"May Day" GRATs: An Excellent Estate Planning Opportunity

April 30, 2020

A confluence of events makes May 2020 a very attractive month for funding grantor retained annuity trusts, better known as "GRATs." As an adjunct to our Alert on tax-efficient estate planning in these uncertain times, these additional questions and answers provide more details on the effective use of GRATs.

What is a GRAT and why is it advantageous now? A "GRAT" is an irrevocable trust that pays an annuity amount to the grantor for a set period of years, after which the remainder passes to or for the benefit of children or others. The effect of a GRAT is to transfer to the trust's remainder beneficiaries all of the appreciation in excess of the so-called "7520 rate" (an IRS prescribed interest rate). The May 2020 7520 rate used to calculate GRAT payments is 0.8%, the lowest since the IRS started publishing these rates in 1989. This very low interest rate, combined with lower equity values, makes a GRAT strategy quite advantageous now.

Do I need estate and gift tax exemption to fund a GRAT? No. A zeroed-out GRAT does not require the use of any gift tax exemption to fund it. In this type of GRAT, the actuarial value of the retained annuity interest is equal in value to the assets used to fund the trust, and the gift value is only a few pennies.

How does a GRAT work? The best way to explain how a GRAT works is by illustration. Assume the grantor wants to contribute 1000 shares of stock worth $1,000,000 to a GRAT. The grantor funds a 2-year GRAT, based on the considerations set forth below. This means that she will receive an annuity for two years, and then whatever is left in the GRAT after two years will pass to the grantor's children. Based on the "7520 rate" in effect for May 2020, the annuity payment that will "zero out" the gift is 50.5996% of the initial contribution, here $505,996 annually. The annuity can be paid in cash, but it is not necessary to sell the stock; the appropriate amount of stock can be distributed to satisfy the annuity requirement. For that purpose, the stock is valued on the date the annuity is paid.

Now, let's look at three (of the many) possible outcomes:

- *Example 1: The stock value increases by 10% in each of the two years of the GRAT.* One year after the gift to the GRAT, the stock in the GRAT is worth $1,100,000 (10% appreciation). The Trustee then distributes $505,996 to the grantor, leaving $594,004 in value in the trust. The trust assets continue to appreciate at the rate of 10% per year, so on the second anniversary (and termination date) of the trust, the assets are worth $653,404. The Trustee distributes the annuity amount of $505,996 to the grantor, and the remaining $147,408 is distributed to the grantor's children, free of gift tax. To recap, the grantor has received distributions with a value of $1,011,992, and her children receive $147,408. (Note that if the stock value had increased by 25% in each of the two years, the children would receive $424,009.)

- *Example 2: The stock value increases by 3% in each of the two years of the GRAT.* With a 3% increase, the stock in the GRAT would be worth $1,030,000 at the end of year one. The Trustee would distribute $505,996 to the grantor, leaving $524,004 in value in the trust. The trust assets continue to appreciate at the rate of 3% per year, so on the second anniversary (and termination date) of the trust, the assets are worth $539,724. The Trustee distributes the annuity amount of $505,996 to the grantor, and the remaining $33,728 is distributed to the grantor's children, free of gift tax. To recap, the grantor has received distributions with a value of $1,011,992, and her children receive $33,728.
- *Example 3: The stock value declines by 10% in the first year and increases by 5% in the second year of the GRAT.* With a 10% decrease, the stock in the GRAT would be worth $900,000 at the end of year one. The Trustee would distribute $505,996 to the grantor, leaving $394,004 in value in the trust. The trust assets appreciate 5% in the second year, so on the second anniversary (and termination date) of the trust, the assets are worth $413,704. The Trustee would distribute all of the trust assets to the grantor, and nothing would be distributed to the grantor's children. Because the assets did not appreciate at a rate greater than the imputed rate of return of 0.8%, the GRAT has not accomplished anything. However, the costs of this "failure" are minimal. All of the stock is returned to the grantor, and other than the transaction costs, she is in the same place financially as she would have been had she not funded the GRAT.

How is a GRAT treated for tax purposes? For *income tax* purposes, the GRAT is a grantor trust, meaning that the grantor pays the income taxes on the trust's income during the term of the GRAT. If the beneficiaries receive any part of their distribution at termination in stock, the beneficiaries would take the grantor's basis in the stock they receive. For *gift tax* purposes, the only taxable gift is the actuarial value (using the prescribed IRS interest rate) of the remainder interest that is projected to pass to the children when the GRAT terminates. In the case of a "zeroed out" GRAT, the annuity is set such that the projected value of the remainder interest is less than one dollar. If the GRAT outperforms the 7520 rate, the assets that pass to the children at the termination of the trust pass free of gift tax. For *estate tax* purposes, as long as the grantor outlives the term of the trust, the GRAT assets will not be included in the grantor's estate when she dies.

How many years can the GRAT term be? It is generally accepted that two years is the minimum term and there is no maximum term. However, for a zeroed-out GRAT, the grantor needs to be alive at the end of the term, so the length of the GRAT term should be set such that the grantor has a strong likelihood of outliving it.

How does one choose the term of the GRAT? The grantor and her lawyer should consider several factors, including the age and health status of the grantor, and the grantor's views about the future appreciation of the asset used to fund the GRAT. Although we have illustrated this technique with 2-year GRATs, a longer term could be quite advantageous, as the 0.8% May 2020 rate would be locked in for the entire term of the GRAT. If, for example, a 10-year term were selected, the GRAT's annual annuity payment would be 10.44528% of the value of the initial contribution.

What is the best time to fund a GRAT? The best time to fund a GRAT is when interest rates are low and asset prices are depressed or otherwise have great appreciation potential. With respect to interest rates, this alert is discussing "May Day GRATs" simply because the IRS interest rate is so low right now. The 0.8% interest rate is in effect for the entire month of May. Sometime in the second half of the month, the IRS will announce the June rates, at which time we will know whether June's rate will be higher, lower, or the same as May's rate. The other key factor is asset values. If you think we haven't seen the bottom yet, then you might want to wait to fund a GRAT. As can be seen in the third example, if asset values do not increase, the GRAT is not effective to transfer wealth to the intended beneficiary. If you think values are at or near the bottom, then this is a good time to cry "May Day!" and fund a GRAT.

What if I funded a GRAT before the crash when stock prices were high? If an existing GRAT is underwater such that nothing is likely to pass to the remainder beneficiaries on termination, it might be a good idea to "freeze" the GRAT by swapping the GRAT's current assets for assets that don't change much in value, such as cash or bonds, and then use the withdrawn assets to fund a new GRAT that would take advantage of the current depressed asset values and low interest rates. The original GRAT would then return the substituted assets to the donor when it terminates (as in example 3 above).

Please contact us if you have questions about GRATs or any other "May Day" planning techniques.

Beth Shapiro Kaufman	Anne J. O'Brien	Megan E. Wernke	Sarah J. Racicot
202.862.5062	202.862.5033	202.862.5088	202.862.7854
bkaufman@capdale.com	aobrien@capdale.com	mwernke@capdale.com	sracicot@capdale.com

-Complex Litigation
-Corporate Law
-Employee Benefits
-Exempt Organizations
-Private Client
-Tax Controversies
-Tax Litigation
-White Collar Defense

For more information, please visit us at www.caplindrysdale.com.

Washington, DC Office:
One Thomas Circle NW
Suite 1100
Washington, DC 20005
202.862.5000

New York, NY Office:
600 Lexington Avenue
21st Floor
New York, NY 10022
212.379.6000

Disclaimer
This communication neither provides legal advice, nor creates an attorney-client relationship with you or any other reader. If you require legal guidance in any specific situation, you should engage a qualified lawyer for that purpose. Prior results do not guarantee a similar outcome.

Attorney Advertising
It is possible that under the laws, rules, or regulations of certain jurisdictions, this may be construed as an advertisement or solicitation.