John Hancock

Blog

Managing interest-rate volatility with rolling GRATs

In 2022, we saw the end of an almost two-year run of historically low interest rates. During the two-year period from January 2020 through January 2022, the IRC §7520 rate averaged 1.03%. Primarily due to federal government spending and supply chain disruption during the pandemic, the Federal Reserve finally acted in an attempt to curb rising inflation by aggressively increasing federal fund rates from near zero to over 4% by the end of 2022. This had a direct impact on the IRC §7520 rate. From January 2022 through December 2022, this rate increased from 1.6% to 5.2%. The increase in rates came as no surprise (although not a pleasant surprise) to many financial planners, as the Feds were quite vocal as to their intentions. As a result, many planners have begun to rethink how to best structure wealth transfer techniques that are interest-rate sensitive. One tried-and-true estate planning technique impacted by rising interest rates is the Grantor Retained Annuity Trust (GRAT). Now may be an opportune time to revisit how we structure GRATs as an invaluable tool to help create flexibility in wealth transfer plans.

As a refresher, a GRAT is a tool commonly used to transfer appreciation out of a taxable estate in a gift-tax efficient manner. With this technique, an owner transfers an asset to a GRAT and receives the right to an annual annuity payment during the GRAT term. The annuity payment is set at the IRC §7520 rate and is fixed for the term of years of the GRAT. Any "remainder" (i.e., excess over the annuity payment and future appreciation) is removed from the taxable estate and transferred to the remainder beneficiary virtually gift-tax free. This make GRATs an effective estate-freeze technique. In addition to transferring the remainder to heirs, GRATs are also used to transfer property to a trust to facilitate exit strategies for private finance, commercial finance and private split dollar arrangements.

During the years of low §7520 rates, some planners structured GRATs over a long-term period. For example, it was not unusual to see GRATs with terms of 10 years or more to lock-in low interest rates. When using long-term annuity periods, estate owners were able to freeze the growth on their assets held in their estate to around 1%. If we are to assume the asset held in that GRAT earned 7% over the 10-year period, the "six-point spread" was transferred to the remainder beneficiary virtually gift-tax free. If you compare that to the January 2023 §7520 rate of 4.6%, the spread is reduced to 2.4%, meaning less growth would be transferred to the remainder beneficiary and more of the asset would be returned to the taxable estate.

Let's look at a hypothetical example: Assume a $5M asset was transferred to a 10-year GRAT in January 2022 when the §7520 rate was 1.6%. The annual annuity payment each year would have been $545,048. Total payments returned to the grantor under the annuity over the 10 years would total $5,450,048. The remainder interest transferred to the remainder beneficiary at the end of the 10-year period would have been $2,305,126. If that same GRAT were created in January 2023 with a §7520 rate of 4.6%, the annuity payments each year would be $635,001 (total payments of $6,350,010) and the remainder transferred to the remainder beneficiary would drop to $1,062,295. That's a difference of over $1.2M! If the purpose of establishing a GRAT is to minimize the growth of a taxable estate by transferring excess growth out of the estate, then these high §7520 rates minimize the effectiveness of the technique when tied to a long-term annuity period.

As mentioned earlier, GRATs are also used to fund exit strategies in various financing techniques used for the payment of life insurance premiums. GRAT remainder interest that is transferred to an ILIT at the end of the GRAT term can be used by the trustee to repay a lender. Because the remainder interest is transferred virtually gift-tax free, the use of a GRAT in conjunction with other financing techniques such as commercial premium finance or private split dollar designs can be a very gift-tax efficient way to fund large premiums inside of irrevocable trusts. Higher §7520 rates also impact the efficacy of a GRAT as an exit strategy on these types of arrangements. As the trustee depends on the receipt of the remainder interest to repay a debt obligation, a larger upfront contribution from the grantor into the GRAT is required today to achieve the desired remainder at the end of a GRAT term.

To illustrate, assume a trust borrowed premiums from a lender or grantor for 10 years at $135,670 per year. Assuming the borrower pays the annual interest, at the end of 10 years, the lender would be due $1,356,700. If a 10-year GRAT was created in January 2022 when the §7520 rate was 1.6%, the amount of the GRAT contribution (assuming a 7% return on GRAT assets) would need to be about $2,900,116 to achieve a GRAT remainder of $1,356,700. If this arrangement occurred in January 2023 with a §7520 rate of 4.6%, the amount of the contribution would need to be $6,208,102 to achieve the same remainder interest value.

Date of creation	January 2022	January 2023
7520 rate	1.60%	4.60%
Initial GRAT funding*	$2,900,116	$6,208,102

*Assumes a 7% return and a pay-off amount of $1,356,770

That dramatic increase in the initial contribution could give the proposed insured pause and disrupt the sale. There is a creative way to illustrate this GRAT technique that can give the planners and the insured a way to manage today's high-rate environment.

Some economists believe that the Feds' actions could slow down soon, and we may reach a more stable rate environment. If we can assume rates have reached or are near their peak levels, history indicates we could see reductions in interest rates within the next 12 to 24 months. Planners may benefit from creating a series of short-term GRATs to take advantage of any future rate reductions — the "rolling" GRAT. The idea of a rolling GRAT assumes that the term of the GRAT is reduced to — 2 years, for example — and at the end of the GRAT term a "new" GRAT is created using the then current §7520 rate. If we assume that the §7520 rate will go down over the next 10 years, we can illustrate a reduced initial contribution. Obviously, since the initial illustration of the rolling GRAT will "guess" at what future §7520 rates might be, the assumptions can be refined after each GRAT period to take into account the actual §7520 rate at the time of the next "rolling" GRAT.

For example, if we use the same assumptions as above for premiums and loan obligations and we assume over the next 10 years the §7520 rate will fluctuate and ultimately go down we can illustrate a reduced initial contribution. Even modest decreases in the §7520 rate (down to 23-year historical average of 3.61%) can have a great impact on the initial contribution that can be illustrated. If we assume the following average rates: 2023 = 4.6%; 2025 = 4.0%; 2027 = 4.2%; 2029 = 3.8%; and 2031 = 3.6%, the amount of the initial contribution can be reduced from $6.2M to $5.0M. While we cannot predict what future interest rates will be, this hypothetical example highlights that rolling, short-term GRATs may be a viable option to help drive planning and may outperform longer-term GRATs.

In general, financing techniques continue to be important tools to fund large life insurance premiums — helping to free up capital for other needs, providing gift-tax efficiency and ultimately giving clients greater control. While many tried-and-true techniques are interest-rate sensitive, the good news is that even with higher interest rates, there are many creative ways to customize and design plans to help meet specific client goals. Incorporating a GRAT as an exit strategy is still an effective repayment technique — we just have to change the design dynamics to manage the client's reluctance during a period of high interest rates.

John Hancock Advanced Markets has a Rolling GRAT calculator that can help design these cases and help you navigate this period of high interest rates. Reach out to the Advanced Markets team to learn more!