William Blair

Private
Wealth
Advisory

# Using a Grantor Retained Annuity Trust (GRAT) for Wealth Transfer Purposes

## What Is a GRAT?

## A grantor retained annuity trust (GRAT) is a wealth transfer technique used by taxpayers who want to gift future asset appreciation to heirs.

It allows an individual, the grantor, to essentially freeze his interest in the growth of an asset and give any excess future growth to beneficiaries, without incurring gift tax.

GRATs are popular and have allowed taxpayers to save more than $100 billion in gift and estate taxes since 2000, which is equivalent to about one-third of all estate and gift taxes the United States has collected since then.*

* Zachary Mider, "Accidental Tax Break Saves Wealthiest Americans $100 Billion," *Bloomberg Business*. December 16, 2013.

## How Does a GRAT Work?

To execute a GRAT, the grantor transfers property to an irrevocable trust with a fixed term, typically two to five years, and retains the right to receive an annuity during the trust's term. The annuity payment is calculated at the outset and can be made with cash or in kind with trust property. At the end of the term, any assets remaining in the trust pass to the trust's beneficiaries, typically the grantor's children.

In a "zeroed-out" or "Walton" GRAT, which is named after the court case involving Wal-Mart heiress Audrey Walton, the annuity amount is set so that the present value of the annuity payments equals the amount transferred to the GRAT, plus an assumed rate of return, commonly referred to as the IRC (Internal Revenue Code) 7520 rate or hurdle rate. This results in the grantor being treated as having made no taxable gift to the ultimate beneficiaries of the GRAT because, from a present value perspective, the grantor will receive back everything he transferred in the form of annuity payments. Accordingly, taxpayers are not required to use any of their lifetime gift and estate tax exemption when executing a zeroed-out GRAT. Figure 1 illustrates the GRAT concept.

## Tax Implications

As previously mentioned, executing a zeroed-out or Walton GRAT does not result in a taxable gift and, therefore, neither exhausts any of the taxpayer's remaining gift and estate tax exemption nor creates a gift tax liability. From a wealth transfer perspective, this makes the use of a GRAT analogous to a free pull at a slot machine. If the GRAT "hits," assets are transferred to the beneficiaries free of gift tax. If it doesn't, the grantor is in the same tax situation as before the GRAT was executed.

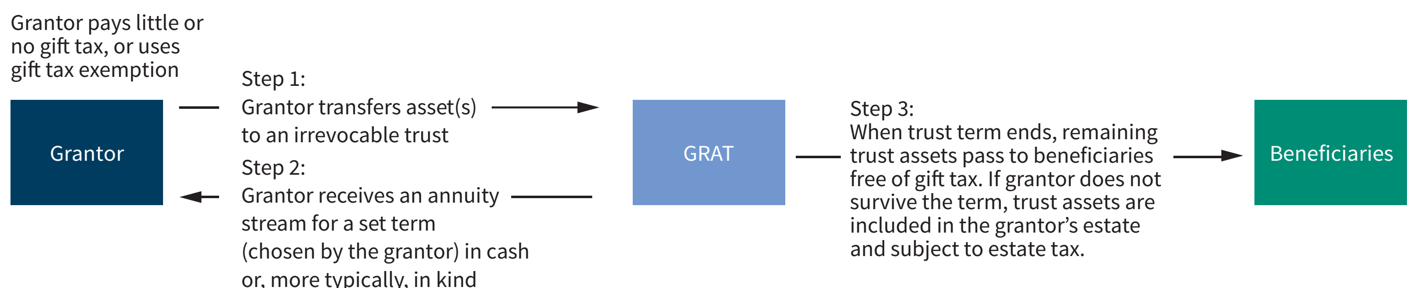
With respect to income taxes, the grantor is treated as the owner of the assets during the GRAT term and reports all income earned by the GRAT on his individual income tax return. To avoid having to file its own fiduciary income tax return, the GRAT should not apply for a separate taxpayer identification number. Rather, the grantor's Social Security number should be used for any bank or brokerage accounts opened in the name of the GRAT. Once the GRAT term ends and the final annuity payment has been made, the remaining assets are transferred to the beneficiaries, who will bear the tax burden for any future income the assets generate.

A GRAT is not an effective tool to leverage a taxpayer's generation-skipping transfer (GST) tax exemption. While the decision to allocate GST can be made at any time, the actual allocation of GST cannot be made until the GRAT term ends, resulting in the ability to allocate GST only on the full value of the remaining assets. Consequently, GRATs are typically structured to transfer wealth solely to the next generation.

## Why Are GRATs Popular?

A principal reason for the wide use of GRATs is that they are one of the few sophisticated wealth transfer techniques that are IRS approved. IRC section 2702 contains the specific requirements for GRATs and, as long as these requirements

**Figure 1: How a Zeroed-Out GRAT Works**



are met and GRATs are administered properly, they are unlikely to be challenged by the IRS. Consequently, risk-averse taxpayers generally choose to implement GRATs rather than other wealth transfer techniques.

Another reason GRATs are favored, particularly when dealing with hard-to-value assets like private companies or partnerships, is that they contain minimal valuation risk. One of the primary risks of any wealth transfer technique is that the IRS will audit the transaction and assess a higher value for the assets being transferred, resulting in a larger taxable gift and corresponding gift tax liability. However, GRATs can be drafted so that there is an automatic adjustment to the annuity payment in the event the IRS assesses a higher value in the gifted property. This ensures that properly structured GRATs will remain zeroed-out from a gift tax perspective and prevents any unintended gift tax consequences.

Use of GRATs has surged in recent years since their potential for wealth transfer is magnified in low-interest-rate environments. Because GRATs succeed in transferring wealth only if the underlying assets appreciate more quickly than the IRC 7520 rate, all else equal, one should look to execute GRATs when interest rates are low. IRC 7520 rates have steadily decreased over the past 25 years and have hovered between 1% and 3% in recent years. The following example quantifies the benefit of executing GRATs in a low-rate environment like the one we currently find ourselves in.

Assume $2 million in marketable securities were contributed to a five-year GRAT and that these securities earned a 9% annualized return during this period. If the GRAT were executed at an IRC 7520 rate of 2.0%, about $600,000 would remain in the trust at the end of five years and successfully pass to the trust's beneficiaries at that time. If the IRC 7520 rate were 5%, the same transaction would transfer only about $350,000 to beneficiaries. An IRC 7520 rate higher than 9% would result in a failed attempt at wealth transfer since no assets would transfer to beneficiaries. As the example illustrates, GRATs work markedly better when the IRC 7520 interest rate is low.

## Costs/Risks of Executing GRATs

Relative to the opportunity for significant wealth transfer and corresponding estate tax savings, the costs associated with GRATs are minimal.

From a wealth transfer perspective, if the assets transferred to a GRAT appreciate more slowly than the IRC 7520 rate, the GRAT will not be successful. All of the property placed in the GRAT will have been returned to the grantor during the annuity term and nothing will be left for the beneficiaries. Although this may seem like a failed transaction, the taxpayer is not any worse off for having established the GRAT: the taxpayer still has not used up any of his gift or estate tax exemption and still retains the asset.

In addition, the administrative costs associated with GRATs are nominal. Legal fees must be paid to an attorney to draft the trust document and a gift tax return needs to be filed. Further, the trustee of the GRAT needs to ensure that the annuity payments are made every year. While these obligations will add some cost and complexity to the grantor's estate plan, they are modest relative to the potential wealth transfer from a successful GRAT.

The primary risk associated with GRATs is mortality risk. In nearly all instances, if the grantor dies during the trust term, the transaction will fail and all of the trust assets, including income and appreciation, will be pulled back into his estate. Mortality risk can generally be mitigated by executing shorter-term GRATs, making them significantly more common than longer-term GRATs. Two-year GRATs are particularly prevalent since two years is the industry-recognized minimum term for a GRAT to confidently meet IRS requirements.

## Potential GRAT Candidates

Virtually any individual with a taxable estate and a desire for wealth transfer can benefit from using GRATs. Yet the ideal GRAT candidate may be one who has either already exhausted his gift tax exemption or only wants to part with the appreciation of an asset, not with the asset itself.

GRATs are appealing for taxpayers who have already used their lifetime exemption as zeroed-out GRATs afford them the opportunity to make additional gifts without incurring

any gift tax. Sheldon Adelson, one of the world's richest men, has reportedly used GRATs to legally give $7.9 billion to heirs while avoiding about $2.8 billion in gift tax.

GRATs are also a popular estate planning technique for taxpayers who would like to keep an asset but are comfortable parting with an asset's appreciation. A common scenario involves taxpayers who need the asset to maintain their lifestyle but can "afford" to gift away the asset's appreciation.

For example, assume a taxpayer with a $15 million portfolio determines he needs this $15 million to permanently maintain his accustomed standard of living, including $1 million for living expenses over the next 12 months while he awaits the first annuity payment. This taxpayer could create a GRAT with $14 million of his portfolio, retain this principal via annuity payments over the GRAT term, and transfer the remainder to heirs. Assuming a five-year GRAT term, a 2.0% IRC 7520 rate, and that the assets grow at 15% annualized rate over the GRAT term, the grantor would have successfully transferred $8,985,348 to heirs without incurring any gift tax. Figure 2 details the transaction.

## GRAT Optimization

Even in their most basic form, GRATs can be a powerful wealth transfer tool. However, there are several techniques that can enhance the effectiveness of GRATs. These include:

*Graduated Annuity Payments*
While annuity payments from the GRAT to the grantor must be fixed, the IRS allows them to increase over the term of the GRAT. This increase is limited to 120% of the amount paid in the previous year. By graduating the annuity payments, lower payments are required in the early years and higher payments are necessary in the later years, as compared to a static annuity stream. Given that financial assets generally appreciate over time, leaving more assets in the GRAT to grow over a longer period usually results in greater wealth transfer.

*Separate GRATs*
A GRAT's level of success is based on the performance of the assets transferred to it. In an ideal situation all of the assets placed in the GRAT will appreciate well beyond the 7520 rate. What's more common, however, is that some of the assets transferred to the GRAT appreciate while others stay flat or realize negative returns, resulting in diluted wealth transfer.

To maximize wealth transfer, taxpayers should consider setting up separate GRATs for concentrated positions and segregating GRATs by asset class. For example, if a taxpayer holds $3 million each of Procter & Gamble stock, the S&P 500 Index, and the Vanguard International Stock Index, we would advise setting up three separate $3 million GRATs as opposed to one commingled $9 million GRAT. Here's why: assuming 20% annual returns in the two index funds and a -15% annual return in the Procter & Gamble stock, the additional wealth transferred as a result of setting up separate five-year GRATs at a 2.0% IRC 7520 rate is $1,566,763, as illustrated in Figure 3.

**Figure 2: GRAT - Five-year term, 15% annualized rate of return, and 2% IRC 7520 Rate**

**Taxable gift based on IRC 7520 rate of 2.0%**

| Year | Beginning principal | Annual growth at 2% | Fixed annuity payment | Ending principal |
|---|---|---|---|---|
| 1 | 14,000,000 | 280,000 | 2,009,978 | 12,270,022 |
| 2 | 12,270,022 | 245,400 | 2,411,971 | 10,103,451 |
| 3 | 10,103,451 | 202,069 | 2,894,361 | 7,411,159 |
| 4 | 7,411,159 | 148,223 | 3,473,231 | 4,086,152 |
| 5 | 4,086,152 | 81,723 | 4,167,874 | 1 |

**Wealth transfer based on asset growth rate of 15.0%**

| Year | Beginning principal | Annual growth at 2% | Fixed annuity payment | Ending principal |
|---|---|---|---|---|
| 1 | 14,000,000 | 2,100,000 | 2,009,978 | 14,090,022 |
| 2 | 14,090,022 | 2,113,503 | 2,411,971 | 13,791,554 |
| 3 | 13,791,554 | 2,068,733 | 2,894,361 | 12,965,926 |
| 4 | 12,965,926 | 1,944,889 | 3,473,231 | 11,437,584 |
| 5 | 11,437,584 | 1,715,638 | 4,167,874 | 8,985,348 |

Amount of taxable gift
Tax free wealth transfer to beneficiaries

*Volatile Assets*
Asset selection is a critical success factor for GRATs since, as previously mentioned, a GRAT will be successful only if the underlying assets outperform the hurdle rate. Therefore, taxpayers looking to maximize the opportunity for wealth transfer should fund GRATs with volatile assets that have the potential for significant appreciation rather than with conservative assets with modest upside. In other words, when determining which investable assets should initially be used to fund the GRAT, stocks are generally preferable to bonds.

The reason is that as a result of the power of substitution, the assets only need to outperform the hurdle rate at some point during the GRAT term rather than over the entire term. For example, assume a taxpayer executed a two-year GRAT with small-cap stocks that appreciated 25% during the first year but depreciated back to their original value during the second year. Via the power of substitution, the taxpayer could have locked in the positive volatility after the first year and shielded the GRAT from the subsequent negative volatility, ensuring successful wealth transfer even though the asset's total return during the two-year term was zero.

*Power of Substitution*
Giving the grantor the power to substitute assets is another way to increase the likelihood of a successful GRAT since it provides the grantor with a mechanism for locking in the appreciation in a GRAT. If the value of the assets in the GRAT surges, the grantor exercises this power and swaps the assets in the GRAT for less volatile ones, usually cash. This freezes the value of the GRAT and guarantees that the excess appreciation will be passed on to beneficiaries. It should be noted that by executing this power, the grantor is also imposing a ceiling on the GRAT's level of success since the return on the cash is unlikely to exceed the IRC 7520 rate.

Note that the grantor is not required to use cash to execute the swap: less volatile assets and even a promissory note can be used. While a promissory note will add a layer of administrative complexity, it is a viable option for taxpayers who do not have sufficient cash or other non-volatile assets on hand to execute the substitution.

## The Future of GRATs

While GRATs have been used extensively by the affluent to transfer wealth and minimize gift and estate taxes, their future is uncertain. Recent legislative proposals have attempted to curtail the effectiveness of GRATs by either imposing a 10-year minimum term or by requiring that the actuarial remainder of the GRAT be greater than zero. If enacted, the former proposal would increase mortality risk and end short-term GRATs, while the latter proposal would increase gift tax costs and curb the use of zeroed-out GRATs. Because of this legislative scrutiny and the inevitable future increase in interest rates, taxpayers who have been contemplating zeroed-out GRATs should consider acting sooner rather than later.

**Figure 3: Separate vs. Combined GRATs**

| | Three separate GRATs | | | One combined GRAT | |
|---|---|---|---|---|---|
| | $3MM S&P 500 Index | $3MM Vanguard International Index | $3MM Procter & Gamble | $9MM GRAT | Benefit of separating GRATs |
| Wealth transfers to beneficiaries | $2,999,371 | $2,999,371 | $0 | $4,431,979 | **$1,566,763** |

November 2019

This information has been prepared solely for informational purposes and is not intended to provide or should not be relied upon for accounting, legal, tax, or investment advice. We recommend consulting your attorney, tax advisor, investment, or other professional advisor about your particular situation. Investment advice and recommendations can be provided only after careful consideration of an investor's objectives, guidelines, and restrictions. Any investment or strategy mentioned herein may not be suitable for every investor, including retirement strategies. The factual statements herein have been taken from sources we believe to be reliable, but accuracy, completeness, or interpretation cannot be guaranteed. Past performance is not necessarily an indication of future results. All views expressed are those of the author, and not necessarily those of William Blair & Company, L.L.C. "William Blair" is a registered trademark of William Blair & Company, L.L.C.