How to quadruple your estate tax exemption value

Estate-Plan Edge
By CURT FERGUSON

Key Points

- The election is over, but the estate tax looms.
- Special trusts allow you to leverage your tax exemption.
- Advanced planning techniques require time, so get started.

THE election is behind us. Some seem to believe Congress will act to assure the estate tax will not be coming back with the previously expected vengeance — 45% to 55% rate on all estates worth more than $1 million — but its ultimate fate lies in the hands of the president.

Under any scenario, no one seems to believe the tax is going away completely. The real question is, "How high will the exemption be?" We hope to find out soon.

Let's look at a tax planning idea that can help anyone whose estate is over the exemption amount — whatever that amount turns out to be. It is called a Grantor Retained Annuity Trust, or GRAT.

Irrevocable 'split interest' trust

A GRAT is an irrevocable trust. Irrevocable sounds bad, because people think it means set in stone. But irrevocable trusts can be very flexible, and if you have appointed a trustee whom you really trust, that person can have a lot of flexibility in how the trust is managed.

A GRAT is a "split interest" trust. This means it provides benefits to someone for a while, and then it benefits someone else. You are the beneficiary with specified benefits for a period of time, and your children become the beneficiaries after that time is up.

Let's consider the actual name:

Grantor. That is you, the person who creates and funds the trust. By funding it, you grant assets to the trust.

Retained. You retain (i.e., reserve to yourself for your own benefit) certain interests or benefits from the trust.

Annuity. That is a formal word for a specified stream of payments from the trust.

So a GRAT is a trust in which the person who creates and funds it retains a specified stream of payments for a period of years. It is considered a gift to your children at the time you set it up, even though their benefits are delayed. A GRAT is a good way to leverage your limited ability to pass assets on to your children free of estate tax.

What to put in the GRAT

Your next question is probably "What assets should I put in the GRAT?" If possible, you should select assets that might be discounted in value from what you think the underlying or near-future value will be. It could be an interest in real estate where you share ownership.

For example, an undivided 50% ownership of 100 acres worth $5,000 per acre is going to be worth 10% to 15% less than full ownership of 250 acres. In other words, the discounted value of what you own would be about $1.1 million.

Probably the ideal asset to place in a GRAT would be ownership of a limited liability company that owns some ground and some cash. Properly structured, such an LLC would be worth — for our transfer purposes — 35% to 50% less than the assets it holds.

How it works

Here is an example of how a GRAT works: You and your son each own half of an LLC. The LLC owns $3 million in land and $1 million in cash or securities. Instead of $2 million, if the value is discounted 40%, your half would be worth $1.2 million. The land and investments are making 4% per year income, and the land is appreciating at 4%. You create a GRAT and contribute your half of the LLC.

The GRAT says you will receive a payment of $108,000 per year for eight years. Based on Internal Revenue Service rules and current interest rates, you just gave $409,000 to your son. Upon death, your estate tax exemption is reduced by that amount.

The trustee uses what had been your half of the LLC income ($80,000 per year) plus about $30,000 per year from the investments to make the annual payments to you. After the eight years, your son receives what is left. Your half of the LLC real estate alone, having appreciated 4% per year, is now worth more than $2.05 million, and your "half" of the LLC cash is still more than $200,000. So your son is receiving roughly $2.25 million.

The net result? You had to report to the IRS a gift of $409,000 (and you used up that much of your death tax exemption), but your son receives more than four times that much family wealth.

A tax reduction tool such as a GRAT requires time to work. You can't put it off. If your estate is larger than whatever estate tax exemption we still have next year, get started making leveraged gifts so you can beat the IRS!

Ask the expert

Curt Ferguson is an attorney from Salem who helps families accomplish estate-planning goals. Go online to www.ticplanning.com to learn more.