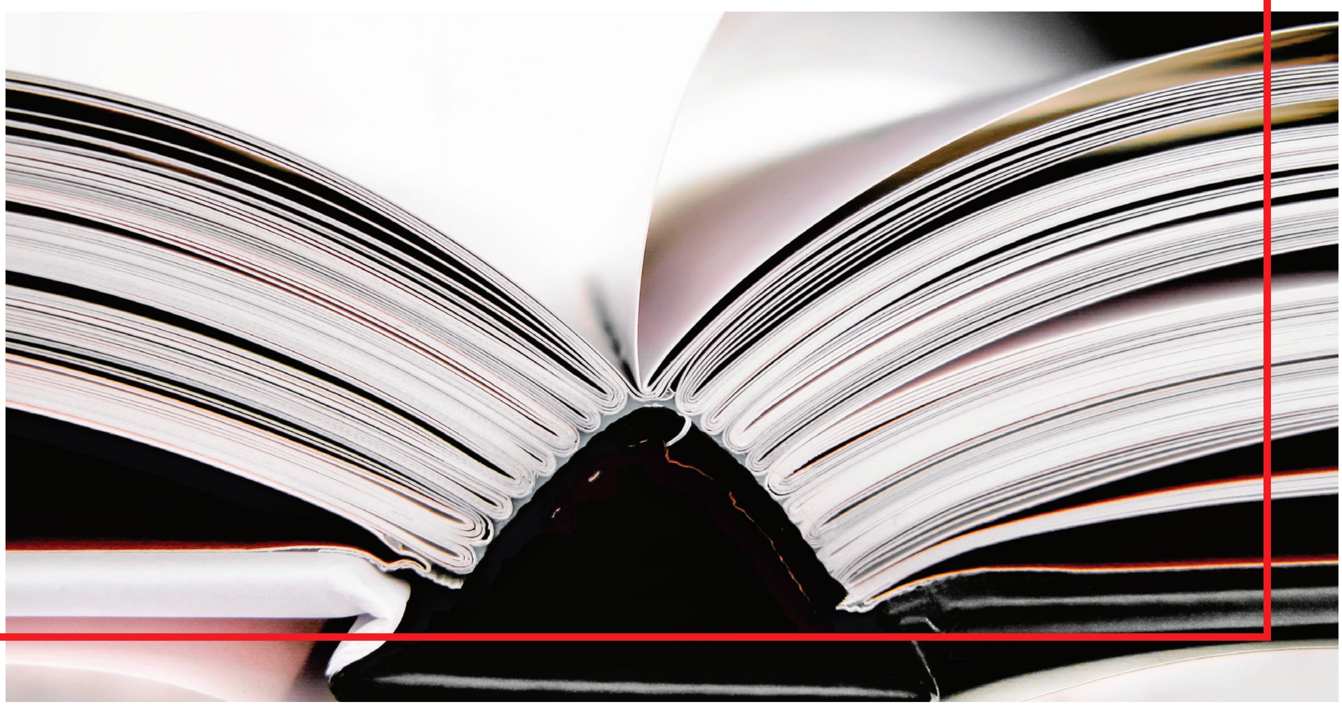
Grantor retained annuity trusts



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A grantor retained annuity trust (GRAT) is an irrevocable trust designed to transfer future appreciation on an asset with little or no gift tax cost. This popular wealth transfer strategy may be appealing if an individual has an asset expected to appreciate significantly in a short time period and wants to hold onto the asset itself but is willing to transfer potential growth. It can also be useful in situations where someone would like to transfer wealth but has already exhausted the lifetime gift tax exemption.

How does it work?

The grantor creates a GRAT and funds it with assets that are expected to appreciate.[1] The trustee of the GRAT distributes an annuity (a fixed annual amount determined at the outset) to the grantor for a term of years. At the end of the GRAT term, any assets remaining in the trust pass to the remainder beneficiaries—often the grantor's children or trusts for their benefit.

The value of the gift to the remainder beneficiaries is calculated at the time the trust is created and funded. The gift tax value is determined by subtracting the present value of the annuity interest retained by the grantor from the fair market value of the assets transferred in trust.

The present value of the annuity interest is determined (in part) using the 7520 rate. The 7520 rate is an interest rate published monthly by the Internal Revenue Service (IRS).[2] GRATs are more likely to achieve gift tax savings when the return on trust assets is more likely to exceed the 7520 rate. If the assets in the GRAT appreciate at a rate that exceeds the 7520 rate used to value the annuity interest, the appreciation in excess of the 7520 rate generally passes to the remainder beneficiary free from gift tax.

Annuity payments from a GRAT can be level, but they can also increase by up to 20% each year. This creates a smaller payment the first year and larger payments each succeeding year. GRATs with increasing annuity payments potentially can transfer more wealth to heirs,[3] since more assets will be retained in the GRAT each year with the potential for growth, hopefully at a rate faster than the 7520 rate.

A GRAT is only obligated to make annuity payments to the extent it has assets to satisfy them. If GRAT assets appreciate at a rate that exceeds the 7520 rate used to value the annuity interest, the remainder beneficiaries generally will receive assets at the termination of the trust. If the assets do not appreciate in excess of that amount, the GRAT is deemed to have "failed." This means that the grantor receives all of the trust assets back as part of the annuity distributions. Assuming the grantor did not use any gift tax exemption, then the grantor is basically no worse off than when they started, except for any legal fees to set up the structure, any accounting or other annual fees, and the opportunity cost of having those assets locked up in a trust during the term.

A GRAT is a grantor trust, which means that all items of income, loss, credit, and deduction of the GRAT are taxed to the grantor. Additionally, transactions between the grantor and the trust are generally disregarded for income tax purposes. The grantor's payment of the GRAT's income tax liability is in effect an additional gift to the trust each year but is not treated as a gift for tax purposes.

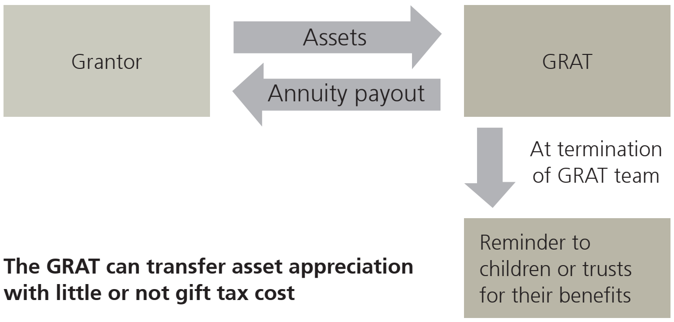
If the grantor dies during the GRAT term, all of the assets of the GRAT are generally includible in the grantor's estate for estate tax purposes.[4] This would negate any tax advantages the GRAT would otherwise provide. GRATs are therefore typically set up with short terms—two or three years—to minimize this mortality risk. Also, because GRATs are subject to special rules regarding the allocation of generation-skipping transfer tax exemption, they are not generally used to transfer assets to skip persons (e.g., grandchildren or more remote descendants).

1 Alternatively, the grantor might fund the GRAT with money or other property that the trustee sells and reinvests into assets that are expected to appreciate.

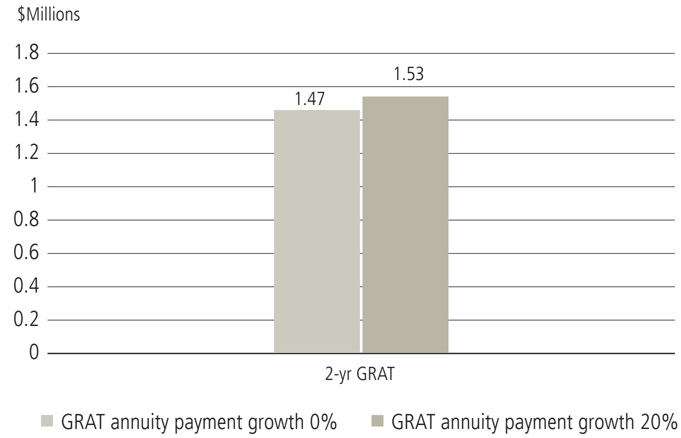
2 More specifically, the 7520 rate is 120% of the federal midterm rate (subject to rounding). IRC § 7520(a)(2). The federal midterm rate is based on the average market yield on outstanding marketable obligations of the United States with a remaining maturity period of more than three years and not more than nine years. IRC § 1274(d)(1)(C)(ii). When valuing the annuity interest, the grantor must use the 7520 rate that's in effect for the month in which the grantor contributes money or other property to the GRAT.

3 This whitepaper uses the term "heir" in the colloquial sense—referring to a person who receives property from a decedent—rather than its strict legal sense.

4 A Proposed Treasury Regulation issued on April 26, 2022, indicates that the applicable exclusion amount as of the date of the grantor's death will apply and not the increased exclusion amount that was available at the time of the transfer to the GRAT. Therefore, if this regulation passes, and if the grantor dies during the GRAT term, not only will some or all of the assets be pulled back into the grantor's estate, but any exclusion that the grantor may have used in creating the GRAT could be wasted. If the grantor used a portion of their exemption to transfer assets to the GRAT and they are subsequently pulled back into the grantor's estate, and at the time of the grantor's death, they have no remaining exemption, then those previously sheltered assets could now be subject to estate tax. It should be noted, however, the proposed regulations provide for a de minimis rule to prevent clawback of includible gifts if the value of the taxable portion of the transfer (determined as of the date of the transfer) was 5% or less of the total value of the transfer.



The GRAT can transfer asset appreciation with little or not gift tax cost



Example[5]

In January of 2020, a grantor transferred $5 million of assets into a GRAT. The term of the GRAT was two years and the 7520 rate was 2.0%. During its two-year term, the performance of the GRAT's asset precisely tracked the S&P 500. Here are the results:

- Annuity payments from the GRAT to the grantor were $2,575,248 in years one and two. The grantor received $5,150,495 in total over the GRAT term. The payments may be made with the assets contributed.
- The historical annual return of the S&P 500 was 14.3% in 2020 and 28.7% in 2021. After the annuity payments have been made to the grantor, the value of the assets transferred to the remainder beneficiaries gift tax free at the end of these two years (based on the above assumptions and historical annual growth rates) was approximately $1,465,342.
- Because the total annuity paid to the grantor actuarially equals the initial amount paid into the GRAT, the present value of the remainder interest is nearly $0. The grantor therefore used minimal of the grantor's gift tax exemption.
- If the GRAT called for annuity payments increasing by 20% each year, $1,527,308 would be transferred to the remainder beneficiaries.

What is a zeroed-out GRAT?

As previously mentioned, the value of the gift to the remainder beneficiaries is determined by subtracting the present value of the annuity interest retained by the grantor from the fair market value of the assets transferred in trust. Often GRATs are structured so that the present value of the annuity payments to be made to the grantor approximately equals the fair market value of the property contributed to the GRAT. In such cases, the value of the remainder interest is nominal or zero. Such a structure is commonly called a "zeroed out GRAT."

The transaction is sometimes structured to include a nominal taxable gift, intentionally triggering the filing of a gift tax return. GRATs are commonly funded with difficult-to-value assets, and the gift tax value is generally determined by a qualified appraiser. Filing the gift tax return starts the running of the statute of limitations—the amount of time the government has to challenge such a valuation. The statute of limitations for gift tax returns is typically three years, although longer for material omissions or fraud. If there is no challenge within that time period, the valuation cannot later be disputed.

[5] Hypothetical illustrations are not a guarantee of future performance. The growth rates and the 7520 rate used in this example are based on historical data. Investing involves risks, including the potential of losing money or the decline in value of the investment.

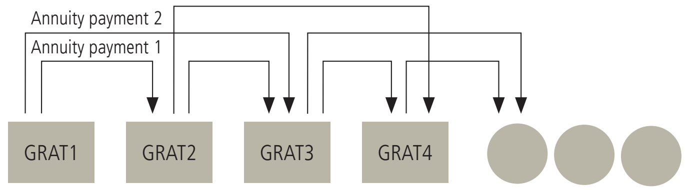
While filing a gift tax return for a zeroed-out GRAT can be beneficial, as discussed above, there are certain requirements that must be met. In order for the three year statute of limitations to apply, the gift tax return must meet the IRS adequate disclosure requirements. To fulfill these requirements, the gift tax return must include detailed information regarding the property transferred, parties to the transaction, vehicles used for the gift (i.e., trust document, if applicable), and the method used to determine the value of the gift (or non-gift). Non-gift transactions require additional information, such as why the transfer is not considered a gift. This process can be cumbersome, however, if not done properly, it could cause the transaction to still be subject to dispute.

Rolling GRATs

GRATs are effective only if asset growth occurs during the annuity term. Often, asset growth is expected, but the timing of that growth is unknown. Extending the annuity term can increase the opportunity for timely growth, but it also increases the chance that the grantor will not survive the annuity term (mortality risk). Rolling GRATs can be used to extend the annuity term while minimizing mortality risk and investment risk.

The term "rolling GRATs" refers to a series of short-term GRATs. The first GRAT is funded with a gift from the grantor. Each subsequent GRAT is funded with the annuity payments from the preceding GRAT. This funding continues until the growth event takes place, is captured in one or two GRATs, and the appreciation is transferred to the remainder beneficiaries.

Shorter annuity terms will reduce mortality risk since the grantor is only required to survive (at minimum) two years.[6] Moreover, if the assets used to fund a GRAT are relatively volatile (e.g., some publicly traded stock), a series of rolling GRATs may be more effective at transferring wealth, because the market periods of good investment performance and poor investment performance will be



isolated and may not offset each other. In other words, good investment performance in one period captured inside a GRAT will effectively transfer wealth to the remainder beneficiaries, and poor investment performance in another could result in a failed GRAT, which means that all of the trust assets will be returned to the grantor in the form of annuity payments and, other than the transactional costs of creating the trust, will have little consequence (assuming no gift tax exemption was used). Rolling GRATs are also flexible—the grantor can scale up or scale down the assets committed to the strategy at any time (or simply abandon it altogether).

Single asset GRATs

Creating single asset GRATs is another way to isolate investment performance. Rather than creating one GRAT holding a diversified portfolio of assets, multiple GRATs can be created and each can be funded with a single stock position or asset class. By dividing uncorrelated asset classes into separate GRATs, negative performance in one asset class will not negate positive performance in another.

Rolling GRATS and single asset GRATS.

The two strategies can be combined as well.

Example: single asset GRATs[7]
Diversified GRAT with multiple positions
The following assumes a two year zeroed-out GRAT created in 2020 and funded with five different assets, a 2.0% 7520 rate, and uses the historical growth rates for each asset in the years 2020 and 2021.

[6] However, while a shorter annuity term may reduce the mortality risk, a longer annuity term may lock in a lower interest rate.
[7] Hypothetical illustrations are not a guarantee of future performance. The growth rates and the 7520 rate used in this example are based on historical data. Investing involves risks, including the potential of losing money or the decline in value of the investment.

Asset	Percentage of GRAT	Initial dollar value	Cumulative returns*
Electronic Arts, Inc.	20%	$1,000,000	22.7%
Best Buy Co., Inc.	20%	$1,000,000	15.7%
Coca-Cola Company	20%	$1,000,000	7.0%
Pioneer Natural Resources	20%	$1,000,000	20.2%
Starbucks Corporation	20%	$1,000,000	33.0%
Projected value of single GRAT remainder:			$591,843

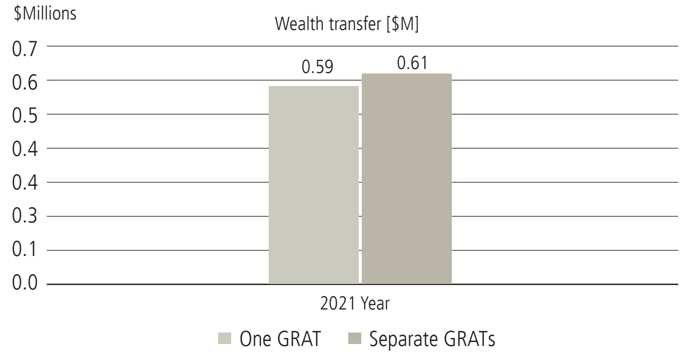
*The cumulative return represents the average overall return of each asset for the years 2020 and 2021.

Five Separate Single Position GRATs

The following assumes five separate zeroed out GRATs, each with a two year term, created in 2020, a 2.0% 7520 rate, and the same growth rates as in the prior example.

GRAT	Asset	Initial dollar value	Cumulative returns*	Value of remainder
GRAT 1	Electronic Arts, Inc.	$1,000,000	22.7%	234,019
GRAT 2	Best Buy Co., Inc.	$1,000,000	15.7%	117,648
GRAT 3	Coca-Cola Company	$1,000,000	7.0%	1,366
GRAT 4	Pioneer Natural Resources	$1,000,000	20.2%	0.0
GRAT 5	Starbucks Corporation	$1,000,000	33.0%	255,624
Projected value of five GRAT remainders:				$608,657

*The cumulative return represents the average overall return of each asset for the years 2020 and 2021.



Example: rolling single asset GRATs[8]

Diversified GRAT with multiple positions

The following assumes an initial two year zeroed out GRAT funded with five different assets and a 1.4% 7520 rate. Each annuity payment is subsequently rolled into a new two year zeroed out GRAT for an ongoing period of ten years. Historical growth rates for each asset and the 7520 rates in the years 2012 through 2021 have been used.

Asset	Percentage of GRAT	Initial dollar value	10 years returns*
Electronic Arts, Inc.	20%	$1,000,000	540.3%
Best Buy Co., Inc.	20%	$1,000,000	334.7%
Coca-Cola Company	20%	$1,000,000	69.2%
Pioneer Natural Resources	20%	$1,000,000	103.3%
Starbucks Corporation	20%	$1,000,000	408.4%
Projected value of single GRAT remainder:			$13,476,546

*The cumulative return represents the average overall return of each asset for the years 2012 through and 2021.

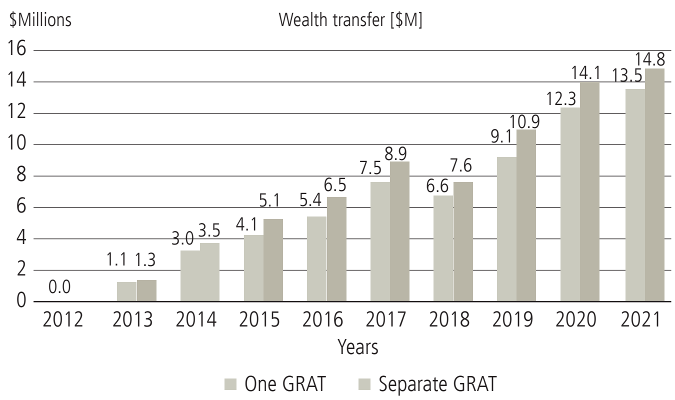
[8] Hypothetical illustrations are not a guarantee of future performance. The growth rates and the 7520 rates used in this example are based on historical data. Investinginvolves risks, including the potential of losing money or the decline in value of the investment.

Five Separate Single Position GRATs

The following assumes five separate zeroed out GRATs, each with a two year term and a 1.4% 7520 rate. Each annuity payment is subsequently rolled into a new two year zeroed out GRAT for an ongoing period of ten years. Historical growth rates for each asset and the 7520 rates as in the prior example.

GRAT	Asset	Initial dollar value	10 years returns*	Value of remainder
GRAT 1	Electronic Arts, Inc.	$1,000,000	540.3%	5,560,681
GRAT 2	Best Buy Co., Inc.	$1,000,000	334.7%	3,768,829
GRAT 3	Coca-Cola Company	$1,000,000	69.2%	451,937
GRAT 4	Pioneer Natural Resources	$1,000,000	103.3%	1,151,392
GRAT 5	Starbucks Corporation	$1,000,000	408.4%	3,869,706
Projected value of five GRAT remainders:				$14,802,544

*The cumulative return represents the average overall return of each asset for the years 2012 through and 2021.



Appendix

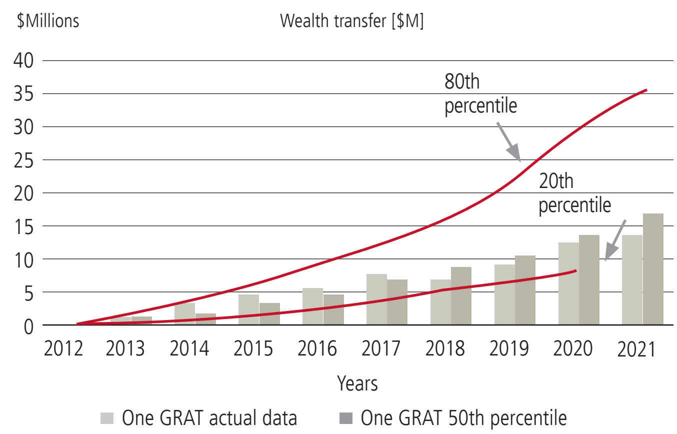
Monte Carlo simulation

In addition to the historical growth rates used in the above examples, the below illustrates the range of potential outputs of the GRAT strategy. This was done using 1,000 model paths, simulated using the bootstrapping technique for asset returns, and the 7520 rate from the last 10 years. The graph shows the comparison between historical returns over the last 10 years and the median results from the simulation, with confidence bands reflecting the 20th and 80th percentile results.

Illustration: Last 10 years output vs median output, with confidence bands for 20th and 80th percentile results[9]

Diversified GRAT with multiple positions

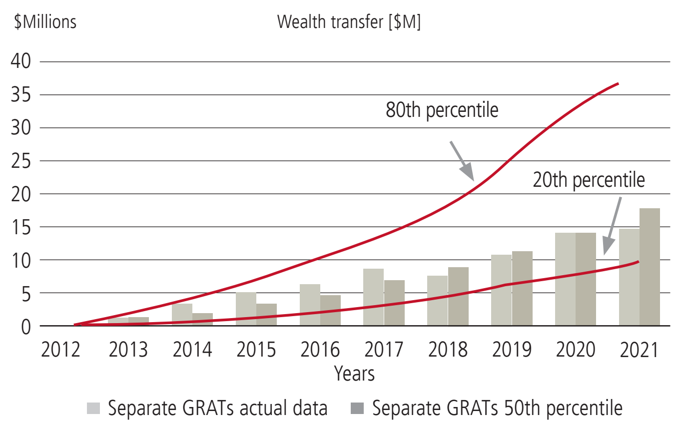
The following assumes an initial two year zeroed-out GRAT funded with five different assets and historical 7520 rates. Each annuity payment is subsequently rolled into a new two year zeroed out GRAT for an ongoing period of ten years. Historical growth rates for each asset in the years 2012 through 2021 have been used and the percentile values refer to values from the Monte Carlo simulation.



[9] Hypothetical illustrations are not a guarantee of future performance. Growth rates used are based on historical data, similar to the 7520 rate. Investing involves risks, including the potential of losing money or the decline in value of the investment.

Five Separate Single Position GRATs

The following assumes five separate zeroed out GRATs, each with a two year term and a historical 7520 rate. Each annuity payment is subsequently rolled into a new two year zeroed out GRAT for an ongoing period of ten years. Historical growth rates for each asset in the years 2012 through 2021 have been used and the percentile values refer to values from the Monte Carlo simulation.



Thank you

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