

Planning Strategies

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The Great Thing about GRATs

Grantor Retained Annuity Trusts (or “GRATs”) allow for the tax-efficient transfer of the future appreciation of assets. As long as the assets appreciate over the IRS’s hurdle rate, and the grantor survives the term of the trust, heirs can take the remaining assets (representing the future appreciation) free of any gift tax. This can be achieved by the grantor retaining an annuity interest having a present value equal to the value of the assets contributed to the trust. To get it exactly right, this annuity amount is determined by using the IRS’s hurdle rate and the number of years the trust will run. In effect, this retained interest cancels out the present value of the gift, thus making it tax free. The combination of recent tax changes, the 2020 election cycle, and the hostility by some toward certain tax loopholes make 2020 the year to focus on estate planning.

There has been no better time to do estate planning. Why?

- Extremely low interest rates
- Lower stock market valuations
- Market dislocation
- High estate/gift tax exemption
- Political uncertainty

Everyone needs at least a basic estate plan. But for those who may be subject to federal or state estate taxes, tax-efficient wealth transfer is also a major concern. The GRAT is one tool estate planners have been using for years that allows wealth to be transferred at a zero tax cost to heirs.

What is a GRAT?

Under current law, the GRAT allows for the tax-efficient transfer of the future appreciation of assets in excess of a pre-determined interest rate. As long as the assets appreciate over the pre-determined interest rate (aka the “hurdle rate”), and the grantor survives the term of the trust, your heirs can take the remaining assets (representing the future appreciation) free of any wealth transfer tax when the trust terminates. Is this too good to be true? In a sense, yes. The great thing about GRATs is that they are specifically sanctioned in the Internal Revenue Code.¹ While this is a blessing, it’s

also a curse. That’s because the government could change the rules in the future, which makes 2020 an especially compelling year to create a GRAT.

Gift of future appreciation

Assume that on April 15, 2020, you give 10,000 shares of ABC Co. worth \$2,000,000 to your kids. That’s a reportable gift and will use up part of your \$11.58 million lifetime estate/gift tax exemption. Assume further that the shares appreciate 8% per year over the next two years. On April 15, 2022, their value is \$2,332,800. The \$332,800 of excess value isn’t reported on the 2020 gift tax return because the appreciation occurred after the date of the gift. Of course, the asset also could lose value over the same time period. Would the future loss reduce the value of your gift in 2020? No. Future appreciation of gifted property inures to the donee, not the donor. Losses, as well, will be borne by the owner of the shares. What if there was a way to give only the future appreciation of those 10,000 shares without giving up today’s value of the shares?

How does a GRAT work?

In 1990, Congress enacted section 2702 of the Internal Revenue Code to cut down on abusive estate planning techniques. However, in so doing, they actually made the problem worse. The Grantor

¹ See IRC section 2702.

Retained Annuity Trust is a statutorily sanctioned type of irrevocable trust that allows the grantor to retain an “annuity” (i.e., a return of a fixed dollar amount), the present value of which is subtracted from the value of the initial gift. Thus, the amount of the gift reportable on a gift tax return is just the net value (i.e., after backing out the annuity). The statute sets no minimum term (although 2 years is thought to be the minimum) and requires no minimum remainder amount. Picking up on this, estate planners started recommending short-term “zeroed-out” GRATs, such as 2-year GRATs with no assumed residual value. This can be achieved by the grantor retaining an annuity interest having a present value equal to the value of the assets contributed to the trust. To get it exactly right, the annuity amount is determined by a calculation using the IRS’s hurdle rate in effect when the trust is created and the number of years the trust will run.

Example

- In April 2020, the IRS’s hurdle rate is 1.2%
- Grantor makes a gift of \$2,000,000 of ABC stock to a 2-year GRAT
- Grantor retains an annuity of \$1,018,018.80 per year (which is 50.90094% of the assumed value of the trust’s assets)
- The sum of the two annuity payments is \$2,036,037.60, the present value of which is \$1,999,999.73 (27 cents shy of \$2,000,000)
- If the assets grow at 8% per year over that term, the remainder will be \$217,798.51 upon expiration of the term
- The remainder may be distributed to heirs or a trust for their benefit free of estate and gift taxes²

Why is this such a good deal? Because the grantor has transferred \$217,798.51 free of gift tax. That happens because, at funding, the hypothetical value of the trust remainder is zero. Further, under the tax code, we are forced to use a very low rate of return when measuring that hypothetical value. And, the grantor gets the most of the principal back (less any losses).

2020 is an especially compelling year to create a GRAT

Income tax aspects of GRATs

GRATs also have a special feature that makes them even more compelling. They are “grantor trusts.” This means that all income of the trust is taxable to the grantor. All dividends and capital gains are reported on the grantor’s Form 1040. This allows the trust’s assets to grow unburdened by income tax. In addition, the grantor trust rules permit the grantor to have a “swap power” whereby the grantor may exchange trust property for another asset of equivalent value. The swap power, which must be written into the trust agreement, allows the grantor to swap in cash for an appreciated asset and, thus, lock in the appreciation inside the GRAT. You would consider doing this if the GRAT had a good run and was close to its termination date, for example. You also might decide to swap out if the asset has underperformed. In that case, you could create a new GRAT with the same asset to capture more future upside.

When the grantor funds a GRAT with property, such as marketable securities, they have a carryover basis. That is, the basis of the securities in the hands of the trustee is the same as it was in the hands of the grantor. Further, when the trust terminates, there is carryover basis when the assets are transferred to the remainder beneficiary. Moreover, because of the grantor trust rules, an exchange for cash with the grantor would not result in a capital gain or change in tax basis. However, if the grantor dies before the expiration of the term, then the trust assets are included in his/her estate and would get a stepped-up basis as of the date of death.

How do I set up a GRAT?

You will need a lawyer to draft the trust instrument. The document is fairly straightforward and easy to create. In fact, it’s so easy, many grantors will set up several GRATs with staggered terms. Once the document has been executed, a new account is

² Consult your attorney about planning for the Generation-Skipping Transfer (GST) tax.

opened and funded. Each year, the annuity payment is paid over to the grantor, which may be paid “in-kind” with shares of stock or some other asset.

Will the GRAT rules be changed in 2021?

Political uncertainty

The federal estate and gift tax exemption is now at an all-time high at \$11.58 million per person, and twice that for a married couple. Under the Tax Cuts and Jobs Act of 2017, that exemption amount is scheduled to revert to pre-2018 levels (of half that amount) on January 1, 2026. However, Congress could change all this as soon as next year if the President signs the legislation. So, that raises a question. Will Congress take action to repeal the most generous estate tax exemption in history? And, if it were so inclined, what else might it do?

GRATs have come under scrutiny before. One proposal that has been floated in the past is to require a minimum term of 10 years. This would increase mortality risk, since if the grantor dies during the term, the entire trust is included for estate tax purposes (which is why short-term GRATs are favored). Another is to require a minimum actuarial remainder amount (such as 25%). This would trigger a taxable gift upon funding and limit the ability to transfer future appreciation on a tax-free basis. Both of these changes could kill the GRAT as we know it today.

A final note

The combination of the recent changes in the Tax Cuts and Jobs Act, the recent fiscal stimulus acts passed in reaction to the COVID-19 pandemic, and the 2020 election cycle make 2020 the year to focus on estate planning.

This piece on GRATs fits into a series we have been doing on estate planning. While the GRAT has been around for a long time, these times are truly unprecedented. The GRAT has never before been such a powerful estate planning tool. For more information, see [“Planning in a Low Interest Rate Environment”](#) (Aug. 2019) and [“An Update on Planning in a Low Interest Rate Environment”](#) (March 2020). Both review other planning ideas that you might wish to consider. Please contact your Portfolio Manager or Client Advisor at 1919 Investment Counsel for more information on these and other planning strategies.



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