



Trusts & Estates

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Grantor Trusts

CASE SUMMARY

This article examines establishing grantor trusts to reduce the taxable estate.

This article focuses on the use of GRATS in conjunction with the use of tax-free gifts to reduce the taxable estate.

A grantor trust is established by the grantor irrevocably transferring property to a trust during his or her lifetime while retaining an interest for a number of years with the remainder to the beneficiary. The remainder interest to the beneficiary is subject to gift tax and its value is ascertained per the tables provided by Internal Revenue Code Section 7520.

There are three types of grantor trusts. Grantor retained annuity trusts (GRATS), grantor retained unitrusts (GRUTS), and grantor retained income trusts (GRITs). This article focuses on the use of GRATS in conjunction with the use of tax-free gifts to reduce the taxable estate. A GRAT is an irrevocable trust created by the grantor for a specified time period. The grantor pays the gift tax on the value of the remainder interest when the trust is established. The assets are deposited into the trust and an annuity payment is made each year to the grantor. When the trust

expires the beneficiary receives the remaining assets tax-free.

A wealthy individual or couple should first determine the amount of money they will require to comfortably support their lifestyle until their death. The assets that exceed this amount can be transferred during life to the later generations to avoid estate taxes upon their death. A wealthy individual can make annual exclusion gifts in the amount of \$12,000.00 per recipient for the year 2009 and can gift up to \$1,000,000.00 using his or her lifetime gift tax exclusion with no gift tax payment. A married couple can make annual gifts of \$24,000.00 per recipient and gift up to \$2,000,000.00 using their combined lifetime gift tax exclusions with no

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gift tax payment.

The benefit of these tax free gifts can be greatly increased by making the gifts to a grantor trust rather than directly to the individual. The



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income produced by the grantor trust will be taxable to the grantor while the assets of the grantor trust will not be included in the grantor's gross estate. The grantor is responsible for paying the income tax on the income of the grantor trust so the payment of this tax is not included in the amount of the gift. By paying the income tax on the grantor trust income, the grantor further reduces the value of his or her estate. This allows the assets in the grantor trust to increase in value without the beneficiaries having to pay any tax on the income.

The \$12,000.00 annual exclusion and \$1,000,000.00 lifetime gift tax exclusion can allow the grantor to transfer a surprisingly large amount of money out of his or her estate through grantor trusts. By making the annual exclusion gift to a single grantor trust annually for twenty years, it is estimated that the grantor will transfer more than \$400,000.00 in inflation adjusted dollars. A grantor will transfer an estimated \$3,000,000.00 over twenty years by transferring the \$1,000,000.00 lifetime gift tax exclusion to a grantor trust. These amounts can be greatly increased by creating separate grantor trusts for the grantor's children and the children's spouses, and for each grandchild. A dynasty trust for the grantor's descendants can also be created to transfer additional wealth from the grantor's estate.

The above strategy can be applied to reduce the taxable estate of moderately wealthy individuals but for extremely wealthy individuals

another dimension may be added to increase the amount of wealth transferred from the grantor's estate. The additional dimension is to use a series of rolling GRATs. A rolling GRAT works by the grantor applying the annuity he or she receives from a GRAT and using it to establish a new GRAT. The use of a rolling GRAT system maintains all the assets the grantor is attempting to transfer out of his or her estate in the GRAT transfer. The use of simply a single GRAT will result in the annuity payments paid out of the GRAT being brought back into the grantor's estate. A system of short term rolling GRATs also protects against the chance of a good investment year being offset by a poor investment year because rolling GRATs are usually of short duration.

A system of rolling GRATs can transfer substantial assets from very wealthy estates and leave the grantors with the amount of capital they calculate necessary to live out the remainder of their lives at the lifestyle they choose. Rolling GRATs are of short duration, as short as two years, so they offer the grantor the ability to adjust the flow of assets out of his or her estate at a rate comfortable to the grantor even in volatile markets. The grantor can cease creating new GRATs and stop making annual gifts in order to reduce the flow of assets out of his or her estate.

A wealthy individual or couple can reduce their taxable estate by transferring assets during their

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lifetime to their beneficiaries using the annual gift tax exclusion and lifetime gift tax exclusion. This transfer process is made more effective by transferring the assets to GRATS rather than directly to the individual because this allows for the beneficiaries to receive the income of the transferred assets tax-free as the grantor is responsible for payment of the income tax. The system of rolling GRATS can be used to increase the scale of transfer resulting from the use of gifts combined with conventional GRATS where the amount of wealth to be transferred is substantial or must be accomplished in a short time period.