive, time-consuming and very public court proceeding.

A will also is an essential estate planning document, but a will by itself won’t avoid probate and functions only after your death; it won’t provide for the management of your assets if you become incapacitated. Assuming no incapacity, a living trust gives you complete control over your assets during your lifetime. You can revoke the trust or dispose of the assets in any manner you wish.

For an asset to be covered by your living trust, it’s important to change the asset’s title from your name to the name of the trust. Any assets titled in your name (unless governed by a beneficiary designation) will be subject to court-appointed guardianship if you become incapacitated and to probate at your death.

Ordinarily, this doesn’t present a problem when you first set up your living trust — your attorney will remind you to change the title of your home, life insurance policies, retirement plans and other assets. But once your living trust is signed, it’s easy to forget to change the title of property you acquire later.

If you don’t know whether all of your assets are properly titled in your living trust’s name, consult your estate planning advisors to discuss. If all your assets aren’t properly titled, the living trust may not serve its purpose.