John Hancock
LIFE INSURANCE

# *Client Profile*
# Estate Equalization and Grantor Retained Annuity Trusts (GRATs)

| CLIENT PROFILE | |
|---|---|
| Age: | 55 and older |
| Status: | Business owners or owners of real estate |
| Concern: | Would like to transfer assets to the next generation and fund life insurance for liquidity and estate equalization. |

## SITUATION

Your clients may have a business or investment assets such as real estate that they would like to transfer to the next generation, at a minimal gift tax cost. In some cases, the children who are involved in a business or an investment venture will receive that entire asset from their parents or a larger portion of the asset than their siblings, as a result of their involvement or location. As a result, the parents will need to fund a life insurance policy to provide wealth replacement for their other children as well as liquidity at their death.

## SOLUTION

Your client can use an income producing asset such as stock in a business or real estate to fund a Grantor Retained Annuity Trust (GRAT) for the benefit of one or more of their children.[1] The GRAT can be set up with reduced gift tax cost or as a "zeroed out GRAT" and the annuity payment from the GRAT can be used to help fund a life insurance policy inside of an Irrevocable Life Insurance Trust (ILIT). The GRAT technique can be used to "freeze" the value of an asset after the initial valuation. A "zeroed out" GRAT (also known as a Walton GRAT) is a popular type of GRAT in which the present value of the annuity interest retained by the grantor equals the fair market value of the assets transferred to the GRAT, causing the gift to the trust to be valued at zero.[2] A GRAT must last for a specified term of years. If the grantor predeceases the term of the trust, some or all of the property inside of the GRAT will be included in the grantor's taxable estate.[3]

Declining interest rates can make GRATs an even more attractive option. As the Section 7520 rate goes down, the annuity interest increases and the remainder interest decreases, causing the gift amount to be even lower.[4]

Your clients' key planning objectives are to transfer assets to the next generation and also fund a single life or survivorship life insurance policy to provide liquidity and estate equalization.

## HOW DOES IT WORK?

In this strategy, the business or investment assets can be used to fund a GRAT (usually a zeroed out GRAT), and the annuity payments from the GRAT can be used to fund an ILIT. At the end of the GRAT term, the asset can transfer either directly to one or more family members or to a trust for their benefit, but in either case the asset will be outside of the taxable estate, and the funding of the life insurance policy inside of the ILIT will be coordinated with the GRAT. In order for this strategy to be successful, the asset transferred to the GRAT must generate a sufficient amount of income to make the annuity payments. This approach can be particularly useful for people with assets such as rental real estate or S corporations, which produce large amounts of cash annually.

| **CASE STUDY:** TOM AND ANGELA EVANS | |
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| **Clients:** | Tom and Angela Evans, both age 68, three children, $20 million estate |
| **Asset:** | $15 million S corporation |
| **Asset Transfer:** | Transfer $10 million of stock in their business to a GRAT for their two children who are involved in the business and fund life insurance to provide liquidity and wealth replacement for all of their children, including one child who is not in the business. |
| **Product:** | $18,000,000 John Hancock Protection SUL-G policy with annual premiums of $241,254 |

## **CASE STUDY:** TOM AND ANGELA EVANS (continued)

The ILIT is the beneficiary of the GRAT, and will receive the remainder interest of the GRAT ($10,091,159) in year 10 when the GRAT terminates. In this case, because of the size of the premium, Tom and Angela will make a loan to the ILIT (private financing), rather than make gifts, and then the ILIT will pay off the loan, including principal and deferred interest, to Tom and Angela in year 11. Following year 11, the ILIT will have sufficient assets and cash to pay the annual premium on the life insurance policy. The trustee of the ILIT will be able to make distributions of assets and cash to each of Tom and Angela's children. The chart below is a "snaphot" of how the numbers for the transaction would look in years 1–22.

| YEAR | LOAN PRINCIPAL AMOUNT TO ILIT | LOAN INTEREST AT 4.46% (DEFERRED) | GRAT ANNUITY PAYMENT TO TOM AND ANGELA | DEATH BENEFIT FROM ILIT | NET TO HEIRS FROM ILIT[5] |
|---|---|---|---|---|---|
| 1 | $241,254 | $10,760 | $1,295,051 | $18,000,000 | $17,907,988 |
| 10 | $241,254 | $131,974 | $1,295,051 | $18,000,000 | $26,472,478 |
| 11 | ($3,091,044) | $0 | $0 | $18,000,000 | $25,299,571 |
| 22 | $0 | $0 | $0 | $18,000,000 | $30,682,909 |

This is a supplemental illustration. Not all benefits and values are guaranteed. The assumptions on which the non-guaranteed elements are based are subject to change by the insurer. Actual results may be more or less favorable. *Based on Male, Preferred Non Smoker age 68 and Female, Preferred Non Smoker age 68, full-pay policy, Michigan residents. The loan interest rate of 4.46% and the Section 7520 rate of 4.4% are the published rates for January 2008. Year 22 is joint life expectancy.*

In this case, Tom and Angela were able to transfer a large chunk of stock to their children through the GRAT at a zero gift tax value. They were also able to fund a large life insurance policy using the GRAT income and private financing, to provide both estate equalization and liquidity at death. Using private financing with deferred interest for ten years and loan repayment occurring in year 11 (after the ILIT received the GRAT remainder interest), enabled Tom and Angela to fund their ILIT with no gifts and transfer over $30 million to their heirs free of estate tax. Since the ILIT is the beneficiary of the GRAT remainder interest, the trustee of the ILIT can then make distributions to each of their children, using the business assets as well as the cash within the trust.

1. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.
2. Walton v. Commissioner, 115 T.C. 589 (2000).
3. In June 2007, the IRS issued REG-119097-05, a proposed regulation that provides new guidance on valuing the portion of a GRAT that is includible in the grantor's taxable estate if the grantor has a retained interest in the trust and has deceased before the end of the trust term. Under the proposed regulation, the formula for determining the inclusion amount of a GRAT at the grantor's death is the annual annuity amount divided by the Section 7520 rate on the date of death. As a result, if a grantor dies during the term of a long-term GRAT, under the proposed regulations, some of the GRAT assets will be outside of the taxable estate. However, for many short-term zeroed out GRATs, the formula under the proposed regulations will still result in 100% inclusion of the GRAT assets in the grantor's taxable estate.
4. The projected value of a GRAT remainder interest is inversely related to the Section 7520 rate; the performance of GRATs improves with lower interest rates and declines with higher interest rates.
5. In this chart, the Net to Heirs in Years 1–10 represents the ILIT proceeds less the loan repayment net of estate taxes on the loan to the ILIT. In year 10, the ILIT is projected to receive $10,091,159 from the GRAT and in year 11 the ILIT will use $3,091,044 to repay the loan to Tom and Angela. From year 11 on, the ILIT includes the GRAT assets, which will be distributed to their children in the form of assets and cash. This example assumes a Section 7520 rate of 4.4% for the GRAT and an interest rate of 4.46% for the private financing loan (both are published rates for January 2008). Year 22 is the joint life expectancy.

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