

GRATs in late 2020

Different than your traditional GRAT?

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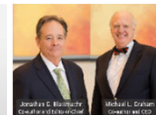
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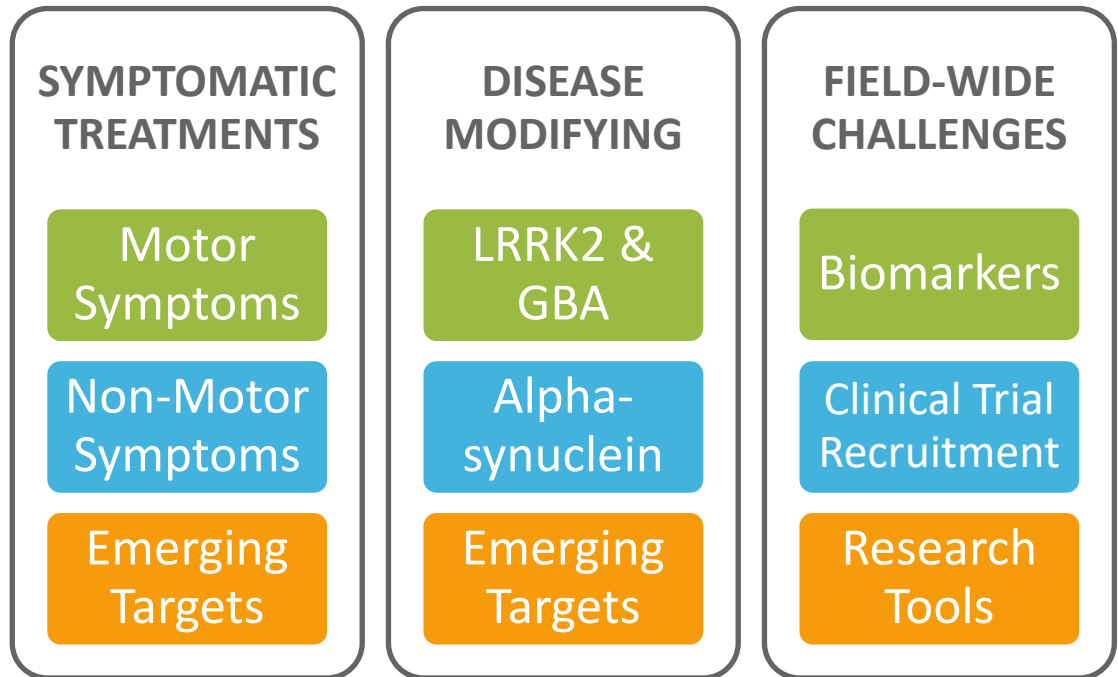
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GRATs

**Introduction and
Basic GRAT Rules**

GRATs Chapter 14 and Qualified Interests

- The general rule of Chapter 14 of the Code is that when a donor makes a transfer and retains an interest in the property transferred, the value of the retained interest is deemed to be zero unless specific criteria are met. The presumption is that the value of the gift is the full value of the property transferred, unless exceptions or special rules apply. IRC Sec. 2702. The retained interest must constitute a “qualified interest” (or fall outside the scope of the section or within a special rule) to allow it to be subtracted from the full value of the property transferred to calculate the taxable gift.
- A “qualified interest” includes either: (1) A right to receive fixed amounts paid at least annually under the terms of a grantor retained annuity trust or GRAT, typically for a stated term of years; or (2) A right to receive a variable amount payable at least annually that is a fixed percentage of the annual value of the trust assets (a grantor retained unitrust or GRUT). Because the unitrust calculations require valuations of potentially hard to value assets, but more significantly, because its formula would result in more appreciation being paid to the grantor/donor’s estate, GRUTs are rarely used. IRC Sec. 2702(b).
- GRATs are described in Internal Revenue Code (“Code”) Section 2702 and Treas. Reg. 25.2702-3(b).

Typical or Traditional GRAT

- The common application of the GRAT technique has been to structure a short-term, typically two-year GRAT, designed to capture upside market volatility (although it is unknown if there is a longer minimum term required).
- The result of this traditional GRAT approach is that a substantial portion of the value of the assets of the GRAT (principal plus the Section 7520 mandated return) would be paid back to the client/grantor.
- Market returns, above the mandated federal interest rate, would inure to the benefit of the grantor's "heirs" (or a trust for their benefit either created under the GRAT instrument or otherwise).
- See Blattmachr & Zeydel, "Comparing GRATs and Installment Sales," 41 Philip E. Heckerling Institute on Estate Planning, Ch 2.

Rolling or Cascading GRATs

- With short term 2-year GRATs the structure/plan often entailed the client “re-GRATING” the large (annuity) distribution received in each year of the GRAT to a new GRAT.
- Example: If a million-dollar GRAT were created, the first one-year annuity payment (of, perhaps, \$500,000+) would be paid back to the client as the grantor, who could then gift that payment into a new GRAT.
- This is why the technique of using repetitive short-term GRATs has been referred to as “rolling” or “cascading” GRATs. The concept of re-GRAT-ing each year’s distribution to a new GRAT has been a common part of the GRAT technique.

Zeroing Out a GRAT

- The annuity paid to the grantor could be set high enough so that the GRAT would have a nominal value for gift tax purposes--a so-called “post-Walton zeroed out” GRAT. See *Walton v. Comm’r*, 115 T.C. 589 (2000), acq. IRS 2003-44 I.R.B. 964, Notice 2003-72.
- There are different perspectives on whether or not to use a zeroed out GRAT. Some practitioners think that it is perfectly acceptable while others prefer to structure the GRAT so there’s a very modest initial gift value that can appropriately be reported on a United States Gift Tax Return (Form 709).
- In any case, it may be possible to draft for minimum value.
- If the grantor dies before the term of the GRAT ends, the annuity payments should be made payable to the grantor’s estate. The result will be that the value of the property transferred will be reduced both by the amounts payable to the grantor and to the grantor’s estate. This approach is necessary to achieve a zeroed out (or close to zeroed out) GRAT.

Zeroing Out a GRAT

<ul style="list-style-type: none">GRANTOR RETAINED ANNUITY TRUOVERVIEWINTRODUCTIONDRAFTING PREFERENCESTRUST DETAILSPAYMENTS DURING TERMDISPOSITIONMARITAL TRUST TERMSFAMILY TRUSTDESCENDANTS SEPARATE TRUSTSSEPARATE TRUST BENEFICIARY INTIGRANTOR TRUST ISSUESDEFAULT TAKERSTRUSTEE INFORMATIONTRUSTEESTRUSTEE PROVISIONSSPECIAL TRUSTEE PROVISIONSTRUST PROTECTORSTRUSTEE POWERSINVESTMENT POWERSSPECIAL TRUSTEE POWERSSPECIAL ASSET POWERSOPTIONAL PROVISIONSEXECUTION DETAILSCLOSING	<h3>PAYMENTS DURING TERM</h3> <p>Payment Pattern</p> <p>Select payment pattern</p> <p><input type="radio"/> Grantor</p> <p><input checked="" type="radio"/> Grantor and estate</p> <p><input type="radio"/> Grantor and Spouse</p> <p><input type="radio"/> Parallel GRATs</p> <p><input type="checkbox"/> Preserve marital deduction if Grantor dies</p> <p>Payments During Term</p> <p>Trust Term (min 2 yrs) yrs <input type="text" value="2"/></p> <p><input type="checkbox"/> Trust will be unitrust</p> <p>Taxable remainder percent % <input type="text" value="0.000"/></p> <p><input checked="" type="checkbox"/> Anti-Atkinson provision should be added.</p> <p>Select timing of payments</p> <p><input type="text" value="Anniversary of initial funding"/></p>
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GRAT Payments


- The annuity amount can be determined in any one of several ways.
- A stated dollar figure. This approach is generally not used because if there is a valuation issue with the transferred property, a substantial gift tax could be triggered.
- A specified percentage of the original value of the property transferred to the GRAT. The percentage approach is the norm so that if there is a dispute with the IRS over the value of the property transferred to the GRAT the annuity payment self adjusts to minimize or eliminate any gift tax exposure. A word formula can be used to describe the value of the taxable remainder such as .1% of the gift tax value of the property contributed to the GRAT. This should avoid any so-called Proctor issue.
- An increasing percentage that is increased by no more than 20% per year (so 120% of the prior year annuity). Treas. Reg. 25.2702-3. This can be used to defer GRAT payments and maximize the growth inside the GRAT. This approach may be useful if a longer term GRAT is used and projections reflect potential cash flow problems in earlier years to meet the annuity payment.
- However, it may be best to maximize the first year annuity.

GRAT Payment Drafting Examples

Payments During Term


Trust Term (min 2 yrs)
yrs

Trust will be unitrust

Taxable remainder percent
% 

Anti-Atkinson provision should be added.

Select timing of payments
Anniversary of initial funding

Select how to express annuity
Fixed payment formula 

Use Safe Harbor GRAT Formula

Payments During Term


Trust Term (min 2 yrs)
yrs

Trust will be unitrust

Taxable remainder percent
%

Anti-Atkinson provision should be added.

Select timing of payments
Calendar year basis

Select how to express annuity
Increase payment formula 

Use Safe Harbor GRAT Formula

GRAT Payments

- The annuity amount may be paid annually or more frequently, such as semi-annually, quarterly, or monthly.
- Rarely are payments made more frequently since the tax-free growth out of the grantor/donor's estate is maximized by paying the annuity only annually. Treas. Reg. Sec. 25.2702-3(b)(3).
- However, in some instances where an important goal is cash flow for the grantor, more frequent payments may be desired by the client, but that is contrary to maximizing the tax benefit of the GRAT.

When Should GRAT Payment Be Made? - 1

- When evaluating the options to mandate when a GRAT payment is due practitioners should bear in mind the economics of a GRAT. Making earlier GRAT payments reduces the leverage and benefit of the GRAT. The longer a payment can be deferred, the longer the assets can compound inside the GRAT.
- The annuity amount must be paid based on either the anniversary date of the creation of the trust, or the grantor's tax year (which is the same as the tax year of the settlor since it is a grantor trust).
- Using a calendar year date may be easier for many to adhere to since this makes the required annuity payment due prior to the April 15 tax deadline, hence harder to overlook. However, in a two-year rolling GRAT (which may not be feasible after the end of 2020) this can result in three GRAT annuity payments instead of the two. That would be required if the payments were based on the anniversary date of the GRAT itself. A calendar year also makes it hard to determine the size of the annuity payments.

When Should GRAT Payment Be Made? – 2

- If the GRAT document specifies that the annuity payments are to be paid annually, based on the anniversary of the GRAT, the payments must be made by 105 days after the anniversary date. Treas. Reg. Sec. 25.2702-3(b)(4).
- If the payment is instead going to be made based on the calendar year (rather than the anniversary date), proration of the annuity amount is required for each short taxable year of the GRAT during the GRAT's term. The prorated amount is the annual annuity amount multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365 (366 if February 29 is a day included in the numerator). Treas. Reg. Sec. 25.2702-3(b)(3).

105-Day Provision Example

Frequency and Source of Payments. The Annuity Amount shall be paid on the day before the anniversary of the initial funding of the GRAT (*which shall be the date upon which the Grantor gives the Trustee written notice that this instrument and each trust created hereunder are irrevocable*) from income and, to the extent income is not sufficient, from principal. In accordance with Reg. 25.2702-3(b)(4), each payment of the Annuity Amount must be made no later than one hundred five (105) days after the payment date to which it relates. The Trustee is prohibited from issuing a note, other debt instrument, option or similar financial arrangement in satisfaction of the annuity payment obligation.

When Should GRAT Payment Be Made? – 3

- Caution should be exercised in drafting the GRAT in the event that the funding occurs on a date after the execution of the GRAT.
- Some suggest having the GRAT become irrevocable on funding.
- Consider that the longer that the assets can grow inside the GRAT the longer the payment should be deferred, because the income earned on the GRAT payment inures gift tax free to the GRAT remainderman.
- Some suggest the GRAT should be revocable until the last/final funding so that the requirement that there only be one single funding to the GRAT is satisfied. The earlier funding while the GRAT is revocable is not completed funding. So if the GRAT becomes irrevocable on the last funding, there can only be one funding and the GRAT requirement not violated.

What if a Payment is Missed?

PAYMENTS DURING TERM

Payment Pattern

Select payment pattern

Grantor

Grantor and estate

Grantor and Spouse

Parallel GRATs

Preserve marital deduction if Grantor dies

Payments During Term

Trust Term (min 2 yrs)
yrs 2

Trust will be unitrust

Taxable remainder percent
% 1.000

Anti-Atkinson provision should be added.

Select timing of payments
Anniversary of initial funding

Select how to express annuity
Increase payment formula

Use Safe Harbor GRAT Formula

Select when annuity income taxes

View Resource

Add Anti-Atkinson provision?

Check the box (effectively answering this question "Yes") if you would like to add the anti-Atkinson provision?

In *Atkinson v CIR*, 115 TAX COURT 26 (2000), aff'd, 309 F.3d 1290 (11th Cir. 2002), it was stated that a trust was not a "qualified" charitable remainder annuity trust under Code Section 664 where the trust was found not to have made any annuity payments to the grantor-annuitant.

In at least one gift tax audit, the IRS has stated that a GRAT was not "qualified" for purposes of Code Section 2702(b) because the annuity payments were not paid within the 105 days grace period. IRS contends, therefore, that the entire amount transferred to the GRAT (and not just the actuarial value of the remainder) constitutes a taxable gift.

Although strong arguments can be made that failure to make an annuity payment within the 105 day payment grace period cannot cause the GRAT to fail to qualify, it is not a certainty.

By checking the box to this question, a provision will be added to the instrument to have the otherwise undistributed annuity amount (or unitrust amount if a GRUT is created) vest in the grantor at the end of the 105 day payment grace period. Such vesting should cause the annuity (or unitrust amount) to be paid within the grace period.

Protective Payment Language

Payments to Vest. If any portion of the annuity payable to the Grantor or the Grantor's estate, as the case may be, on a particular date is not distributed in its entirety by the Trustee to the Grantor or the Grantor's estate, as the case may be, by the end of the last day (the "Annuity Amount due date") on which it must be paid in order for the Annuity Amount to be treated as a Qualified Interest, including any applicable grace period (such unpaid portion of the Annuity Amount being hereinafter sometimes referred to as the "undistributed Annuity Amount"), then, at the end of the Annuity Amount due date, the Annuity Property (as hereinafter defined) held by the trustee shall vest absolutely in the Grantor or the Grantor's estate, as the case may be. The trust shall immediately terminate as to the Annuity Property, and the Trustee, in the Trustee's capacity as Trustee, shall have no further duties, power, authority or discretion to administer the Annuity Property notwithstanding any provision of applicable law or this Trust Agreement to the contrary. If the Annuity Property shall remain in the hands of the Trustee after the Annuity Amount due date, the Trustee shall hold such property exclusively as nominee and agent for the Grantor or the Grantor's estate, as the case may be. The Grantor hereby authorizes the Trustee, but only as nominee and agent for the Grantor or the Grantor's estate, as the case may be, to invest the Annuity Property on the Grantor's behalf or on behalf...

Other GRAT Requirements

There are a host of other GRAT requirements that can affect distribution and immunization planning. Reg. 25.2702-3.

- The time period (term) of the qualified interest must be fixed and ascertainable when the GRAT is created.
- The term must be for the life of the holder, a specified term of years, or the lesser of these.
- The GRAT document must prohibit distributions from the trust to or for the benefit of anyone other than the holder of the annuity interest during the term of the GRAT.
- The GRAT document must prohibit prepayment (commutation) of the grantor/donor's annuity interest. However, the grantor's right to the annuity payments can be sold as that would not be a commutation.

The More Granular the Better

- The more granular you make the GRAT, the more likely to capture upward market swings. Creating several GRATs each funded with one sector of the market is more likely to succeed than one GRAT funded with all of a market (or, perhaps, better yet, each funded with a separate stock). The reason is that, with one GRAT, good performance in one sector (or stock) will be offset by negative performance in another. But each GRAT funded with its own sector of the market (or separate stock) can stand alone without erosion of other sectors.

Non-“Family” Member Beneficiaries

- If the remainder beneficiaries of the GRAT plan are people whose relationship falls outside the scope of how the tax law defines “family” for these purposes (for example, a niece or nephew), then a property owner can use a grantor retained income trust, or a GRIT. The key benefit of a GRIT over a GRAT is that, instead of an annuity stream, the grantor receives back the income (in the trust accounting sense). The GRIT’s success does not depend upon growth in the assets contributed to the trust (which is the case for a GRAT) but the value of the gift of the remainder will be quite high while the Section 7520 rates are low, meaning a large gift.

Traditional GRAT Immunization

**GRATs Should be
Managed – This is
More Important as the
Term is Extended**

GRAT Immunization Generally

- Immunization is the process of substituting non-volatile assets for volatile assets after a large increase in value inside the GRAT to lock in that appreciation (to effectively immunize the GRAT from losing the tax benefit).
- If you could time the market you would immunize at the high point of the asset/portfolio.
- The traditional approach to GRAT immunization is to swap in cash for a highly appreciated security to freeze the gain inside the GRAT. With a two-year rolling GRAT that approach is feasible. For GRATs created in the current environment a different approach may be required. That will be discussed below.

GRATs in Late 2020

**Perfect Storm But
Consider
Temporary
Exemption**

Perfect “Storm” For GRATs - 1

- In the current planning environment GRATs, may be a powerful planning tool for three reasons.
- (1) Suppressed asset values (but this depends on the particular stock or business. Some businesses continue to hemorrhage). Funding a GRAT when asset values are low and hopefully likely to rise significantly in future years will shift all that appreciation above the applicable Section 7520 rate outside the grantor’s gross estate for federal estate tax purposes. For example, if a GRAT is funded with \$1 million and the taxable remainder is only \$1,000, any remainder passing to the successor beneficiaries in excess of \$1,000 makes a gift tax free transfer.
- (2) Interest rates are at near historic lows (the Section 7520 rate for Sept and Oct 2020 is .4%). For comparison, in 1989, the Code Section 7520 hurdle interest rate was at a high of nearly 12 percent. In March of 2009, it was almost 3 percent. GRATs are a technique that shines brightest when the lower the interest rates are in effect as it maximizes the value of the annuity stream retained.

Perfect “Storm” For GRATs - 2

- Simply put, the lower the interest rate the lower the annuity payment that has to be made periodically back to the grantor to minimize the taxable gift made with funding a GRAT, and hence the greater value shifted outside the estate. Going back to the above example, if the Section 7520 was .4%, any growth and income above that rate will pass gift tax free to the successor beneficiaries.
- (3) The massive federal bailout, and more may be coming, may eventually require that taxes on the wealthy (and the not so wealthy) be raised. While no one can forecast what tax law changes may occur, it seems logical that estate taxes will increase, perhaps, markedly so. Therefore, shifting assets out of an estate using current favorable laws, such as by using GRATs, may prove very advantageous.
- However, while the current environment may be the so-called “perfect storm” for GRAT planning, practitioners need to be aware of a number of nuances to this planning. In many instances, it will not be GRAT planning as usual. This presentation explores some of the differences in how practitioners may choose to plan for GRATs in the current environment.

Only Use GRATs for Appropriate Situations

- While it is obvious to most practitioners, GRATs are not an ideal tool for many clients who have remaining unused gift exemption. The current exemption of \$11.58 million is the highest in history and may be reduced, perhaps substantially, by future legislation and is slated under current law to be halved effective 2026. Thus, clients with remaining exemption should consider gifts to GST exempt trusts, and other planning techniques that use exemption, before using GRATs.
- GRATs are not a technique that secures remaining GST exemption. Some suggest that sometime after a GRAT is funded an old and cold GST exempt trust may purchase the remainder from the GRAT to thereby shift future appreciation into a GST exemption solution. So, practitioners should merely consider the GST planning implications when determining whether to use a GRAT in the current environment in contrast other planning techniques. And it seems appropriate to mention that the IRS has indicated it would not respect such a purchase of the remainder in a GRAT to provide GST exemption. See PLR 200107015 (not precedent).
- One possible solution is a split purchase annuity trust.

Split Purchase Annuity Trusts

**How and When
They Can Work**

Split Purchase Annuity Trusts

- Background: Under Section 2702 a retained interest in a trust, or an interest in an asset acquired in a split purchase, has zero value if family members hold the remainder interest.
- A special rule (not an exception) applies if the retained or acquired interest is a qualified annuity within the meaning of section 2702.

Split Purchase Annuity Trusts

- GRAT downside: (1) no GST Exemption leverage, (2) some estate tax inclusion (difficult to use for client with short life expectancy).
- Good news: low Section 7520 rates mean high value for the retained annuity interest, so a lower taxable gift.

Split Purchase Annuity Trusts

- GRAT estate inclusion risk can be avoided through a Split Purchase Annuity Trust.
- Client and a GST-exempt trust enter into an agreement by which client purchases an annuity for life (or a term of years) in an asset, and the GST-exempt trust purchases the remainder interest in the asset.
- Values are determined by standard actuarial tables meaning there is no gift if the underlying property is correctly valued.
- Because the Section 7520 rates are low, the client pays a significant amount for the annuity interest.

Split Purchase Annuity Trusts

- Can be use for clients with short life expectancy (if death is not imminent).
- No estate tax inclusion.
- GST exemption can be leveraged.
- Cannot “zero-out” the value of the remainder if annuity is retained for life.
- Value of the retained annuity will drop as the Section 7520 rates increase (as they are likely to).

GRATs in Late 2020

Failed GRATs



Failed GRATs from Asset Value Decline - 1

- A GRAT that was created pre-Covid may now have suffered a dramatic decline in asset value because of recent economic decline. Instead of earning more than the mandated interest rate, as anticipated when the GRAT was created and funded, the GRAT may be worth perhaps 20 percent less than what was initially transferred to it. Thus, these GRATs will fail, resulting in no assets inuring to the intended trust for remainder beneficiaries. All the assets will be distributed back to the grantor to meet the periodic required annuity payment, with nothing left for heirs.
- What should be done in such a case? As the GRAT assets are repaid to the grantor in the form of periodic required annuity payments, he or she might continue the plan by re-GRAT-ing the assets received as the annuity payment into new GRATs. The implications to how a practitioner might choose to such a structure these new GRATs is discussed below and this may be different than the traditional application of the GRAT technique.

Failed GRATs from Asset Value Decline - 2

- Remember volatility was the rationale behind using the GRAT technique in the first instance, and that is exactly what the GRAT experienced (just not in the intended direction). Remind yourself that, just as with rebalancing portfolios during market upswings and declines, assets should be re-GRAT-ed to new GRATs. If, in fact, the markets are at a low enough point now, the new GRATs will remove the anticipated market recovery from the client's estate. So, for many facing GRATs that have "busted," establishing a new GRAT and gifting the assets to that new GRAT as they are received from the old GRAT may be an appropriate strategy to consider.

Steps to Consider for Failed GRATs - 1

- A GRAT may pay back all assets to the grantor to meet the required annuity payment as a result of recent declines in asset values. Devoid of assets, the GRAT will fail. Consider having the trustees execute a short acknowledgement that the GRAT has been terminated with a final payment to the grantor, so that there is an obvious record in the files of what happened should a question arise in the future and to demonstrate there was no commutation of the grantor's interest in the GRATs, which the governing instrument must prohibit.
- Example: GRAT has been funded, but asset values have plummeted. Say the client has gifted \$2 million to the GRAT. First payment is about \$1 million, but the asset value then is only \$1.2 million. Do you have to leave all of the \$200,000 in the GRAT? What can be done?

Steps to Consider for Failed GRATs - 2

- Can you buy that amount back from the GRAT for a note? Although commutation of the grantor's interest must be prohibited as required by the Regulations, buying the assets back for a note is not prohibited in this context because it is the grantor writing a note to the GRAT not vice versa (which is prohibited). Treas. Reg. 25.2702-3(d)(5).
- However, it likely would not be wise to distribute this note back to the grantor in satisfaction of the annuity to ensure that there is no violation of the Regulations. Treas. Reg. 25.2702-3(d)(6). Moreover, the note may have a zero basis, meaning income recognition when it is paid. Rather, some other asset should be substituted for the note so that asset and not the note is distributed to the grantor.
- Consider having the grantor buy the remainder interest in a long-term GRAT after the 3-year statute of limitations for the gift tax audit has run on the GRAT.

Steps to Consider for Failed GRATs - 3

- Alternatively, the grantor can substitute assets or purchase assets if the GRAT is a grantor trust (as it almost certainly would be) and take assets out of the GRAT for cash and re-GRAT them. There would be no taxable income. See Rev. Rul. 85-13, 1985-1 CB 184.
- If the client feels the GRAT rules may change, this may be important to do now. Remove the assets that are intended to be shifted out of the estate from the GRAT that will fail and re-GRAT them while GRATs remain viable.
- Another option is to re-GRAT the entire annuity interest. It seems likely that the grantor's annuity interest would be valued in the same manner as it was when the GRAT was created as Section 7520 mandates how non-commercial annuities are to be valued for gift and estate tax purposes.

GRATs in Late 2020

**Possible Changes
to GRAT Rules**

Biden Proposals to Restrict GRATs

- Despite a tidal wave of planning going on in late 2020 (as of the date of this presentation), Democratic nominee Biden has not made any proposal in detail about the estate tax or GRATs.
- The discussion following is based on the presumption (wild guess) that: (1) Biden wins the Presidency; (2) The Democrats obtain control of the House and Senate; and (3) that he enacts changes along the lines of prior Democratic proposals (e.g., President Obama's Greenbook, etc.).

Sanders' Tax Proposal as to GRATs

- Congressman Bernie Sanders' proposed tax act proposal would, if enacted, eliminate the viability of the GRAT technique in many cases by requiring a minimum 10-year term for any GRATs created after the enactment of the Act. If the grantor does not outlive the term of the GRAT, some or all the assets would be included in the grantor's estate. That would dramatically decrease the risk of a GRAT succeeding.
- There is also a proposed minimum required gift amount of at least 25% of the value of the assets contributed to the trust, effectively removing the ability to have a zeroed out GRAT and likely preventing most GRATs from being successful at all. These two changes could potentially make GRATs impractical for taxpayers who have traditionally used GRATs when they no longer had gift tax exemption remaining. It would also seem to eliminate the commonly used technique of "rolling-GRATs."
- "For the 99.8 Percent Act," S. 309 116th Cong. (2019). S. 309 §7(a) and (b).

Consider a Safe-Harbor Formula

PAYMENTS DURING TERM

Payment Pattern

Select payment pattern

Grantor

Grantor and estate

Grantor and Spouse

Parallel GRATs

Preserve marital deduction if Grantor dies

Payments During Term

Trust Term (min 2 yrs)
yrs 2

Trust will be unitrust

Taxable remainder percent
% 1.000

Anti-Atkinson provision should be added.

Select timing of payments
Anniversary of initial funding

Select how to express annuity
Increase payment formula

Use Safe Harbor GRAT Formula

View Resource

Use Safe Harbor GRAT Formula?

Check the box (effectively answering this question "Yes") if you would like to use the Safe Harbor GRAT Formula?

It is not completely certain how small the remainder in a GRAT may be or if the annuity must be paid for a certain minimum term (such as five years or ten years). Wealth Transfer Planning offers a "Safe Harbor Formula" which will provide that the remainder must be the greater of the percentage you have specified or the minimum necessary in order for the GRAT to be qualified. In addition, the Safe Harbor Formula will provide for the annuity to be paid for the longer of the term you have specified or the minimum term for a GRAT to be qualified.

If there is no required minimum value for the remainder of a GRAT and no required minimum term for a GRAT, the value of the remainder you have selected and the term you have selected will apply.

For more information, See Blattmachr & Zeydel, "Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth," Estates, Gifts & Trusts (Tax Management, January 27, 2006), which may be also be found at http://www.bnatax.com/tm/meeting_agenda_mar06.htm.

Proposals to Restrict GRATs Not New

- These proposals are not new. President Obama's Greenbooks included proposals to restrict GRATs by requiring a minimum 10-year term, which would have eliminated short term rolling GRATs. If the Democratic presidential candidate wins the 2020 election, tax proposals may include restricting GRATs in this way. However, even if Republicans retain control in Washington, there may well have to be similar restrictions put in place in order to raise revenues to fund the substantial bailout plans.
- Thus, when structuring new GRATs in the current environment, consideration should be given to how they may be changed, since the elimination or severe restriction of the GRAT technique could prevent rolling or cascading GRATs set up today when annuity payments are paid out in the future.
- See, e.g., <https://www.wealthmanagement.com/estate-planning/treasury-releases-2017-greenbook>.
- But practitioners should caution clients that this is all speculation.

GRATs in Late 2020

**End of
Rolling/Cascading
GRATs?**

Will Rolling/Cascading GRATs End? - 1

- As mentioned above, a common GRAT technique has been the use of short-term rolling or cascading GRATs which are intended to capture upside market volatility. The mathematical superiority of short-term rolling GRATs over a single long-term GRAT has been documented. See Bernstein Journal, vol. VI, no. 1, Summer 2008, p. 9.
- What is the likelihood of the next administration making the estate tax rules tougher? Might GRATs be eliminated? Or might a required minimum 10-year term and a specified 25% minimum gift value on GRAT funding be enacted? Either of these restrictions would have a chilling effect on post-enactment GRAT plans and effectively undermine the assumptions of rolling GRATs for currently funded GRATs, if the successor GRATs are so fundamentally altered. If the next administration wants to raise taxes on the wealthy, or if there really is no choice in order to fund the very large bailouts during the coronavirus crisis, GRATs may disappear.

Will Rolling/Cascading GRATs End? - 2

- Note also that restrictions on GRATs could be coupled with the elimination of discounts on related party transactions, elimination or restriction on so-called Crummey powers (which are used to allow gift tax annual exclusions for transfers to trust), etc. See, generally, “Building an Effective Life Insurance Trust,” 129 *Trusts & Estates* 29 (May 1990).
- The result may be a substantial enhancement of estate tax revenues.
- If a rolling GRAT plan is being funded with discounted interests in a family or other closely held business, what impact will a legislative repeal or restriction on such discounts have on the plan? Short-term GRATs require high payouts to minimize or eliminate gift tax. That may mean that a significant portion of the equity in the family business may be repaid to the grantor in the form of GRAT annuity payments. If so, when the grantor wishes to re-GRAT, the assets may not, at that future date, qualify for discounts. This actually could be beneficial.

Should 2020 GRATs be Longer? Should Laddered GRATs be Considered?

- Therefore, it may be advisable to lock in the discounts by using a longer term GRAT now (i.e., not the traditional two-year GRAT term). Query, if discounts are eliminated by future legislation might that permit the payment of annuity amounts in kind (e.g. stock in a closely held business held in the GRAT), valued without discounts even though discounts applied to the valuation of the interests when gifted to the GRAT?
- What about creating a long-term GRAT instead of a series of short-term GRATs on account of the possibility that Congress may restrict GRATs? Although many have demonstrated the superiority of short-term GRATs compared to longer-term GRATs, the assumption is that a short-term GRAT is one in a series. Short term GRATs may not be allowed in the future.

GRATs in Late 2020

**New GRAT
Immunization
Thoughts**

If GRATs are Longer, Immunization Techniques Should Be Reconsidered - 1

- GRAT immunization, as discussed briefly above, refers to the process of substituting a nonvolatile asset such as cash for the assets inside the GRAT. So, if the GRAT holds Zoom stock which is appreciated dramatically, the grantor could swap in cash and swap out equivalent value of Zoom stock. The rationale for this is that if the GRAT, whatever the term, realizes a significant uptick in value, the client will want to lock in that uptick by substituting less volatile assets. The application of this technique is discussed in the section that follows.
- Considering the preceding factors does not change the fact that short-term rolling GRATs are a better strategy, but that strategy may not be given sufficient duration to succeed if the GRAT rules are changed by new legislation. Perhaps, a safer long-term strategy might be to create a series of longer-term GRATs. If the GRAT technique is repealed, GRATs that have been executed and funded before the repeal might be grandfathered from these adverse changes.

If GRATs are Longer, Immunization Techniques Should Be Reconsidered - 2

- But with longer-term GRATs, the traditional approach of immunization using cash or Treasury bills won't make economic sense. The reason is that swapping cash or treasuries into a two-year GRAT, and typically after some time is already run on that GRAT term, does not leave significant wealth unproductive for a long period of time. However, by opting into, for example, a ladder of six, eight and 10-year GRATs, the GRAT arrangements will be locked in for a longer time.
- In case future legislation restricts or eliminates short term GRATs, immunization has to be looked at differently. If in the second year of a 10-year GRAT there is a spike in the stock market, immunization may make sense but, in contrast to a two-year GRAT that may have mere months to run, this six, eight or ten year GRAT may have five or more years left to run. Holding assets idle in cash or treasuries for that long a period is not likely to be desirable.

If GRATs are Longer Immunization Techniques Should Be Reconsidered - 3

- Thus, a more sophisticated investment technique will have to be implemented in order to immunize new longer-term GRATs.
- Example: A client establishes a series of ten \$1 million ten-year GRATs, each for a different asset class. One of the 10-year GRATs experienced a substantial gain in year one, doubling in value. Under the rolling GRAT paradigm, this would have been a 2-year GRAT, not a 10-year GRAT. The client likely would have been advised to substitute Treasury bills for the \$2 million in the GRAT, thus locking in the large gain. This strategy will not be acceptable in a 10-year GRAT unless the client would retain Treasury bills for the nine remaining years. However, a 2-year GRAT will not work either if GRATs are restricted next year by new legislation, or if it takes three or more years for that asset class to recover from the current coronavirus recession. Instead, while clearly less advantageous, the 10-year (or some other term longer than the traditional two year) GRAT might prove the only practicable effective technique. There are several approaches to consider. One might be to substitute a diversified portfolio with a nine-year time horizon for the \$2 million appreciated GRAT property.

If GRATs are Longer, Immunization Techniques Should Be Reconsidered - 4

- Although clearly not as secure as locking in the gain with Treasury bills on a 2-year GRAT with 1 year remaining, it will be more secure for purposes of retaining that gain than, perhaps, the ten year-long term overall asset allocation. Assume that the client generally has a 20+ year investment horizon and an overall asset allocation consisting of 60 percent equities, 25 percent bonds, and 15 percent alternatives. Alternatively, perhaps, the grantor should buy the remainder in the GRAT if it has been vested in a grantor trust.
- Perhaps, the nine-year remaining GRAT might be given as substitute property a more conservative allocation designed to minimize downside risk of giving up the \$1 million initial gain, but still consider the long 9-year time horizon and the need for growth inside the GRAT. The client's wealth manager might recommend a 40 percent equity, 45 percent bond, and 15 percent alternative strategy. Perhaps, option techniques can be used to hedge the downside risk in the highly successful GRAT while leaving some upside potential for growth in light of the nine years remaining. Although that strategy will come at a cost that will reduce the upside, it can, perhaps, be viewed as insurance on preserving the large gain in the early years of a long term GRAT.

If GRATs are Longer, Immunization Techniques Should Be Reconsidered - 5

- Long-term GRATs are not as efficient as a series of short-term GRATs can be. However, the budget deficit that the next administration will have to address, the uncertainty whether GRATs will survive, and the unknown timing of market improvements make it worth reconsidering them.

GRATs in Late 2020

**Fund ILITs before
Annual Gift
Exclusion is
Capped**

GRATs as a 2020 ILIT Funding Tool

- Irrevocable life insurance trusts (ILITs) are a ubiquitous planning tool. Many ILITs are funded using annual exclusion gifts. IRC Section 2503(b).
- This technique is also on the chopping block under proposed legislation. The Sanders tax proposal, for example, includes a cap on annual exclusion gifts of \$20,000 per donor (not per donee). S. 309 §10(a).
- That could undermine the funding in many traditional life insurance trusts. Practitioners may want to consider, in the current environment given what some view as an increased risk of harsher tax legislation to pay for the current bailouts, using GRATs to “pre-fund” future life insurance premiums in ILITs. If the insurance trust is not GST exempt, a GRAT could be structured to pour into the insurance trust as its remainder beneficiary and thereby infuse capital now before restrictions are created on ILIT Crummey Trust funding. If the ILIT is GST exempt, it could, perhaps, borrow at the low applicable Federal rate (AFT) from the successful GRAT and without income tax effect if each is a grantor trust as to the same grantor. However, it is not certain that the safe harbor Section 7872 AFR can be used for this type of loan.

GRATs in Late 2020

**Long-Term GRATs
as a Late 2020
Strategy**

99-Year GRAT - 1

- So, for clients that have used all of their current high temporary exemption a bet now that asset values will grow substantially and interest rates will be much higher by death may make a 99-year GRAT a valuable planning tool. If the Section 7520 rate rises before the grantor dies, he or she could sell the remaining annuity payment before then and exclude a significant part of the trust from his or her estate.
- See Treas. Reg. 20.2036-1(c), especially Example 2.

Illustration of a Successful 99 Year GRAT

- Client Funds GRAT with \$ 1 Million When the Section 7520 Rate Is One Percent to Pay \$11,000 a Year to the Client or Her Estate for 99 Years. The Value of Remainder Is Nearly Zero
- When the Client Dies, What Is Included in Her Estate Is the Lesser of the Whole Trust or the Annuity/Section 7520 Rate In Effect When She Dies..
- Client Dies When the Section 7520 Rate Is Still One Percent. Hence, the Amount Includible No More than $\$11,000 / .01$ or $\$11,000 \times 100$ or $\$1,100,000$ (or the Value of the Trust If Less than That)

Illustration of a Successful 99 Year GRAT Continued

- Client Dies When the Section 7520 Rate Is Five Percent. Hence, the Amount Includible Is $\$11,000/.05$ or $\$11,000 \times 20$ or $\$220,000$ (or the Value of the Trust If Less than That).
- Client Dies When the Section 7520 Rate Is Ten Percent. Hence, the Amount Includible Is $\$11,000/.1$ or $\$11,000 \times 10$ or $\$110,000$ (or the Value of the Trust If Less than That).
- If the Section 7520 Rates Goes Up Before Death, the Client Could Sell Her Annuity Interest (Without Gift Tax) for Its Value As So Determined to a GST Exempt Trust (Perhaps, the Trust That Is the Remainder Beneficiary of the GRAT and May Be a Grantor Trust).

Conclusion and Additional Information

GRATs in 2020



Conclusion

- Existing GRATs should be reviewed to determine whether or not they will remain viable and, if likely not, whether remedial action should be taken now.
- For new planning in the current environment, the GRAT, while subject to shortcomings of not being an efficient tool for using remaining exemption or GST planning, can provide a valuable planning tool for many clients.
- Consider the SPLAT as an alternative.
- Consider protective language/safe-harbor provisions

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