Using Grantor Retained Annuity Trusts In The Current Environment

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Introduction to GRATs

Grantor retained annuity trusts ("GRATs")[1], have been a popular planning tool. In the current planning environment, GRATs may be a powerful planning tool for three primary reasons:

Suppressed asset values (at the time of this writing the stock market has declined about 25% from its highs, and businesses are hemorrhaging during stay home orders). Funding a GRAT when asset values are low and hopefully likely to rise significantly in future years will shift all that appreciation above the applicable § 7520[2] rate outside the grantor's gross estate for federal estate tax purposes. For example, if a GRAT is funded with $1 million and the taxable remainder is only $1,000, any remainder passing to the successor beneficiaries in excess of $1,000 makes a gift tax free transfer.

Interest rates are at near historic lows (the § 7520 rate for April 2020 is 1.2%).[3] For comparison, in 1989, the Code § 7520 hurdle interest rate was at a high of nearly 12%. In March of 2009, it was almost 3%. GRATs are a technique that shine brightest when the lower interest rates are in effect. Simply put, the lower the interest rate, the lower the annuity payment that has to be made periodically back to the grantor to minimize the taxable gift made with funding a GRAT, and hence the greater value shifted outside the estate. Going back to the above example, if the § 7520 was 1.2%, any growth and income above that rate will pass gift tax free to the successor beneficiaries.

The massive federal bailout, and more that may be coming, will eventually require that taxes on the wealthy (and the not so wealthy) be raised. While no one can forecast what tax law changes may occur, it seems logical that estate taxes will increase, perhaps markedly so. Therefore, shifting assets out of an estate using current favorable laws, such as by using GRATs, may prove very advantageous.

However, while the current environment may be the so-called "perfect storm" for GRAT planning, practitioners need to be aware of a number of nuances to this planning. In many instances, it will not be GRAT planning as usual. This article will explore some of the differences in how practitioners may choose to plan for GRATs in the current environment.

Only Use GRATs for Appropriate Situations

While it is obvious to most practitioners, it is so important that it warrants stating it explicitly here. GRATs are not an ideal tool for most clients who have remaining gift exemption. The current exemption of $11.58 million is the highest in history and may be reduced, perhaps substantially, by future legislation and is slated under current law to be halved effective 2026. Thus, clients with remaining exemption should consider gifts to GST exempt trusts, and other planning techniques that use exemption, before focusing on GRATs.

Again, as practitioners are aware, GRATs are a not a technique that generally secure remaining GST exemption. Some suggest that after a GRAT is funded, an old and cold GST exempt trust may purchase the remainder from the GRAT to thereby shift future appreciation into a GST exemption solution. So, practitioners should consider the GST planning implications when determining whether to use a GRAT in the current environment in contrast other planning techniques. It seems appropriate to mention that the IRS has indicated it would not respect such a purchase of the remainder in a GRAT to provide GST exemption.[4]

Overview of the GRAT Technique

The common application of the GRAT technique has been to structure a short-term, typically two-year GRAT, designed to capture upside market volatility. The annuity paid to the grantor would be set high enough so that the GRAT would have a nominal value for gift tax purposes— a so-called "post-Walton zeroed out" GRAT.[5] There are different perspectives on whether or not to use a zeroed out GRAT. Some practitioners think that it is perfectly acceptable while others prefer to structure the GRAT so there's a very modest initial gift value that can appropriately be reported on a United States Gift Tax Return (Form 709). In any case, it may be possible to draft for minimum value.[6]

The result of this traditional GRAT approach is that a substantial portion of the assets of the GRAT (principal plus the § 7520 mandated return) would be paid back to the client as the grantor. Market returns, above the mandated federal interest rate, would inure to the benefit of the grantor's "heirs" (or a trust for their benefit either created under the GRAT instrument or otherwise). This could result in the client "re-GRATing" the large distribution received in each year of the GRAT to a new GRAT. In other words, if a million-dollar GRAT were created, the first one-year annuity payment (of, perhaps, $500,000+) would be paid back to the client as the grantor, who could then gift that payment into a new GRAT. This is why the technique of using repetitive short-term GRATs has been referred to as "rolling"

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or "cascading" GRATs. The concept of re-GRAT-ing each year's distribution to a new GRAT has been a common part of the GRAT technique. However, it has two important implications to GRAT planning in the existing environment.

The first application is to a GRAT that was created recently and now has suffered a dramatic decline in asset value because of the coronavirus economic decline. Instead of earning more than the mandated interest rate, as anticipated when the GRAT was created and funded, the GRAT may be worth 20% less than what was initially transferred to it. Thus, these GRATs will fail, resulting in no assets inuring to the intended trust for remainder beneficiaries. All the assets will be distributed back to the grantor to meet the periodic required annuity payment, with nothing left for heirs.

What should be done in such a case? As the GRAT assets are repaid to the grantor in the form of periodic required annuity payments, he or she might continue the plan by re-GRAT-ing the assets received as the annuity payment into new GRATs. The implications to how a practitioner might choose to structure these new GRATs are discussed below and this may be different than the traditional application of the GRAT technique.

Remember volatility was the rationale behind using the GRAT technique in the first instance, and that is exactly what the GRAT experienced (just not in the intended direction). Remind yourself that, just as with rebalancing portfolios during market upswings and declines, assets should be re-GRAT-ed to new GRATs. If, in fact, the markets are at a low enough point now, the new GRATs will remove the anticipated market recovery from the client's estate. So, for many facing GRATs that have busted, establishing a new GRAT and regifting the assets to that new GRAT as they are received from the old GRAT may be an appropriate strategy to consider.

Be mindful that Congressman Bernie Sanders' proposed tax act[7] would, perhaps, eliminate the viability of the GRAT technique in many cases by requiring a minimum ten-year term for any GRATs created after the enactment of the Act.[8] If the grantor does not outlive the term of the GRAT, some or all

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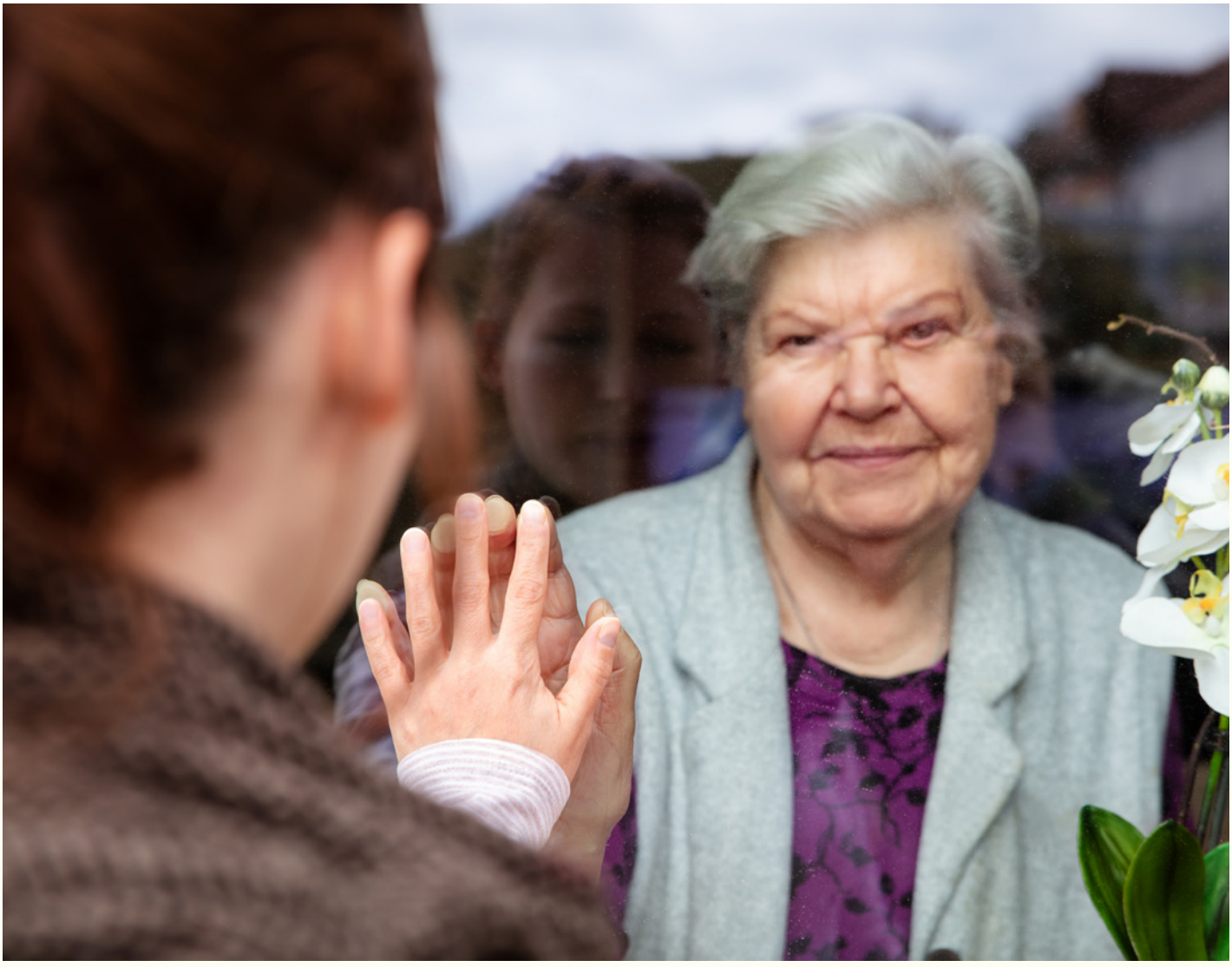

the assets would be included in the grantor's estate and that would dramatically decrease the risk of a GRAT succeeding. There is also a minimum required gift amount of at least 25% of the value of the assets contributed to the trust, effectively removing the ability to have a zeroed out GRAT and likely retarding the use of most GRATs being successful at all.[9] These two changes could potentially make GRATs impractical for taxpayers who have traditionally used GRATs when they no longer had gift tax exemption remaining. It would also seem to eliminate the commonly used technique of "rolling-GRATs."[10]

These proposals are not new. President Obama's Greenbooks included proposals to restrict GRATs by requiring a minimum ten-year term for GRATs that would have eliminated short term rolling GRATs. If the Democratic presidential candidate wins the 2020 election, tax proposals may include one that restricts GRATs in this way. However, even if the election retains Republican control in Washington, there may have to be similar restrictions put in place in order to raise revenues to fund the substantial bailout plans. Thus, when structuring new GRATs in the current environment, consideration should be given to how they may be changed since the elimination or severe restriction of the GRAT technique could prevent a rolling or cascading GRAT set up today when annuity payments are paid out in the future.

If the remainder beneficiaries of the GRAT plan are people whose relationship falls outside the scope of how the tax law defines "family" for these purposes (for example, a niece or nephew), then a property owner can use a grantor retained income trust, or a GRIT. The key benefit of a GRIT over a GRAT is that, instead of an annuity stream, the grantor receives back the income (in the trust accounting sense). The GRIT's success does not depend upon growth in the assets contributed to the trust (which is the case for a GRAT) but the value of the gift of the remainder will be quite high while the § 7520 rates are low.

Create a Paper Trail for Failed GRATs

A GRAT may pay back all of its assets to the grantor to meet the required annuity payment as a result of recent declines in asset values. Devoid of assets, the GRAT will fail. Consider having the trustees execute a short acknowledgement that the GRAT has been terminated with a final payment to the grantor, so that there is an obvious record in the files of what happened should a question arise in the future and to demonstrate there was no commutation of the grantor's interest in the GRATs, which the governing instrument must prohibit.

How to Handle an Existing GRAT That Will Likely Fail

Assume a GRAT has been funded, but asset values have plummeted. Say the client has gifted $2 million to the GRAT. First payment is about $1 million, but the asset value then is only $1.2 million. Do you have to leave all of the $200,000 in the GRAT? What can be done?

Can you buy that amount back from the GRAT for a note? Although commutation of the grantor's interest must be prohibited as required by the Regulations,[11] buying the assets back for a note is not prohibited in this context because it is the grantor writing a note to the GRAT not vice versa (which is prohibited). However, it likely would not be wise to distribute this note back to the grantor in satisfaction of the annuity to ensure that there is no violation of the Regulations.[12] Rather, some other asset should be substituted for the note so that asset and not the note is distributed to the grantor.

Consider having the grantor buy the remainder interest in a long-term GRAT after the three-year statute of limitations for the gift tax audit has run on the GRAT.

Alternatively, the grantor can substitute assets or purchase assets[13] if the GRAT is a grantor trust (as it almost certainly would be) and take assets out of the GRAT for cash and re-GRAT them.

Another option is to re-GRAT entire annuity interest. It seems likely that the grantor's annuity interest would be valued in the same manner as it was when the GRAT was created as § 7520 mandates how non-commercial annuities are to be valued for gift and estate tax purposes.

Some Thoughts on Rolling/Cascading GRATs

As mentioned above, a common GRAT technique has been the use of short-term rolling or cascading GRATs which are intended to capture upside market volatility. The mathematical superiority of short-term rolling GRATs over a single long-term GRAT has been documented.[14] There are a few points to consider:

What is the likelihood of the next administration making the estate tax rules tougher? Might GRATs be eliminated? Or might a required minimum ten-year term and a specified 25% minimum gift value on GRAT funding be enacted? Either of these restrictions would have a chilling effect on post-enactment GRAT plans and effectively undermine the assumptions of rolling GRATs for currently funded GRATs, if the successor GRATs are so fundamentally altered. If the next administration wants to raise revenues on the wealthy, or if there really is no choice in order to fund the very large bailouts during the coronavirus crisis, GRATs may disappear. Note also that restrictions on GRATs could be coupled with the elimination of discounts on related party transactions, elimination or restriction on so-called Crummey powers[15] (which are used to allow gift tax annual exclusions for transfers to trust), etc. The result may be a substantial enhancement of estate tax revenues.

If a rolling GRAT plan is being funded with discounted interests in a family or other closely held business, what impact will a legislative repeal or restriction on such discounts have on the plan? Short-term GRATs require high payouts to minimize or eliminate gift tax. That may mean that a significant portion of

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the equity in the family business may be repaid to the grantor in the form of GRAT annuity payments. If so, when the grantor wishes to re-GRAT, the assets may not, at that future date, qualify for discounts. Therefore, it may be advisable to lock in the discounts by using a longer term GRAT now (i.e., not the traditional two-year GRAT term). Question: if discounts are eliminated by future legislation, may that permit the payment of annuity amounts in kind (e.g. stock in a closely held business held in the GRAT), valued without discounts, even though discounts applied to the valuation of the interests when gifted to the GRAT?

What about creating a long-term GRAT instead of a series of short-term GRATs on the possibility that Congress may restrict GRATs? Although many have demonstrated the superiority of short-term GRATs compared to longer-term GRATs, the assumption is that a short-term GRAT is one in a series and may not be allowed in the future.

The more granular you make the GRAT, the more likely to capture upward market swings. Creating several GRATs each funded with one sector of the market is more likely to succeed than one GRAT funded with all of a market. The reason is that, with one GRAT, good performance in one sector will be offset by negative performance in another. But each GRAT funded with its own sector of the market can stand alone without erosion of other sectors.

GRAT Immunization

GRAT immunization refers to the process of substituting a nonvolatile asset such as cash for the assets inside the GRAT. So, if the GRAT holds Zoom stock, which has appreciated dramatically, the grantor could swap in cash and swap out equivalent value of Zoom stock. The rationale for this is that if the GRAT, whatever the term, realizes a significant uptick in value, the client will want to lock in that uptick by substituting less volatile assets. The application of this technique is discussed in the section that follows.

GRAT Immunization Will Have to Change

Considering the preceding factors does not change the fact that short-term rolling GRATs is a better strategy, but that strategy may not be given sufficient duration to succeed if the GRAT rules are changed by new legislation. Perhaps a safer long-term strategy may be to create a series of longer-term GRATs. If the GRAT technique is repealed, GRATs that have been executed and funded may be grandfathered in from these adverse changes. However, with longer-term GRATs, the traditional approach of immunization using cash or Treasury bills won't make economic sense. The reason is that swapping cash or treasuries into a two-year GRAT, and typically after some time is already run on that GRAT term, does not leave significant wealth unproductive for a long period of time. However, by opting into, for example, a ladder of six, eight and ten-year GRATs, the GRAT arrangements will be locked in for a longer time. In case future legislation restricts or eliminates short term GRATs, immunization has to be looked at differently. If in the second year of a ten-year GRAT there is a spike in the stock market, immunization may make sense but, in contrast to a two-year GRAT that may have mere months to run, this six, eight or ten year GRAT may have five or more years left to run. Holding assets idle in cash or treasuries for that long a period of time is not likely to be desirable. Thus, a more sophisticated investment technique will have to be implemented in order to immunize new longer-term GRATs.

Example: A client establishes a series of ten $1 million ten-year GRATs, each for a different asset class. One of the ten-year GRATs experienced a substantial gain in year one, doubling in value. Under the rolling GRAT paradigm, this would have been a two-year GRAT, not a ten-year GRAT. The client likely would have been advised to substitute Treasury bills for the $2 million in the GRAT, thus locking in the large gain. This strategy would not be acceptable in a ten-year GRAT unless the client retained Treasury bills for the nine remaining years. However, a two-year GRAT will not work either if GRATs are restricted next year by new legislation, or if it takes three or more years for that asset class to recover from the current coronavirus recession. Instead, while clearly less advantageous, the ten-year (or some other term longer than the traditional two-year) GRAT might prove the only practicable, effective technique. There are several approaches to consider. One might be to substitute a diversified portfolio with a nine-year time horizon for the $2 million appreciated GRAT property. Although clearly not as secure as locking in the gain with Treasury bills on a two-year GRAT with one year remaining, it will be more secure for purposes of retaining that gain than, perhaps, the ten year-long term overall asset allocation. Assume that the client generally has a 20+ year investment horizon and an overall asset allocation consisting of 60% equities, 25% bonds, and 15% alternatives. Perhaps the nine-year remaining GRAT may be given as substitute property, a more conservative allocation designed to minimize downside risk of giving up the $1 million initial gain, but still consider the long nine-year time horizon and the need for growth inside the GRAT. The client's wealth manager might recommend a 40% equity, 45% bond, and 15% alternative strategy. Perhaps option techniques can be used to hedge the downside risk in the highly successful GRAT while leaving some upside potential for growth in light of the nine years remaining. Although that strategy will come at a cost since it will reduce the upside, it can, perhaps, be viewed as insurance on preserving the large gain in the early years of a long term GRAT.

Long-term GRATs are not as efficient as a series of short-term GRATs. However, the budget deficit that the next administration will have to address, the uncertainty whether GRATs will survive, and the unknown timing of market improvements make it worth reconsidering them.

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GRATs As an ILIT Funding Tool

Irrevocable life insurance trusts (ILITs) are a ubiquitous planning tool. Many ILITs are funded using annual exclusion gifts.[16] This technique is also on the chopping block under proposed legislation. The Sanders tax proposal, for example, includes a cap on annual exclusion gifts of $20,000 per donor (not per donee).[17] That could undermine the funding in many traditional life insurance trusts. Practitioners may want to consider, in the current environment given what some view as an increased risk of harsher tax legislation to pay for the current bailouts, using GRATs to "pre-fund" future life insurance premiums in ILITs. If the insurance trust is not GST exempt, a GRAT could be structured to pour into the insurance trust as its remainder beneficiary and thereby infuse capital now before restrictions are created on ILIT Crummey Trust funding. If the ILIT is GST exempt, it could borrow at the low applicable Federal rate (AFT) from the successful GRAT and without income tax effect if each is a grantor trust as to the same grantor.

The Very Long Term GRAT

A concept that has been discussed for a number of years is often called a ninety-nine year GRAT. This technique is really an interest arbitrage and it is a technique whose time may be optimal right now. Many practitioners are under the misconception that if you died during the term of a GRAT, the entire GRAT principle is included in your taxable estate. That is not correct. Rather, to determine what portion of a GRATs assets are included in this settlor's estate, you take the required annuity payment and divide it by the § 7520 rate at the date of the grantor's death.[18] If interest rates are higher at the date of death, the full value of the GRAT will not be included in the grantor's estate if he or she dies during the GRAT term. With interest rates at historic lows, it may be a reasonable bet to assume that interest rates will be higher, perhaps substantially higher as of the date of death. So for clients that have used all of their current high temporary exemption, a bet now that asset values will grow substantially and interest rates will be much higher by death may make a ninety-nine year GRAT a valuable planning tool. If the § 7520 rate rises before the grantor dies, he or she could sell the remaining annuity payment before then and exclude a significant part of the trust from his or her estate.

Conclusion

Existing GRATs should be reviewed to determine whether or not they will remain viable and, if likely not, whether remedial action should be taken now. For new planning in the current environment, the GRAT, while subject to shortcomings of not being an efficient tool for using remaining exemption or GST planning, can provide a valuable planning tool for many clients.

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Endnotes

1 Described in Internal Revenue Code ("Code") § 2702 and Treas. Reg. 25.2702-3(b).

2 26 U.S. Code § 7520.

3 Rev. Rul. 2020-09.

4 *See* PLR 200107015 (not precedent).

5 *See Walton v. Comm'r*, 115 T.C. 589 (2000), acq. IRS 2003-44 I.R.B. 964, Notice 2003-72.

6 *See Blattmachr & Zeydel*, "Comparing GRATs and Installment Sales," 41 Philip E. Heckerling Institute on Estate Planning, Ch 2.

7 "For the 99.8 Percent Act," S. 309 116th Cong. (2019).

8 *Id.* at S. 309 §7(a) and (b).

9 *Id.* at S. 309 §7(a)(4).

10 *See*, e.g., https://www.wealthmanagement.com/estate-planning/treasury-releases-2017-greenbook.

11 Treas. Reg. 25.2702-3(d)(5).

12 Treas. Reg. 25.2702-3(d)(6).

13 There would be not taxable income even under Rev. Rul. 85-13, 1985-1 CB 184.

14 *See* Bernstein Journal, vol. VI, no. 1, Summer 2008, p. 9.

15 *See, generally*, "Building an Effective Life Insurance Trust," 129 Trusts & Estates 29 (May 1990).

16 26 U.S. Code § 2503(b).

17 S. 309 §10(a).

18 See Treas. Reg. 20.2036-1(c), especially Example 2.