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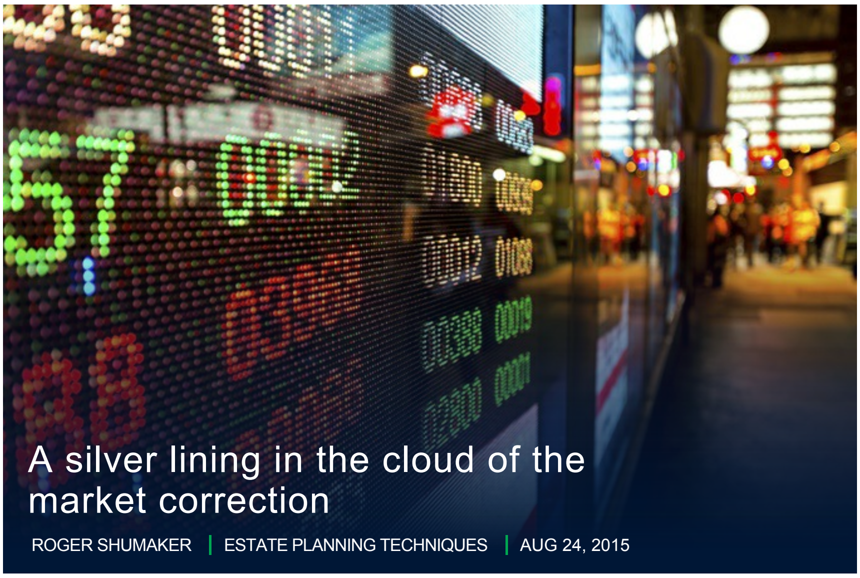

A silver lining in the cloud of the market correction

ROGER SHUMAKER | ESTATE PLANNING TECHNIQUES | AUG 24, 2015

From an estate planning viewpoint, the current drop in security values offers two opportunities – funding a Grantor Retained Annuity Trust (GRAT) and funding a Charitable Lead Annuity Trust (CLAT). The success of these types of trusts is dependent on realizing investment returns in excess of the IRS issued valuation rate that changes every month. This opportunity is enhanced by the likely rebound of investment values over the term of the trust. If a client is pessimistic, i.e., bearish, about the increase of security values from their current levels, then this strategy may not make sense. Let me explain.

GRANTOR RETAINED ANNUITY TRUST (GRAT)

A GRAT involves establishing a trust for a term of at least two years during which the trustee will pay a sizable annuity to the grantor (the person who creates the trust) based on an assumed rate of return of 2.2 percent so that the annuity nearly equals the value of the property transferred. This results in the gift being worth zero or nearly zero. If the property transferred (securities or cash to be invested in securities) realizes a return greater than 2.2 percent, the value that is left will be greater than zero and will typically be distributed to family members of the grantor with no gift tax due or gift tax exemption used.

For example, a two-year GRAT would pay 51.6555 percent of the value transferred to the GRAT as an annuity at the end of the first year and again at the end of the second year. Suppose the amount transferred was $1,000,000 that realizes a return of $100,000 over the two-year term. After paying out the two annuities totaling $1,033,110, the net remaining value would be $65,890 ($100,000 of “gain” less $33,110 paid to the Grantor along with the $1,000,000 initial contribution). This may not seem like much, but consider the potential for greater returns or the multiplier effect of increasing the amount of the initial transfer to the GRAT.

The worst case scenario is that the property doesn’t return more than assumed rate and the family members get nothing. The Grantor still has his value (at about what it would have been if he had held on to it instead of transferring it to the GRAT), but is only out the cost of setting up and administering the GRAT, probably less than $5,000. The Grantor will pay the income tax on the income produced by the GRAT's assets during the term. The Grantor’s payment of the income tax allows the GRAT’s assets to appreciate without being reduced by taxes and operates just like a non-taxable gift accruing to the benefit of the family members.

CHARITABLE LEAD ANNUITY TRUST (CLAT)

A CLAT is the same as a GRAT with typically a longer period of time with the same investment principle – investing for a greater return, but the distinguishing characteristic of the CLAT is the payment of the annuity to one or more qualified charities; the beneficiaries of what is left at the end of the CLAT term passes to family members. With a CLAT for a longer term, the annuity payments are smaller, but often exceed income earned; however, the same principle applies – realizing a return over the term that exceeds the valuation rate results in a non-taxable gift to the family members. The Grantor can be the income tax payer, which provides a current income tax deduction but does not have to. If the trust is the income tax payer the ultimate success will be less than if the Grantor pays the tax.

There are several considerations in designing a GRAT or a CLAT, including the risk of the Grantor’s death during the term of the trust. But the key in this period of lower stock market values is trying to capture appreciation on the market rebound that is greater than market returns in normal circumstances.

ROGER SHUMAKER

With 40+ years of estate planning experience, I provide peace of mind by helping you design and implement an estate plan that will address your circumstances and objectives.

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