Thought Leadership

Making GRATs GREAT for Tax-Free Wealth Transfers

Darin Christensen, Esq.

When implemented in an effective and timely manner, a series of grantor retained annuity trusts (each a "GRAT") can be used to transfer as much of an individual's wealth as desired without any significant gift or estate tax cost. The performance of a GRAT is significantly affected by the taxpayer's choices about the term, annuity stream, and assets transferred. This discussion provides an overview of GRATs and summarizes several planning strategies to make GRATs even more effective.

Introduction

When used effectively and given enough time, a series of grantor retained annuity trusts (each a "GRAT") can be used to transfer as much of an individual's wealth as desired without incurring any significant gift or estate tax cost. Because GRATs are so effective at transferring wealth without incurring gift or estate tax liability, the President's 2014 budget proposals[1] request several changes to limit the effectiveness of GRATs.[2] Unless or until the proposals are adopted,[3] GRATs should be among the primary planning options considered for high net worth estate planning clients.

This discussion summarizes ideas to make GRATs work even more effectively and provides examples to illustrate the potential impact of the planning strategies.

What Is a GRAT?

A GRAT is an irrevocable trust that pays back to the creator of the trust (the "grantor," "settler," or "trustor," depending on the lawyer preparing the trust) payments at least annually over a fixed term of at least two years.[4] The payments can be expressed as a fixed dollar amount or as a fixed percentage of the value of the assets transferred to the trust as finally determined for gift and estate tax purposes.[5]

At the end of the trust term, any assets remaining in the trust are transferred to the remainder beneficiary or beneficiaries free of any gift or estate taxes, other than any taxable gift caused by creation of the trust. Although the grantor's intended beneficiaries can be the remainder beneficiaries, the remainder beneficiary is usually another trust for their benefit.

The taxable gift to the remainder beneficiaries is determined by (1) taking the value of the assets transferred to the trust and (2) subtracting the value of the annuity payments. That value is determined using Internal Revenue Service ("Service") valuation tables.

The value of the payment stream or annuity is determined using a discount rate called the Internal Revenue Code Section 7520 rate. This rate is based on the yield of intermediate term Treasury securities, and it was 1.4 percent in July of 2013.

Unlike some other estate planning techniques, GRATs are specifically provided for by statute.[6] This removes the risk inherent in some estate planning strategies that the Service or the courts will determine that the strategy is invalid.

The grantor retains the right to payments during the grantor's life. Because of this, all or a substantial part of the GRAT assets will be included in the grantor's estate if the grantor dies during the term of the GRAT. This is the case even if the GRAT assets are worth a lot more than the remaining payments due to the grantor.[7] This effectively means that the benefits of a GRAT are obtained only if the grantor survives the GRAT term.

Also, because of the grantor's right to payments, a GRAT is a grantor trust for income tax purposes. Primarily, this status results in the following:

1. All taxable income, gains, deductions, and losses of the GRAT are reported on the grantor's income tax return.
2. The GRAT does not file an income tax return.
3. Transactions between the GRAT and the grantor have no income tax consequences.

These characteristics provide planning flexibility and help to minimize administrative burdens.

Maximizing GRAT Effectiveness

The seven strategies to improve GRAT effectiveness are summarized below.

1. Always Use a Zeroed Out GRAT

Most GRATs are set up so the value of the annuity payments is equal to the value of the trust assets. This type of GRAT is called a "zeroed out GRAT." With a zeroed out GRAT, the taxable gift made upon funding the GRAT is usually under $1.00 even for very large gifts.

The overall effect of a zeroed out GRAT is to transfer to the remainder beneficiaries, free of gift and estate taxes, any earnings and growth in the trust assets in excess of the Section 7520 rate.

Let's assume assets worth $10,000,000 are transferred to a simple two-year zeroed out GRAT[8] in July of 2013. The trust would be required to make annual payments of $5,105,166 at the end of each of the two years. The taxable gift on formation would be $0.84.

If the trust assets increased in value (earnings and growth) at an 8 percent annual rate, then the remainder beneficiaries would receive $1,045,254.72 free of gift and estate taxes at the end of the second year—a lot more than the $0.84 taxable gift.

Using a non-zeroed-out GRAT reduces the

If the return on the bonds over the remaining year and a half is 1.4 percent,[12] the GRAT transfers $197,136 to the remainder beneficiaries at the end of the two-year term—regardless of future performance of the stock. If the stock value continues to increase during the next two years, additional amounts also will be transferred to the remainder beneficiaries.

Second, when a GRAT substantially declines in value, the grantor can substitute stable value assets for the GRAT' assets and transfer those assets into a new GRAT. This lets the GRAT restart at a lower value[13]—significantly improving subsequent results if the stock recovers even part of the loss.

Let's assume a two-year GRAT is funded with $1,000,000 of stock on July 1, 2013. One week later the stock value falls 20 percent. At that time, stable value assets are substituted for the stock and a new GRAT is created with the stock.

By July 1, 2014, let's assume the stock returned to its $1,000,000 value, and it increases in value 5 percent in the subsequent 12 months. If no substitution had been made, $3,440 would have been transferred to the remainder beneficiaries. By making the substitution and creating the new GRAT, $212,753 is transferred to the remainder beneficiaries.

Third, assets can be substituted when the grantor wants only a limited amount to transfer to the remainder beneficiaries. By substituting stable value assets, the grantor locks in the amount the beneficiary will receive.

Let's assume that a grantor wants his child to receive no more than $1,000,000. Let's also assume that a GRAT for the child's benefit is funded with $10,000,000 of stock. Once the GRAT assets have increased sufficiently to have a $1,000,000 remainder after the remaining annuity payments are made, stable value assets are substituted for the original assets. The child receives a tax-free gift of approximately $1,000,000,[14] and the grantor receives back all other transferred assets.

7. Use Discounted Assets When Feasible

Using assets subject to discounts to their underlying value amplifies GRAT performance.

Let's assume a ten-year GRAT is funded in July of 2013 with 10 percent of the ownership interests in a closely held limited liability company (LLC). The LLC owns assets worth $15,000,000 that generate a 10 percent return each year, and the LLC distributes 70 percent of the income and reinvests the other 30 percent. The 10 percent interest in the LLC is valued with a 35 percent combined discount for lack of control and lack of marketability.

Let's further assume that (1) the value of the LLC's assets does not change during the ten-year life of the GRAT except that it is increased by the reinvested income and (2) the GRAT earns 2 percent interest on the cash it receives but does not use to make the annuity payments. At the end of the ten years, the LLC liquidates and distributes its assets to its owners.

Based on this scenario, the remainder beneficiaries would receive $2,175,707. On the other hand, if the same GRAT was funded with a $1,500,000 value asset that produced a 10 percent return but was not subject to a valuation discount, the beneficiaries would receive only $1,312,076.

The biggest challenge with this strategy is that assets that are subject to valuation discounts usually don't have readily ascertainable values. A valuation would be required upon asset contribution and upon any distribution of the underlying asset to the grantor to make the annuity payment.

Also, to the extent that the annuity payment exceeds the income generated to the assets, the payment to the grantor would be made in discounted value assets. For difficult to value assets, it may be both more effective and more simple to use a sale to a grantor trust[15] as the estate planning strategy.

A variation on this strategy of using discounted assets involves transferring assets that the grantor believes are going to significantly increase in value. Let's assume an investor owns stock worth $1,000,000 in a company that strategic buyers are beginning to investigate. Let's also assume the investor transfers the stock to a two-year GRAT.

Eight months later, a strategic buyer submits an offer to acquire the company for $3,000,000. Four months after that, the sale is completed. If the GRAT's annual return on the proceeds of the sale is 5 percent, then at the end of the GRAT, the remainder beneficiaries would receive $2,103,441.

Sample GRAT Performance

This discussion considers how different GRAT types would have performed over the last ten years. Exhibit 3 presents results for different GRAT terms with five stocks, a bond exchange traded fund, a stock exchange traded fund, and some mixes of

Exhibit 3
Sample GRAT Performance

	Type of GRAT and Use of the Remainder						
	10-year GRAT	5-year GRAT			2-year GRAT		
Asset:		Cash	Diversify	Shares	Cash	Diversify	Shares
Intel	0	0	0	0	411,581	524,121	459,234
Schnitzer Steel	865,327	4,907,291	6,074,388	1,175,326	2,506,500	3,558,344	842,635
Nike	2,821,969	2,171,278	2,569,060	3,849,038	2,241,243	2,678,894	3,626,784
Precision Cast Parts	10,931,023	5,849,471	7,075,502	11,808,414	5,529,128	7,421,450	12,689,584
Stancorp Financial Group	508,380	1,198,506	1,483,546	1,204,831	966,569	1,134,967	1,073,385
Equal Mix of Five Stocks	2,819,245	2,581,169	3,195,047	3,309,228	2,317,883	3,033,757	3,480,754
Five Separate GRATs	3,025,340	2,825,309	3,440,499	3,607,522	2,331,004	3,063,555	3,738,324
PIMCO Total Return A	234,158	706,185	843,408	828,683	328,774	420,846	374,212
Vanguard Total Stock Market	401,222	811,403	1,004,378	1,022,548	803,058	965,913	995,282

Exhibit 4
Adjusted Closing Prices of Selected Stocks and the Section 7520 Rate

	Selected Stocks								Section 7520 Rate
	Intel	Schnitzer	Nike	PCP	Stancorp	PIMCO	Vanguard	Equal Mix	
1-Jul-03	19.57	14.7	11.2	15.9	23.21	6.04	39.46	15.90	3
1-Jan-04	24.03	28.63	15.16	23.1	27.35	6.34	45.92	22.78	4.2
1-Jul-04	19.25	29.59	15.91	27.85	29.58	6.38	44.99	23.67	5
1-Jan-05	17.79	32.99	19.06	34.79	36.22	6.61	49.21	27.37	4.6
1-Jul-05	21.65	27.42	18.55	44.56	36.79	6.72	52.67	28.68	4.6
1-Jan-06	17.07	32.1	18.04	49.52	42.92	6.76	55.09	30.63	5.4
1-Jul-06	14.59	32.57	17.74	59.2	37.17	6.79	55.05	31.39	6
1-Jan-07	17.17	37.02	22.35	88.29	41.87	6.98	62.89	40.55	5.6
1-Jul-07	19.56	52.15	25.72	136.22	41.1	7.09	63.97	54.65	6
1-Jan-08	17.63	54.56	28.03	113.15	43.73	7.85	61.05	51.26	4.4
1-Jul-08	18.76	86.94	27.11	92.95	43.81	7.74	57.63	54.16	4.2
1-Jan-09	11.07	37.87	21.08	64.67	23.45	7.98	37.7	32.13	2.4
1-Jul-09	16.83	51.89	26.66	79.54	31.26	8.6	46	41.73	3.4
1-Jan-10	17.22	39.11	30.28	104.95	39.87	9.14	50.71	46.32	3
1-Jul-10	18.56	44.28	35.24	121.91	34.96	9.63	52.94	51.78	2.8
1-Jan-11	19.63	59.67	39.76	142.73	42.24	9.77	63.02	61.74	2.4
1-Jul-11	20.76	49.15	43.78	161.15	31.49	10.14	64.11	63.00	2.4
1-Jan-12	25.03	42.25	50.87	163.51	37.59	10.37	65.51	65.52	1.4
1-Jul-12	24.72	27.97	45.97	155.46	28.94	10.85	68.82	58.19	1.2
1-Jan-13	20.62	28.7	53.66	183.35	38.89	11.08	76.54	66.81	1
1-Jul-13	23.89	23.9	62.33	230.01	50.55	10.77	83.36	79.70	1.4

them. Exhibit 4 presents the adjusted values of each stock each six months since July 1, 2003.[16]

Conclusion

When used effectively, GRATs are one of the most efficient strategies to transfer wealth free of gift and estate taxes. By understanding the strategies that improve GRAT performance, GRATs can be dramatically more effective than they would be otherwise.

Notes:

1. This 256-page report issued in April of 2013 is titled the "General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals." Informally, it is called the "Green Book."
2. The proposals would apply only to trusts created after the date of their enactment and are (a) to require a minimum 10-year term for GRATs, (b) to prohibit zeroed out GRATs, and (c) to prohibit decreases in the annuity amount.
3. It does not look likely that Congress will adopt the GRAT proposals this year. The President previously made the same proposals and Congress did not pass them. Also, the House and the President have significantly different budgetary priorities.
4. The term can be for (a) the grantor's life or (b) the shorter of the grantor's life or a fixed term.
5. These amounts can increase by up to 20 percent per year. There is no express prohibition on decreasing annuity payments. Decreasing annuity amounts are sometimes used to create the substantial equivalent of a one-year (or shorter) GRAT. It is still an open question as to whether such GRATs will be respected for tax purposes.
6. See Section 2702 and the Section2702 Regulations.
7. See Sections 2036 and 2039 and the respective Regulations.
8. Unless otherwise stated, all examples use zeroed out GRATs with level annual annuity payments created July 1, 2013.
9. Using the geometric mean: multiplying the returns and then taking the 10th root of the result to determine the average return over the period.
10. The primary exception would be when the assets have a very good return in the early years and then a poor return in the later years. For example, if a two-year GRAT had assets that increased in value 50 percent the first year and decreased 30 percent the next year, a level GRAT would have a remainder payment of $182,122. A GRAT that increases the annuity 20 percent would have a remainder payment of just $167,634.
11. Increasing the annuity for a two-year GRAT increased the remainder payout by roughly 3 percent. With an 8 percent annual return, the remainder payout increased from $104,525 to $107,560. With a 15 percent annual return, the remainder payout increased from $224,889 to $231,152.
12. The Section 7520 rate for July 2013.
13. Unless the stable value assets appreciate in value more than the prior loss and the Section 7520 rate, the grantor will get all the stable value assets back at the end of the GRAT term.
14. Any difference would be due to differences in the return generated by the stable value assets and their anticipated return.
15. Often such a grantor trust is called an intentionally defective grantor trust (IDGT) or intentionally defective irrevocable trust (IDIT) This is because it is designed to be excluded from the grantor's estate. Such trusts are considered to be "defective" under the income tax grantor trust provisions so transactions with the grantor will not be subject to the income tax.
16. I selected five publicly traded companies in different industries—without analyzing their performance before selection. I also selected the PIMCO Total Return A (PTTAX) fund to represent a diversified bond portfolio and the Vanguard Total Stock Market ETF (VTI) to represent a diversified stock portfolio.

    I obtained the adjusted (for dividends) closing price from Yahoo Finance every six months over the ten-year period. I determined the amount that would be transferred over the ten-year period using a ten-year zeroed out GRAT, a series of (two) five-year GRATs, and a series of two-year GRATs. I performed this procedure for each of the seven investments, together with a diversified portfolio of equal values of the five stocks—based on their July 1, 2003, values.

    For each of the GRAT periods (other than the ten-year GRAT which had no remainder distribution prior to the ending date for the analysis), I compared the results if (a) the remainder were invested in cash that then grows at the Section 7520 rate, (b) the remainder is reinvested in a 50 percent stock/50 percent bond blend, and (c) the distributed shares were held for the entire ten-year period.

Darin Christensen is an attorney in the Portland, Oregon, office of Bullivant Houser Bailey PC. Licensed in Oregon and Washington, his practice focuses on tax planning, estate planning, probate, and business transactions. Darin can be reached at (503) 499-4497 or at darin.christensen@bullivant.com.