Heads I Win, Tails I Can't Lose

THE GRANTOR RETAINED ANNUITY TRUST

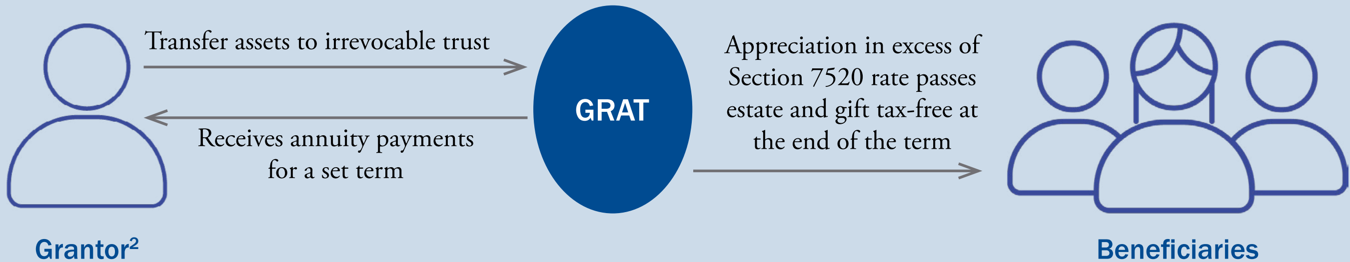
What if you could transfer wealth to the next generation with minimal estate and gift tax consequences? Grantor Retained Annuity Trusts ("GRATs") can do just that. They enable families to transfer appreciating assets and/or assets that have significant positive free cash flow to the next generation estate and gift tax-free. Often described as a "Heads I Win, Tails I Can't Lose" tax strategy, GRATs are particularly attractive because they have essentially no downside risk. However, they can be complicated, and even when executed properly, do not always result in the successful transfer of wealth. In this paper, we will explain what GRATs are, who they are appropriate for and some key considerations to think about before creating a GRAT.

What is a GRAT?

A GRAT is an irrevocable trust which is established by a written trust agreement. The creator of the trust (the "Grantor") contributes assets with appreciation and/or cash flow potential to the GRAT while retaining the right to receive fixed annuity payments over the trust's term. At the end of the term, the assets' appreciation in excess of the required annuity payments is distributed to the Grantor's beneficiaries, estate and gift tax-free.

While GRATs are very complicated, the inner workings can be broken down into three distinct steps:

1. The Grantor makes an irrevocable gift to a trust for a period of time (typically 2 - 5 years).
2. The Grantor receives annuity payments over a fixed term. The annuity payments are calculated by using an interest rate determined by the IRS called the Section 7520 rate. [1]
3. When the GRAT's term expires, the leftover assets (assets that remain after the annuity payments) pass to the trust's beneficiaries free of estate and gift tax.



Why Consider a GRAT?

GRATs enable individuals anticipating a sizable estate tax liability to freeze the value of their estate at current values, and shift most, if not all, of the future appreciation to the next generation. For example, if you own an asset worth $1 million, which is expected to appreciate to $1.3 million over the next two years, a GRAT will allow you to transfer the majority of the $300,000 of appreciation to your beneficiaries, estate and gift tax-free. [3]

Who is a Good Candidate for a GRAT?

An individual or family that meets some of the following criteria should consider implementing a GRAT as part of their estate plan.

- Anticipates having a taxable estate
- Expects that their assets will be sufficient to sustain their retirement and income needs over their lifetime
- Has assets with strong growth or cash flow potential
- Wants to move some of the growth portion of their assets outside of their estate in an estate and gift tax-free manner
- Has used up their lifetime exemption [4]

What are the Best Assets to put in a GRAT?

The best assets to transfer into a GRAT are those with the most potential for growth and/or have significant positive cash flows. This includes marketable securities, hedge funds, private equity investments, real estate and business interests. Entrepreneurs often place pre-IPO stock into a GRAT with the expectation that all of the post-IPO appreciation can be transferred to their beneficiaries with little transfer tax cost. In addition, closely-held business interests (partnerships, LLCs, S Corporations) are great candidates for a GRAT, especially if you plan to sell your business in the next couple of years. Finally, difficult to value assets are also good candidates for GRATs because a re-valuation by the IRS of the assets contributed to the GRAT will not produce an additional gift tax liability if the trust documents are drafted properly.

We do not recommend placing cash in a GRAT because the yield on cash is less than the Section 7520 rate.

[1] *The Section 7520 rate is equal to 120% of the applicable federal mid-term rate compounded annually.*

[2] *The Grantor is typically the trustee of the GRAT.*

[3] *If you are considering transferring assets to your grandchildren or more remote descendants, you should consider other planning techniques, such as a sale to an intentionally defective grantor trust, rather than a GRAT. This is due to the Generation Skipping Transfer ("GST") tax considerations.*

[4] *The lifetime exemption is the dollar amount that individuals can transfer by gift or will without having to pay any estate and gift taxes. For 2020, the lifetime exemption is $11.58 million for individuals and $23.16 million for married couples.*

What's the Best way to Structure a GRAT?

The optimal structure of a GRAT depends upon the underlying assets within the GRAT.

Marketable Securities: We recommend establishing a series of GRATs for each asset class to hedge against negative performance in any given asset class. For example, an individual can have one GRAT for U.S. equities and a second GRAT for international equities. With this format, only one asset class needs to have strong performance to move a sizable amount of growth outside the estate. More importantly, negative performance of one asset class does not impact the potential success of the other GRAT strategy.

Non-marketable Securities: We recommend establishing separate GRATs to hold non-marketable security assets with similar characteristics. For example, an individual that owns both residential and commercial real estate investments may consider a separate GRAT for the residential property and another GRAT for the commercial property to hedge against cap rate or occupancy changes in one of the properties.

How do you set the Term for a GRAT?

While the minimum term for a GRAT is two years, grantors typically select a term that matches the return expectations or cash flow projections for the underlying assets within the GRAT. For example, GRATs with marketable securities are often created with a two-year term to mitigate some of the risks associated with a GRAT such as the Grantor dying before the term is over or the trust assets underperforming. Many people then establish a series of consecutive short-term GRATs often referred to as "laddered" or "rolling" GRATs which are funded with the previous GRAT's annuity payments. Rolling GRATs can capture rapid asset appreciation and have the flexibility to stop at any time.

The GRAT term for real estate investments and other private investments is typically three to five years depending on the expected future cash flow from the underlying assets.

What is the downside of a GRAT?

The downside of implementing a GRAT is limited. However, there are two downsides to be aware of:

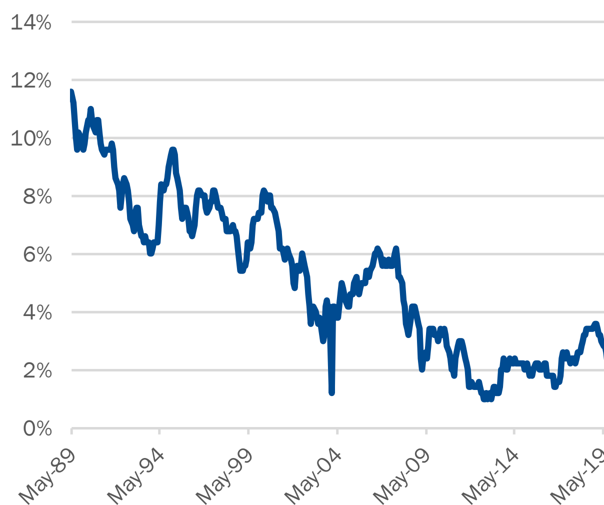
1. If you do not outlive the trust, the amount transferred into the GRAT will revert back to the estate and be subject to estate tax.
2. If the GRAT assets underperform the Section 7520 rate, the GRAT will fail and you will not have succeeded in transferring wealth to your beneficiary estate and gift tax-free.

In both of these cases, the downside is mainly the opportunity cost of doing something else, the money required to set up the GRAT, the appraisal costs to determine the valuation of any illiquid investments and the cost to file a gift tax return. It is important to note that there are no tax penalties for a failed GRAT.

Why Now?

We believe that current market conditions are ripe for GRATs. Because Section 7520 rates are tied to treasury rates, they are at an all-time low. Over the last 30 years, the Section 7520 rate has been as high as 11.6% and as low as 1%. With a 30-year average of 5.1%, the January 2020 rate of 2.0% is at the very bottom of this range. Low Section 7520 rates make it easier for the assets in the GRAT to exceed the hurdle rate and thus easier for the GRAT to be successful. The chart to the right puts the historically low Section 7520 rate into context.

Section 7520 Rates



As the Section 7520 rate hovers around a record low, GRATs are a highly effective and valuable tool to transfer wealth from one generation to the next. However, GRATs are not for everyone. The suitability of a GRAT requires the thoughtful consideration of a wide range of tax and non-tax factors. At Hirtle Callaghan, we have created countless GRATs on behalf of our family clients over the past 20 years. We have the experience and the team in place to work with you and your other advisors to determine if GRATs make sense for you.

For more information, please reach out to your Investment Officer or Portfolio Manager.

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