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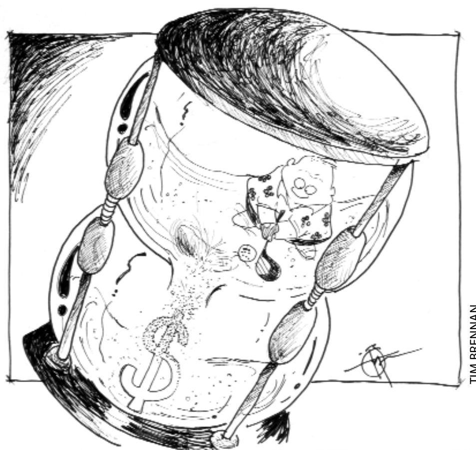
CEO ADVISOR

By Jerry Simon



TIM BRENNAN

# In GRAT We Trust

*Grantor retained annuity trusts can be a great estate planning tool for family-owned businesses.*

**MANY** entrepreneurs would love to pass their business on to their children, but hesitate to explore the idea for fear of gift taxes, estate taxes, or both, not to mention their own desire to maintain control of their company.

In fact, it is possible to transfer a business interest to the second generation without incurring big gift taxes now or estate taxes later on, all while keeping control of the enterprise and enjoying the income it generates. As a bonus, the technique involved is conservative in nature, and today's low interest rates make it particularly attractive.

Called a grantor retained annuity trust, or GRAT for short, the technique is tailor-made for family-owned businesses, but you can use a GRAT to transfer virtually any asset to your children without crippling taxation.

How do GRATs work? Why are they an especially good idea right now for the founders of a family-owned business?

A GRAT is an irrevocable trust into which you transfer part or all of your ownership in an asset for a specified period of time, after which the asset passes to your children as beneficiaries of the trust.

In exchange for the transfer, the trust pledges to pay you a fixed income for the duration of the trust in an amount specified by you. In essence these payments constitute an annuity, and this leads to favorable tax consequences, especially in a climate of low interest rates.

To see how that happens, assume that you and your spouse run a thriving family business worth $6 million.

The business generates $500,000 in income annually, and the two of you figure to work another 10 years and then go play golf in Hawaii. You have two children, both involved in the business, to whom you want to leave equal shares.

You establish a 10-year GRAT into which you transfer stock in your company worth $4 million, taking in exchange the right to receive payments of $500,000 annually for the life of the trust.

You retain sole ownership of the balance of the business interest, or $1 million for yourself and $1 million for your spouse, because under current tax law you can give that much to your children without taxation anyway.

The transfer of the $4 million to the trust, however, does not trigger gift taxation now or estate taxation later on, even though you might expect it to. Why?

The answer to that question lies in the answer to another: If you give your children something that they can't enjoy for 10 years, what value does it have right now?

Probably not much — especially when you consider that you and your spouse will enjoy the value of the gift for 10 years in the form of the annual payments.

Technically, tax law permits you to subtract the present value of the income stream from the value of the assets that you transfer to the GRAT, determined as of the date of the creation and funding of the trust.

The calculation can be complex, and it utilizes an interest-rate assumption published monthly by the federal government and often called the 7520 rate, after the section of the IRS code in which it appears. The 7520 rate has averaged less than 4.4 percent since the beginning of last year, and because you use the rate to calculate the value of the income stream, the lower the interest, the smaller the resulting gift.

As a consequence, properly structured, a GRAT can eliminate both gift and estate taxation.

Even better, because the trust becomes the owner of the asset – in our example, a business interest – any increase in the value of the asset accrues to the trust, not to your estate, and passes directly to your children, once again without triggering taxation. In plain English, this means that the value of your business can multiply during the life of the trust and still pass to your

children without taxation of any kind.

Typically, when establishing a GRAT, you fix the payout as a percentage of the assets. It is possible to change the payout later on, but in general, once you fix the payout, it stays the same for the life of the trust. As a rule, the term of the trust must be at least two years but not longer than your life expectancy.

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It is crucial to the success of a GRAT that the assets in the trust produce a return greater than the 7520 rate, lest the taxation benefits be wasted. Given a healthy business, not to mention the low level of the 7520 rate right now, this shouldn't pose a problem. It won't pose a problem in the future, either, no matter what happens to interest rates, because you lock in the assumption when you create the trust.

One caution with GRATs is that, under federal tax law, the asset will revert to your estate automatically if you die before the termination of the trust.

Put another way, if you transfer an interest in a business to a 10-year GRAT and die after five years, the entire value of the asset goes back into your estate and becomes subject to taxation.

There is, however, a simple solution to this problem: a life insurance policy owned by and payable to your children in an amount equal to the likely tax liability.

This caution aside, GRATs provide the founders of family-owned businesses with a unique and powerful estate planning tool. It is a conservative, time-tested technique for passing wealth from one generation to the next without giving up control of the enterprise before you're ready to do so and without giving the tax man a slice of the pie.

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*Jerry Simon is a member of SAK Financial LLC of Encino, a fee-based consulting and advisory firm serving middle-market companies, their owners, and key executives in California and other western states. He may be reached at jsimon@sakfinancial.biz.*