

PODCASTS | 08.10.2020

Long-Term Planning: A Guide to GRATs

Renat Lumpau and Jes Lambert, principals in Choate's Wealth Management Group, and Christine Wright, a portfolio manager at Choate Investment Advisors, discuss the compelling role that Grantor Retained Annuity Trusts (GRATs) can play in long-term planning, how they should be structured to maximize the planning benefits, and identify the investment strategies that make the most sense to use in a GRAT.

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Transcript

Renat Lumpau: I am a principal attorney in the Wealth Management Group at Choate, Hall & Stewart. I am joined today by Jes Lambert and Christine Wright. Jes is also a principal attorney at Choate. Jes and I specialize in advising high net worth clients on all legal and tax aspects of their wealth management needs. Christine is a Portfolio Manager at Choate Investment Advisors, where she works closely with our clients to develop tailored investment recommendations. Christine also holds a CFP designation. Today we are talking about GRATs, which is a very popular estate planning technique.

Jes, I'd like to start with a question for you, what is a GRAT and why is it called that?

Jes Lambert: A GRAT is an irrevocable trust for a fixed term of years. "GRAT" stands for "grantor retained annuity trust." It's called that because the grantor contributes property to the trust and retains the right to receive back annuity payments from the trust.

Most commonly, the annuity payments are annual, and come due on the anniversary of the funding date, but the rules provide that the actual payment to the grantor may be made at any time within 105 days after the annuity date. The annuity payments cannot, however, be made in advance of the payment date. For that reason, it is important to consider the cash flow constraints on the grantor when deciding which assets will be used to fund the GRAT. If cash flow is a concern, it's a good idea to model out anticipated cash flow prior to funding. Importantly, the annuity payments are structured to return to the grantor the entire value of the assets contributed to the GRAT plus a required amount of interest.

Because the grantor gets back assets equal in value to what he or she put in, there is no gift upon the funding of a GRAT. What this

means is that a GRAT uses up no gift tax exemption.

The key to a successful GRAT is that if the assets contributed to the GRAT appreciate at a rate higher than the statutory interest rate (which we often refer to as the “hurdle rate”), then all of the appreciation in those assets passes to the named remainder beneficiaries completely free of gift and estate tax at the end of the GRAT term.

RL: And how is the interest rate determined?

JL: The interest rate is determined by the IRS each month, and the applicable rate is based on month in which the GRAT is funded.

In general, the IRS interest rate follows prevailing market rates. At the moment, it is at an all-time low, only 0.6% and will be decreasing even further to 0.4% in August. For this reason, right now is a great time to create new GRATs, because the interest rate “hurdle” to a successful GRAT is extremely low. This creates a significant opportunity to pass assets tax free to the beneficiaries.

RL: You mentioned that a GRAT has a fixed term of years. How is that term of years determined? And what happens at the end of the term?

JL: The term of the GRAT is chosen by the grantor when the GRAT is first created. The minimum duration for a GRAT is two years, and that is a very popular choice for many clients. But longer GRATs are also common, and some clients decide to establish GRATs that last 3, 5 or 10 years.

The choice of an optimal GRAT term is driven by several factors. Short-term, 2-year GRATs are popular because they allow the grantor to quickly capture investment upside and transfer it to GRAT beneficiaries. On the other hand, choosing a longer term allows the grantor to lock in the current very low interest rates, which may be attractive if the assets held in the GRAT are expected to increase in value over a longer period of time.

As I mentioned, the GRAT term ends when all of the required annuity payments have been made. At that time, any remaining GRAT assets – being the investment appreciation over and above the hurdle rate – will pass to the beneficiaries named in the GRAT instrument, who are chosen by the grantor. Typically, the remainder beneficiaries will be the grantor’s children or a trust for their benefit.

RL: Does this mean that the grantor has to decide right at the outset who the remainder beneficiaries will be?

JL: Not necessarily. It is possible to structure the GRAT to defer the decision about the specific remainder beneficiaries until the end of the GRAT term. This is done by appointing an independent trustee when the GRAT ends and giving that trustee the power to decide how the remaining GRAT assets will benefit the class of permissible beneficiaries chosen by the grantor.

RL: Is it possible for a GRAT to fail?

RL: Yes, a GRAT will be unsuccessful if the GRAT assets do not appreciate over and above the annual IRS hurdle rate for the month of funding. But a really nice feature of the GRAT technique is that, even if a GRAT is unsuccessful, all of the GRAT assets will revert back to the grantor. In that case, assuming the GRAT was properly administered, the grantor will be in exactly the same position as if he or she never funded the GRAT. In other words, there is very little downside to a properly structured and administered GRAT.

Christine Wright: From an investment perspective, keep in mind that an unsuccessful or “failed” GRAT does not mean that you made a poor investment choice. It just means that the assets did not appreciate more than the hurdle rate so you’re not able to pass on a tax-free gift. However, the assets in the GRAT are owned by the grantor and are looked at as part of a broader portfolio, so they would have been owned regardless of the GRAT.

RL: Christine, from an investment perspective, are there particular types of assets that are best suited for a GRAT and are most likely to end with success?

CW: Remember that GRATs are specifically designed to transfer the appreciation from the assets in the GRAT during the term. For that reason, it is best to fund GRATs with assets that are expected to experience significant growth during the GRAT term, either through market movements for publicly traded assets or through a liquidity event for privately held investments.

RL: Can you suggest some best practices or rules of thumb in thinking about the funding decision?

CW: Yes, there are a couple recommended best practices to maximize the effectiveness of a GRAT.

First, you essentially want to choose assets that are expected to go up in value quickly or have the ability to move quickly – essentially, assets with a lot of volatility. There are many catalysts that could cause an asset to appreciate, but a prime example is right after a large market decline when prices are depressed, like we saw in March of this year. Because GRATs allow us to capture the upside for the remainder beneficiaries while keeping downside risk with the grantor, volatility works in our favor.

Second, it is usually best to fund a GRAT with either a large single asset or stock position because they exhibit the most volatility. Some of the most successful GRATs we've funded have been with large individual stock positions that clients were holding as part of a broader portfolio.

However, if a client does not have a concentrated stock position like this, another good option is publicly traded funds within the same asset class so that they are likely to experience similar market movements. For example, mutual funds that hold US stocks.

This allows us to zero in on the expected increase in the value of the one asset or asset class.

RL: What if a client wants to fund with many different types of investment positions?

CW: In that case, it is better to contribute each to its own separate GRAT. That way you avoid having a scenario where positive and negative returns on different holdings cancel each other out and the result is an unsuccessful GRAT. Although diversification is a good thing in a broader portfolio because it helps to reduce volatility, essentially with a GRAT less diversification is better.

As I mentioned before, keep in mind that even if a particular asset underperforms the hurdle rate, there's really no investment downside to putting it in a GRAT. This is why we like to separate assets into independent GRATs, so that each successful GRAT can pass its appreciation to the remainder beneficiaries, and each unsuccessful GRAT can revert back to the grantor without diluting the winners.

RL: Are there any other considerations or operational best practices you recommend following?

CW: Yes, it is helpful to model out the cash flow changes associated with contributing assets to a GRAT and take into the account the dividends that the grantor will no longer be receiving. Some clients use the income generated by their investments, so it's important to understand that any income generated by the assets in a GRAT will not be available to the grantor for the term of the GRAT.

Additionally, many clients like to roll over GRAT annuity payments into new GRATs. What this means is that when the original GRAT makes annuity payments back to the grantor, the grantor contributes those annuity payments to new GRATs in order to continue capturing further investment upside from the investment assets.

Finally, from an operational perspective, it also helps to add a small amount of cash to our GRATs, to cover any account fees and other administrative expenses of the GRAT without having to sell any of the holdings.

RL: What about in dollar terms, is there a typical or recommended funding amount?

CW: There is no set minimum amount, but essentially larger GRATs are likely to be more effective in terms of transferring wealth in a tax-free manner.

For example, if a \$100,000 GRAT that outperforms the hurdle rate by 10%, we would transfer only \$10,000 to the remainder beneficiaries, which is likely easier and less expensive with just an outright gift. However, if you fund a GRAT with \$10M that outperforms by 10%, you transfer \$1M to the beneficiaries, which is much more worthwhile.

For this reason, most clients fund GRATs with at least a few million dollars and often with tens of millions of dollars.

RL: So if the grantor wanted to make a GRAT more effective, could he or she add assets to an existing GRAT after it has been funded?

JL: Unfortunately, the answer is no. GRATs are subject to several very specific tax rules, and one of those rules is that a GRAT can be funded only once and cannot receive additional contributions of assets. This is why when we fund GRATs either with multiple securities or with a single assets and some cash, as Christine mentioned, it is extremely important for all of those assets to be transferred to the GRAT on the same day.

RL: Let's talk about these tax rules. How are GRATs treated for tax purposes?

JL: When we talk about GRATs and taxes, it's important to keep in mind three distinct sets of tax rules. Let's go through them one-by-one.

The first set of tax rules is the income tax rules. For income tax purposes, a GRAT is treated as a special kind of trust called a grantor trust. The specific rules are complicated, but the key point is that for income tax purposes all of the GRATs assets and taxable income are treated as though owned directly by the grantor, and as though the GRAT did not exist. These income tax rules offer some very compelling planning opportunities.

First, the funding of a GRAT is a complete non-event for income tax purposes. That is to say, if the assets contributed to a GRAT have built-in gain, as is very often the case, there is no gain realization on the way in.

Second, all transactions between the grantor and the GRAT are also completely ignored for income tax purposes. For example, it is extremely common for GRATs to make their required annuity payments back to the grantor in kind, using a portion of the assets held in the GRAT. These annuity payments also do not trigger gain realization.

On a related subject, the grantor can at any time during the GRAT term exchange assets held in the GRAT for other assets or cash of equal value owned by the grantor personally. These asset swaps are also completely ignored for tax purposes.

RL: I know there are more tax issues to discuss and I'd like to come back to that in a moment, but I have a question for Christine: Why would the grantor want to swap assets between himself or herself and the GRAT?

CW: An asset swap can be a really useful tool to lock in the GRAT winnings in the middle of the GRAT term.

For example, if the GRAT assets have appreciated rapidly and could decline again before the GRAT term ends, the grantor can swap those volatile assets at that point in time, and replace them with a more stable asset like cash or bonds. This effectively locks in the GRAT's success until the end of the term.

RL: Jes, let's go back to the tax conversation.

JL: Yes, we were discussing the income tax rules that apply to GRATs. So far we've covered several consequences of grantor trust status, and there are a few more:

Because the grantor is treated as the tax owner of all assets held in the GRAT, if the GRAT sells all or a portion of its assets during the GRAT term, the capital gains tax liability will have to be paid by the grantor out of his or her own assets. This has two consequences: On the one hand, it may present cash flow issues for the grantor who has to come out of pocket with respect to the GRAT's tax liability. On the other hand, this feature effectively allows the GRAT assets to grow on an after-tax basis for the benefit of the remainder beneficiaries, which further increases the effectiveness of this planning technique.

On a related subject, it is important to note that the amount of capital gains will be determined with reference to the grantor's original tax basis in the asset. This is true both during the GRAT term and also when the remainder beneficiaries eventually decide to sell the assets they received from a successful GRAT. As a result, when deciding to implement a GRAT it is important to weigh the gift and estate tax savings against the income tax consequences of losing basis step up that would occur if the grantor held on to the assets until his or her death.

The final income tax consideration is that the GRAT does not need to file a separate income tax return. Instead, all taxable income, including capital gains, realized by the GRAT will be reported on the grantor's own income tax return. Likewise, the GRAT does not need its own taxpayer identification number and can use the grantor's Social Security number for tax reporting purposes.

RL: In addition to these income tax rules, are there any gift and estate tax considerations?

JL: As I mentioned earlier, GRATs are an especially attractive planning technique because the funding of a GRAT does not result in a taxable gift. Similarly, when the GRAT term ends, any assets passing to the remainder beneficiaries are also not subject to any gift or estate taxes.

Even though the funding of a GRAT has no gift tax consequences, it is very important to report the funding of a GRAT to the IRS on a gift tax return. A gift tax return is a separate filing from the regular income tax return, and in general is due at the same time.

Also, it is important to note that gift tax returns are a specialty, and we always advise clients to hire accountants with deep expertise in all the relevant gift and GST tax rules, to avoid potentially costly mistakes. And we like to review drafts of gift tax returns before

they are filed with the IRS.

RL: But if there's no taxable gift, what's the purpose of filing a gift tax return?

JL: There are two reasons to report the funding of a GRAT to the IRS. First, if the GRAT is funded with non-publicly traded assets, the filing of a return starts the statute of limitations on a possible valuation challenge by the IRS. And second, it is a best practice to make some technical GST tax elections with respect to the GRAT in the year of funding.

RL: Could you tell us more about the GST tax rules that apply to GRATs?

JL: Yes, the GST tax rules are the third set of relevant tax issues.

As I mentioned, GRATs do not use the grantor's gift and estate tax exemption. But for generation-skipping transfer tax purposes, the rules are different, as a result of which GRATs don't offer the same GST tax benefits as they do for gift and estate taxes.

It is not possible to allocate GST exemption to a GRAT until the end of the GRAT term. The amount of GST exemption that will need to be allocated at that time in order to fully protect the assets passing to the remainder beneficiaries from the GST tax is the entire value of the remaining assets, even though those very same assets will pass to the beneficiaries without using up any of the grantor's gift and estate tax exemption. This is why many clients will use GRATs to preferentially benefit only their children and not grandchildren or more remote descendants, although there are exceptions.

JL: If a client really wants to use GRATs to plan for the grandchildren's generation, are there any good options?

JL: Yes, there is one specific way to use GRATs to benefit grandchildren in a tax-efficient way. Under the GST tax rules, GRAT assets can pass to an ongoing trust that can pay for the grandchildren's educational expenses free of GST taxes, even if the grantor does not allocate his or her GST exemption at the end of the GRAT term. This is a great planning opportunity for many clients.

RL: Christine, let's go back to our earlier discussion about the types of assets that are best suited for a GRAT. What are some of the pros and cons of funding GRATs with publicly traded securities as opposed to private investments?

CW: The chief advantage of using publicly traded securities is that they are very easy to value and transfer. One of the key requirements of administering a GRAT is that it is necessary to value the GRAT assets on the day of funding and on each anniversary date during the GRAT term, where we need to use the average of the high and low trading values on those dates.

This is very easy to do for publicly traded assets. In comparison, with privately held securities, this is much more difficult. For a private company, the client will need to obtain independent third-party appraisals of the GRAT assets at least once a year during the GRAT term. This can easily add considerable expense and delays.

RL: Jes, are there any additional issues from a legal perspective?

JL: Yes, funding GRATs with privately held assets can add significant paperwork to document both the initial transfer into the GRAT as well as the annual annuity payments. This will almost always involve dealing with lawyers for the private company, which adds to the cost.

In addition, funding GRATs with privately held interests can raise securities law issues, which can be very difficult to navigate, not to mention expensive.

RL: Let's talk about the cost of creating a GRAT. How much work and legal time is involved?

JL: Typically, drafting a GRAT is very straightforward. The best way for clients to manage costs is to focus on the key decisions that need to be made. These include the desired GRAT term, who the remainder beneficiaries should be and whether the client wants to retain flexibility to allocate the GRAT winnings at the end of the term, and the specific assets to be contributed to the GRAT.

CW: From an investment perspective, it is also a good idea to consider preparing the GRAT documentation and establishing an investment account in the name of the GRAT in advance, and then it can be beneficial to wait and take advantage of a short-term dip in values to fund the GRAT.

For example, if a client has done this in advance, they could have taken advantage of the market declines earlier this year, and it turns out we've since had the US stock market increase over 40%.

RL: GRATs sound like a really great technique. Jes, before we wrap up, are there any downsides to GRATs that clients should be aware of?

JL: Yes, there are two important considerations that clients should keep in mind, in addition to several points we discussed earlier.

First, it is critically important to strictly comply with all funding and administration rules. This includes, for example, not making any additional contributions to an existing GRAT, as we discussed earlier, and to make annuity payments within the time frame authorized by the IRS rules.

And second, a GRAT will fail if the grantor dies during the initial term. To be clear, there is no tax penalty if that happens, but all of the GRAT assets will be included in the grantor's taxable estate as though the GRAT had not been funded. The required annuity payments will continue to be paid out to the grantor's estate over the course of GRAT term. This means that even though all of the GRAT assets will be included in the grantor's estate, the assets will not be returned to the estate until the prescribed annuity dates, which can pose liquidity constraints on the estate. This is another factor that is important to keep in mind when setting the duration of the GRAT, especially for older clients. Some clients choose to purchase term life insurance policies to provide liquidity for their estate if they die during the GRAT term.

RL: Jes and Christine, thank you for your time and for sharing your insights. I really enjoyed our discussion, and I hope everyone did as well.

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