# Tap into the Power of a Grantor Trust

The U.S. survived the worst recession since the Great Depression. But believe it or not, there is a silver lining: this tough economy has driven applicable federal rates ("AFRs") to rock bottom levels.

Each month, the IRS provides these prescribed rates for federal income tax purposes. AFRs are used to calculate the value of remainder and annuity interests and ensure that a debt transaction will not have below-market interest.

So, what do these low AFRs mean for you? It means now is the perfect time to tap into the power of grantor trusts. Read on to learn about a few winning strategies:

## Delving into a DIGT

An intentionally defective irrevocable grantor trust ("IDGT") is a trust in which the income is attributed to the grantor instead of the trust. Although it certainly has a strange name, this type of trust is not literally defective. It's an irrevocable trust created so the grantor is treated and taxed as the owner of the trust's assets for income tax purposes.

By shifting the income tax burden to the grantor, the IDGT offers some valuable income-producing and appreciation opportunities without the typical income tax consequences. In other words, these trusts often accumulate a greater amount of income.

## Lending Funds the Smart Way

One IDGT strategy starts with lending funds to the trust. Because a loan is made with the expectation that it will be repaid by the IDGT to the grantor, there is no gift and the grantor's available lifetime gift tax exemption is preserved.

*Here's how it works:* Let's say you, the grantor, lend money to the IDGT in exchange for an interest-only promissory balloon note, based on AFR. (A balloon note is a promissory note with one large payment -- a "balloon payment" -- due upon maturity.) The trust pays the interest on the loan and the principal at the end of the note's term. Before the end of the term, the trust invests the funds you loaned, and you pay any income tax due on the income produced from these investments. You can then invest the resulting funds into a no-lapse guaranteed life insurance policy.

*Here's an extra plus:* Typically, when you lend a large amount of funds to your DIGT, the income generated from the loan investments will be enough to pay for the interest due on the note, as well as premiums on your related life insurance policy. Because the majority of your loan is preserved, you can then use it to repay the note's principal.

When you use this technique, the promissory note and life insurance premium payments are generally structured to be completed in nine years. This means that by the 10th year, you'll have the funds you loaned back *plus* interest. On top of that, the IDGT now owns a fully paid guaranteed life insurance policy. It's a win-win.

Of course, it's important to realize that this method only works if you make a *large* loan to your grantor trust. So, you'll need to have a significant amount of liquid assets on hand. If you don't have a hefty amount of money to loan to your grantor trust, you may want to consider making a smaller loan that will work as a "sinking fund."

This fund is designed to be consumed over the entire term of the promissory note, and it allows you to set up a longer premium payment schedule for your life insurance policy. However, you'll need to come up with an "exit strategy," or a way to pay off the principal on the grantor's note. Consult with us about this sinking fund approach and possible exit strategies.

## The Great GRAT Method

When AFRs are low, it is also a good time to look into a grantor retained annuity trust (“GRAT”). A GRAT is basically an irrevocable trust designed to help you transfer the appreciation on your assets with very little or no gift taxes. This can be a smart strategy in a low-rate market.

If you decide on a GRAT, you can transfer income-producing assets into the trust and reserve an annuity for a specified number of years. At the end of this term, the trust terminates. At that time, if the assets appreciate more than your annuity payouts (and odds are good with low rates), the leftover trust funds are transferred to your beneficiaries tax-free.

On the other hand, if the assets appreciate less than your annuity payments, the trust is considered a "failure" and the funds are returned to you. But you can always open another GRAT and try again. Even if the trust "fails," you don't lose anything.

Not only does a GRAT provide a smart gift-tax efficient way of transferring funds to your beneficiaries, but it also reduces the value of your taxable estate. GRATs can be beneficial for investors who are in their 50s and think their estates will be worth more than the estate tax exemption by the end of their lives.

## Anything but Defective

As you can see, grantor trusts may be called "defective," but when used properly they are anything but. If you're looking for an effective way to transfer assets, take advantage of low AFRs and purchase life insurance with a guaranteed rate of return, a DIGT may be the way to go. Consult with your estate planning advisor about whether this type of grantor trust could work in your situation.

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