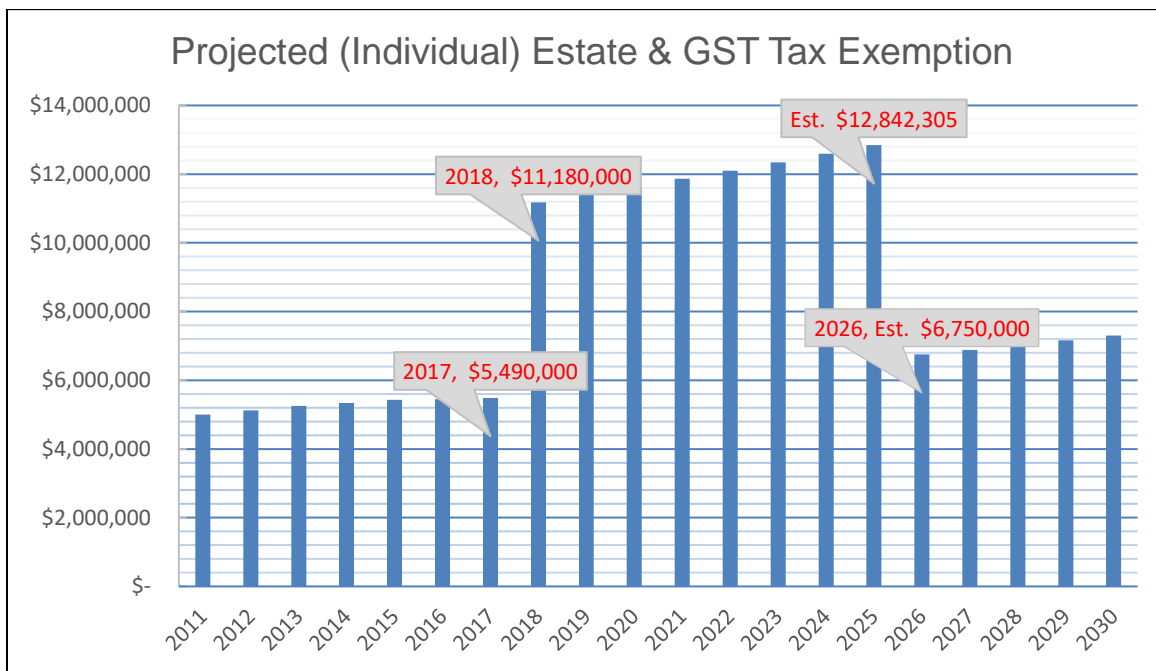


Cascading GRATs: A Flexible Strategy to Reduce or Avoid Estate Taxes

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It's not surprising that, with the "doubling" of the federal estate tax under the Tax Cuts and Jobs Act of 2017 ("TCJA"), planning to reduce or avoid the onerous estate tax has been put in the back burner. After all, with an exemption of \$11.18 million per person (\$22.36 million per couple), few individuals or couples have a "taxable" estate. Unfortunately, complacency of advisors and their wealthy clients may prove to be a costly mistake after the estate tax provisions of the TCJA sunset on December 31, 2025, and the estate tax exemption plummets to an estimated \$6.75 million per individual.



To make matters worse, there's no way to know if the upcoming Congressional mid-term elections (2018 and 2022) or the 2020 presidential election will result in changes to the above TCJA estate tax scheme. Despite the uncertainty, advisors should be encouraging every client who had a taxable estate in 2017—or was approaching the estate tax threshold in that year—to take advantage of various planning strategies available to help reduce the value of their taxable estates or, at the very least, minimize the growth of their estates between now and 2026.

Ultra-wealthy families whose wealth greatly exceeds the federal estate tax threshold have employed costly and complex estate-tax-saving strategies for years. Because such strategies typically involve creating multiple entities and rely heavily on valuation discounts, they are subject to heightened scrutiny by the IRS. Clients whose net worth is just over—or flirting with—the projected 2026 estate tax exemption will be (understandably) reluctant to undertake planning at such an advanced level or risk a challenge by the IRS. However, a GRAT, or series of cascading GRATs, could be an effective, flexible and relatively inexpensive solution for many of these clients.

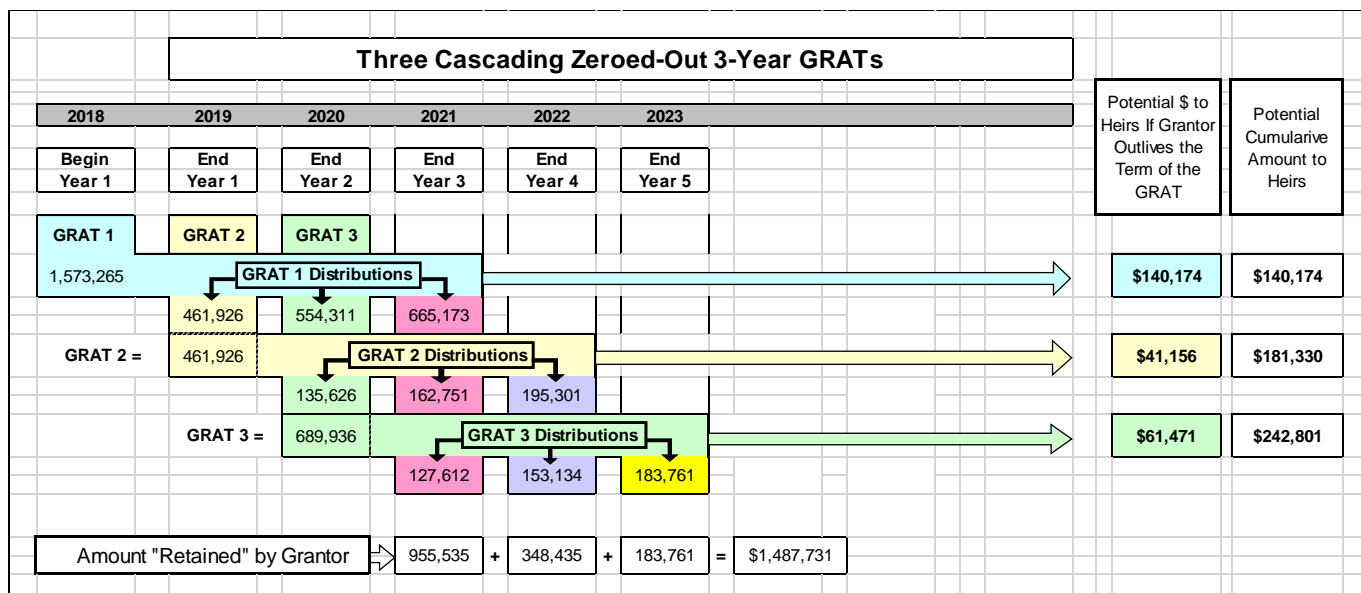
Creating a GRAT starts with the transfer of assets—typically securities expected to appreciate in value—to an irrevocable trust designed to pay the Grantor an annual annuity amount for a specified number of years. When the term of the GRAT ends, the assets left in the GRAT are distributed to the trust beneficiaries. Because the

Grantor must outlive the term of the GRAT, the trust is subject to an Estate Tax Inclusion Period (ETIP) that prevents the allocation of Generation-Skipping Transfer Tax exemption to the trust. Consequently, grandchildren should not be named as beneficiaries of a GRAT.

The amount of the annuity paid to the Grantor each year is calculated using an interest rate determined monthly by the IRS, called the “Section 7520” rate. The 7520 rate for April 2018 is 3.2%. While ordinarily the transfer of assets to an irrevocable trust for the benefit of someone else would be deemed a gift for federal gift tax purposes, a GRAT can be structured so that the Grantor does not incur a gift tax by setting the annuity payment equal to the 7520 rate. By doing so, all of the assets transferred to the GRAT will, theoretically, be returned to the Grantor during the term of the trust, and nothing will be left in the trust when the GRAT ends. Such a trust is known as a “zeroed-out” GRAT. If the rate of appreciation of the assets held in the GRAT exceeds the 7520 rate, the beneficiaries of the trust will receive the excess growth *gift tax free* when the term of the trust ends.

GRATs can be an appealing strategy for risk-adverse clients because of the considerable body of regulations and favorable tax court rulings supporting the use of GRATs. While the risk of IRS scrutiny is minimal, GRATs do have some drawbacks. First, it’s possible that the rate of growth of the assets held in the GRAT will be less than the 7520 rate, meaning that the Grantor will receive back all of the trust property, leaving nothing for heirs. Second, if the Grantor dies during the term of the GRAT, the trust assets revert automatically to the Grantor’s estate where they will be included for federal estate tax purposes. And third, as interest rates increase, so will the 7520 rate, potentially raising the growth threshold necessary for getting tax-free growth to heirs.

What Are “Cascading” or “Rolling” GRATs? The cascading, or rolling, GRAT strategy is initiated when the Grantor’s annuity payment from **Year One** of **GRAT One** is transferred by the Grantor to a newly-established **GRAT Two**. Similarly, the Grantor’s annuity payments from **Year Two** of **GRAT One** and **Year One** of **GRAT Two** are subsequently transferred to a new, **GRAT Three**, and so on. Here is a diagram created using my “Cascading GRAT Simulator” (see page 3) of the hypothetical results from 3, three-year cascading GRATs (Initial funding = 1.57 Million; Section 7520 rate = 3.2%; & annual growth rate = 7%):



There are 2 factors that have prompted many advisors to recommend “cascading” or “rolling” GRATs over longer-term, single GRATs: 1) Research shows that shorter-duration GRATs provide more benefit to heirs than

longer-term GRATS based solely on investment volatility; and 2) Upon establishing a GRAT, the 7520 rate in the month it is created is locked in for the duration of the GRAT. Rather than waiting until the end of the term of **GRAT One** to fund a new GRAT—keeping in mind that the 7520 rate is likely to increase during the intervening months—it's far more prudent to create **GRAT Two** at the end of year one of **GRAT One** funded with the first-year annuity payment from **GRAT One**, thereby locking in the lowest possible 7520 rate for the term of **GRAT Two**. Similarly, the Grantor's annuity payment from year two of **GRAT One** plus the Grantor's annuity payment from year one of **GRAT Two** are used to fund **GRAT Three**, and so on. In addition, immediately establishing successive GRATS with the annuity payments from each previously-established GRAT starts the potential accumulation of growth of trust assets that can be distributed to the beneficiaries when the term of each GRAT expires.

What if the 7520 rate rises so high in the future that the rate of growth of the underlying GRAT assets is unlikely to exceed the 7520 rate? Or, what if other tax-saving strategies arise that could provide more benefit to the Grantor and her heirs? That's where the flexibility of the cascading GRAT strategy comes into play. If continuing to fund successive GRATS is no longer a viable asset-transfer strategy or if the Grantor decides to use her annuity amount for a different purpose, the Grantor simply discontinues funding new GRATS.

Demonstrating to clients the potential benefit of establishing one GRAT or a series of cascading GRATS can be extremely challenging. To help my clients understand and get comfortable with GRAT strategies and see the potential benefits, I have developed a "Cascading GRAT Simulator" that I've shared on my website. The Simulator calculates the hypothetical results of funding a single, 3-year GRAT or as many as 10 cascading 3-year GRATS at various 7520 rates and various rates of annual growth of the GRAT assets.

To access the Simulator, just go to my website www.ElderLawEstatePlanning.org and click on the "Cascading GRAT Simulator" tab in the top menu. I've also posted additional detail about GRATS that can be found under the "How a GRAT Works" tab.

I welcome the opportunity to answer your questions and discuss opportunities to incorporate one or more GRAT strategies into your clients' estate plans.



As a licensed attorney for more than 3 decades, Attorney Krall has helped thousands of individuals and families protect and preserve assets & reduce the cost and complexity of transferring assets to loved ones. By staying on top of the rapidly-changing income tax and estate tax laws, Attorney Krall continues to help clients identify and take advantage of tax-saving opportunities while planning for life's inevitable transitions.