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Real Life Example

Transferring Growth Without Gift Tax

by William Russell

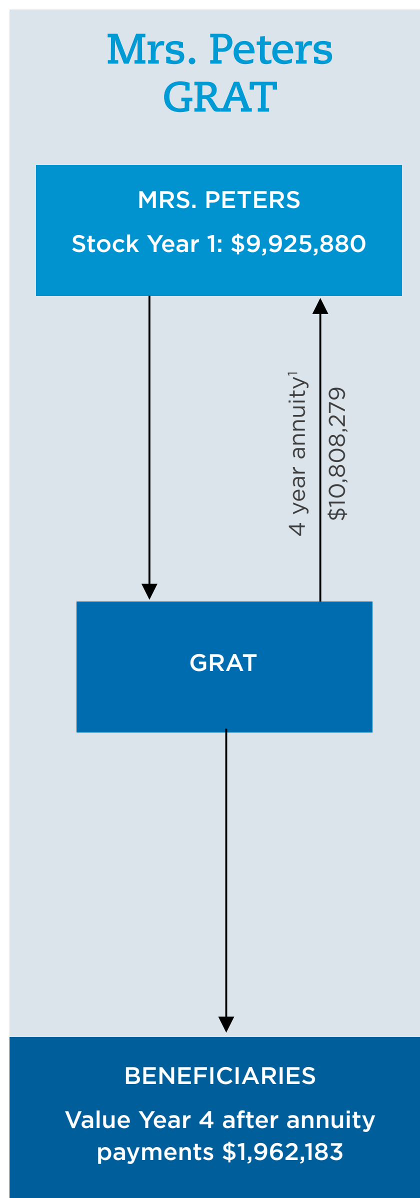
A FREEBORN & PETERS CORPORATE TEAM WHITE PAPER

ABOUT THIS WHITE PAPER:

A real story (with the names changed) of how one client shifted millions of dollars of growth to her family, free of gift tax.

Mrs. Peters is worth about $15 million, of which about $13 million is in marketable securities. Mrs. Peters likes to provide gifts for her family, but wants to maintain her current level of assets to support her through her retirement and as reserve against financial recessions. She is willing, however, to shift growth to her family. She knows that the ever-increasing growth of her assets will result in substantial additional estate taxes under the status quo, 40% on every dollar of growth.

As a solution, in 2010 Mrs. Peters decided to create a special type of trust to shift growth to her family with very little use of her gift exemption and no gift tax. She created a Grantor Annuity Trust, or "GRAT," and funded it with about $10 million of stock, worth $9,925,880 at funding, to be exact. The GRAT paid her an annuity payment over four years that returned to her all of her investment in the GRAT, plus a small return. The annuity was designed so that under IRS regulation it almost "zeroed out" any net taxable gift as follows (continued on the next page):



[1]4 year annuity beginning at $2,013,465, increasing 20% per year.

Per Gift Tax Return

FMV of Assets Transferred	$9,925,880
Present Value of Annuity Payments	($9,924,972)
Net Taxable Gift	$ 908

All additional growth that remained in the GRAT at the end of the four years was distributed to family members. While the IRS tables may assume a low growth rate, the true investment return may be substantially higher. In this case, the GRAT paid back to Mrs. Peters a total of $10,808,279 in annuity payments over the four years, which is her initial investment plus a 3.2% annual return (the minimum return required by the IRS when the GRAT was established). In fact, the GRAT assets grew at a rate of 8.75% per year over four years. In 2014, at the end of the four year period, after all annuity payments, *$1,962,183 remained in the GRAT*, which was distributed to family members as a tax-free gift. Alternatively, the GRAT could have been structured to retain the assets in trust at the end of four years for the benefit of her family. If gift tax were due on this $1,962,183 gift, $784,873 would have been due the IRS. Instead, by using the GRAT, there was a taxable gift of only $908 on transferred growth of almost $2 million.

Actual Result

Total Assets transferred to Trust plus all growth	$12,770,462
Total Payments back to Grantor	($10,808,279)
Wealth Transferred to Family Year 4	$ 1,962,183

What about the income tax on this growth? Mrs. Peters retained all the income tax obligation with respect to this growth. By keeping the income tax obligations, Mrs. Peters effectively gave an additional amount equal to the capital gains tax on the appreciation of the trust assets. How did this work? Mrs. Peters transferred low basis publicly-traded stock to the GRAT in the beginning plus some cash. The GRAT is specifically designed so that under the income tax regulations, the trust assets are deemed owned by Mrs. Peters *for income tax purposes only*. Each year, the GRAT paid her a gradually increasing annuity beginning at $2,013,465 and ending in the fourth year at $3,479,267. The annuity was paid to her in kind with the marketable stock, i.e. the stock portfolio she originally gifted. However, the annuity payments were not taxable income to Mrs. Peters. Instead she was taxed on the GRAT assets as if she owned them directly.

Mrs. Peters did not sell the securities, but used them to pay the annuity back to herself. At the end of the fourth year, Mrs. Peters swapped (tax-free) the last $1,962,183 of securities for cash. All the securities were returned to her (and she would ultimately have the capital gains when she sold them). The beneficiaries received a substantially gift-tax free transfer of $1,962,183 in cash with no income tax!

What if the stock market had gone down? Then the GRAT would have paid the annuity payments back to Mrs. Peters until it ran out of assets. Mrs. Peters would be back to where she would have been had she just retained the assets and never set up the GRAT in the first place. She would also have the tax benefit of the loss on the sale of any of the securities.

Think of it this way. Mrs. Peters set aside almost $10 million in stock in a trust, but she retained all the income tax cost if the stock was sold as if she owned the stock directly. She could also trade assets back and forth between herself and the GRAT at fair market value without any income tax recognition. She paid herself back in annuity payments consisting of the stock, and the annuity payments were not taxable to her. The beneficiaries received whatever was left at the end of the GRAT term. To make sure the beneficiaries had no income tax cost, Mrs. Peters swapped out any residual securities in the trust in exchange for cash.

A GRAT, if administered properly, is not an aggressive tax play, but is specifically sanctioned by IRS regulations. The downside is that the donor must commit assets to the GRAT for a specified period. If the donor dies during the GRAT term, all the trust assets effectively revert back to the donor's estate, including all growth, and may be subject to estate tax. The donor chooses the GRAT term. It can be as short as two years. But once chosen, the donor cannot accelerate the timing of the annuity payments coming back. Subject to these caveats, a GRAT is an excellent way to shift asset growth tax-free.

For more information on GRAT's and other advanced estate planning options, contact Bill Russell at (312) 360-6373.

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Bill is a Partner in the Corporate Practice Group. Bill advises closely held businesses and professionals on business and tax matters. His practice consists of corporate transactions and business consulting, advanced estate planning and probate, and asset protection.

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