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GRANTOR RETAINED ANNUITY TRUSTS

REVISITED – NEW OPPORTUNITIES

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We published an article last fall about the estate planning benefits of grantor retained annuity trusts. Based on recent economic developments, there are new opportunities with this planning technique and we have updated the article to highlight those opportunities.

Under current federal transfer tax law, you can transfer up to a combined total of $11,580,000 during life or at death without incurring federal estate or gift tax.[1] If you transfer assets in excess of this exemption amount, there will be a transfer tax of 40% on the excess assets. If you are at risk of a transfer tax liability and have appreciating assets, a grantor retained annuity trust ("GRAT") can be a useful tool to pass assets beyond your exemption amount free of tax. Based on the tax-savings that GRATs can provide and the fact that the usefulness of GRATs is at an all-time high, it is well worth your time to learn about this planning technique now.

A GRAT, at its most basic level, is an irrevocable trust. In most cases, creating and funding an irrevocable trust will reduce your federal estate and gift tax exemption amount by the value of the contributed assets. If you have already fully-utilized your estate and gift tax exemption amount, there will be a gift tax equal to 40% of the contributed assets. However, a GRAT can be structured so that a gift to it has a net present value of zero and will not reduce your exemption amount or otherwise trigger tax.

A net present value of zero is obtained by retaining a right to receive a stream of annual payments, an annuity of sorts, from the GRAT that offsets the value of the gift. For example, if you make a gift of $1,000,000 to a GRAT, you could retain the right to receive payments back totaling $1,000,000, plus interest, over a ten year term. Assuming the correct interest rate is used, the annuity payments have a net present value equal to $1,000,000. In other words, the annuity payments zero out the value of the gift.

Once the annuity payments have all been paid, the remaining GRAT assets can be distributed to your selected beneficiaries free of estate and gift tax. In most cases, the beneficiaries are children or trusts for their benefit. The beneficiary should not be a

[1] The current federal estate and gift tax exemption is $11,580,000 per person. A married couple could transfer up to $23,160,000 free of federal estate and gift tax. The exemption is set to increase annually to account for inflation. The exemption will also, as of January 1, 2026, decrease by half. A handful of states impose an estate tax and the exemptions in those states are generally significantly lower than the federal exemption amount.

charity. There are much more tax-efficient strategies than GRATs for charitable gifts.

The key for a GRAT is the spread between the interest rate used to structure the annuity payments and the actual growth rate of the assets contributed to the GRAT. As the spread of the actual growth rate of the GRAT assets over the interest rate used to structure the annuity payments increases, the larger the remainder passing to your beneficiaries free of estate and gift tax. However, you cannot select the interest rate to be used. The IRS calculates and issues the rate on a monthly basis. The rate is commonly referred to as the IRC 7520 rate. The rate used for a given GRAT is the IRC 7520 rate in effect at the time the GRAT is created and funded. The IRC 7520 rate is 1.2% for April 2020, the lowest rate in almost seven years.

Continuing the example from above of a GRAT funded with $1,000,000, if we assume that the GRAT is funded in April of 2020, the annual annuity payments are paid to you over a ten year period, and that the GRAT assets grow at a rate of 7% during that ten year period, the result is that the GRAT remainder will be approximately $600,000 after the annuity payments. Assuming you have a taxable estate, $600,000 passing to your beneficiaries tax-free represents an estate tax savings of $240,000! The following table illustrates the year-to-year operation of the example GRAT:

Year	Beginning GRAT Value	GRAT Growth (7%)	Annuity Payments to Donor*	Taxes on GRAT Income	Ending GRAT Value
1	$ 1,000,000	$ 70,000	($41,820)	$ -	$ 1,028,180
2	1,028,180	71,973	(50,184)	-	1,049,969
3	1,049,969	73,498	(60,220)	-	1,063,246
4	1,063,246	74,427	(72,264)	-	1,065,410
5	1,065,410	74,579	(86,717)	-	1,053,271
6	1,053,271	73,729	(104,061)	-	1,022,939
7	1,022,939	71,606	(124,873)	-	969,672
8	969,672	67,877	(149,847)	-	887,702
9	887,702	62,139	(179,817)	-	770,024
10	770,024	53,902	(215,780)	-	608,146
	Total annuity payments		$ 1,085,583	Any tax is paid by donor	$ 608,146
					Amount transferred free of gift & estate tax

* The annuity payments do not have to be level as long as no payment exceeds 120% of the value of the immediately preceding payment.

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What are the income tax implications of a GRAT?

The funding of the GRAT in exchange for the right to receive annuity payments from the GRAT has no income tax consequences. Similarly, the transfer of the annuity payments to you from the GRAT, whether in cash or in-kind with non-cash assets, has no income tax consequences. This is because the GRAT is a grantor trust for income tax purposes. The IRS effectively views you and the GRAT as the same taxpayer and a taxpayer cannot engage in taxable transactions with himself or herself.

Since the GRAT is a grantor trust for income tax purposes, you are responsible for any income tax attributable to income generated by the GRAT assets. As the annuity payments are made over time, the GRAT assets will be invested and generate interest, dividends, and capital gains. This income will be reported on your personal return and you will be responsible for the associated income tax. This has a significant estate and gift tax benefit. Since the GRAT is not bearing the burden of income taxes, the GRAT is effectively growing income tax free. This will maximize the remainder passing gift and estate tax free to your beneficiaries after the annuity payments have been made.

Why is now potentially a good time for a GRAT?

Low interest rates, depressed asset values and the possibility of an administration change make now a good time to consider GRATs.

GRATs have been available for a long time, but high IRC 7520 rates in the past limited the use and effectiveness of GRATs. A GRAT is most effective at minimizing estate and gift taxes if created in a low IRC 7520 rate environment. It is less effective in a high IRC 7520 rate environment. The actual growth rate of the assets within a GRAT must exceed the applicable IRC 7520 rate to provide estate and gift tax savings. If the actual growth rate of the GRAT assets does not exceed the applicable IRC 7520 rate, the annuity payments will ultimately exhaust the GRAT and there will be no remainder to distribute to your beneficiaries free of estate and gift tax. There is no negative consequence other than that the GRAT failed to provide any estate and gift tax savings.

The IRC 7520 rate bottomed out at 1% several times in 2012 and 2013. Since then, rates have fluctuated up and down and have gone as high as 3.6% in November and December of 2018. Rates started to creep down during 2019 and hit 1.2% for this April, the lowest rate since June of 2013.

The IRC 7520 rate applicable to a given GRAT is the rate in effect at the time of the creation and funding of the GRAT so the current low rate environment is an ideal time for a GRAT. Subsequent changes in the IRC 7520 rate will not negatively affect a GRAT and will not require any recalculation of the annuity payments.

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GRATs were quietly used for many years by high net worth taxpayers to transfer large sums outside the estate and gift tax system. Over time, GRATs began to attract public attention. An article from 2013 projected that Sheldon Adelson, the CEO of a major casino and resort company, transferred his heirs at least $7.9 billion from 2010 through 2013 while avoiding $2.8 billion in gift taxes.[2] The same article notes that use of GRATs "may have cost the federal government more than $100 billion since 2000."

In the current negative economic environment, certain asset values may be artificially depressed. Assuming the values normalize during the term of a GRAT, the asset growth rate over the IRC 7520 rate will be boosted. This will increase the remainder of the GRAT and the amount passing free of estate and gift tax to your beneficiaries.

During the prior administration, several legislative proposals were made to restrict the use of GRATs, but none of the proposals were adopted into law. It seems unlikely that any similar proposals would gain much traction under the current administration, but another administration change might reignite a legislative spotlight on GRATs and other estate and gift tax planning techniques. Even if the administration does not change, the estate tax could be revisited as an avenue to help cover deficits created by the recent stimulus bill and planning techniques could become restricted.

Is a GRAT an overly-aggressive technique?

Even though the estate and gift tax savings provided by a GRAT can be significant, it is not an overly-aggressive technique. GRATs are provided for in the Internal Revenue Code. Assuming the structure mapped out in the code is used, a GRAT funded with cash or publicly-traded securities carries little risk of challenge. Funding a GRAT with non-marketable assets, such as real estate and closely-held businesses, can create some risk. The contribution of non-marketable assets to a GRAT will require an appraisal to establish a value for the assets. Since the value of non-marketable assets is often subject to debate, the IRS could challenge the appraisal. A successful challenge might limit the effectiveness of the GRAT, but will generally not create negative tax consequences if the GRAT is properly drafted.

What are the best assets to contribute to a GRAT?

Generally, rapidly-appreciating assets are the best assets to contribute to a GRAT. Rapidly-appreciating assets are most likely to grow in excess of the applicable IRC 7520 rate and result in a larger remainder that passes to beneficiaries free of estate and gift tax. Rapidly-appreciating assets include assets that may be artificially depressed in value in the current economic environment and that will rebound during the term of a GRAT.

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[2] https://www.washingtonpost.com/business/grat-shelters-an-accidental-tax-break-for-americas-wealthiest/2013/12/27/936bffc8-6c05-11e3-a523-fe73f0ff6b8d_story.html

Also, high basis assets can be better to contribute to GRATs than low basis assets. An asset includible in a decedent's gross estate for federal estate tax purposes generally receives a stepped-up tax basis.[3] The stepped-up tax basis of an asset is equal to the value of the asset on the owner's date of death. The stepped-up tax basis eliminates any built-in gain that existed at the time of death. As an example, if you buy a share of stock for $1, your tax basis for the share is $1. If that share of stock is now worth $10, you will recognize $9 of income if you sell the share. If you die holding that share of stock and it is worth $10 at your death, your beneficiaries will receive a stepped-up tax basis of $10 for the share. If your beneficiaries immediately sell that share of stock for $10, no gain is recognized because the sales proceeds did not exceed the tax basis.

The GRAT remainder assets passing to your beneficiaries will not be within your gross estate for federal estate tax purposes. Accordingly, those remainder assets will not receive a stepped-up basis at your death. For this reason, contributing high basis assets to a GRAT can be best. Transferring low basis assets passes along a built-in taxable gain to your beneficiaries.

If you do add low basis assets to a GRAT, you can avoid passing along the built-in taxable gain to the beneficiaries by selling the assets while the GRAT is a grantor trust. The sale will trigger the gain. Since the GRAT is a grantor trust for income tax purposes, you are responsible for paying the income taxes associated with the gain and will use non-GRAT funds for payment of the taxes.

What happens if you die during the annuity term of a GRAT?

If you die while annuity payments are still being made to you, some or all of the GRAT assets will be included in your gross estate for federal estate tax purposes. The portion included in your estate will depend on the IRC 7520 rate in effect at your death. Inclusion of a portion of the GRAT assets in your estate is not great. However, that leaves your beneficiaries no worse off than if you had not tried the GRAT in the first place.

GRATs can be a powerful estate tax planning technique that carry little or no risk and several variables have aligned to make now the time to consider GRATs. If you wait, the effectiveness of GRATs may decline. An administration change could very well result in legislation limiting the use of GRATs, and at some point, interest rates will rise and depressed asset values will rebound.

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[3] Assets considered "income in respect of a decedent," such as retirement benefits, do not receive a stepped-up basis.

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