WRMarketplace

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TOPIC: It's Déjà Vu: Planning (Again) in the Face of Uncertainty - Estate Freeze Series: Zeroed-Out GRATs.

MARKET TREND: Zero-gift planning techniques, like zeroed-out grantor retained annuity trusts (GRATs), have taken on renewed importance in legacy planning as a way to remove assets from the estate and preserve the federal unified credit for later income tax (basis) planning, if needed.

SYNOPSIS: The zeroed-out GRAT can transfer asset appreciation without gift or estate tax, but only if the grantor survives the term of the GRAT and the assets transferred outperform a federally-set investment hurdle rate known as the "7520 rate." The approach is particularly suited to today's planning, since the GRAT's unique features, including options to backload and delay annuity payments, variations in term selection, and the application of mandatory valuation adjustments, can enhance its flexibility to adapt to future changes and create opportunities to optimize the trust's performance and probability of success.

TAKE AWAYS: For estate planning, GRATs currently benefit from their codified status and their unique flexibility with regard to term selection and annuity payment structure. Since GRATs only transfer an asset's appreciation, numerous factors can impact the approach's success, including the availability of valuation discounts, the use of powers of substitution, and the continuation of grantor trust status after the GRAT term. On-going management and performance reviews are critical for a GRAT to achieve its intended objectives. Accordingly, GRATs must be regularly monitored to review asset performance and the need for investment changes, such as exercising a substitution power to lock-in growth.

As discussed in *WRMarketplace No. 17-10*, in this uncertain tax environment, legacy planning advisors are consistently recommending the use of "estate freeze" plans, which transfer asset appreciation to family members or trusts for their benefit with minimal transfer tax exposure. A GRAT is a popular estate freeze approach that is particularly suited to today's planning, since the GRAT's unique features enhance its flexibility to adapt to future changes and create opportunities to optimize the trust's performance and its probability of success.

WHAT ARE GRATS?

A GRAT is a codified[1] "estate freeze" in which a grantor transfers assets to a trust, retaining the right to an annual annuity payment for a specified term. Typically, the annuity is expressed as a fixed percentage of the trust's initial value[2] and calculated based on the federally-set, monthly adjusted 7520 rate in effect for the month of the GRAT's creation. At the end of the GRAT term, any remaining trust assets pass to the grantor's designated beneficiaries, without estate tax, but only if the grantor survives the GRAT term.

WHY USE GRATS NOW?

No Gift. A GRAT is most efficient for gift and estate tax purposes if the grantor "zeros-out" the gift tax value of the GRAT's remainder interest (*i.e.*, the present value of the annuity stream equals the fair market value of the assets given to the trust). Since a zeroed-out GRAT does not result in a taxable gift,[3] it can reduce a taxable estate if the grantor survives the GRAT term while preserving gift and estate tax exemptions for later planning, if needed.[4]

Appreciation Only. A GRAT only transfers asset appreciation above the 7520 rate to the GRAT's remainder beneficiaries. The initial asset value, along with growth up to the 7520 rate, is retuned in a predictable annual annuity stream to the grantor, which can allay concerns about irrevocably parting with too much wealth to allow the grantor to maintain his or her current lifestyle.

Rising 7520 Rates. GRATs benefit from low 7520 rates, which likely will rise as the Federal Reserve Board continues to raise its benchmark interest rates (the latest increase just occurred on March 15th). Even relatively minor increases in the 7520 rate can have a significant effect:

> ***Example:*** Amy creates a 7-year, zeroed-out GRAT at a 7520 rate of 2.6% (for April 2017) and transfers $5 million in assets to the trust. The annuity payments to Amy increase annually by 20%. At 5% average annual growth, the GRAT leaves $705,573 to the remainder beneficiaries. If the 7520 rate increases by just 0.4%, to 3.0%, the ***remainder beneficiaries' share is cut by $114,500***.

The serious potential for rising rates makes now a prime time for GRAT implementation, possibly for a longer term to lock-in the currently low rates (see below).

HOW TO OPTIMIZE?

Since GRATs only transfer asset appreciation beyond the 7520 rate, numerous factors in addition to the hurdle rate can impact the approach's success; for example, the projected and actual rate of return on the trust, the use of delayed or "backloaded" annuity payments, the selection of the term, the availability of valuation discounts, the continuation of grantor trust status after the GRAT term, etc. These features provide GRATs with unique flexibility and optionality to enhance their overall performance.

Annuity Payments

"Backloaded" Payments. A grantor can structure GRAT annuity payments to increase annually by up to 20% of the prior year's payment. Increasing annuity payments may generate a larger GRAT remainder if the assets appreciate at a relatively constant rate over the GRAT term.

> ***Example:*** Assume Jill funds a 7-year, zeroed-out GRAT with $5 million, when the 7520 rate is 2.6%. Jill anticipates 5% annual growth. If the GRAT makes level annuity payments, approximately $599,440 passes to the remainder beneficiaries. If the annuity payments increase each year by 20%, ***this remainder increases to $705,573.***

Increasing annuity payments are particularly appealing for GRATs involving hard-to-value or illiquid assets that are held in anticipation of an eventual liquidity event, but which will initially generate little cash flow (*e.g.*, closely-held stock). In this case, to avoid in-kind distributions, the GRAT can be funded with sufficient cash to meet the smaller initial annuity payments until the occurrence of the liquidity event.[5]

Delayed Payments. A GRAT has up to 105 days following its anniversary date to make its annual annuity payment,[6] allowing the GRAT to take advantage of an additional three months of compounding or dividend payments on those assets before distribution.

Term Selection. A grantor can create a GRAT for a term as short as two years or as long as the grantor's life expectancy. The choice of the term will depend on several issues, including the current and projected interest rate environment, the type of assets contributed, their projected performance, and the grantor's life expectancy.

- Short-Term. Over the past several years of declining and low 7520 rates, short-term GRATs have been a popular approach for dealing with the potential investment volatility of the transferred assets. A series of short-term "rolling" GRATs can capture interim investment volatility and avoid offsetting periods of trust growth and depreciation. Short-term GRATs also hedge against the mortality risk of the grantor's death during the term. However, the approach faces the risk of future increases in the 7520 rate.

- Long-Term. In a rising rate environment, funding longer-term GRATs with consistently high return assets, such as high-dividend paying stock, may be preferred. The longer term can lock in a low 7520 rate and require smaller annual payments, allowing the

GRAT to maximize the benefits of long-term compounding growth. A longer term also may be preferred for the early transfer of the expected growth in highly-appreciating, non-marketable assets that will not produce significant initial liquidity (*e.g.*, interests in a closely-held business that expects a future sale).

For examples of ***selecting the term and annuity payment structure in a rising rate environment*** see the following chart illustrating certain scenarios:

Scenario	Grantor to transfer interest in closely-held business and expects future liquidity event	Grantor to transfer assets with high annual income or dividend yield and has concerns over rising rates	Grantor to transfer marketable assets with potential for significant investment volatility
Selected Term	Long-term	Long-term	Short-term (but closely monitor rising rate impact)
Selected Annuity Payment	Backloaded	Backloaded (level if the grantor wants to maximize annuity return vs. growth)	Backloaded

<u>**Valuation**</u>

Mandatory Adjustments. GRATs effectively have sanctioned formula valuation clauses, which protect grantors from exposure to unexpected gift tax liability due to IRS valuation challenges. If a GRAT annuity is structured as a fixed percentage of the trust's initial value and the trustee incorrectly values the trust assets, the GRAT must make a compensating payment to the grantor within a reasonable time of the valuation adjustment.[7] This feature has particular appeal for planning with hard-to-value or "discountable" assets (see below) since the IRS continues to challenge the use of formula valuation clauses in other planning approaches.

Discounts. With the uncertainty regarding the proposed Treasury Regulations under Code §2704, traditional valuation discounts for assets transferred to a GRAT should remain available, at least for now.[8] Funding a GRAT with discounted assets can enhance the probability that those assets will outperform the 7520 rate. But advisors must keep in mind that, if the GRAT must make in-kind distributions to satisfy the annuity payments, those distributions also would need to be valued and may be subject to valuation discounts when returned to the grantor, which can undermine the original planning. If a liquidity event is expected with regard to the discounted assets, then, as noted above, backloading annuity payments and funding the GRAT with sufficient cash to meet the smaller initial payments may help minimize in-kind distributions and maximize the remainder passing to the family beneficiaries.

Substitution Power. If a GRAT provides the grantor with a nonfiduciary power to substitute or swap trust assets for assets of an equivalent value, the grantor can exercise this power to either rescue an underperforming GRAT or lock in the gains of an exceedingly successful GRAT.

> ***Example***: Jack created a 3-year, zeroed-out GRAT funded with 30,000 shares in X Co. At funding, the share price was $66 ($1.98 million total), and the 7520 rate was 1%. In Year 1, the shares increase in value to $83/share (almost 26%, for a total gain of $510,000). In Years 2-3, however, the share price falls and stays at $68 per share. Compare the outcomes if Jack leaves the shares in the GRAT, or in Year 1, substitutes a bond portfolio with a 3% average return.

End of GRAT Term – Year 3	Substitution	No Substitution
GRAT Remainder	$560,721	$143,260
Potential Estate Tax Savings (at 40%)	$196,252	$50,141

Grantor Trust Status. If at the end of the GRAT term, the GRAT remainder continues in a grantor trust for federal income tax purposes, trust growth will compound without reduction for annual taxes (which are paid by the grantor).[9] This added growth can enhance the GRAT's remainder value after the term.

> ***Example***: A GRAT leaves a $500,000 remainder in a continuing trust for the remainder beneficiaries, and the grantor has a 25 year life expectancy. Assume a top federal ordinary income tax rate of 43.4% and a 23.8% long-term capital gains tax rate applies (both factoring in the 3.8% net investment income tax), and the trust has a 5% average annual return (70% ordinary income; 30% capital gain). If the remainder trust is taxed as a non-grantor trust, at the end of 25 years, the trust will have almost $1,079,000; ***if the trust continues as a grantor trust for that time, the trust holds $1,693,000, a $614,000 increase***.

TAKE-AWAYS

- For estate planning, GRATs currently benefit from their codified status and their unique flexibility with regard to term selection and annuity payment structure.
- Since GRATs only transfer an asset's appreciation, numerous factors can impact the approach's success, including the availability of valuation discounts, the use of powers of substitution, and the continuation of grantor trust status after the GRAT term.
- On-going management and performance reviews are critical for a GRAT to achieve its intended objectives. Accordingly, GRATs must be regularly monitored to review asset performance and the need for investment changes, such as exercising a substitution power to lock-in growth.

NOTES

[1] *See* Internal Revenue Code ("**Code**") § 2702 and Treas. Reg. § 25.2702-3.
[2] The annuity also can be set as a fixed dollar amount.
[3] Note that the grantor does not need to pre-fund the GRAT with a separate gift, unlike installment sale transactions to grantor trusts which may require a gift of so-called "seed money" (typically 10% of the value of the assets sold) to evidence the trust's ability to make payments under the installment note (Installment sales will be discussed in Part II of the Estate Freeze Series).
[4] All references in this article to GRATs assume a zeroed-out GRAT.
[5] *See* Carlyn S. McCaffrey and John W. Porter, "GRATs - Current Issues Regarding Creation, Maintenance, and Operation," 40th Annual Heckerling Institute on Estate Planning, Special Session I-B, Jan. 15, 2014.
[6] Treas. Reg. § 25.2702-3(b)(4) requires that the annuity must be paid no later than 105 days after the anniversary date of the creation of the trust if the annuity is payable based on the anniversary date and no later than the date on which the trustee must file the trust's income tax return (determined without extensions) if the annuity amount is payable based on the taxable year of the trust.
[7] *See* Treas. Regs. §§ 25.2702-3(b)(2) and § 1.664-2(a)(1)(iii).
[8] Treasury officials also have commented that, if issued in final, the effective date of the regulations would be on or after the date of issuance. However, for transactions entered into after proposal of these regulations (released on Aug. 2, 2016), if disclosing the transaction on a gift tax return, clients and tax advisers may want to consider disclosing that the asset valuation does not factor in the impact of the proposed §2704 Treasury Regulations, since the regulations do not apply to transfers made before the regulations are issued in final.
[9] Of course, the continuation of grantor trust status and the grantor's payment of the trust's income tax burden must consider the financial impact to the grantor. Thus, the trust may want to allow for the termination of grantor trust status during the grantor's lifetime if the tax burden becomes economically impractical for the grantor to bear.