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Improving the Tax Management of Grantor-Retained Annuity Trusts

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In a May 2020 panel discussion with three family office veterans, we explored how various family offices were handling the COVID-19 pandemic. When asked how families were approaching wealth planning in light of low interest rates and reduced asset values, our panelists noted increased interest in the useof grantor-retained annuity trusts (GRATs). GRATs are frequently used to help reduce estate and gift taxes by removing assets and their appreciation from the grantor's estate. If used correctly, they can allow grantors to gift appreciated assets free of tax.

This type of trust poses some nuanced income and capital gains tax management concerns. In this paper we explore these concerns in light of the current economic downturn and renewed possibility of rising tax rates. We also explore how GRATs can incorporate a Parametric Custom Core® portfolio.

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Overview

A GRAT works as follows: A grantor transfers assets with substantial growth potential, or cash to be invested in such assets, to a trust from which they'll receive a fixed annual amount—an *annuity*—for a designated term.

If the grantor is living at the end of the term, the beneficiaries named in the trust instrument will receive the assets remaining in the GRAT free of gift and estate tax. If the grantor has died before the end of the term, gift and estate taxes become applicable.

Depending on the GRAT's cash flow and the appreciation of its assets, the grantor and their beneficiaries can achieve substantial estate and gift tax savings. The value of the grantor's taxable gift isn't the value of the assets transferred to the GRAT; it's the current value of the beneficiaries' right to receive the assets in the future. The amount of the annuity and the term of the trust are typically determined so that the amount the grantor receives is equal to the value of the initial gift, according to an interest rate set by the Internal Revenue Service (IRS 7520). This form of GRAT is known as a zeroed-out GRAT.

If the GRAT's investment return is lower than the IRS interest rate, there will be no tax savings, leaving the grantor out the time and expense of establishing and maintaining the GRAT. That's why GRATS are frequently funded with assets that have significant anticipated appreciation, such as IPOs, private equity, and public equity. However, if the investment return exceeds the IRS 7520 interest rate—currently 0.6% for July 2020—there may be significant assets left in the trust when it ends, and those assets will pass tax-free to the named beneficiaries.

Let's imagine a grantor transfers $1 million to a GRAT, which will pay them an annuity of roughly $103,000 for each of 10 years. At the end of that term, if the grantor is still living, their children will receive the remaining funds in the trust. Assuming that the IRS 7520 interest rate for the month of the gift is 0.6%, the present value of the grantor's retained annuity payments for gift tax purposes is the entire $1 million, and the value of the taxable gift—the remaining interest to the beneficiaries—is zeroed out.

Now let's assume this GRAT earns an annual investment return of 6% on the $1 million. At the end of 10 years, the grantor's children will receive tax-free assets worth more than $425,000. They'll also receive any growth or income from this amount between the end of the GRAT term and the death of the grantor. However, if the grantor dies before the term ends, the federal estate tax would be $170,000, assuming a rate of 40%.

There are many ways to use GRATs to manage mortality risk and performance risk, such as rolling assets from one short-term GRAT to another. The above is a simple example used to set up questions about managing investment-related taxes covered below.

Asset choice and tax management can help mitigate the income tax load on the grantor and their beneficiaries.

Income tax implications of the GRAT

Assets can grow without income tax dilution

Although there are significant estate tax advantages to GRATs, it's also important to consider the income tax implications. During the term of the GRAT, the grantor will be taxed on all the income and capital gains earned by the trust, without regard to the annuity amount. Estate planners emphasize that the grantor is considered the owner of the trust for income tax purposes and is therefore taxed on all the income. The grantor's income tax payment is an additional tax-free gift to the trust beneficiaries, since the trust's assets can grow without income tax dilution.

Another feature of a well-drafted GRAT is a swap or substitution power. This allows the grantor to exchange assets of like value for those in the trust. This can be done to lock in appreciation or to substitute low-basis holdings for high-basis holdings, which helps reduce future capital gain taxes incurred by the beneficiaries. Since these assets are outside the grantor's estate, they don't get a step-up in basis. Here too it falls to the grantor to pay capital gains taxes on these appreciated holdings.

Thankfully advisors can give grantors a break. Asset choice and tax management can help mitigate the income tax load on the grantor and their beneficiaries. One option is to transfer marketable securities such as equities, which are particularly attractive due to their liquidity, readily available valuations, flexibility relative to annuity payments in kind, and capital gain and loss realization. Proper tax management can lower the drag to the grantor and the beneficiaries all while achieving market-like returns.

Using Parametric Custom Core in GRATs

Using the sample case above, let's assume the grantor makes a cash investment in a Parametric Custom Core large-cap equity portfolio worth $1 million. The portfolio seeks to provide the pretax return of an equity exposure like the S&P 500® while systematically harvesting tax losses. The Custom Core portfolio strives to realize no net gains but rather net losses while pursuing market-like returns. Those excess losses can be used to shelter gains realized by the grantor's other GRAT investments or those outside the GRAT. Additionally, since annuity payments can be satisfied in kind, the Custom Core account is a potential source of annuity funding.

Returning to the first example discussed above, assuming the grantor's GRAT has the necessary substitution power, they can now decide to swap the $425,000 of appreciated low-basis assets—such as their Custom Core holdings—for cash or other high-basis assets of like value. In doing so they bring the low-basis assets back into their estate, where the $425,000, plus any other gain in excess of their basis, will receive a new basis equal to fair market value upon their death. This has the effect of eliminating capital gains tax that their beneficiaries would otherwise be required to pay upon the sale or exchange of the assets. The grantor has successfully transferred $425,000 out of their estate at virtually no tax cost, and they've eliminated the capital gains tax liability on the assets retained in their estate.

This technique—sometimes called *GRAT immunization*—can be especially effective if the grantor expects the value of the assets to fall dramatically prior to the substitution. By exchanging a depreciating asset back into their estate in exchange for a less volatile asset, such as cash, they can freeze the value of assets excluded from their estate and eliminate any capital gains liability. Best of all, they can do this while managing the portfolio's relative equity market risk.

Using a Custom Core portfolio gives the grantor many other options. They can use their assets for charitable giving, or they can strategically take gains to hedge against basis step-up changes or increased tax rates.

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Conclusion

A GRAT paired with a Parametric Custom Core solution can be an excellent tool for both estate tax and income tax arbitrage. This is especially true at a time of low asset values and favorable IRS 7520 rates. The current administration made significant changes under the Tax Cuts and Jobs Act of 2017, nearly doubling the sizes of estates that would be subject to taxation. It's possible that Congress will revise or repeal some of those changes if a new administration takes office in 2021. Any long-term planning should take this possibility into consideration. For many high-net-worth investors, the GRAT is a sensible tool for transferring wealth. Working with a team consisting of an estate attorney, an accountant, and a financial advisor, investors can decide whether a GRAT is right for them. Together they can develop a plan to grow their assets, minimize taxes, and efficiently transfer their wealth to their heirs.

This article is for general educational purposes only and is not intended as legal or tax advice.

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Bob is responsible for distribution channel management for the HNW/Retail, International, and DCIO Institutional segments. Bob also leads Parametric's Family Office Advisory Group, a family office resource. Prior to joining Parametric in 1998, Bob was a vice president with Harris Bank and a manager in the family wealth and financial planning practice of Arthur Andersen & Co. He earned a BA in economics from Wabash College and a JD from Valparaiso University.

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