



# GRAT Funding and Administration: An Insider's View from a Financial Institution

**HOUSTON BUSINESS AND ESTATE PLANNING COUNCIL**

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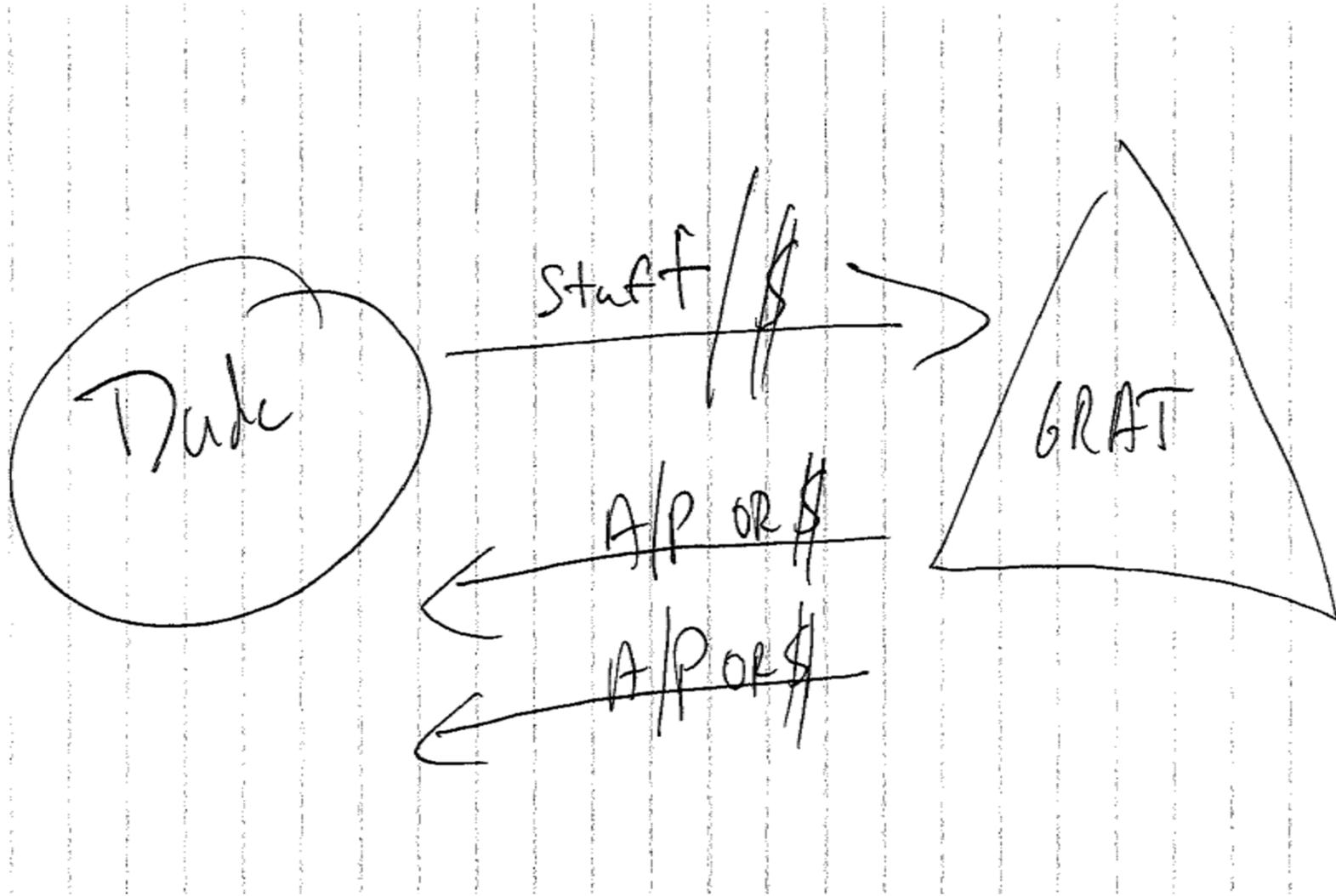
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## DISCUSSION TOPICS

- I. Introduction
- II. GRAT Funding
- III. Calculating the Annuity Amount
- IV. Payment of Annuities
- V. Grantor Trust Status
- VI. Capturing Gains and Re-GRATTING Losses

WHERE IT ALL STARTED



## GRAT REQUIREMENTS

1. Irrevocable right to receive a fixed amount.
2. Governing instrument must meet certain requirements regarding incorrect determination of fair market value (if annuity stated as a fraction or percentage of initial fair market value).
3. Annuity payable at either anniversary date of trust or taxable year of trust.
4. Annuity must be paid either 105 days after anniversary date or, if the annuity date based on a taxable year, by the due date of the federal income tax return without regard to extensions.
5. Governing instrument must prohibit additional contributions to the trust.

Treas. Reg. § 25.2702-3(b)

## GRAT REQUIREMENTS

1. Qualified Annuity Interest must be a qualified annuity interest in every respect.
2. Qualified Annuity Interest must be payable in any event to or for the benefit of the holder for the fixed term of the interest.
3. Governing instrument must prohibit distributions to any person other than the holder of the qualified annuity interest.
4. Governing instrument must fix the term of the qualified annuity interest and the term must be fixed or ascertainable upon creation of the trust.
5. Governing instrument must prohibit commutation of the qualified annuity interest.

Treas. Reg. § 25.2702-3(d)

## Single Date of Funding

“The governing instrument must prohibit additional contributions to the trust.”

Treas. Reg. § 25.2702-3(b)(5)

# Financial Assets

1. Single Stock Position
2. Multiple Stock Positions
3. Mutual Funds
4. Private Equity / Hedge Funds
5. Separately Managed Accounts
6. Multiple Institutions

Remember: Community Property

## Potential Solutions

### 1. “Pre-GRAT” Revocable Trust

Consider funding a “Pre-GRAT” Revocable Trust to gather assets that may arrive on separate dates. Once the trust is fully funded, the Grantor could then release the revocation power and begin the term of the GRAT.

However, consider under §§ 2035(a) and 2038(a)(1) whether such a mechanism would extend the mortality risk of a two-year GRAT to three years.

### 2. Letter of Direction

Consider having the Grantor deliver an irrevocable letter of direction to the financial institution responsible for transferring the assets to pinpoint the date of transfer.

However, consider whether this is effective for tax purposes.

### 3. Partnership or LLC

Consider funding a partnership or LLC to gather assets (rather than a revocable trust) and using partnership or LLC interests as the asset transferred to the GRAT.

However, also consider valuation issues as well as additional administrative expenses.

## Inadvertent or Prohibited Funding

1. Asset properly accepted by the Trustee?
2. Loan?
3. Contribution to a new GRAT?
4. Pay attention to expenses
  - a. Legal and Accounting Fees
  - b. Investment Management Fees
5. Statements

## Annuity Description in the GRAT Agreement

1. Sum Certain
2. Percentage Certain
3. Word Description – “amount necessary to...”
4. Mathematical Formula

## Mathematical Formula

### Two-Year Zeroed-Out GRAT (Level Payments) Example

#### System of Equations

$$[\text{Funding Amount} + (\text{Funding Amount} \times \text{\$7520 Rate}) - \text{Payment}] = \text{End of Year 1 Amount}$$

$$[\text{End of Year 1 Amount} + (\text{End of Year 1 Amount} \times \text{\$7520 Rate}) - \text{Payment}] = 0$$

#### Yields

$$\text{Annual Payment} = \frac{[(1 + \text{\$7520 Rate})^2 \times \text{Funding Amount}]}{(2 + \text{\$7520 Rate})}$$

# Challenges

1. Security Accounts
  - a. Uneven / Indivisible Lots – Picking and Choosing Securities
  - b. Rebalancing
  - c. Basis Management
2. Valuation
  - a. Treas. Reg. § 25.2512-2(b) – mean between the high and low on date of transfer (gift tax valuation for publicly traded securities).
  - b. Information not always available on date of transfer.
  - c. Assets may not be immediately transferrable.
3. True-Ups
  - a. Over / Under Valuation
  - b. Insufficient Cash

## Application of Grantor Trust Rules

1. § 673 – Reversionary Interest
2. § 677 – Income for Benefit of Grantor
3. § 675 – Administrative Powers (Power of Substitution)
4. Post-GRAT Term

## Overview

1. Exercise of Power of Substitution
2. Substitution of Promissory Note
3. Short-Term GRATs
4. Declining Payment GRATs

## Example: Poor Performance

Grantor creates two-year zeroed-out GRAT when the §7520 Rate is 10%. It is funded with \$1 Million. Level annuity payments of \$576,191 are due annually. At the end of Year 1, asset values had decreased 20% leaving \$800,000 of value in the GRAT.

After the first annual payment, \$223,809 remains in the GRAT.

In order for the GRAT to return any value to remainder beneficiaries, assets must exceed \$576,191 at the end of Year 2. Thus, the value of the GRAT assets would need to increase by more than \$352,382 (over 150%!). Highly unlikely.

## Potential Solution: Exercise of Power of Substitution

Grantor substitutes low volatility assets (typically bonds) in exchange for the remaining GRAT portfolio allowing the grantor to re-GRAT the substituted assets more quickly.

## A Most Unusual Balance Sheet

<b><u>Asset</u></b>	<b><u>Value</u></b>
Cash	\$2 Million
Real Estate	\$3 Million
GRAT Annuities Receivable	\$95 Million

## Potential Solution: Substitution of Promissory Note

Instead of substituting a bond portfolio into the GRAT, could the Grantor substitute a promissory note instead?

Maybe.

See *In re Condiotti*, 14CA0969 (Colo. App. 2015) and *Benson v. Rosenthal*, 2016 WL 2855456 (E.D. La. 2016).

## Potential Solution: Short-Term GRATs

Could a Grantor deploy a GRAT with a term of less than two years to mitigate volatility and perhaps return devalued assets more quickly to permit re-GRATTING?

Again, maybe.

IRC §2702(b)(1) – amounts payable not less frequently than annually?

Treas. Reg. §25.2702-3(b)(3) – payments may be made more frequently than annually.

See *Kerr v. Commissioner*, 113 TC 449 (1999), aff'd 292 F.3d 490 (5<sup>th</sup> Cir. 2002) (366 day GRAT unchallenged).

## Potential Solution: Declining Payment GRATs

Instead of using a short-term GRAT, could the first annuity be increased such that unsuccessful assets would almost all certainly be returned at the end of the first year?

Once again, maybe.

See Treas. Reg. §25.2702-3(b)(1)(ii) – the annuity amount cannot increase more than 20% per year (there is no corresponding prohibition with respect to decreases).

Potential Downside: Rising interest rates.

## Potential Solution: Declining Payment GRATs

Example 1: Assume Grantor funds a two-year zeroed-out GRAT with \$1 Million when the §7520 rate is 10%. Instead of level annuity payments, the GRAT provides for a \$1,089,991 payment at the end of year 1 and an \$11,010 payment at the end of year 2 (a 99 to 1 ratio). If the GRAT does not return a rate of almost 9% in year 1, all of the assets would be returned with the first-year annuity payment.

Example 2: Same facts except Grantor creates a level payment GRAT and the assets return 5% in year 1. At the end of year 1, the GRAT holds \$1,050,000 in value and makes a \$576,191 annuity payment leaving \$473,809 in the GRAT. The value of the assets would need to increase \$102,382 to outrun the second annuity payment. That growth is approximately 21.6%. Not impossible, but also unlikely.

Example 3: Same facts as Example 1 except assets return 20% in year 1. At the end of year 1, the GRAT holds \$1,200,000 in value and makes a \$1,089,991 annuity payment leaving \$110,009 in the GRAT. The remaining annuity payment is only \$11,010. The assets would have to decrease almost 90% for this GRAT to fail.

Example 4: Same facts as Example 3 except Grantor creates a level payment GRAT. After payment of the first-year annuity of \$576,191, the GRAT holds \$623,809 in value with a \$576,191 payment remaining. A decrease in asset values of just over 7.6% would cause the transaction to fail.

## BIOGRAPHY



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### EXPERIENCE

Nolan joined Northern Trust in 2017 after practicing estate planning and tax law for over a decade with firms that include Norton Rose Fulbright, Snell & Wilmer, and Baker Botts. Nolan currently is a Regional Wealth Advisor.

### EDUCATION

Nolan graduated from Louisiana State University in 2002 with a B.S. in both accounting and finance, from Tulane University Law School in 2005 with a J.D., and from New York University School of Law in 2006 with an LL.M. in Taxation.

### CREDENTIALS

Nolan is licensed to practice law in both Louisiana and Texas and is an inactive member of the Arizona bar. He also is Board Certified in Estate Planning and Probate Law by the Texas Board of Legal Specialization.

### INTERESTS

Nolan lives in Houston with his wife, Jamie, and sons, Nolan IV and William. Nolan enjoys watching his Tigers play, outdoor cooking, and the occasional poorly played game of golf. Nolan also spends his weekends coaching his sons in Little League.

### EXPERTISE

Nolan manages the Advisory Practice for Northern Trust's Texas Region. In this role, he provides insight and guidance on wealth planning and tax issues of interest to clients, their businesses, and their advisors.

### COMMUNITY INVOLVEMENT

Nolan is a member of the National Board of the LSU Foundation and helped found a Houston Chapter for its Planned Giving Advisory Council. He is the former Chair of the Fiduciary Income Tax Committee of the American Bar Association's Tax Section and has previously served as a Co-Chair of the Houston Bar Association's Elder Law Committee.

# QUESTIONS?



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