



GRANTOR RETAINED ANNUITY TRUSTS

Memorandum to the Settlor and to the Trustee

by Layne T. Rushforth

1. **GENERALLY**

This memorandum is for the Settlor and the Trustee of an irrevocable grantor-retained annuity trust, which we refer to as a “GRAT”. There is a section for each of you, but we recommend that the Settlor and the Trustee read both sections.

2. **SETTLOR**

Here are a few guidelines for the Settlor to keep in mind after signing an irrevocable trust:

2.1 **Initial Contribution:** After signing the trust, make the initial contribution of assets *to the trustee*. You must give up all of your rights to the trust assets except for the right to receive the annuity payment provided for in the trust. You may not retain direct or indirect control over trust assets. You should not give the trustee written instructions, especially regarding asset management or distributions to beneficiaries; however, written clarifications regarding your intent are acceptable.

(a) The contributions is a taxable gift. Since the beneficiaries of the trust (other than you) will not receive any benefits immediately, the contribution to this trust is a gift of a future interest, and the annual gift-tax exclusion of \$14,000 will NOT apply. You will need to file a gift tax return by April 15 of the year following the year in which the contribution is made (although that date can be extended on the same form used to extend the filing date for your individual income tax return). You will have to pay a gift tax if the value of the gift exceeds your unused “applicable exclusion”.¹

(b) A GRAT is not a good place to allocate your “GST exemption”, which is the exemption for generation-skipping transfer tax (“GST tax”) purposes. We recommend that you consult us before giving grandchildren or lower generations (“skip persons”) benefits under this trust other than the right to receive the share of a parent who predeceases them.

(c) Because the GRAT requires annual annuity payments to you, it is important to “fund” the trust with income-producing assets. If the trust income is less than the annuity payment due to you, the trust’s principal will be depleted during your term, reducing the trust’s effectiveness as a tool to transfer value to your intended beneficiaries. For this reason, life insurance should not be put into a GRAT. Also, tax-deferred annuities are not appropriate assets for a GRAT.

2.2 **Subsequent Contributions:** Once you have transferred the initial assets to the trust, no further contributions are permitted.

3. **TRUSTEE**

The trustee of an irrevocable annuity trust should follow these instructions:

3.1 **Acting as Trustee:** All transactions you make in behalf of the trust should clearly reflect that you are acting as trustee.

3.2 **Annuity Payments:** The annuity payments provided for in the trust are mandatory. If the trust income is insufficient, the payment must be made from the trust principal. The trust does authorize you to borrow funds for trust purposes, but we caution against doing that without consulting us or your accountant

3.3 **Bank Accounts:** All cash contributions should be deposited into a separate account established solely for the trust. The bank (or other financial institution) should be given the trust's tax identification number when the account is opened.

3.4 **Personal Account:** Never deposit trust contributions into a personal account or make payments in behalf of the trust from a personal account.

3.5 **Records; Tax Returns:** Keep meticulous records relating to the trust's assets, income, and expenditures. During the Settlor's term, the trust is a "grantor trust" for income tax purposes, and the trust's income will be reported by the Settlor. During each year of the Settlor's term, you may wish to file a fiduciary income tax return (IRS Form 1041), but after the Settlor's term, the filing of the tax return is mandatory.

3.6 **Independence:** You *must* act independently. If the IRS perceives that you are merely an agent for the Settlor, the trust assets may be included in the Settlor's estate for federal estate tax purposes, even if the Settlor outlives the Settlor's term.

3.7 **Estate Tax; Liabilities:** A GRAT is written so that if the Settlor outlives the Settlor's term, its assets will NOT be considered part of the Settlor's estate for federal estate tax purposes. Some GRATs are written so that if the Settlor dies during the Settlor's term, the assets revert to the Settlor's estate or revocable trust, making the entire trust subject to the federal estate tax. Other GRATs are written so that if the Settlor dies during the Settlor's term, the annuity payments continue to the Settlor's estate and only the present value of the annuity payments during the balance of the Settlor's term will be included in the taxable estate. As Trustee, you should never pay any tax or other liability owed by the Settlor, the Settlor's estate, or the trustee of any other trust created by the Settlor unless advised to do so by an accountant or attorney who is familiar with the trust and applicable federal tax law. You can grant loans and make purchases as permitted in the trust document.

NOTE: This memo provides general information only and does not contain legal, accounting, or tax advice. For brevity, this memo is oversimplified and should not be relied on for any particular situation. Nothing in this memo can be relied upon to avoid any tax penalties.

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NOTES

1. Internal Revenue Code § 2010(c) provides for an "applicable exclusion", which is the cumulative amount that can pass free of gift and/or estate tax. The applicable exclusion is \$5,430,000 for 2015, \$5,450,000 in 2016, and \$5,490,000 in 2017. For the applicable exclusion in prior years, see <https://www.rushforthfirm.info/advintro.html#ae>.