

GRATs in Estate Planning Under Current Tax Law

Structuring Considerations, Income, Gift, Estate, and Generation-Skipping Transfer
Tax Consequences

TUESDAY, FEBRUARY 22, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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GRANTOR RETAINED ANNUITY TRUSTS: STRATEGIES

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*The Higher
Calling of the Law*

Estate Planning Topics

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BACKGROUND: THE FEDERAL TRANSFER TAX SYSTEM

Federal Transfer Tax System

The United States government imposes taxes on certain transfers of property.

There are three types of federal transfer tax:

Gift Tax

- Imposed on transfers of property that a person makes during his or her lifetime

Estate Tax

- Imposed on transfers of property at death

Generation-Skipping Transfer (“GST”) Tax

- Imposed on certain transfers of property that skip a generation

Rate:

- The gift tax, estate tax, and GST tax are all currently imposed at a **40%** rate

Federal Transfer Tax Exemptions

No transfer tax is due unless a person's taxable transfers exceed his or her available exemption amount.

Gift and Estate Tax Exemption

- The gift and estate tax exemptions are “unified,” which means that each person has a certain exemption from both gift and estate tax.
 - The gift and estate tax exemption is \$12,060,000 in 2022.*
 - Taxable gifts during a person's lifetime use up the exemption amount (meaning less is available to reduce estate tax at death).
 - The federal gift and estate tax exemptions and taxes are separate from any transfer taxes imposed at the state level.

Gift and
Estate Tax
Exemption

GST Tax Exemption

- Each person also has a GST tax exemption.
 - The GST tax exemption is \$12,060,000 in 2022.*

GST Tax
Exemption

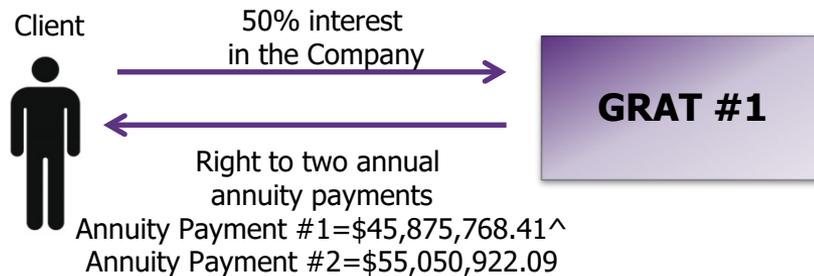
*Under current law, the exemption amounts are scheduled to revert to \$5 million, indexed for inflation, on January 1, 2026.

INTRODUCTION TO GRANTOR RETAINED ANNUITY TRUSTS [“GRATS”]

Grantor Retained Annuity Trusts (“GRATs”)

Creation Date

- Client creates a two-year GRAT and funds it with his or her 50% interest in the Company.
- As of the Creation Date, an appraiser values a 1% interest in the Company (e.g., at \$2,000,000).
- The GRAT provides that the Client, as Grantor, is entitled to guaranteed annuity payments,^{*} the total present value of which equals \$100 million on the Creation Date.



Grantor: Client

Trustee During Annuity Term: Independent Trustee (may pay annuity payments more frequently than annually)

Trustee Following Annuity Term: Anyone other than Client

Beneficiaries Following Annuity Term: Client's spouse and descendants

- Because the interests exchanged between Client and GRAT #1 are almost identical in value on the Creation Date, Client's contribution to GRAT #1 is a minimal gift and uses little of his or her lifetime gift tax exemption.

* For simplicity, annuity payments in this example are annual, but they can be more frequent.

[^] Based on a first-year annuity payout percentage of 45.87576841%, which then increases by 20% in the second year. An optimized payout percentage is a function of a discount rate set by the IRS. The rate is projected to yield an optimized first annual annuity payout percentage of 45.87576841% in February, 2021.

GRATs

First Anniversary—Annuity Payment #1

- Assume that the Company has appreciated 5% on the First Anniversary. An appraiser values a 1% interest in the Company at \$2,100,000.
- Client, as Grantor, is entitled to an annuity payment of \$45,875,768.41 (or a 21.845604005% interest in the Company).

GRAT #1
28.154395995% of
the Company after
Annuity Payment #1

Annuity payments may also
be satisfied with available
cash from any Company
distributions

21.845604005% of the Company

**Annuity
Payment
#1**

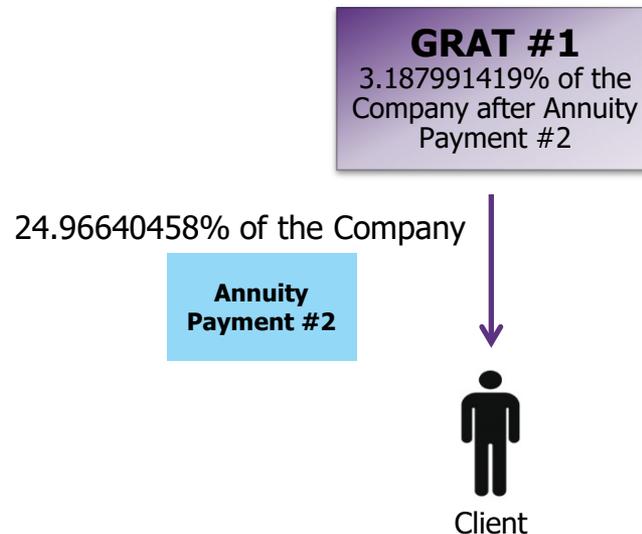


Client

GRATs

Second Anniversary—Annuity Payment #2

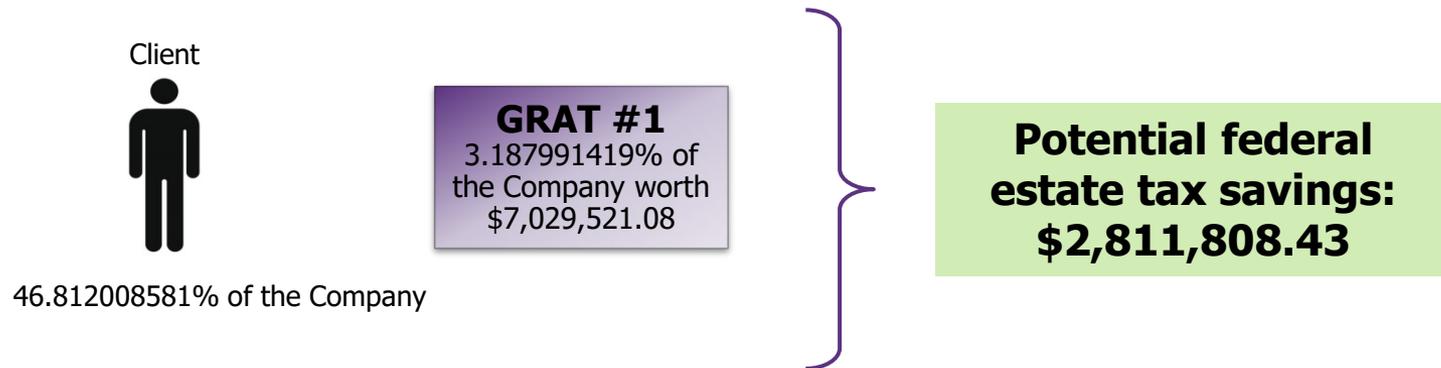
- Assume that the Company has appreciated another 5% on the Second Anniversary. An appraiser values a 1% interest in the Company at \$2,205,000.
- Client, as Grantor, is entitled to an annuity payment of \$55,050,922.09 (or a 24.96640458% interest in the Company).



GRATs

End of GRAT #1 Term

- Client has a 46.812008581% interest in the Company and GRAT #1 has a 3.187991419% interest in the Company.
- Client has transferred interests approximating \$7,029,521.08 out of his or her taxable estate with little reduction in his or her lifetime gift tax exemption.
- In addition, all future appreciation on the \$7,029,521.08 will be outside of Client's taxable estate, potentially saving additional estate taxes.



- The GRAT can be for the benefit of Client's spouse and descendants and is not subject to estate tax. Client's spouse can have the power to appoint the GRAT to any individuals and charities at death.
- The GRAT will require further GST tax planning.

GOVERNING INSTRUMENT REQUIREMENTS

Governing Instrument Requirements for GRATs

- The governing instrument must be drafted to meet the requirements of Section 2702, so that a client's retained interest is a "qualified interest", meaning it may be subtracted from the value of the transferred property in determining the client's gift to the remainder beneficiaries.
- If a GRAT does not meet the requirements of Section 2702, the client's retained interest is valued at zero and the gift made by the client to the remainder beneficiaries is the entire value of the trust assets, which defeats the purpose.
 1. Section 2702(b) defines a "qualified interest" as:
 - Any interest which consists of the right to receive fixed amounts payable not less frequently than annually, and
 - Any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually).
 2. The term of the annuity in a GRAT must be a fixed amount of time equal to the life of an annuitant, a specified term of years, or the shorter of those two periods.
 3. The GRAT must require that the annuity amount be payable back to the taxpayer who created the GRAT, i.e., the holder of the annuity interest, at least annually (Treas. Reg. § 25.2702-3(b)(1)), and the annuity amount must actually be paid.
 4. The annuity payment may be based on the taxable year of the trust or on the anniversary date of the trust (Treas. Reg. § 25.2702-3(b)(3)).

Governing Instrument Requirements for GRATs

- The GRAT should state explicitly that a note, other debt instrument, option or similar financial arrangement may not be used, directly or indirectly, to pay the annuity amount.
- The GRAT must contain a provision requiring adjustment to annuity payments previously made if an error was made by the Trustee in determining the annuity amount.
- The GRAT instrument must prohibit:
 - Additional contributions to the GRAT.
 - Commutation, or the prepayment by the Trustee of the grantor's annuity interest.
 - The purpose of this provision is to prevent termination of a GRAT when the grantor's life expectancy is short.
 - If a taxpayer dies during the GRAT term, the GRAT's assets will be included in the grantor's estate under Section 2036.
 - Payments from the GRAT before the expiration of the qualified interest to or for the benefit of any person other than the annuitant.

Variations in the Annuity Amount

- The annuity amount must be a fixed amount expressed in the terms of either a fixed dollar amount or a fixed percentage of initial fair market value of the property transferred to the trust as finally determined for federal tax purposes (*see* Treas. Reg. § 25.2702-3(b)(1)(ii)).
- The fixed amount does not have to be the same amount for each year.
- However, variations in the annuity amount from year to year may not exceed 120% of the amount payable in a previous year (*see* Treas. Reg. § 25.2702-3(b)(1)(ii)).
- Generally, it's more beneficial to include adjustment provisions in the GRAT annuity payments that state the annuity payment will grow each year by 120%, as it provides a better chance of exponential growth by leaving assets in the GRAT as long as possible.
 - Calculation showing exponential growth:

Varying Annuity Payments

<u>Year</u>	<u>Percentage Payouts</u>	<u>Payment</u>
1	45.8757683%	\$4,587,576.83
2	55.0509220%	\$5,505,092.20

Economic Schedule

<u>Year</u>	<u>Beginning Principal</u>	<u>5.00% Growth</u>	<u>0.0% Annual Income</u>	<u>Required Payments</u>	<u>Distributed Discount</u>	<u>Remainder</u>
1	\$10,000,000.00	\$500,000.00	\$0.00	\$4,587,576.83	\$0.00	\$5,912,423.17
2	\$5,912,423.17	\$295,621.16	\$0.00	\$5,505,092.20	\$0.00	\$702,952.13
Summary	\$10,000,000.00	\$795,621.16	\$0.00	\$10,092,669.03	\$0.00	\$702,952.13

Annuity Payment Based on the Anniversary Date of the GRAT

- The annuity payment may be based on the anniversary date of the GRAT.
- If the annuity payment is based on the anniversary date of the GRAT's creation date, it must be paid anytime between the anniversary date and no later than 105 days after such anniversary date.
- This is the most common method of scheduling the annuity payments.

Annuity Payment Based on the Taxable Year of the GRAT

- The annuity payment may also be based either on the taxable year of the GRAT.
- If the annuity payment is based on the taxable year:
 - Proration of the annuity amount is required for each short taxable year of the GRAT during the grantor's term.
 - Prorated amount is the annual annuity amount multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365 (or 366 if the proration is in a leap year).
- An annuity payment based on the taxable year of the GRAT may be paid in the subsequent year so long as the annuity is paid by the date on which the Trustee must file the income tax return for the GRAT determined without regard to extensions.
- This method is much less common than making annuity payments based on the anniversary date of the GRAT.

FUNDING & TERM

Consider a Gift/Sale to a Grantor Trust

- Instead of doing a GRAT, consider a simple gift or sale to an Intentionally Defective Grantor Trust (IDGT) for a Note:
 1. A sale to an IDGT for a Note accomplishes the same result as a GRAT: appreciation on the asset above a mandated interest rate is removed from the taxpayer's estate.
 2. A valuation is only needed one time, and there is no added administration of annuity payments.
 3. GST exemption can be leveraged on a sale to an IDGT (whereas, GRATs are typically not good vehicles for GST exemption).
- Reasons for doing a GRAT instead:
 1. Asset is uncertain to appreciate, so it is not worth wasting gift credit on or potentially bringing down other assets in an IDGT.
 2. IDGTs generally require 10% equity to do a sale. If a client does not have enough gift credit to equitize an IDGT, then the transaction will not work.

What Kind of Assets Work Well for GRATs?

- Any asset that is expected to grow rapidly in a short period or any asset for which we can get a significant discount at funding.
- Business assets:
 - Can get a low valuation and apply discounts up to 30%-35%
 - Works especially well when the business asset produces income (more on this later)
 - Can be more complex to GRAT – must carefully review corporate documents for transferability provisions
 - Assets closer to a possible liquidation event
- Stocks:
 - Market has been doing very well
 - Easy to transfer
- Assets to put in GRATs with caution:
 - Cash
 - Real estate – can create realty transfer tax issues and unlikely to grow significantly in a short amount of time

* If a client funds a GRAT with a closely held business, care should be taken to continue to pay all distributions on a pro rata basis. The formality of pro rata distributions is an important indicator in the case of an audit of the GRAT by the IRS that all formalities were respected.

Funding of GRATs

Consider husband/wife GRATs

- GRATs fail if the grantor dies during the annuity term.
- Sometimes clients will divide assets so that a husband creates a GRAT for the benefit of his wife and descendants and the wife creates a GRAT for the benefit of her descendants.
 - Much more unlikely that both spouses will die within the GRAT term.
 - Trusts cannot be too similar – must avoid the reciprocal trust doctrine.

Separate asset classes in each GRAT

- Helps turbocharge planning to put separate asset classes in each GRAT.
- If client places two asset classes in the same GRAT and one asset class appreciates greatly and the second asset class declines sharply during the retained term:
 - the two assets will have canceled out any gain in the GRAT and wasted the gift and estate tax opportunity
- If the client separates the two asset classes and one does really well and the second asset class declines, the first GRAT will be successful and the second GRAT will fail.
- Many clients have in excess of seven GRATs a year, separated as follows: micro cap, small cap, mid cap, large cap, developed markets, emerging markets, and bond GRATs.

Funding date

- Need to work closely with the client and the investment advisor to ensure that the assets move into the GRAT on the date the GRAT is signed.

Formation of LLC to Handle Difficult-to-Transfer Assets

- Sometimes a client wishes to transfer an asset or a class of assets that are difficult or time-consuming to transfer.
- Instead of transferring the difficult-to-transfer asset into the GRAT and then out of the GRAT upon each annuity payment due date, the relevant LLC interests can be transferred in and out of the GRAT with simple LLC interest assignment documentation.
- Once the client is finished with the GRAT program, he or she can distribute all of the assets out of the LLC and terminate the structure.
- Minor costs associated with preparing the formation documentation and state filing fees.
- Useful for transferring entire investment portfolios.

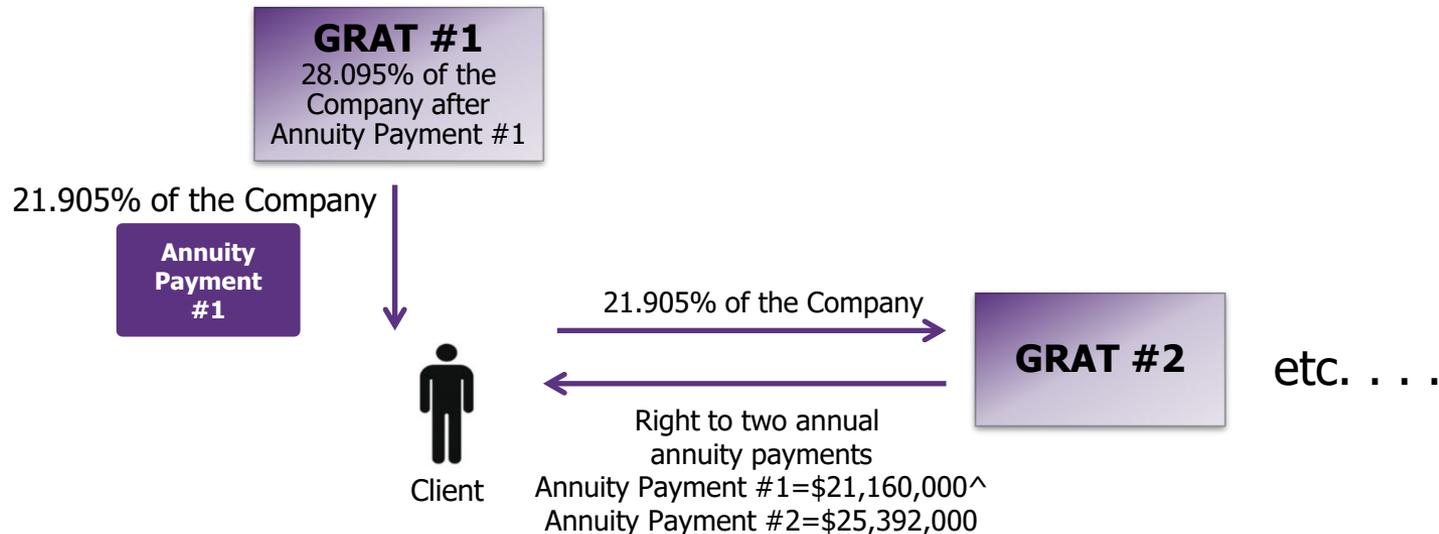
Term of GRATs

- GRATs must have a term of at least one year.
- In *Kerr v. Commissioner*, 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002), there was a GRAT with a term of 366 days.
- Typically, we use two-year terms for our GRATs.
- Occasionally, we will use longer terms, but this is uncommon.
- The Obama administration proposed a requirement for GRATs to have at minimum a 10-year term.

Rolling GRATs

The benefits of GRATs can be multiplied with a rolling GRAT program in which new GRATs are created each year with the interests that Client receives as an annuity from existing GRATs.

- After Annuity Payment #1, Client contributes his or her 21.905% interest in the Company (worth \$46,000,000) to a new GRAT #2.



Assuming 5% appreciation each year during the GRAT terms, Client transfers Company interests worth an additional \$3,105,000 at the end of the GRAT #2 term and Company interests worth an additional \$5,154,300 at the end of the GRAT #3 term out of his or her estate.

Total potential estate tax savings from GRAT #1, GRAT #2 and GRAT #3: \$6,003,720

ANNUITY PAYMENTS

When to Make Annuity Payments?

- Timing with the market
 - For GRATs funded with securities, you can time the market in order to make annuity payments when the market is high.
- Payments more frequently than annually
 - Regulations allow annuity payments more frequently than annually (*see* Treas. Reg. § 25.2702-3(b)(3)).
 - This is more complicated, but gives you extra flexibility to exploit market surges if the GRAT is funded with securities.

What to Use to Make Annuity Payments?

- Recommend that you use cash first to make any annuity payments
 - For example, if you put an income-producing asset in a GRAT, then the GRAT would have cash at the time of the annuity payments.
 - We would recommend that you make annuity payments with cash before you make them with other assets.
- Borrowing
 - The GRAT can borrow cash and/or marketable securities from one trust and use that cash or marketable securities to make the annuity payment.
 - The client should not lend money to the GRAT to make the annuity payment – this is prohibited under the Regulations.
 - The GRAT cannot use a promissory note to make the annuity payment.

TAX REPORTING FOR GRATS

Gift Tax Return Reporting for GRATs

- Always recommend that a taxpayer file a gift tax return to report a gift to the GRAT.
 - This runs the statute of limitation on a gift to the GRAT, the valuation of the assets transferred to the GRAT, and the effective administration of the GRAT.
 - Recommended that you opt out of automatic GST exemption allocation to a GRAT on the gift tax return reporting the gift to the GRAT.
 - Generally, GRATs are not an effective use of GST exemption.
- A timely filed gift tax return can be used to opt out of automatic GST exemption allocation to a GRAT at the close an ETIP.
- Careful records of the GRAT's administration should be maintained showing that the annuity payments were paid and in the proper amount.
 - IRS gift tax return audits can request this documentation.

GST Planning

- Despite GRATs not being considered GST planning vehicles, the careful planner can build GST planning into his or her GRAT program.
- At the conclusion of the GRAT term, if GST exemption is allocated to a GRAT, the GRAT will be either fully GST Exempt or partially GST Exempt.
- If a GRAT is partially GST Exempt, the GRAT can be divided with a qualified severance under Treas. Reg. § 26.2642-6.
- Once divided, the assets of the GST Nonexempt GRAT could be sold to the GST Exempt GRAT at the long-term AFR rate.
 - Such a freeze puts the growth in the GST Exempt GRAT.
- Another method to achieve a GST freeze (as well as potentially facilitate annuity payments) involves selling GRAT assets to another GST Exempt Trust in the client's trust portfolio.

Other Tax Considerations

Estate Tax

- Payments made to grantor are fully includable
- If grantor dies during term, some portion will be includable – calculated based on an amount of principal needed to generate sufficient income to satisfy grantor's retained payment. (see Treas. Reg. §20.2036-1(c)(2)(i))
- Resulting trusts should be drafted to be excluded from estate of grantor.

Income Tax

- Grantor trust during annuity term.
 - No recognition of gain/loss if noncash payments made.
 - When grantor pays tax, preserves trust assets and allows tax-free growth.
- After annuity term – depends on provisions of resulting trust.

LIMITATIONS & RISKS OF GRATS AND HOW TO LIMIT THOSE RISKS

Limitations and Risks of GRATs

- Grantor cannot be a beneficiary or Trustee of the GRAT after the term has ended.
- Some states, including Pennsylvania, do not recognize grantor trust status for trusts, so Pennsylvania income taxes must be paid on the GRAT.
- The GRAT has to be administered carefully to ensure the annuity payments are made properly.
- Grantor has to survive the term of the GRAT; otherwise, the GRAT will fail.
- If the transferred interests depreciate in value over the GRAT term and the GRAT transfers all of its assets back to Grantor, the GRAT has failed.
- If the GRAT is successful, the Grantor loses the opportunity to get the basis step-up at his or her death, which saves capital gains taxes if the asset is sold.
- GST exemption can only be allocated to GRATs at the end of the term, not at the outset.
- Attorney has to take steps to ensure that GST exemption is not automatically allocated to the GRAT at the end of the term of the GRAT.

Obtaining the Marital Deduction if the Taxpayer Dies During Annuity Term

- If the grantor dies during the GRAT term, his or her estate planning documents should include provisions that the right to the remaining annuity payments passes to the surviving spouse.
 - This ensures that the value of the remaining annuity interest qualifies for the estate tax marital deduction under IRC 2056.
- As such, the grantor's estate planning documents should provide that if the grantor's spouse survives the grantor, the annuity payments will either:
 - Pass outright to the surviving spouse or his or her estate.
 - Pass to a marital trust over which the surviving spouse has a general power of appointment.

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