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Grantor Retained Annuity Trusts

A Grantor Retained Annuity Trust (GRAT) is a compelling tax-efficient strategy individuals and families can use to transfer wealth to their beneficiaries. Learn what a GRAT is, how it works, key advantages and potential risks, and who can benefit.

Defining a GRAT

A Grantor Retained Annuity Trust (GRAT) is an irrevocable trust sanctioned by Section §2702 of the Internal Revenue Code. A GRAT is typically funded with growth assets and has a defined term of years. During the term, the Grantor receives an annuity and at termination, the assets remaining in the GRAT pass to the Grantor's named beneficiaries with no additional estate or gift tax.

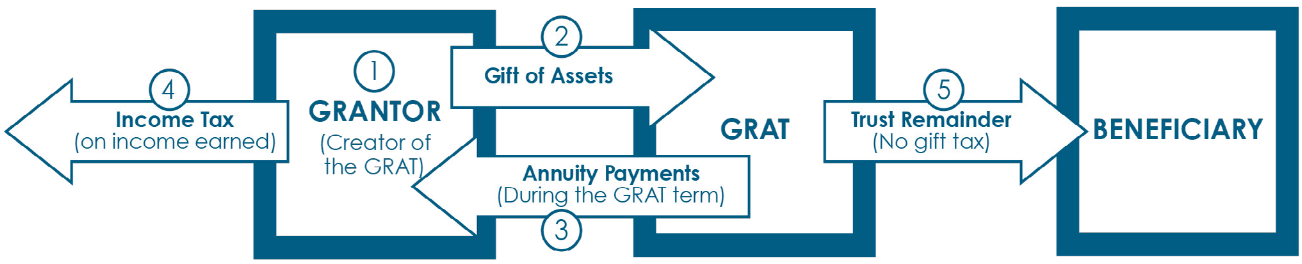
Who can benefit from a GRAT?

GRATS can be a powerful tax-efficient wealth-transfer strategy for individuals or families who anticipate having an estate valued at more than the federal taxable estate exemption amount— $11.58 million for individuals and $23.16 million for married couples in 2020—and have assets with strong short-to-midterm growth potential, such as undervalued securities, real property or a business, they can use to fund the trust.

How GRATs work

There are several ways to structure a GRAT, but all typically include the following elements.

1. A person establishing the GRAT (the "Grantor") partners with legal counsel to establish the trust, which has a fixed term—typically two to three years. Should the Grantor pass away before the term ends, the GRAT assets become included in the Grantor's taxable estate.
2. The trust is funded with a one-time transfer of assets.
3. GRATs are typically funded with assets that have potential for capital appreciation over the term of the trust. The tax effectiveness of the transaction derives from the outperformance of the investments against an IRS-defined "hurdle rate." GRATs are most often funded with a single security or a basket of correlated securities. After the GRAT is funded, the Grantor receives an annual (or more frequent) annuity payment from the GRAT throughout its term.
    - The amount of the annuity payment is calculated with reference to IRS regulations and, in the aggregate, is often equal to the amount initially contributed to the GRAT plus a rate of return referred to as the "hurdle rate". The hurdle rate is roughly equivalent to120% of the current one-month average yield on 3-9-year Treasury notes.
    - Some GRATs are structured so that the actuarial value of the annuities plus the IRS-required assumed rate of return is exactly equal to the funding amount. This is called a "zeroed-out" GRAT because the actuarial value of the taxable gift to the remainder beneficiaries is zero.
4. For income tax purposes, the Grantor pays the income tax on all income earned inside the GRAT for the duration of the term.
5. When the GRAT's term expires, the trust remainder—that is, the appreciation earned in the trust less the amount paid as the annuity—passes to the beneficiaries outright or is used to fund a new, separate trust for the beneficiaries.



How GRATS work: An example

Chris is a 40-year-old woman with an estate valued at $15 million. She establishes a GRAT in October 2020 with a 2-year term and names her son Bill as beneficiary. Chris funds the GRAT with $5 million of high-growth potential securities—an investment that she expects will appreciate significantly over the term of the GRAT.

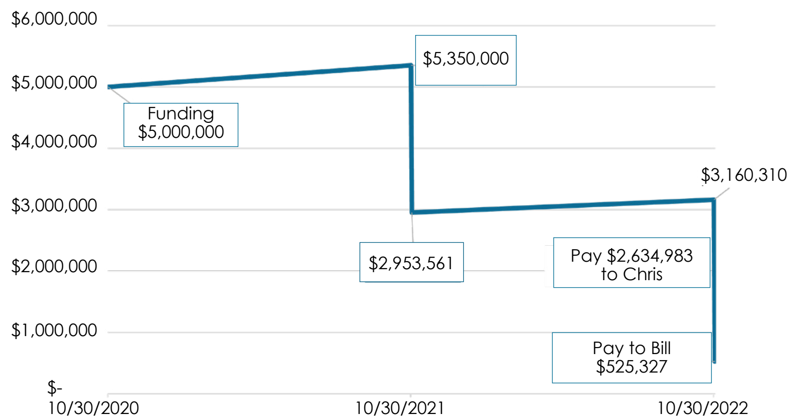
According to the trust agreement and referencing the IRS "hurdle rate", Chris will receive an annuity payment of $2,395,439 at the end of the first year, and another annuity payment of $2,634,983 at the end of the second year of the trust. Let's assume that the rate of return on the trust assets will be 7.0% annually, and the IRS' assumed "hurdle rate" of return is 0.4%.

The market value of the trust assets is $5 million at the trust's inception. The present value of the annuity is $4,999,999.99 based on IRS regulations.

Subtracting this present value from the market value of the trust assets, a taxable gift valued at one penny by the IRS remains. The gift-tax liability will effectively be zero. At a 7% rate of return, the assets remaining in the trust at the end of the two-year period will be $526,397; this will pass tax-free to Bill.

Note that, by the end of the trust term, Chris will have recouped the value of the assets she used to establish the trust. If Chris retained the assets during this same two-year period and did not create the GRAT, that same $526,397 which goes to Bill from the GRAT would be retained in her taxable estate and subject to a 40% estate tax. In other words, if your assets exceed the estate tax exemption, as Chris' do, then any appreciation of assets in your estate will be reduced by the 40% estate tax at your death.

Two-year GRAT, 0.4% hurdle rate, 7% growth



Key advantages

- GRATs are sanctioned by the Internal Revenue Code, supported by strong case law.
- Grantors retain the initial assets in the form of an annuity. No income tax is imposed on transfers into or out of the GRAT, making it possible to fund the trust with low basis securities.
- The annuity can be paid with a distribution of property; cash is not required.

- The remainder, approximately equal in value to any appreciation during the term of the GRAT, passes to beneficiaries as a tax-free gift.
- The remainder is excluded from Grantor's gross estate on the condition the Grantor outlives the GRAT's term of years.
- "Cascading" or "rolling" GRATs can be funded using the annuity stream of an existing GRAT. As each annuity payment is received, it is "rolled" into a new GRAT. By keeping the term of each GRAT short, the Grantor reduces the likelihood the appreciation on the assets will be pulled back into the taxable estate should the Grantor pass away before the GRAT expires.
- The Grantor remains liable for income tax on sales and other income within the GRAT. This can be an additional estate planning benefit, since having the Grantor pay the tax for the trust leaves more assets inside the trust for the beneficiaries—it is essentially an additional tax-free gift to the beneficiaries.
- The Grantor can swap assets with the GRAT during its term to lock in appreciation before the end of the term. Specifically, if (1) there is exceedingly rapid appreciation early in the GRAT term; and (2) the Grantor worries about downside volatility over the balance of the term, then replacing or swapping the appreciating asset with cash or other assets can "freeze" the inside value of the GRAT.

Potential risks

Mortality risk: Estate tax

If the Grantor dies during the term of the trust, the assets of the trust will be included in the Grantor's estate, nullifying any anticipated tax benefits.

Careful consideration of the Grantor's age, health and other risk factors is important when establishing the term of the trust.

Underperformance risk

If the assets in the GRAT decline in value below the IRS' assumed rate of return, it will negate any tax benefits of the GRAT. There will be no appreciation to transfer to beneficiaries, and all property in the trust will revert to the Grantor. The Grantor will lose the cost of establishing the GRAT—usually the legal and accounting fees.

Legislative risk

In the past, GRATs have been identified as a "loophole for the wealthy," making them a potential target for future tax reform legislation. If you are considering a GRAT, monitor ongoing discussions in Congress closely and consult with a tax attorney.

Other considerations

- Assets pass to the remainder beneficiaries with a carry-over tax basis—not a stepped-up basis as with other inherited assets. Beneficiaries are liable for any taxable gain should those assets be later sold.
- GRATs are not appropriate for generation-skipping asset transfers. The estate-tax inclusion period rules prevent allocating the generation-skipping tax exemption until after the expiration of the term, when the value has presumably increased.
- Once assets are placed within a GRAT, only the annuity is available to the Grantor.
- If the assets used to fund a GRAT are unique and hard to value, a qualified appraisal may be needed when the Grantor trust is established and for each subsequent annuity payment.

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Summing up

A well-structured GRAT can help some individuals and families transfer significant assets to their beneficiaries with no estate tax and little-to-no gift tax burden. GRATs are especially compelling in today's low interest rate environment, as the current low IRS "hurdle rate" for trust asset appreciation maximizes the potential for substantial tax-free gifts. To learn more about this powerful, tax-efficient wealth transfer strategy and how it might fit into your wealth and estate planning goals, please contact your Relationship Manager.