New headwinds for a powerful estate planning strategy

Rising rates and recent proposals could affect your ability to pass assets tax-free.

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Key takeaways

- Grantor retained annuity trusts (GRATs) can provide protection against the estate tax, as well as income tax advantages.
- However, recent legislative proposals and rising interest rates could potentially undermine the effectiveness of these trusts in the future.
- Individuals and families who are interested in passing assets to the next generation should consult with their attorneys or tax professionals to determine if a GRAT is right for them.

Grantor retained annuity trusts can help individuals and their families move assets out of their estate, and potentially allow the appreciation on those assets to pass to the next generation free from gift and estate tax. But recently, legislative proposals in Washington, DC have sought to significantly curtail the benefits of GRATs, while the prospect of rising interest rates threatens to reduce their effectiveness as an estate planning tool in the months and years to come. For those concerned with protecting their legacy against estate taxes, it's important to understand how these trends could affect your ability to plan for your family's future.

How does a GRAT work?

"Conceptually, a GRAT is straightforward," says David Peterson, head of Wealth Planning at Fidelity Investments. "An individual—the grantor—funds an irrevocable grantor trust with assets they hope will appreciate over time. In return, they receive an annuity payment for a certain number of years. When structured properly, any assets that are left in the trust at the end of the term pass to the beneficiaries, or a trust established on their behalf, without incurring estate tax." If the grantor passes away before the term ends, however, the assets are pulled back into the estate.

Under the current rules, if established as an intentionally defective grantor trust, income generated by the trust assets can be taxed to the grantor. This means that during your lifetime, income earned by the trust is considered your personal income and can be included on your personal income tax return—typically a major benefit, because the personal income tax brackets are more favorable than those for trusts. Since taxes aren't paid out of the trust, the trust's principal can grow more quickly, providing extra benefit to your heirs.

What changes have been proposed?

The Build Back Better Act (BBBA) proposed changing the grantor trust rules so that all assets held in a grantor trust established after the passage of the bill would be included in the grantor's estate at death. Though that bill has stalled in Congress, changes to grantor retained annuity trust rules reappeared in President Biden's proposed 2023 budget. "If passed, these proposals would effectively eliminate many of the benefits that GRATs provide," says Peterson.

The proposals include:

- **Extending the minimum length of the GRAT term from 2 years to 10 years.** "Given that trust assets would be included in the grantor's estate if they were to pass away before the end of the term, this presents a risk, particularly for older or at-risk grantors," according to Greg Doyle, a vice president on Fidelity's Advanced Planning team.
- **Establishing a minimum remainder value.** "Under current law, it's possible to create what's called a 'zeroed-out GRAT,' where the grantor seeks to eliminate the transfer tax by equalizing the value of the grantor's retained annuity interest and the amount they initially transferred into the trust," says Doyle. "The proposed rules limit this by requiring the grantor to make a taxable gift of at least 25% of the initial value, or $500,000—whichever is higher."
- **Taxing asset substitutions.** "With a GRAT, the ability to swap assets of equal value between your estate and the trust can be very powerful," says Doyle. "Today, you can swap high-cost-basis assets out of your estate for low-cost-basis assets in the GRAT. Once in your estate, the low-cost-basis assets would enjoy a step-up in basis at death, and the high-basis assets in the GRAT would pass to your beneficiaries with a lower income tax burden, should they decide to sell them. Under the proposed rules, these swaps would be taxable."
- **Treating income taxes paid by the grantor as a taxable gift.** "Trust income becomes subject to the highest marginal income tax bracket very quickly," says Doyle, "beginning with any undistributed net income over $13,451. Under current law, the grantor can include trust income from a GRAT in their personal income, where the tax brackets are significantly more forgiving." The new proposal would seriously complicate the tax treatment of trust income. "Grantors would need to work with their tax advisor to determine the best option for their particular situation," says Doyle.

At the moment, neither the BBBA nor President Biden's proposed 2023 budget seems destined to become law, at least not in their current form. However, it seems that changes to grantor trust rules are likely to be a part of budget negotiations for the foreseeable future. "Reacting to proposals is never a prudent strategy," says Peterson, "but it's wise to understand what might happen so you can be prepared in the event that these proposals become law someday."

How will rising interest rates affect GRATs?

While legislative changes to grantor trust rules may not be imminent, the Federal Reserve has already begun raising interest rates and further hikes could have a big impact on GRATs.

"As the Federal Reserve raises the federal funds rate, what's called the §7520 rate or hurdle rate also rises, and this rate is integral to the GRAT strategy," says Doyle. The annuity payments a grantor receives during the term of the GRAT are calculated using the §7520 rate, set at the month the GRAT is established. The higher the §7520 rate, the less appreciation passes to beneficiaries, assuming the rate of return for GRAT assets is the same.

With possibly as many as 8 interest rate hikes by the end of 2022, it's possible that the §7520 rate could rise significantly in the near future. If you've been considering a GRAT as part of your estate plan," says Doyle, "it may be wise to speak with your financial consultant to see if you would benefit from establishing one sooner rather than later, to lock in the relatively lower §7520 rate."

Consult your attorney and tax professionals

While the legislative proposals and interest rate hikes may create a sense of urgency, it's important to be thoughtful and deliberate in your approach. Moving too quickly could result in missteps that undermine the tax efficiency of your overall strategy. Before you determine your next step, consult with your attorney and tax professionals and work together to identify the best approach for your specific situation.

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