



Life Insurance: Your Blueprint for Wealth Transfer Planning

Grantor Retained Annuity Trust Producer Guide

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Grantor Retained Annuity Trust

The Grantor Retained Annuity Trust (“GRAT”) is a flexible planning tool which can be used by wealthy clients to:

- Reduce estate and gift taxes through an estate “freeze”.
- Reduce gift taxes that could be incurred when funding an irrevocable life insurance trust (ILIT). Or,
- As an “exit strategy” for other estate planning techniques such as premium financing or private split-dollar.

What is a GRAT?

A GRAT is a wealth transfer technique where an individual (the Grantor) transfers assets to an irrevocable trust (the GRAT) in exchange for a stream of payments (an annuity) and designates remainder beneficiaries who will receive any assets left over in the trust at the end of the annuity term. In essence, a transfer to a GRAT is like a sale, only the payments for the property are characterized as an annuity that lasts for a term of years rather than as payments of principal and interest. The tax treatment of the transfer to a GRAT depends on the value of the annuity payments retained by the Grantor.

When Does a GRAT Make Sense?

The GRAT technique is especially appropriate for high net-worth clients (individuals with \$3 million or more in assets or married couples with \$5 million) who:

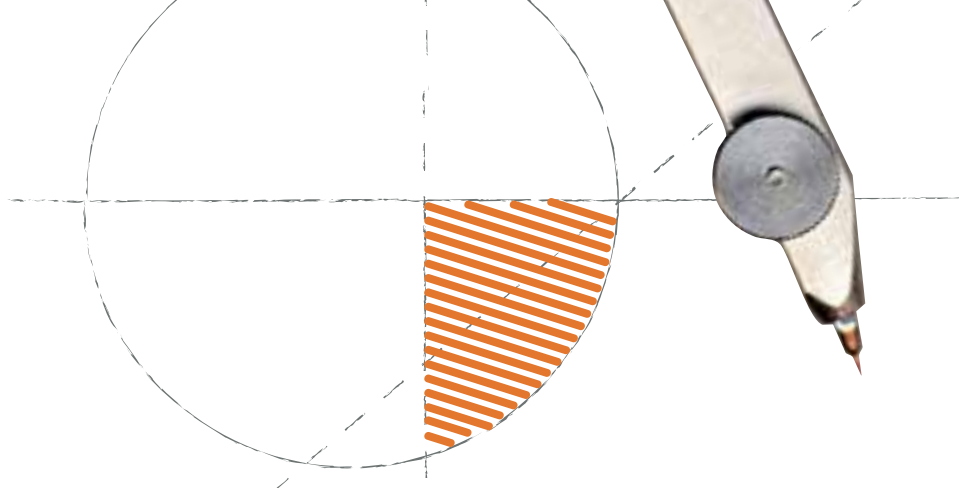
- Have highly appreciating assets (such as closely-held stock or real estate).
- Are funding life insurance that requires premiums which exceed the amounts available for annual gifting. Or,
- Are involved in or is considering premium financing, split-dollar, private split-dollar, or similar financing techniques and they want to reduce the level of risk by having an “exit strategy.”

Grantor Retained Annuity Trust

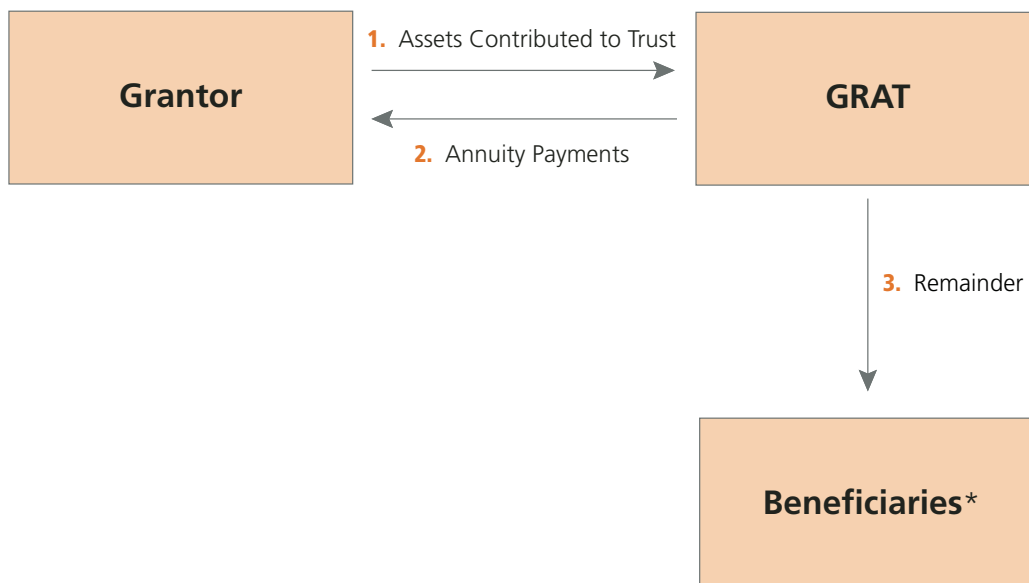
How It Works

Implementing the GRAT technique involves five steps:

- 1. Client creates a grantor trust** The first step is to have the client’s attorney draft a grantor trust. This is an irrevocable trust which is specially designed so that the trust assets are excluded from the Grantor’s estate for estate and gift tax purposes, but the assets are treated as belonging to the Grantor for income tax purposes. This allows the Grantor (your client) to buy and sell from the trust without incurring income taxes on the sales. At the same time, the Grantor has removed the trust assets from his estate.
- 2. Transfer assets to trust in exchange for an annuity** The second step is to transfer assets into the trust in exchange for an annuity. The annuity must be for a “fixed amount” and be for either a term of years or for the life or lives of the Grantor(s). Once inside the trust, the assets can be used to purchase life insurance. Or, if there is already life insurance, the assets can be used for an exit strategy: to pay-off the loan for premium financing or buy out a policy funded through private split-dollar.



- 3. Trust makes annuity payments** The third step is to have the trust make scheduled annual payments to the Grantor. As already mentioned, the IRS requires GRATs to make “fixed” annuity payments. The payments must be based on either a stated dollar amount or a stated percentage of the initial value of the assets contributed to the trust. Although the IRS calls the payments “fixed,” it does allow the scheduled payments to systematically increase or decrease by as much as 20% a year.
- 4. Grantor pays income taxes for the trust** Step five is for the Grantor to pay income taxes on the Trust’s income. This is a tax-free gifting opportunity for the Grantor. If he had kept the assets he would pay these taxes. If he had given the assets away to his children, they would have to pay the taxes. If he wanted to pay the taxes for the children he would have to pay gift taxes, too. By paying taxes for the trust, he makes a tax-free gift and allows the trust assets to grow for his children or other remainder beneficiaries designated in the GRAT.
- 5. At end of GRAT term, remaining assets pass to beneficiaries tax free** Finally, if the Grantor outlives the term of the GRAT, the trust assets will pass to his beneficiaries free of any estate taxes. If the trust owns a life insurance policy, the death benefits will pass to the beneficiaries free of income taxes as well. If the Grantor dies before the GRAT term has expired, then all of the trust assets are brought back into the Grantor’s estate. So clients should try to limit the length of a GRAT and may even want to purchase life insurance to provide protection against premature death during the GRAT term.



*Beneficiaries can be individuals or an ILIT

Advantages of the GRAT

The GRAT technique offers clients the following potential benefits:

- **Estate Freeze** Future asset growth is removed from the Grantor's estate
- **No Pre-Funding Required** Unlike an installment sale to a grantor trust, a GRAT does not require the Grantor to gift money into the trust prior to the transaction.
- **Exit Strategy** A GRAT can be used to provide an ILIT with funds to repay loans and terminate premium financing or private split-dollar arrangements.

Disadvantages of the GRAT

Of course, the GRAT technique also has some possible disadvantages:

- **Estate Inclusion** If the client dies before the GRAT term has finished, all of the assets are brought back into his or her estate.
- **Performance Risk** The GRAT technique only works if the assets contributed to the trust grow at a higher rate than the § 7520 rate used by the IRS to value the annuity payments.

What Is an Estate Freeze?

One of the primary uses for GRATs is to help wealthy clients create an “estate freeze.” Planners use the term “freeze” to describe an attempt to move all future asset growth outside of an individual's estate. Generally, an estate freeze is any technique that allows a person to fix or freeze an asset's value for estate and gift tax purposes at a given time, so that any future appreciation in value of the asset can pass to selected recipients at no additional tax cost. The goal of an estate freeze is to limit the date-of-death value of an asset or an estate to the value the asset or estate has today.

GRATs contribute to an estate freeze by leveraging the difference between anticipated growth on estate assets and the standard growth expectation used by the IRS to value gift transfers. For any given month, the IRS publishes a table of rates to be used to measure the value of gifts, loans, and annuities. The rates published include short-term, mid-term, and long-term rates for valuing loans, and the § 7520 rate for valuing annuity payments. These rates reflect the IRS' view on what growth rates a typical asset should experience in future years.

A GRAT can create an estate freeze to the extent assets contributed to the trust out-perform the rate established by the IRS. For example, if a GRAT is established at a time when the § 7520 rate is 5.0 percent, and assets contributed to the GRAT actually grow at an annual rate of 8.0 percent, then the extra 3.0 percent of growth is removed from the Grantor's estate free of any gift or estate taxes (assuming the Grantor survives for the entire term of the GRAT). Thus, GRATs work best with assets that are expected to experience high growth during the GRAT's term.

How Can GRATs be Used to Reduce Gift Taxes for ILITs?

In addition to being used as a stand-alone technique for reducing estate and gift taxes through estate freezes, GRATs can be used in conjunction with irrevocable life insurance trusts (“ILITs”) to reduce the gift taxes that may be incurred when funding large on-going life insurance premiums.

Planners use ILITs to help clients create a source of funds to pay anticipated estate taxes without subjecting those funds to taxation. The trustee of the ILIT purchases life insurance on the Grantor and the trust agreement provides direction on how the death benefit should be applied. The Grantor (and his or her spouse) must make contributions to the ILIT so that the trustee will have funds to pay the insurance premiums. The ILIT may include withdrawal rights (often called “Crummey Powers”) for trust beneficiaries which allow the Grantor’s contributions to qualify as “present interest” gifts meaning that the Grantor can use his or her annual gift exclusion rather than using up a portion of his or her available lifetime exclusion.

A problem arises for wealthier clients who decide to purchase larger life insurance policies to meet estate liquidity needs. As of 2005, an individual’s annual gift exclusion is limited to \$11,000 per beneficiary (or \$22,000 if married and the spouse consents to gift-splitting). If the life insurance policy purchased by the ILIT calls for annual premiums that are greater than \$11,000/\$22,000 per trust beneficiary, the Grantor will have to use some of his or her lifetime gift exclusion each year premiums are due.

To avoid this problem, clients can use a GRAT to fund the ILIT. Rather than naming children or other family members as the remainder beneficiary of the GRAT, the Grantor names the ILIT as the beneficiary. A series of short-term GRATs (two-year or three-year terms) can be used to create an ongoing source of gift-tax free contributions to the ILIT which will provide funds for the ILIT trustee to pay insurance premiums.

What Is an Exit Strategy?

GRATs can be especially useful as an exit strategy for other wealth transfer techniques. All wealth transfer strategies include some element of risk. The level of risk is higher for some strategies than others. And for some strategies—such as premium financing, split dollar, and private split dollar—the level of risk increases with time.

An exit strategy is a technique clients can use to reduce risk by providing the funds needed to terminate wealth transfer strategies that become too expensive. Premium financing, for example, carries an interest rate risk—i.e., there is a risk that interest rates will increase over time. Similarly, split dollar and private split dollar become more expensive over time because the measure of the gift—the “economic benefit” or “term costs” of life insurance coverage—increases as the insured becomes older. For each technique, the client can choose to accept this risk, avoid this risk, or plan for this risk by having an exit strategy.

The GRAT works as an exit strategy for premium financing, private split dollar, and similar techniques, by creating a set of funds which can be used to terminate a transaction when it is no longer producing economic advantages to the client. In the case of premium financing, for example, if interest rates are fixed for a period of time the client can fund a GRAT that will provide a remainder benefit to the ILIT at the end of the fixed interest rate period. If interest rates increase, the ILIT trustee can use the funds received from the GRAT to pay off the loan. If interest rates do not increase, the trustee can hold onto the funds for use in terminating the financing arrangement in the future. Meanwhile, the assets passed to the ILIT from the GRAT are also moved outside of the Grantor’s estate.

Gift and Estate Tax Consequences

The purpose of the GRAT transaction is to move assets out of the Grantor’s estate and into the hands of children and heirs with little or no gift or estate taxes. To accomplish this goal, the Grantor sets the annuity payments from the trust at a level that is high enough that no gift results upon the contribution of assets to the trust. Whether the GRAT results in a gift depends on the value of the remainder interest in the trust determined

on the date the GRAT is created. To determine the value of the remainder interest, the present value of the annuity stream to be paid to the Grantor is subtracted from the fair market value of the assets contributed to the trust.

The IRS characterizes a GRAT as a transfer to a trust with a retained interest—i.e., the right to receive annuity payments from the trust is an interest retained by the Grantor. For gift tax purposes, transfers to trusts with retained interests are subject to special valuation rules outlined in IRC § 2702.

Under the special valuation rules, the value of the gift to the remainder beneficiaries is determined by taking the total value of the assets transferred to the trust and subtracting the value of the interest retained by the Grantor. But if the retained interest of the Grantor does not meet the requirements of a qualified interest, the value of the retained interest will be treated as being zero. IRC § 2702(a)(2)(A). This means that if a transfer does not meet the requirements of § 2702, the full value of the transferred assets will be treated as a gift even though the Grantor is receiving payments for the assets.

To be a qualified interest, the interest retained upon the transfer of property to a trust must be either the right to receive payments of a fixed amount no less than annually (GRAT), or the right to receive payments no less than annually of a fixed percentage of the value (determined annually) of the trust assets (Grantor Retained Unitrust or “GRUT”). In the case of a GRAT, the fixed amount may be expressed in terms of dollars or as a percentage of the initial total value of the assets contributed. GRATs may provide payments for a term of years or for the life of the Grantor.

- Final regulations under § 2702 allow some flexibility for the term fixed amount. Annuity payments can be systematically increased or decreased by up to 20 percent per year. A GRAT which provides for increasing annual payments is sometimes referred to as a Ramp-Up GRAT.

Where the retained interest meets the requirements of a qualified interest, the value of the income stream is determined by using the discount factor published by the IRS under IRC § 7520. The § 7520 rate is published monthly and is 120 percent of the mid-term applicable federal rate (AFR) for the month rounded to the nearest two-tenths of a percent.

Ideally, a Grantor wants to fix payments from the GRAT at a level that would result in no gift taxes. To do this, the Grantor sets the payments at an amount that would be valued as equal to the fair market value of the assets transferred to the trust. This results in a value of zero for the GRAT’s remainder interest meaning that there is no gift in the transaction. While the IRS has argued that all GRATs must involve some gift, a recent tax case (*Walton v. Commissioner*, 115 T.C. No. 41 (12/22/2000)) held that, so long as the annuity payments are set high enough, a transfer to a GRAT can be structured so that there is no gift (such GRATs are sometimes referred to as *Walton* GRATs or zeroed-out GRATs).

Finally, it should be noted that the beneficial gift tax treatment applies only if the Grantor outlives the GRAT term. If the Grantor dies before the GRAT has terminated, the entire value of the trust assets will be brought back into the Grantor’s estate. This is true even if the GRAT calls for annuity payments to be made to the Grantor’s estate for the full remainder of the trust term. Thus, long-term GRATs carry a risk that assets will be included in the Grantor’s estate if he or she does not survive the GRAT term.

Income Tax Consequences of a Grantor Trust

As indicated above, a GRAT is a grantor trust that, in exchange for the Grantor's contribution of assets, makes annuity payments to the Grantor which qualify as a retained interest under IRC § 2702. This raises two questions: (i) What is a grantor trust? and (ii) What are the income tax consequence, of using a grantor trust?

What Is a Grantor Trust?

Grantor trust is a term used in the Internal Revenue Code to describe any trust over which the Grantor or other owner retains the power to control or direct the trust's income or assets. In essence, a grantor trust is a trust that is not recognized as a separate entity for income tax purposes, but which may be a distinct entity for estate and gift tax purposes. The Grantor (also known as trustor, settlor or creator) is the creator of the trust relationship and is the owner of the assets initially contributed to the trust. The Grantor establishes in the trust instrument the terms and provisions of the trust relationship between the Grantor, the trustee, and the beneficiary.

If a Grantor retains certain powers over or benefits in a trust, the income of the trust will be taxed to the Grantor, rather than to the trust. Some examples of power over or benefits in a trust include:

- The power to decide who receives income
- The power to vote or to direct the vote of the stock held by the trust or to control the investment of the trust funds
- The power to revoke the trust, etc.

All revocable trusts are by definition grantor trusts. An “irrevocable trust” can be treated as a grantor trust if any of the grantor trust definitions contained in IRC §§ 671, 673, 674, 675, 676, or 677 are met. If a trust is a grantor trust, then, for income tax purposes, the Grantor is treated as the owner of the assets, the trust is disregarded as a separate tax entity, and all income is taxed to the Grantor.

Income Tax Consequences

There are a number of income tax consequences to having a trust structured as a grantor trust:

1. **Trust income is taxed to the Grantor** The first, and most obvious, consequence is that any income generated inside the trust is taxed to the Grantor. This applies both to ordinary income from receipt of dividends and to capital gains generated from the sale of trust assets. Although it may be permissible for the trust to reimburse the Grantor for payment of income taxes, there should be no requirement, agreement, or understanding that the trust will automatically do so. If such an agreement or understanding exists, the IRS has ruled that the trust assets will be included in the Grantor's estate under IRC § 2036. See Rev. Rul. 2004-64.
 - The fact that the Grantor is responsible for income taxes of a grantor trust should not necessarily be viewed negatively. Many planners consider the Grantor's responsibility for income taxes as an advantage of the grantor trust arrangement. This is because, in essence, the payment of such taxes is a tax-free gift to the trust beneficiaries. If the trust were required to pay the income taxes, this would reduce the amount of assets ultimately passing to the trust beneficiaries. In fact, if the

Grantor wanted to add funds to the trust to pay taxes and prevent this loss of benefits, he or she would have to make a taxable gift. Moreover, the fact that taxes are being paid by an outside source increases the likelihood that trust assets will grow at a rate higher than the rate prescribed by the IRS to value the initial transfer to the trust.

- 2. Transfers between Grantor and trust ignored** A second tax consequence to grantor trust status is that transfers between the Grantor and the trust will be ignored for income tax purposes. Whether the Grantor contributes assets to the trust in exchange for annuity payments or sells assets to the trust in exchange for a note requiring payments of principal and interest, there is no transfer for income tax purposes. This means that the contribution or sale does not trigger any recognition of capital gains by the Grantor. It also means that payments from the trust, whether in the form of annuity payments or principal and income payments, do not create income for the Grantor. For all income tax purposes, the grantor trust is treated as if it doesn't exist. The Grantor is responsible for the same income taxes as if he or she continued to own the assets outright and no new income is created by payments from the trust.
- 3. No basis adjustment for contributed assets** A third tax consequence to grantor trust treatment is that the basis of assets transferred to a grantor trust is unaffected by the transfer, regardless of how the assets are transferred into the trust. Because transfers between a Grantor and a grantor trust are ignored for income tax purposes, there is no adjustment to the basis of assets that are sold to the trust. This is consistent with the fact that the Grantor does not recognize any gain on such transactions. It also means that trust beneficiaries will not benefit from a step-up in basis at the Grantor's death.
- 4. Transfer for value problems avoided** A final set of tax consequences from grantor trust status has to do with life insurance. Life insurance is a unique asset under the Internal Revenue Code with specialized tax treatment. In particular, death benefits received from a life insurance policy are not ordinarily subject to income taxes. The income tax-free nature of such benefits, however, can be lost if, during the insured's life, the policy is subject to a transfer for value and the transfer does not fall into one of several exceptions to the transfer for value rules. Because a grantor trust is ignored for income tax purposes, a transfer of a life insurance policy between the Grantor and the trust will not be characterized as a transfer for value. Moreover, if the Grantor is the person insured under the policy, transfers to the grantor trust will qualify as a transfer to the insured which is an exception under the transfer for value rules.

Comparison of GRAT to Installment Sale

GRATs and Installment Sales to Grantor Trusts are similar concepts. Both techniques rely on the creation of a grantor trust, also referred to as an intentionally defective grantor trust, to receive assets in exchange for an income stream—structured alternatively as:

- An annuity (GRAT), or
- Loan with principal and income payments (Installment Sale).

In each case, the value of the income stream is set at a level that will not result in gift taxes. While the income stream comes back into the Grantor's estate, any appreciation in the assets in excess of the amount used by the IRS to measure the initial value of the income stream has been transferred free of any estate or gift taxes. Because these assets can be directed to an ILIT, both techniques can be good exit strategies for premium financing, private split dollar, or similar techniques.

The primary differences between the strategies have to do with flexibility, estate inclusion, pre-funding requirements (seed money), and rates applied for valuation. Because GRATs are governed by the retained interest rules of IRC § 2702, annuity payments must be of a fixed amount and the Grantor must outlive the GRAT term to avoid having assets brought back into the estate. Installment Sales offer complete flexibility as to how to structure payments to the Grantor (principal and interest, interest only, balloon payments, etc.), but require seed money up front to meet the IRS requirement of independent economic viability. Consequently, while there is no risk of estate inclusion with Installment Sales, Grantors may have to use up a portion of their lifetime gift exemptions to implement the strategy. Finally, GRATs use the § 7520 rate to value the income stream while Installment Sales will use an AFR rate. Since the § 7520 rate is 120 percent of the mid-term AFR rate, Installment Sales often offer more leverage for gifting.

Comparison of GRAT to Installment Sale

	GRAT	Installment Sale
Are fixed payments required?	Yes	No
What is included in the estate if Grantor dies prematurely?	All remaining trust assets	Unpaid amount on note
Must trust be pre-funded?	No	Yes
Rate used to measure value of retained income stream?	§ 7520 rate (120% mid-term AFR)	Depends on term of note: < 3 yrs = short-term AFR 3 yrs to 9 yrs = mid-term AFR > 9 yrs = long-term AFR Demand loan = short-term blended annual AFR rate
Able to zero-out?	Yes	Yes, except for pre-funding
Able to unwind transaction?	No	Yes, can pre-pay
Can make future transfers?	No	Yes

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