Journal of Accountancy

Great time for a GRAT

A grantor retained annuity trust can form the cornerstone of an estate plan.

By Megan M. Burke, CPA, Ph.D.
October 1, 2019

Photo by emholk/iStock

Grantor retained annuity trusts (GRATs) represent an opportunity for a client to transfer appreciating assets to the next generation with little to no gift or estate tax consequences. Wealthy families can use GRATs to freeze the value of their estate while transferring any future appreciation to the next generation free of tax. Additionally, GRATs have little downside.

Moreover, now may be an opportune time for taxpayers who can benefit from a GRAT to consider forming one, with their CPA tax adviser's help. There have been recurring proposals by some in the federal government to limit the benefits GRATs can provide. Also, while the estate tax exemption is now $11.4 million (for 2019), that figure is currently scheduled to revert to $5 million as adjusted for inflation, which was $5.49 million in 2017, the amount it was before the changes made by the law known as the Tax Cuts and Jobs Act, P.L. 115-97. This would make more estates potentially taxable. And, finally, the trusts work best when the Sec. 7520 interest rates are low, which is currently the case, but based on current interest rate trends, may not be for much longer.

GRAT BASICS

A GRAT is created when a grantor contributes assets with appreciation potential to a fixed-term, irrevocable trust. The grantor then retains the right to receive an annuity stream over the trust's term. At the end of the term, the assets are distributed to noncharitable beneficiaries — typically, the grantor's children.

Note that the grantor receives the right to an annuity stream and not the income of the trust. If the trust does not generate sufficient income, the trustee must invade the principal to make the annuity payment. A taxable gift is calculated by subtracting the value of the grantor's retained interest from the fair market value of the property transferred into the trust.

The IRS assumes that the trust assets will generate a return of at least the applicable Sec. 7520 rate in effect for the month the assets were transferred to the trust. Any appreciation in excess of the Sec. 7520 rate passes to the beneficiaries free of gift tax. (This article uses for illustrative purposes the 3.4% rate in effect for January 2019. To find the current rate, see the latest monthly IRS revenue ruling with the applicable federal rate tables (see Table 5 of the revenue ruling), or consult the IRS's "Section 7520 Interest Rates" webpage, available at irs.gov (https://www.irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates).)

If the assets in the GRAT fail to outperform the Sec. 7520 rate, the assets are returned to the grantor. The grantor would have paid little to no gift tax and only have incurred minimal administrative costs to establish and maintain the GRAT. There are no other adverse tax consequences of a substandard-performing GRAT.

> ***Example 1:*** A client places $5 million in a GRAT (an irrevocable trust meeting the Sec. 2702 requirements) when the Sec. 7520 rate is 3.4%, with the right to receive an annuity of $500,000 for 10 years. At the end of 10 years, the remainder will be distributed to the grantor's children. Using the IRS Publication 1457, *Annuities, Life Estates & Remainders*, Table B factor of 8.3587, the annuity stream is valued at $4,179,350, and the remainder interest is valued at its present value of $820,650. If the assets appreciate at a Sec. 7520 rate of 3.4%, the grantor will receive a stream of 10 payments of $500,000, and the beneficiaries will receive $1,146,484 at the end of the 10-year term (the future value of $5 million, minus 10 annual payments of $500,000, and appreciating at 3.4% per year).

If the assets instead appreciate at a rate of 8%, with the same stream of payments, the beneficiaries will receive $3,551,344 (with a present value at 3.4% of $2,542,069). Only the present value of the remainder interest, or $820,650, would be subject to gift tax.

As this is a gift of a future interest, it is not a completed gift and does not qualify for the annual gift tax exclusion. Any appreciation in excess of this amount will transfer to the grantor's children free of gift tax consequences.

Since a GRAT represents an incomplete gift, it is not a suitable vehicle to use in a generation-skipping transfer (GST), as the value of the skipped gift is not determined until the end of the trust term. The opportunity to leverage the GST tax exemption is lost in the GRAT structure. The assets transferred to the beneficiaries will receive a carryover basis rather than a stepped-up basis. As such, higher-basis assets are more appropriate for contributing to a GRAT than low-basis assets.

In addition to the gift tax benefits, the value distributed to the beneficiaries is removed from the grantor's estate. The value of the annuity payments remains in the grantor's estate. If the grantor dies during the trust term, the value of the remainder interest is also included in the grantor's estate. However, the grantor can pass the right to receive any remaining annuity payments to his or her surviving spouse (either outright or through a marital trust) to qualify for the estate tax marital deduction, which could eliminate any estate tax liability relating to the GRAT assets.

A properly structured GRAT will be treated as a grantor trust for principal and income purposes, which provides several benefits. First, all income, gains, losses, and credits are taxed to the grantor. Income tax payments by the grantor related to income from the GRAT are not treated as additional gifts to the trust. As such, the trust assets are not reduced by income taxes, resulting in a higher residual payment to the beneficiaries. Second, a grantor trust may be an S corporation shareholder. Finally, any transactions between the grantor and the GRAT will be ignored, so no gain or loss is recognized on sales between the two.

INCREASING PAYMENTS

While the GRAT described above provides gift tax savings, GRATs can be structured to provide additional value. First, Regs. Sec. 25.2702-3(b)(1) allows the annuity payment to increase by up to 20% per year. This means that the grantor can receive smaller annuity payments in the early years of the GRAT term, leaving more assets in the GRAT to appreciate.

> ***Example 2:*** A grantor contributes $5 million in assets to a GRAT. The grantor will receive a stream of annuity payments beginning with $192,614 and increasing by 20% each year. This annuity stream will result in a higher gift tax valuation for the remainder interest of $1,017,681 because with a growth rate equal to the Sec. 7520 rate, the beneficiaries will receive $1,421,730 at the end of the GRAT term rather than the $1,146,484 in the standard GRAT (see Table 1). If the assets grow at 8%, the remainder payout is $4,321,492 (but with the same gift tax valuation of $1,017,681) (see Table 2).

Table 1: Basic GRAT with increasing payments and return of 3.4%

Year	Beginning value	Growth	Payment	Ending value	
1	$5,000,000	$170,000	$(192,614)	$4,977,386	
2	4,977,386	169,231	(231,137)	4,915,481	
3	4,915,481	167,126	(277,364)	4,805,243	
4	4,805,243	163,378	(332,837)	4,635,785	
5	4,635,785	157,617	(399,404)	4,393,998	
6	4,393,998	149,396	(479,285)	4,064,109	
7	4,064,109	138,180	(575,142)	3,627,147	
8	3,627,147	123,323	(690,170)	3,060,300	
9	3,060,300	104,050	(828,204)	2,336,146	
10	$2,336,146	$ 79,429	$(993,845)	$1,421,730	
Present value of distribution to beneficiaries at 3.4%					**$1,017,681**

Table 2: Basic GRAT with increasing payments and return of 8%

Year	Beginning value	Growth	Payment	Ending value	
1	$5,000,000	$400,000	$(192,614)	$5,207,386	
2	5,207,386	416,591	(231,137)	5,392,840	
3	5,392,840	431,427	(277,364)	5,546,903	
4	5,546,903	443,752	(332,837)	5,657,818	
5	5,657,818	452,625	(399,404)	5,711,039	
6	5,711,039	456,883	(479,285)	5,688,637	
7	5,688,637	455,091	(575,142)	5,568,586	
8	5,568,586	445,487	(690,171)	5,323,902	
9	5,323,902	425,912	(828,205)	4,921,609	
10	$4,921,609	$393,729	$(993,846)	$4,321,492	
Present value of distribution to beneficiaries at 3.4%					$3,093,345

ZEROED-OUT GRAT

The downside of the GRAT structure discussed above is that gift tax is determined at the start of the GRAT term. If the assets in the GRAT fail to appreciate at the Sec. 7520 rate, the grantor would have paid gift tax (or used a portion of his or her lifetime credit) on the present value of the remainder interest while transferring few assets to the beneficiaries.

A second alternative GRAT structure uses a zeroed-out, or *Walton*, GRAT. This structure was made possible as a result of the holding in *Walton*, 115 T.C. 589 (2000). With it, the grantor sets the annuity payment such that the present value of the annuity stream is equal to the value of the property transferred into the trust. This results in a valuation of zero (or close to zero) for gift tax purposes. A zeroed-out GRAT allows the grantor to transfer any appreciation in excess of the Sec. 7520 rate without using any of the grantor's lifetime exemption. If the assets fail to appreciate at the Sec. 7520 rate, the only cost to the grantor will have been the legal and administrative costs of setting up the GRAT.

> ***Example 3:*** A grantor contributes $5 million to a zeroed-out GRAT in exchange for a 10-year annuity of $598,179. The value of the remainder interest for gift tax purposes is $12. If the assets in the GRAT appreciate at a 3.4% Sec. 7520 rate, the beneficiaries will receive $17 (see Table 3). However, if the assets in the GRAT appreciate at 8%, the beneficiaries will receive $2,129,068, but the gift tax value of the remainder interest will remain $12 (see Table 4).

Table 3: Zeroed-out GRAT with return of 3.4%

Year	Beginning value	Growth	Payment	Ending value	
1	$5,000,000	$170,000	$(598,179)	$4,571,821	
2	4,571,821	155,442	(598,179)	4,129,084	
3	4,129,084	140,389	(598,179)	3,671,294	
4	3,671,294	124,824	(598,179)	3,197,939	
5	3,197,939	108,730	(598,179)	2,708,490	
6	2,708,490	92,089	(598,179)	2,202,399	
7	2,202,399	74,882	(598,179)	1,679,102	
8	1,679,102	57,089	(598,179)	1,138,012	
9	1,138,012	38,692	(598,179)	578,526	
10	$ 578,526	$ 19,670	$(598,179)	$ 17	
Present value of distribution to beneficiaries at 3.4%					$12

Table 4: Zeroed-out GRAT with return of 8%

Year	Beginning value	Growth	Payment	Ending value	
1	$5,000,000	$400,000	$(598,179)	$4,801,821	
2	4,801,821	384,146	(598,179)	4,587,788	
3	4,587,788	367,023	(598,179)	4,356,632	
4	4,356,632	348,531	(598,179)	4,106,983	
5	4,106,983	328,559	(598,179)	3,837,363	
6	3,837,363	306,989	(598,179)	3,546,173	
7	3,546,173	283,694	(598,179)	3,231,688	
8	3,231,688	258,535	(598,179)	2,892,044	
9	2,892,044	231,364	(598,179)	2,525,228	
10	$2,525,228	$202,018	$(598,179)	$2,129,068	
Present value of distribution to beneficiaries at 3.4%					$1,523,997

ZEROED-OUT GRAT WITH INCREASING PAYMENTS

It is possible to combine the previous strategies — a zeroed-out GRAT with increasing annuity payments. The grantor would contribute property to the GRAT and create a payout structure where the payments increase by 20% each year and the present value of the payment stream equals the value of the property transferred to the trust. This would result in no (or little) taxable gift and allow more assets to appreciate within the trust during the early years.

> ***Example 4:*** The grantor transfers $5 million to a GRAT and receives a payment of $241,836 in the first year, with a 20% larger payment in the following year. If the assets appreciate at the Sec. 7520 rate, the beneficiaries will receive $7, and the taxable value of the gift in the year of creation would be $5 (see Table 5).

Table 5: Zeroed-out GRAT with increasing payments and return of 3.4%

Year	Beginning value	Growth	Payment	Ending value	
1	$5,000,000	$170,000	$ (241,836)	$4,928,164	
2	4,928,164	167,558	(290,203)	4,805,518	
3	4,805,518	163,388	(348,244)	4,620,662	
4	4,620,662	157,103	(417,893)	4,359,872	
5	4,359,872	148,236	(501,471)	4,006,637	
6	4,006,637	136,226	(601,765)	3,541,097	
7	3,541,097	120,397	(722,118)	2,939,376	
8	2,939,376	99,939	(866,542)	2,172,772	
9	2,172,772	73,874	(1,039,851)	1,206,796	
10	$1,206,796	$ 41,031	$(1,247,821)	$ 7	
Present value of distribution to beneficiaries at 3.4%					$5

If the assets grew at 8%, the beneficiaries would receive $2,667,300 in year 10 on a taxable gift of $5 (see Table 6).

Table 6: Zeroed-out GRAT with increasing payments and return of 8%

Year	Beginning value	Growth	Payment	Ending value	
1	$5,000,000	$400,000	$ (241,836)	$5,158,164	
2	5,158,164	412,653	(290,203)	5,280,614	
3	5,280,614	422,449	(348,244)	5,354,819	
4	5,354,819	428,386	(417,893)	5,365,312	
5	5,365,312	429,225	(501,471)	5,293,066	
6	5,293,066	423,445	(601,765)	5,114,746	
7	5,114,746	409,180	(722,118)	4,801,807	
8	4,801,807	384,145	(866,542)	4,319,410	
9	4,319,410	345,553	(1,039,851)	3,625,112	
10	$3,625,112	$290,009	$(1,247,821)	$2,667,300	
Present value of distribution to beneficiaries at 3.4%					$1,909,266

A summary comparison of the GRAT structures is presented in Table 7. The zeroed-out GRAT with increasing payments results in an increase of more than $500,000 in the distribution to the beneficiaries, without gift tax consequences. Again, if the assets fail to appreciate at the Sec. 7520 rate, the only costs to the grantor are the legal and administrative fees.

Table 7: Comparison of GRAT structures

GRAT structure	Return on assets		Value of gift for gift tax purposes
	3.4%	8%	
Basic GRAT (Example 1)	$1,146,484	$3,551,344	$ 820,650
Basic GRAT with increasing annuity payments (Example 2)	1,421,730	4,321,492	1,017,681
Zeroed-out GRAT (Example 3)	17	2,129,068	12
Zeroed-out GRAT with increasing annuity payments (Example 4)	$ 7	$2,667,300	$ 5

ROLLING GRATs

A 10-year GRAT term comes with some risk. The assets need to appreciate faster than the Sec. 7520 rate over the term, and the grantor needs to live past the last payment in the term. To reduce the risk of the grantor's dying during the GRAT term, he or she can set up a series of rolling, shorter-term zeroed-out GRATs. Without the rolling GRATs, if the grantor dies during the trust term, nothing will pass to the beneficiaries, and the remaining assets are included in his or her estate. However, if the grantor establishes rolling GRATs and dies before the end of the 10-year term, only the value remaining in the active GRATs will be included in his or her estate.

> ***Example 5:*** The grantor contributes $5 million to a two-year GRAT. The GRAT can be structured as a zeroed-out GRAT with the payment increasing by 20% in year 2. Each year, the grantor contributes the distribution to a similar, new two-year GRAT. The Sec. 7520 rate is 3.4%, and the assets actually appreciate at 8%. If the grantor dies in year 6, the beneficiaries will receive $1,106,339 (see Table 8), which will be removed from the grantor's estate. The assets remaining in GRAT No. 5, the year 6 payment of $2,230,865, and the remaining value of $292,228, will remain in the grantor's estate, and the beneficiaries will not receive a payment from this GRAT. If a 10-year GRAT had been used instead of rolling GRATs, the entire amount would have been included in the grantor's estate, and nothing would have transferred to the beneficiaries.

Table 8: Two-year rolling GRATs with a return of 8%

GRAT No.	Source	Funding	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Remainder to beneficiaries
1	Grantor	$5,000,000	$2,392,918	$2,871,502					$ 376,147
2	GRAT 1	2,392,918		1,145,211	$1,374,253				180,018
3	GRATs 1 and 2	4,016,713			1,922,333	$2,306,800			302,174
4	GRATs 2 and 3	3,296,586				1,577,692	$1,893,230		248,000
5	GRATs 3 and 4	$3,884,492					1,859,054	$2,230,865	-
Total to contribute to next GRAT			**$2,392,918**	**$4,016,713**	**$3,296,586**	**$3,884,492**	**$3,752,284**	**$2,230,865**	**$1,106,339**

GRATs work best with assets that can outperform the Sec. 7520 rate. As a result, pre-IPO (initial public offering) stock, appreciating stocks, real estate, and hedge fund investments are great choices for a GRAT. Additionally, properly structured GRATs can be shareholders in S corporations, so closely held business interests may be contributed to a GRAT. GRAT distributions can be stated in dollar amounts or as a percentage of the assets contributed to a trust. Because the distribution can be stated in a percentage-of-assets formula, hard-to-value assets can be contributed to a GRAT without a significant risk of a substantial increase in the gift tax owed if the IRS determines the value of the asset was understated. If the IRS revalues the assets, there would be no gift tax consequences if the assets are contributed to a zeroed-out GRAT using a percentage-of-assets-contributed formula. In a GRAT that is not structured as a zeroed-out GRAT, a change in valuation of the assets contributed would generally result in a minimal change in the taxable gift amount.

POSSIBLE CHANGES AHEAD

GRATs are excellent vehicles for transferring appreciation to beneficiaries with little to no gift tax cost. They work especially well when interest rates are low. The trusts can be structured with substantial upside and little downside. As a result, GRATs have been the target of potential legislative changes. Specifically, former President Barack Obama, in his fiscal 2010 and 2011 budgets, proposed requiring GRATs to have a minimum term of 10 years and a residual value greater than zero (eliminating zeroed-out GRATs). Similar restrictions were contained in the Small Business and Infrastructure Jobs Tax Act of 2010, H.R. 4849, which was passed by the House of Representatives. Several similar proposals have been made by candidates in the 2020 presidential election. With interest rates expected to rise in the future and a GRAT-friendly Code that could be subject to changes in the next several years, now may be the time to speak with your clients about GRATs in their estate plans.

About the author

Megan M. Burke, CPA, Ph.D., is an assistant professor of accounting at Marist College in Poughkeepsie, N.Y.

To comment on this article or to suggest an idea for another article, contact Paul Bonner, a JofA *senior editor, at* *Paul.Bonner@aicpa-cima.com (mailto:Paul.Bonner@aicpa-cima.com)* *or 919-402-4434.*

- Form 706 and Form 709 engagement letters, organizers, and checklists, aicpa.org (https://www.aicpa.org/interestareas/tax/resources/compliance/annualcompliancekit.html) (Tax Section member login required)

Video

- "The Adviser's Guide to Financial & Estate Planning: Grantor Retained Interest Trusts," aicpa.org (https://www.aicpa.org/news/aicpatv.6039870795001.html/p/5716732016001/c/Personal-Financial-Planning/)

***The Tax Adviser* and Tax Section**

Subscribe to the award-winning magazine *The Tax Adviser*. AICPA Tax Section members receive a subscription in addition to access to a tax resource library, member-only newsletter, and four free webcasts. The Tax Section is leading tax forward with the latest news, tools, webcasts, client support, and more. Learn more at aicpastore.com/taxsection (https://www.aicpastore.com/AST/Main/CPA2BIZ_Primary/Tax/Research/PRDOVR~PC-TAXSEC01/PC-TAXSEC01.jsp). The current issue of *The Tax Adviser* and many other resources are available at thetaxadviser.com (https://www.thetaxadviser.com/).

PFP Member Section and PFS credential

Membership in the Personal Financial Planning (PFP) Section provides access to specialized resources in the area of personal financial planning, including complimentary access to Broadridge Advisor. Visit the PFP Center at aicpa.org/PFP (https://www.aicpa.org/interestareas/personalfinancialplanning.html). Members with a specialization in personal financial planning may be interested in applying for the Personal Financial Specialist (PFS) credential. Information about the PFS credential is also available at aicpa.org/PFS (https://www.aicpa.org/PFS?tab-1=3).

(https://future.aicpa.org/home)