

Estate Planning Amid Market Volatility: Leveraging GRATs

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Among other potential strategies, while the markets remain volatile, if timed right, a short-term grantor retained annuity trust (GRAT) could be an option to pass significant wealth to the next generation. Investments used to fund the GRAT that have dropped in value due to temporary volatility could be transferred to a GRAT and, assuming the investment returns to its earlier value, the difference between the low value at the time of transfer and the more reasonable long-term value will pass to the next generation without any gift tax. The remainder of this alert will briefly describe a GRAT and explain how a GRAT can be used to pass significant wealth to the next generation. You should discuss the potential use of a GRAT with your investment advisor and estate planning attorney to make sure it is appropriate for you.

A short-term GRAT can be used to transfer income/appreciation in your investments to your children at a low gift tax cost. A short-term GRAT has the following characteristics:

1. The trust would have a stated term of two to four years.
2. While the trust is in existence, the trust would have an obligation to pay you a specified annual amount (the “retained annuity”).
3. When the trust terminates, any property remaining in the trust would be distributed to your children free of any gift or estate tax.
4. If you die before the trust terminates, the trust would not result in any benefit to your estate, because the remaining property in the trust would be included in your estate for estate tax purposes.

The purpose of this type of trust is to allow your children to receive, on a virtually tax-free basis, the investment returns on property in excess of a stated Internal Revenue Service interest rate. Since January 2023, that interest rate has fluctuated between 4 and 6 percent. Thus, if the funds in the trust generate a total return in excess of the IRS rate, your children would receive that excess return. On the other hand, if the property does not generate a return of at least the stated IRS rate over the course of the trust, then all of the trust assets would ultimately be repaid to you. Your children would receive nothing from the trust, but they would not have suffered any loss either.

If you made a gift of the property to your children and the property declined in value, then you would have paid gift tax on the property at a value higher than is ultimately received by your children. The same is true if you were to loan money to your children and they either had losses or did not achieve a return equal to the minimum IRS rate (approximately 4-6 percent for short-term loans), because they would still owe you the principal amount of the debt. In this regard, the GRAT is essentially a risk-free technique.

For example, if you transfer \$1 million of assets to a two-year GRAT and your children invest those funds and receive an annual return of 6 percent, at the end of two years, your children would receive a tax-free gift of approximately \$50,000-80,000. You would transfer \$1 million of securities to the trust and the trust would promise to pay you approximately \$510,000-530,000 at the end of

the first year (depending on the IRS interest rate), and an additional \$510,000-530,000 at the end of the second year. These annual payments constitute your “retained annuity.” By paying you this amount, there is a very small taxable gift at the time the trust is established. If the trust promised to pay you a smaller amount, then there would be a significant gift at the time the trust is established. If the trust earns 6 percent in the first year, the net value of the trust at the end of the first year would be \$1,060,000. At that time, the trust would pay you \$520,000 in cash or other property. The trust would then invest the remaining \$540,000 for another 12-month period and earn a 6 percent return equal to \$32,400. At the end of the second year, the trust would have \$572,400, and it would owe you the second annuity payment of \$520,000. Thus, at the end of the second year, the trust would have a net amount of about \$53,000, which is paid to your children.

The reason to keep the term of the trust short is to avoid offsetting gains in early years against losses in later years. For example, if a trust had a six-year term and experienced 12 percent gains in the first two years, then had a loss in years three and four, then had significant gains again in years five and six, the bad years would offset the good years, reducing the amount ultimately payable to your children. However, if you established a two-year trust and then established a new two-year trust each time a distribution was made, you would better capture the gains in the good years, and, as noted above, if the trust experiences a loss (or does not earn at least the minimum Internal Revenue Code stated interest) your children would not have to make up the loss. The trust would merely transfer all of its assets back to you in full settlement. Having a short-term trust also minimizes the risk that you would die during the term of the trust, eliminating any benefit which might have previously accrued under that trust. On the other hand, if interest rates rise, then each new two-year trust would be required to make larger annuity payments, reducing the net returns to your children.

Because of the nature of a GRAT, it is generally advisable for either you or your spouse to establish a trust, or you could each establish a separate trust, but you should not establish one trust together with community property. Thus, it may be necessary for you to partition community property so that you can establish the trust with separate property. This is not a problem with cash, but it might have adverse consequences if you use property which has a low-income tax basis. If you were to partition community property with a low-income tax basis, you would then each hold that property as separate property. And if one of you dies, the other spouse’s one-half of the property would not receive a new income tax basis on death (thereby forfeiting one of the advantages of community property).¹

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