Proskauer

Funding "GRATs" in a Market Decline

March 2, 2020

Creating a grantor retained annuity trust (commonly referred to as a "GRAT") is a relatively simple way to transfer property to your children at virtually no gift tax cost. The recent decrease in the market poses an opportunity to transfer wealth with minimal gift tax cost by creating a GRAT. Any security or other asset that has been significantly affected by the decrease may be a strategic asset to fund a GRAT because if the value rebounds, most of the appreciation over the current depressed value will benefit your children with little gift tax consequences. In addition, because of the low interest rate environment and down markets, the advantages of creating a GRAT are magnified. When properly structured, a GRAT can pass to your children all of the future appreciation of the transferred property and reduce the value of the gift to virtually zero.

Basic Operation of a GRAT

In a typical GRAT, you contribute assets to a trust which provides that you are to receive an annuity payment annually for a fixed number of years (the "annuity period"). The annuity amount is typically a stated percentage of the initial fair market value of the trust. It can be stated as a fixed percentage or as a percentage that can increase as much as 20% per year over the trust's term.

At all times during the term of the trust, you will receive the predetermined annuity amount, regardless of how much income the trust assets actually generate or whether the value of its assets rises or falls. To the extent that the income is insufficient to cover the annuity payments, trust principal will be paid to you to make up any shortfall.

At the end of the annuity period, any property remaining in the trust passes to the ultimate beneficiaries of the trust, typically your children or other family members, in further trust or outright, depending upon your preference. Alternatively, you can delay the transfer of assets to your children by naming a trust for your spouse and your descendants as the beneficiary until the spouse's death, at which time your children (or other family members) become the beneficiaries.

Gift Tax Is Minimized

The transfer of property to a GRAT constitutes a gift for gift tax purposes, but the value of that gift is only the value of the trust assets on the date of the transfer reduced by the present value of the annuity you have retained. The calculation of the present value of your retained annuity is based, in part, upon the interest rates promulgated by the IRS for the month the transfer is made, or the I.R.C. Section 7520 rate, commonly referred to as the "hurdle" rate. The hurdle rate is linked to the market yield on U.S. government-issued debt, which is largely determined by the Federal Reserve's monetary policy. The hurdle rate for March 2020 has dropped to 1.8%.

In order for a GRAT to be successful, the combined appreciation and income of the assets used to fund the GRAT must exceed the hurdle rate. At the end of the annuity period, the value of the appreciation and income exceeding the hurdle rate will pass to the beneficiaries (or to trusts for their benefit), free of transfer tax. As a result, when the 7520 rate is low, it is "easier" to have a successful GRAT. Since interest rates are currently near historic lows, the potential tax savings are maximized. Additionally, it may be easier to identify appropriate assets to contribute to a GRAT in a down market, where asset values are depressed and significant future growth is expected.

The most popular use of this device in sophisticated estate plans has been the short-term, "zeroed-out" GRAT, in which the term is typically limited to two or three years and the annuity amount is maximized in order to produce as small a taxable gift as possible. For zeroed-out GRATs, the gift, for gift-tax purposes, is usually negligible. In this way, it is possible to use anticipated short-term growth in the trust assets for estate planning purposes without risking longer-term uncertainty, and the risk of depreciation is neutralized by virtually eliminating the gift tax cost.

Suppose you create a GRAT with $5,000,000 to pay yourself an annuity of $2,567,632.50 per year for two years. Applying March's hurdle rate, the value of your retained interest is approximately $4,999,950, making the taxable gift about $50. This amount would be reported on a gift tax return, but no tax would be due unless you have no remaining gift tax exemption, which, as a practical matter, is extremely unusual. If the principal of the trust appreciates (including capital growth and income) over the two-year period, so that, after receiving your annuity payments, there are assets remaining in the GRAT – whether one dollar or millions of dollars – your children will receive that amount at no gift tax cost (other than the nominal tax paid, if any, on the initial gift of about $50). On the other hand, if the value of the trust falls or fails to beat the hurdle rate, you will simply get back everything you put in, and you will have lost nothing. Distributions may be made in-kind so there is no need to sell any property in order to receive your annuity payments or transfer assets to individuals or trusts upon completion of the annuity period.

In a two-year zeroed-out GRAT, your children or other named beneficiaries will receive the remaining principal in the trust at the end of two years at no gift tax cost to you or them.

No Extra Cost If You do not Survive the Annuity Period

If you die prior to the end of the annuity period, the annuity will continue to be paid to your estate and the value of the assets in the GRAT at your death will be included in your gross estate for estate tax purposes. Your estate will receive credit for any gift tax already paid, however. Thus, although you will have lost the tax advantage the GRAT was designed to achieve, your estate will be in the same position as if you had not created it.

Gift of Stock in a Closely-Held Business

From the perspective of the IRS, the hurdle rate represents a reasonable assumption of the generally expected yield at market based on general economic factors. From your perspective, however, it may be feasible to select "hot" assets that are expected to generate greater returns. You may be able to achieve substantial benefits by transferring a closely-held business interest or real estate, which you anticipate will increase in value, to your GRAT. In fact, this may be the ideal estate planning device for such a transfer to your children, because you may be in a unique position to predict the future growth of your own business or real estate assets.

Of particular appeal is the fact that the GRAT also removes the risk of undervaluing a closely-held business interest or real estate asset for gift tax purposes. With an outright gift, there is no way to guard against a substantial gift tax deficiency if the value of the property is later challenged by the Internal Revenue Service and increased on audit. But, if instead the gift is the remainder interest in a "zeroed-out" GRAT, and if the annuity amount is expressed as a percentage of the initial value of the trust principal (rather than a dollar figure), any increase in the value of the business (or real estate) determined on an audit of the gift tax return would result almost entirely in an increase in the value of the retained interest and, in turn, in only a nominal gift tax increase.

In the previous example, if the IRS successfully asserts that the value of your company's stock transferred to the trust is $6,000,000 instead of $5,000,000, because your annuity is defined as a percentage of the value of the stock, your annuity is now worth $5,999,940 and the value of the resulting gift to your children, is about $60 instead of $50.

Income Tax Considerations

Since the GRAT is a "grantor trust" for income tax purposes, all of its income and deductions are included on your personal return, as if there had been no transfer at all, until the property passes to the ultimate beneficiaries of the GRAT. Therefore, the GRAT is generally income tax-neutral, meaning that your income taxes should be the same whether or not you create the GRAT. If you choose to keep the property in trust for your children (or your spouse and children) after the annuity period, the continuing trust or trusts also can be structured as grantor trusts so that you can continue to pay the income tax attributable to the trusts' income each year until you choose otherwise. Ordinarily, payment of another person's income taxes would have potentially negative tax consequences. However, because a grantor trust is treated as your alter ego for income tax purposes, your payment of the trust's income tax essentially is an additional tax-free gift to your children and can further decrease the value of your estate. Paying the income tax liability from an external source (*i.e.*, from individually owned assets that would have otherwise been includible in your estate) also allows the trust assets to continue to grow and compound on an internally "income tax-free" basis outside of your estate. This is an extremely effective estate planning tool.

Fixing 2019 GRATs that may be Underwater due to Recent Market Decline

A GRAT may include provisions to allow you, as the Grantor, to engage in a "substitution transaction" during the annuity period without triggering any tax. In other words, you can retain the right to swap assets held within the trust for other assets of equal value. This creates an opportunity to take advantage of market volatility or other factors that cause the value of the contributed assets to decline. Assume, for example, that, following the creation of the GRAT, the value of the asset decreases by 20% and it appears unlikely that the value will rebound to the extent necessary to beat the hurdle rate. During the annuity period, you could make the decision to "pull the plug" on the GRAT by substituting cash for the lower value assets. Then, immediately following the swap, you could contribute the same assets to a different GRAT and start the process again. A patient Grantor could simply implement multiple GRATs over time, using the same assets, until their values eventually rise. This is often an attractive option in an environment where asset values have declined and interest rates remain low. This strategy should also be considered for startup companies, which may experience substantial initial costs, but are expected to appreciate dramatically at some point in the future.

Similarly, you may choose to make the continuing trusts under your GRAT grantor trusts and include substitution provisions. This can produce a unique opportunity to eliminate capital gains tax, leverage timing to your advantage and create multiple GRATs using the same assets after the annuity period has ended. Returning to the first example discussed above, assume further that the initial $5,000,000 contribution to the GRAT experienced capital growth over the annuity period at an annual rate of 10% and that you have retained a substitution power over continuing trusts for your children. Making these assumptions, the GRAT will succeed and about $660,000 worth of value will pass to the continuing trusts.

You can now make the decision to substitute the $660,000 worth of assets for cash. By doing this, you are bringing the assets back into your estate, where the $660,000 worth of assets (in addition to any other gain in excess of your basis) will receive a new basis equal to fair market value on your death. This has the effect of eliminating capital gains tax that would otherwise be payable on a sale or exchange of the assets. You have now returned to where you started, except you have successfully transferred $660,000 out of your estate at virtually no tax cost, and you will have eliminated your capital gains tax liability on the assets that you retain in your estate. This technique can be especially effective if, prior to the substitution, you expect the value of the assets to fall dramatically.

By swapping a depreciating asset back into your estate in exchange for a stable asset, such as cash, you can "freeze" the value of assets excluded from your estate, expose your estate to the downside risk and eliminate any capital gains liability. If you subsequently believe the stock will rebound, you can simply contribute the stock to a new GRAT. In effect, a GRAT can be an excellent tool for both estate tax and income tax arbitrage.

Similarly, many clients opt to "reGRAT" the assets they receive in satisfaction of their annuity payments. This technique, often referred to as a "rolling GRAT" approach, allows the Grantor to exclude appreciation from his estate on a continual and incremental basis without the need commit to a lengthy annuity period. This creates a significant amount of flexibility to reassess your plan as interest rates and asset values change over time.

Summary

When properly structured, a GRAT can truly have a "heads you win, tails you break even" result. By adjusting the terms of your trust, you can nearly eliminate the gift tax associated with the transfer of property to your children.

Upon termination of the GRAT, all the appreciation on the assets in excess of the hurdle rate will pass to your children free of gift tax. But if the appreciation is not as expected, or if you do not survive the term of the trust, there are no adverse tax consequences.

GRATs are extremely versatile and can be designed with significant estate tax and income tax savings in mind. With thought and careful planning, they can be used to take advantage of fluctuations in value in a broad array of circumstances.

Finally, in designing the manner in which the ultimate beneficiaries of the GRAT are to receive the trust assets at the end of the GRAT period, you may choose among many options available to achieve the result most consistent with your family and financial objectives.

Special thanks to associate Daniel W. Hatten for his contributions to the drafting of this client alert.

Related Professionals

- **Mitchell M. Gaswirth**
  Partner
- **Albert W. Gortz**
- **Stephanie E. Heilborn**
  Partner
- **Andrew M. Katzenstein**
  Partner
- **Henry J. Leibowitz**
  Partner
- **David Pratt**
  Partner
- **Jay D. Waxenberg**
  Partner
- **Nathaniel W. Birdsall**
  Partner