



Advanced Markets Blog

Grantor Retained Annuity Trusts — Your specialized but overlooked tool

Contributor: Kevin W. Blanton JD

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The planner's toolbox contains many different devices, some that get used every day in various ways for almost every client, while others have one specialized function that make them the appropriate tool for a particular job. For example, trusts can be revocable or irrevocable and can be adapted to meet a targeted need at a particular time (such as to hold funds in escrow until a date two months away) or to meet the as-yet unknown needs of a growing class of beneficiaries for generations to come. At the other end of the spectrum is the Grantor Retained Annuity Trust or GRAT. While a planner has some flexibility in the design of a GRAT, for the most part the GRAT has a specific purpose. Its one function is to deliver a valuable gift to a designated recipient at some point in the future with as small a tax consequence as possible. That is all a GRAT does, but this one function can be extremely useful as part of a larger plan where often nothing else will do.

How the GRAT works

Technically, a GRAT works by making a present gift of a future interest and, by using growth-rate arbitrage (explained in detail below), is able to fund a trust with limited gift tax consequence. In other words, a client makes a gift of cash or other valuable property to an irrevocable trust but retains the right to a specified annuity from that trust for a specified term. The GRAT terminates at the end of that term and whatever is left in the trust is the property of the trust's beneficiary. This beneficiary is called the GRAT "remainderman," because its sole interest in the trust is in the remainder at the termination of the GRAT. While theoretically straight-forward, the work and benefit of the GRAT is a result of specific numbers that are set in stone at the point the GRAT is created and funded.

Remember, the primary function of a GRAT is to deliver a valuable gift to the remainderman at a targeted future date at a minimum gift-tax cost. And while the GRAT terms specify that the property will be delivered to the remainderman at the targeted date, the gift is considered "made" at the creation of the GRAT. For this reason, the gift value is taxed for gift-tax purposes at the time the GRAT is created and funded. In addition, because the gift is made and taxed at the time the GRAT is created, no gift tax will be triggered upon the termination of the GRAT when the remaining assets are distributed. This establishes the opportunity for rate arbitrage.



So, what is the value of the gift of the future interest to the remainderman at the specified future date? If you are thinking “no one can possibly know what that value will be in the future,” you are absolutely correct. But we must be able to tax this gift, so we must have a value. The GRAT rules in the Internal Revenue Code require that we use the §7520 rate (provided by the Code for just such purposes) to determine the gift’s value. The lower the §7520 rate, the lower the projected value that the rules will produce and therefore the lower the gift value; the higher the §7520 rate is the higher the projected value and higher the gift will be.

But, you are probably thinking, even at a lower §7520 rate, won’t the projection be of a greater value than the current value of the property transferred at the creation of the GRAT? Yes, it would, except remember that the “Grantor” has “Retained” the right to an “Annuity” from the “Trust.” The value of this stream of payments retained by the grantor must be subtracted from the projected future value of the remainder. By adjusting the term of the GRAT and the level of the annuity (the amount or rate), the grantor can manage to reduce the projected gift value to zero or close to it. Any growth of the property inside the GRAT before termination will then pass to the remainderman gift-tax free. Plus, of course, the more the actual growth rate of the gift inside the GRAT exceeds the §7520 rate, the greater the difference that will transfer gift-tax free — i.e., the growth rate arbitrage.

Finally, it is important to choose the GRAT term carefully because if the grantor does not survive the GRAT term, the GRAT is said to have “failed.” In such a case, the GRAT is unwound and all assets in it are returned to the grantor’s estate, with no adjustment for the original gift tax (or credit) expended. The longer the GRAT term, the lower the gift valuation, all other things being equal, but the longer term increases the risk of the grantor predeceasing the GRAT term and losing the benefit of the GRAT planning. Let’s look at a simple illustration of how this can work.

Example

Grantor transfers \$1M to a GRAT for 15 years in May 2021 when the §7520 rate is 1.2%, while retaining the right to an annuity in the amount of 7%. This means that the grantor will receive a distribution of \$70K from the GRAT each year for the 15-year term. Using the applicable §7520 rate and the GRAT rules, the value of the gift made by the grantor to the remainderman is a little more than \$44K. At the same time, if the \$1M grows at just 5% inside the GRAT, the remainderman will receive more than \$568K at the end of the GRAT term. This is almost 13x as much as was taxed!

Now, if the grantor increases the annuity rate slightly to 7.3%, the gift value will be reduced to \$0.03 and the remainderman will still receive almost \$500K. Additionally, the grantor has received distributions back from the GRAT totaling \$1,050,000 over 15 years. Thereby, the specialized function of the GRAT is accomplished.

How are GRATs useful to planners?

Obviously, if a client needs to get money from point A to point B today, the GRAT is not going to be the answer. However, where a client has a future need for liquidity and has the present ability to commit assets to that need today, the GRAT is an effective tool to use. In this way the GRAT can be a valuable part of a larger plan that might not work without it. For example, without a funded roll-out strategy, the benefit of a split-dollar arrangement can diminish over time as the outstanding repayment liability grows. Likewise for financing arrangements between a grantor and its ILIT, there needs to be a plan to exit the strategy and pay principal and interest when the note comes due. By setting up a GRAT in parallel with these funding arrangements, the client can help ensure that adequate liquidity is available at the precise moment that it is most needed.

The GRAT may not be the everyday hammer in the toolbox, which comes out for every job, but when the need arises, almost nothing else can get the job done as effectively.

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Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds.

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