



Practical GRATs

Although underutilized, simple GRATs made up of marketable equity securities can be very effective estate planning tools.

By Bruce A. Weininger

For years, family limited partnerships and intentionally defective grantor trusts were the “sexy” estate planning ideas for family offices and high-net-worth individuals.

Grantor retained annuity trusts (GRATs), meanwhile, were considered too boring unless you had a concentrated position or an asset that lent itself to a heavily discounted valuation. But even then, GRATs have been largely left unused in the advisor’s tool kit because of the complexity involved in them. They require frequent appraisals of illiquid, hard-to-value assets as well as appraisals for discount valuations on what could turn out to be little (or no) tax savings. Many estate-planning attorneys don’t realize how averse some clients are to complexity and costs.

Historically, GRATs have also been underutilized because many estate planning attorneys have opted for more aggressive strategies or waited for the ideal asset—often either a privately owned business or an illiquid piece of real estate that could be discounted based on its lack of marketability or some other issue.

Yet very simple, GRATs with low (or no) tax risk made up of marketable equity securities—even diversified stock portfolios—can be very effective estate planning tools. When you use an existing portfolio of (easy-to-value) marketable equities securities, the client’s concerns can be alleviated.

First, the basics. On October 8, 1990, Section 2702 of Chapter 14 of the Internal Revenue Code gave taxpayers and their advisors a blueprint for the use of GRATs. If done correctly, these trusts are statutory in nature, and unlike family limited partnerships and sales to defective trusts, which are not statutory, GRATs do not involve tax risk.

The taxpayer creates a trust for a term of at least two years and takes back an annual annuity. Annuity payments are based on the section 7520 rates (which change monthly). If the

assets appreciate faster than the Section 7520 interest rate (which is currently the October 2009 rate of 3.20%), then any appreciation in excess of that amount can pass to a taxpayer’s descendants—or more likely, to a trust for those descendants—without it being considered a gift.

If the assets don’t appreciate at a rate that exceeds the 7520 rate, then all of the assets revert to the grantor as if nothing ever happened. In short, heads you win, tails you tie. But you can’t lose.

Two-year rolling GRATs are easy to draft, relatively inexpensive and, if funded with marketable securities, don’t require expensive appraisals. The idea of “rolling” GRATs means that after the first year, approximately half of the GRAT proceeds are required to be paid back to the grantor, and they are immediately deposited into a second GRAT. If the term of the first GRAT is years zero to two, the second GRAT would be years one to three, and the third GRAT would be from years two to four, funded with the second distribution from GRAT No. 1 and the first distribution from GRAT No. 2. Essentially, the two-year GRATs overlap.

The beauty of the two-year rolling GRAT is that it is primarily a bet on volatility—the volatility of the stock market is far more important than long-term stock market returns or the absolute level (high or low) of the 7520 interest rate (the hurdle rate).

To illustrate this point, we have gone back to January 1, 1991, when GRATs were first made statutory, and started with \$10 million in marketable securities. We began rolling two-year GRATs forward to the end of 2008. Over those 18 years, we would have succeeded in removing more than \$25 million from the taxpayer’s estate (and far more if we included earnings on the funds removed). This calculation uses actual 7520 rates that were in place each January and does not assume that the \$10 million is “trued up,” using additional assets in years in which the equity values declined. (See the attached table.)

Maybe the most interesting fact in our example is

that despite the cumulative losses in equity markets for the last eight years, GRATs were still successful in removing more than \$4.2 million from the taxpayer’s estate during that period. (Remember, there were times in which the stock market did well over a two-year period during these past eight years.) In fact, two-year rolling GRATs would have successfully removed at least \$3.5 million of assets—or more than 35% of the assets you started with—from the grantor’s estate even during the worst five-year period (2000-2005) since the statute was enacted in 1990.

These benefits are actually understated, since at the end of the GRAT term assets can be successfully passed to a trust for beneficiaries that is “defective” for income tax purposes, thereby allowing the grantor to continue to pay income taxes on the earnings of that trust without it being considered a gift. Making the residual trust defective for income-tax purposes also allows you to avoid the complexity of having to file a tax return for the residual trust. And that same residual trust can be used for multiple GRATs (if desired).

Another advantage to the taxpayer/grantor is that assets successfully passing to the residual trust are protected from creditors, including both spouses and beneficiaries’ spouses, which is helpful in the event of divorce. In the former case, the assets are no longer included in the marital estate. In the latter case, assets shown to be received as a gift or inherited and segregated are generally not considered to be a marital asset—even if the beneficiary is the trustee of the residual trust.

We believe too much attention has been paid to finding the perfect discountable asset (an activity that is complex and expensive for the client) and the result has been lost opportunities to remove assets from taxable estates. We believe that any taxpayer who has a taxable estate—at this point more than \$3.5 million per taxpayer or \$7 million per married couple—and has at least \$1 million of marketable equity securities should be considering rolling two-year GRATs.