

Understanding the Grantor Retained Annuity Trust

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This discussion focuses on the creation and administration of a grantor retained annuity trust (also known as a “GRAT”) for estate planning purposes. This discussion describes the basic principles of the GRAT creation. In particular, this discussion explains the many factors that a typical high net worth individual should consider in the process of assessing the pros and cons of the GRAT creation. With regard to the GRAT creation, these factors include both administrative issues and financial issues. Finally, this discussion reviews both the benefits and the risks of the GRAT creation as part of an estate plan.

INTRODUCTION

Estate planning can be one of the most challenging and complex aspects of developing a comprehensive financial plan, particularly for high-net-worth individuals. Typically, such individuals have applied considerable effort to amass their wealth. Now, they want to ensure that as much of it as possible is passed down to their heirs and beneficiaries.

Depending on the size of the grantor’s estate, the grantor may be responsible for paying a significant amount of tax.

The good news is that individuals in this situation can apply various planning procedures to reduce the transfer taxes they have to pay. Establishing a grantor retained annuity trust, typically referred to simply as a GRAT, is one of the planning procedures that can be considered.

Through the creation of a GRAT, high-net-worth individuals can minimize or eliminate the impact of the gift and estate tax liabilities caused by the transfer of appreciated assets to subsequent generations. A GRAT makes it possible for the high-net-worth individual to “freeze” the value of his or her estate in the near-term future to gift any value appreciation to the beneficiary, who, in turn, avoids tax burdens on the transfer of the estate.

A steady flow of income is distributed to the grantor in accordance with the terms of the trust (in the form of an annual distribution). If an individual owns an asset that he or she believes will increase in value over time (but who does not wish to gift outright immediately), it may make sense to transfer the potential future growth of that asset to the heirs through the use of a GRAT.

WHAT IS AN ANNUITY TRUST?

Let us begin by talking about annuities. Annuities play a significant role in GRATs.

An annuity is a financial instrument in which an individual makes an up-front contribution of funds or a selection of assets (such as shares of stock or options) into a designated account.

That account then distributes money back to the individual regularly in installments, immediately, or at some point in the future.

GRAT BASICS

A GRAT is a trust established so that individuals and families can transfer wealth to heirs while using little of their lifetime federal gift and estate tax exclusion, if any. This tax-advantaged transfer is possible through the implementation of a GRAT.

In practice, an individual would establish an irrevocable trust with the assistance of an attorney; then the individual transfers assets into that trust. In exchange, the grantor would be eligible to receive annuity payments (at a minimum annual basis) for a predetermined length of time.

The initial transfer, plus any additional interest or appreciation, would be returned to the grantor over the trust's term.

Upon the conclusion of the term, the remainder of the trust would be distributed to the grantor's heirs, either:

1. in the form of an outright gift or
2. as the principal for a subsequent trust.

It is important to remember that the grantor only gets the right to a stream of annuity payments—and not the actual income from the trust. If the trust does not produce an adequate amount of income, the trustee is obligated to make the annuity payment out of the principal.

The amount of a taxable gift is determined by:

1. taking the property's fair market value transferred into the trust and
2. subtracting the value of the grantor's retained interest from that property's value.

Annual payments to the grantor on behalf of the GRAT consist of part of the principal amount and an interest rate. The interest payment is determined using the prevailing interest rate as established by the Internal Revenue Service (the "Service"). This interest rate is referred to as the "Section 7520 rate" or the "hurdle rate."

Theoretically, let's suppose a grantor sets the annuity payments to match the hurdle rate. In that case, all assets underlying the GRAT will have been returned, in total, to the grantor, making the value of the assets worth zero to the beneficiaries.

Throughout the lifetime of the GRAT, the grantor is responsible for paying tax on the income earned by the trust, but the grantor does not pay tax on the annuity payments received.

Ideally, after the GRAT, the property's value transferred into the trust will have appreciated beyond the accumulation of the hurdle rate payments. This procedure allows beneficiaries to receive the assets without incurring heavy tax-transfer burdens.

As the initiator of a GRAT, a grantor assumes that the value of the assets will appreciate to a value greater than the value established by the interest rate. If, however, the value of the assets increase at

a rate less than the hurdle interest rate, then the beneficiary of the trust will receive the assets at a depreciated value.

In the event that the GRAT is ended prematurely (i.e., before the terms of GRAT have been fully satisfied), the property is:

1. transferred into the original estate of the grantor and
2. made subject to regular estate taxes.

Therefore, a prospective grantor needs to understand that the benefits of utilizing a GRAT are not assured to the trustee. The use of a GRAT should only be implemented after thoughtful consideration of the implicit risks.

If the trust is set up correctly, any assets still in the trust after the term of the GRAT has expired—including any appreciation greater than the threshold interest rate—will be passed on to the beneficiaries free of gift and estate taxes.

This threshold rate is derived from a rate that the Service prescribes. The rate is variable monthly and fluctuates based on several economic factors; however, the prevailing interest rate at the time of the establishment of the GRAT is the fixed rate at which regular payments are made.

Therefore, for a GRAT to succeed, the assets held within the trust should appreciate by an amount greater than the threshold rate in effect at the time the trust was funded.

When the hurdle rate is low compared to its historical levels, the likelihood that the assets will exceed the hurdle rate may be higher. This could mean significant potential estate tax savings and increased wealth transferred to the beneficiaries.

In creating a GRAT, numerous factors should be considered:

1. The length of the GRAT
2. The funding of the GRAT
3. The appropriate receipt of annuity payments
4. Tax implications
5. The termination of the GRAT

Term of the GRAT

The length of the term for a GRAT can vary. In general, the term typically falls somewhere between 2 and 10 years.

Because a longer-term GRAT can be implemented, a hurdle rate can be fixed for a longer period of time, which may be a potential perk for prospective

grantors. The degree to which one anticipates the value of the trust's assets to increase is a significant factor that should be considered when selecting an appropriate term length.

Compared to speculating over a short time frame, opting for a longer-term GRAT gives the trust more time to appreciate beyond the hurdle rate (assuming favorable market conditions), which increases the likelihood that they will be able to beat said rate.

The more the trust assets can appreciate over an extended period, the higher the remaining balance that will be free of gift and estate tax when passed on to the beneficiaries.

Funding a GRAT

The assets most suitable for contribution to a GRAT include the following:

1. Assets with a current low value compared to their potential future value
2. Assets anticipated to increase in value throughout the GRAT

To the extent that an asset's value can be discounted (because of a lack of marketability or lack of control or certain other constraints), the annuity stream will be computed based on the adjusted (discounted) value of the asset.

This procedure simplifies how the contributed assets may beat the applicable hurdle rate (assuming the annuity is paid with undiscounted assets).

GRATs provide the greatest return on investment when financed with assets that have the potential for considerable appreciation over time (e.g., shares in a family company or pre-IPO equities).

GRATs can also be funded with different types of investable assets. Because of this, GRATs are one of the more flexible financial vehicles available to owners of wealth.

When the GRAT is supported with cash or other investable assets, the process of valuing the assets and transferring those assets is simplified. After the transfer of the assets, the trustee can make investments or reallocations based on the provisions of the trust.

It is difficult and expensive to fund a GRAT with more complicated assets, such as shares in a family-owned company. This is because appraisals may be required if the price for the company shares is not easily identifiable.

Let's consider a scenario in which the grantor has a GRAT that is active and performing well (i.e., assets that have been contributed have appreci-

ated more than the Internal Revenue Service hurdle rate). Under these circumstances, the grantor can consider whether or not it would be beneficial to "lock-in" the appreciation (and, consequently, the benefit to his or her beneficiaries) by exchanging the GRAT assets for assets with lower volatility for the remaining term of the GRAT.

When contemplating the funding of a GRAT with a portfolio of assets—such as with shares of a family business *and* with publicly traded equities—it is important to evaluate whether or not it would be more prudent to establish individual GRATs for each category of assets.

If assets are held in separate trusts, it is possible for one GRAT to exceed the required rate of return, while the other GRAT may not be able to do so. If the assets belong to the same trust and one has a negative impact on the other, the combined appreciation of the assets may not be able to exceed the hurdle rate, resulting in an undesired outcome.

After the funding of a GRAT is completed, assets held within the GRAT may be traded for assets held outside of the GRAT. It is possible that this flexibility could be achieved by designating the grantor as the trustee of the trust. Alternatively, the trust document could be drafted by an attorney to include specific language that grants the grantor this authority.

If the GRAT assets do not perform as well as the grantor anticipated, these assets can be removed from the trust and replaced with other assets. Those other assets would be expected to have a higher potential for appreciation.

This procedure may be helpful for the grantor in avoiding certain risks, such as establishing a GRAT when the stock market is trading at historic highs. Such timing may increase the likelihood of a drop in the stock market and a decrease in stock prices occurring during the course of the GRAT.

Conversely, this procedure could also help the grantor realize the full effects of asset appreciation, such as establishing a GRAT when the stock market is trading at low levels.

If the assets held within the GRAT experience rapid appreciation, it is possible to remove such assets and replace them with cash or other assets that are expected to experience low levels of volatility. This strategy can make it possible for the grantor to lock in the rapid appreciation, which can then be passed on to the heirs when the GRAT term ends.

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Finally, if the grantor requires access to liquid assets, the grantor can take the liquid assets out of a GRAT and invest the money into illiquid investments instead. However, a current valuation of such assets would need to be considered, among other factors, in this scenario.

Appropriate Receipt of Annuity Payments

It is important to ensure that the annuity payments are appropriately considered in their valuation and that the payments are made on time. The grantor may be able to count—as additional contributions to the GRAT—any annuity payments made by the GRAT that are either incorrect or received late. Because of this, the GRAT may be disqualified, rendering this wealth transfer method ineffective.

The trustee has the responsibility to keep accurate records, including account statements and asset appraisals.

When making the appropriate payments for an annuity, a grantor can receive either:

1. monetary compensation or
2. a portion of the trust assets.

Tax Implications

During the GRAT term, the GRAT's income tax liability is passed to the grantor for federal income tax purposes. During the remainder of the term, the tax liability will either:

1. pass through to the grantor or
2. be paid by the trust.

This consideration depends on the structure of the remaining term. It allows the assets in the GRAT to appreciate during the term of the GRAT without incurring any income tax liability. However, this consideration does not allow the grantor to avoid paying income taxes on any appreciation realized during that period.

Termination of a GRAT

After the term of the GRAT, any assets that have been held in trust for the beneficiaries will either:

1. be given to them in their entirety or
2. continue to be held in trust for their benefit.

If several rolling GRATs have been established, the grantor may, for administrative convenience,

consolidate the balances of these trusts into a single trust.

For income tax purposes, the trust can also be treated as a grantor trust, which means that the grantor will:

1. continue to be responsible for paying the income and
2. see an additional reduction in his or her taxable estate.

It is also possible for the trust to acquire new assets, sell existing assets, or receive distributions without triggering the realization of ordinary income or capital gains. The assets held in the trust can be made accessible to whomever the trustee selects, subject to as many or as few restrictions as the trust documents determine.

BENEFITS AND RISKS OF USING A GRAT

Benefits of a GRAT

The creation of a GRAT can result in several advantages. One of the primary benefits of purchasing an annuity is that it can guarantee a certain amount of money during retirement for those who require it.

The primary advantage of creating a GRAT is the possibility of transferring large sums of money to a beneficiary without paying any (or only a minimal amount of) gift tax.

Gift-giving is an important part of estate planning. This is because gifting enables the grantor to transfer assets to a beneficiary free of any tax liability—so long as the value of the gift does not exceed the amount exempt from federal gift tax.

The exemption amount is \$16,000 in 2022, meaning that an individual can make up to that amount annually without paying gift taxes on that income. However, gift taxes are owed on amounts that are given that are greater than \$16,000.

It is possible to transfer much more than \$16,000 to a beneficiary without paying gift taxes. That would occur if the grantor incorporates a GRAT into the grantor's estate planning strategy. Again, this is a benefit for individuals with larger estates—that is, individuals who are wealthy enough to take advantage of it.

The GRAT makes it possible for individuals to transfer more valuable assets or properties in a shorter time. Also, the GRAT allows them to avoid or significantly reduce the gift and estate tax liability that a transfer of this magnitude would typically incur.

Risks of a GRAT

The utilization of a GRAT is not without risks. When a grantor establishes a GRAT, he or she is also responsible for deciding how long the trust will last. After the period has run its course, the beneficiaries will be given the remaining portion of the asset transfer.

If the grantor passes away before the period of the trust is up, then all of the assets in the trust (1) revert to the grantor and (2) are included in the grantor's taxable estate.

Because of this, grantor considerations of the length of the term may include some element of risk. More extended periods provide more time for the grantor's assets to appreciate, resulting in a substantial capital gain. This is the primary motivation for creating a GRAT in the first place.

On the other hand, the longer the period is—for instance, 20 years—the greater the likelihood that the grantor's health may deteriorate—and the greater the possibility that the grantor would not live long enough to see the conclusion of the term.

Because the grantor often only avoids gift tax on asset appreciation, it is a best practice to only populate the GRATs with high-yielding assets, like shares of stock. This is because the grantor only avoids gift tax on asset appreciation.

If the grantor does not anticipate a considerable increase in value for these assets in the foreseeable future, creating this kind of trust may not be financially beneficial.

Let's assume that grantor considers the time and resources needed to establish a GRAT as being too great of a burden. In that case, it may be that the benefits of establishing a GRAT may not justify the costs, and the grantor may be better off donating the monies or assets through more conventional channels.

Lastly, the cost basis that the grantor had in the asset is preserved in the donated asset. When the beneficiaries eventually sell the asset, they will be required to pay capital gain taxes on the entire gain associated with the property—not just on the gain they realized when they received the asset.

These capital gain taxes will be paid in addition to the gain they realized when they received the asset. The recipients may be responsible for paying large income taxes on the donated property.

SUMMARY AND CONCLUSION

A GRAT is a beneficial financial instrument available for individuals who wish to protect their wealth for the benefit of their heirs. GRATs offer individuals

a vehicle to mitigate tax burdens in the transfer of their estate.

When executed appropriately, the GRAT bypasses financial obligations on behalf of the transferee, who would otherwise be liable to pay estate taxes (which may be considerably large sums in the case of larger estates). Moreover, the beneficiary is allowed to fully realize the appreciation in the value of the grantor's estate.

The GRAT should be created only after careful consideration of the many factors and complexities that may influence or complicate the trust.

First, the grantor should consider the appropriate length of the GRAT. What is the appropriate duration for the trust which allows the beneficiary to entirely realize its benefits?

Second, the grantor should consider the outlook of the assets and decide on the optimal duration for which these assets will realize their potential value.

Third, the grantor should also make the sobering consideration as to whether he or she will be around to see it fully gifted to the heirs. In making these decisions, the grantor should weigh the judgment of potential value against the appropriate hurdle rate.

The grantor should decide how to fund the trust, which assets he or she wishes to put into the trust, and how the trust is administered. Should the grantor create separate trusts for various asset classes?

In addition, the grantor should be prepared to adapt to changing circumstances. The flexibility of the GRAT is one of the important features that the grantor should take advantage of.

In times of economic uncertainty or prosperity, a grantor may make the necessary adjustments to reflect the trust's goals.

Another consideration is setting the appropriate annuity amount, as a miscalculation of the trust's ability to make these payments in regular installments may jeopardize the effectiveness of the trust.

In deciding whether or not to create a GRAT, an individual should weigh the prospective benefits and risks. If applied to its full capabilities, the GRAT allows the individual to pass down the advantages of asset ownership while avoiding some of the inconveniences of the asset transfer.

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