

**GRAT FUNDING AND ADMINISTRATION:  
AN INSIDER'S VIEW FROM A FINANCIAL INSTITUTION**

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### **The American College of Trust and Estate Counsel:**

1. “Planning with Respect to Pre-Tax IRAs in the Second Marriage Situation in View of the Secure Act,” ACTEC Employee Benefits Committee, Spousal Rights and Community Property Subcommittee, 2021 ACTEC Annual Meeting, Virtual, March 3, 2021 (with Karen Gerstner, Karen S. Gerstner & Associates, P.C.)

### **State Bar of Texas:**

1. “Directed Trusts: Evolution, Uses, and Drafting Considerations,” State Bar of Texas, 35<sup>th</sup> Annual Estate Planning & Probate Drafting Course, Irving, Texas, October 31, 2024
2. “Update on Directed Trusts,” State Bar of Texas, 48<sup>th</sup> Annual Estate Planning & Probate Course, Houston, Texas, June 12, 2024 (with Gene Wolf, Kemp Smith LLP)
3. “Selected Topics in the Funding and Administration of GRATs,” State Bar of Texas, 47<sup>th</sup> Annual Estate Planning & Probate Course, Dallas, Texas, June 9, 2023
4. “Foreign Trusts and the Throwback Tax,” State Bar of Texas, Section of Taxation Leadership Academy, Houston, Texas, September 23, 2022
5. “Foreign Trusts and the Throwback Tax,” State Bar of Texas, 22<sup>nd</sup> Annual International Tax Symposium, Houston, Texas, November 22, 2019

6. "Estate and Wealth Planning Hot Topics," State Bar of Texas, Section of Taxation Leadership Academy, Dallas, Texas, March 22, 2019
7. "Foreign Trust Tax Issues for Domestic Taxpayers," State Bar of Texas, Tax Section, 21<sup>st</sup> Annual International Tax Symposium, Houston, Texas, November 8, 2018
8. "United States Tax Aspects of Foreign Trusts," State Bar of Texas, Tax Section, International Tax Law in a Day, Webinar, November 3, 2017

**American Bar Association:**

1. "Avoiding Grantor Trust Status," American Bar Association, Real Property, Trust and Estate Law Section, Webinar, April 1, 2025 (with Joshua Caswell, Nixon Peabody LLP)
2. "GRAT Funding & Administration: An Insider's View from a Financial Institution," American Bar Association, Section of Taxation, 2024 May Tax Meeting, Washington, D.C., May 4, 2024
3. "The Art of the Marionette: Retaining Strings under Section 674," American Bar Association, Section of Taxation, 2022 Fall Tax Meeting, Dallas, Texas, October 15, 2022
4. "Selected Tax Aspects of Charitable Remainder Trusts and Charitable Lead Trusts," American Bar Association, Section of Taxation, 2021 Fall Tax Meeting, Virtual, September 23, 2021
5. "Planning under the Secure Act," American Bar Association, Section of Taxation, 2020 Fall Tax Meeting, Virtual, October 1, 2020
6. "A Refresher on the Throwback Tax," American Bar Association, Section of Taxation, 2020 Mid-Year Meeting, Boca Raton, Florida, February 1, 2020
7. "After the Ink Dries: Selected Administrative and Litigation Issues and Practical Solutions for the Trusts & Estates Lawyer," American Bar Association, Section of Taxation, 2019 Joint Fall CLE Meeting, San Francisco, California, October 4, 2019 (with Ashley Sawyer, Loeb & Loeb, LLP and Scott Ingold, Higgs Fletcher & Mack LLP)
8. "Recent Developments in Fiduciary Income Tax (January 1, 2018 – April 10, 2018)," American Bar Association, Section of Taxation, 2018 May Meeting, Washington, D.C., May 12, 2018 (with AK Moody, Venable LLP)
9. "Recent Developments in Fiduciary Income Tax (August 1, 2017 – December 31, 2017)," American Bar Association, Section of Taxation, 2018 Mid-Year Meeting, San Diego, California, February 10, 2018
10. "Recent Developments in Fiduciary Income Tax (April 11, 2017 – July 31, 2017)," American Bar Association, Section of Taxation, 2017 Joint Fall CLE Meeting, Austin, Texas, September 16, 2017
11. "Recent Developments in Fiduciary Income Tax (December 23, 2016 – April 10, 2017)," American Bar Association, Section of Taxation, 2017 May Meeting, Washington, D.C., May 13, 2017 (with Jeff Gonya, Venable LLP)

**Local Organizations:**

1. "Secure Act: Highlights and Planning Considerations," Houston Bar Association, Probate, Trusts & Estates Section, Houston, Texas, November 24, 2020
2. "Secure Act: Highlights and Planning Considerations," East Valley Estate Planning Council, Phoenix, Arizona, November 18, 2020

**Other Publications and Webinars:**

1. "Reporting GRATs, GRUTs, ILITs, and IDGTs on Form 709: GST Exemption Allocation Calculations and Strategies," Strafford Webinar, November 14, 2019 (with Marjorie Horwin, MBAF (now BDO))
2. "Proposed Anti-Clawback Regulations Provide Comfort to Taxpayers," Texas Lawyer, February 28, 2019



## TABLE OF CONTENTS

I.	INTRODUCTION.....	1
II.	IN GENERAL .....	1
III.	FUNDING A GRAT .....	2
	A. Financial Assets.....	2
	B. “Pre-GRAT” Revocable Trust.....	2
	C. Letters of Direction.....	2
	D. Inadvertent or Prohibited Funding.....	3
	1. Contribution to New GRAT.....	3
	2. Use of Partnership or LLC.....	3
	3. Statements.....	3
	E. Trust Expenses.....	3
IV.	CALCULATING THE ANNUITY AMOUNT.....	3
V.	PAYMENT OF ANNUITIES .....	4
	A. Security Accounts.....	4
	B. Valuation .....	4
	C. Annuity Payment True-Ups.....	4
VI.	GRANTOR TRUST STATUS .....	4
	A. Section 673 .....	4
	B. Section 677 .....	5
	C. Section 675 .....	5
	D. Post-GRAT Term.....	5
VII.	CAPTURING GAINS AND RE-GRATTING LOSSES.....	5
	A. Exercise of Power of Substitution.....	5
	B. Example: Significant Decrease in Value .....	6
	C. Substitution of Promissory Note.....	6
	D. Short-Term GRATs .....	6
	E. Declining Payment GRATs .....	7
	1. Example: 99%/1% GRAT.....	7
	2. Example: Poor Year One Returns.....	7
	3. Example: Strong Year One Returns.....	7
	4. Potential Downside .....	7
VIII.	CONCLUSION .....	7
	APPENDIX A .....	9



## SELECTED TOPICS IN THE FUNDING AND ADMINISTRATION OF GRATs

### I. INTRODUCTION

The Grantor Retained Annuity Trust (“GRAT”) is a fairly common estate planning vehicle. Its design is straightforward – a Grantor transfers assets to a GRAT in exchange for a series of annuity payments to be paid at predetermined intervals, typically annually. The benefit, from an estate planning perspective, is that if there are assets remaining in the GRAT after payment of the annuity amounts, the remainder passes to the Grantor’s selected beneficiaries gift tax free. The issue is that the preceding sentences of this paragraph tend to be representative of the entirety of a GRAT user’s (*i.e.*, a client’s) understanding of how GRATs work. All of that is, perhaps, a long way of getting to the fact that clients have a tendency to be a bit surprised with some of the tediousness that occurs in the creation and administration of a GRAT.

This paper will explore a series of selected topics, generally of administrative nature, that should be considered in connection with a GRAT transaction. The genesis of the topics or, at least, the basis for their selection, comes from the author’s experience in advising clients on GRAT strategies from both a seat as an attorney at a law firm and as a wealth advisor at a financial institution. The paper generally will describe the requirements of a GRAT and then discuss topics relating to the funding of a GRAT, determining the annuity amounts, making the annuity payments, the importance of grantor trust status for a GRAT, and strategies for maximizing the remainder of a GRAT transaction.

### II. IN GENERAL

Without overly burdening this paper with the history of and policy behind IRC § 2702, it merely will start with the proposition that IRC § 2702 exists. The purpose, at least in part, is to determine whether certain annuity interests are “qualified interests” and whether and how such annuity interests may be taken into account with respect to the transfer tax valuation of certain transfers in trust.

In general, when an individual makes a transfer in trust to a spouse, any ancestor or descendant of the individual or the individual’s spouse, any sibling of the individual, or any spouse of the foregoing and an interest in the trust is retained by the individual (or by the individual’s spouse, by a lineal descendant of the individual or the individual’s spouse, or by a spouse of any such lineal descendant) the retained interest is deemed to have a zero value. IRC § 2701(e)(1); IRC § 2702(a); Treas. Reg. § 25.2702-2(a)(1). This means that the entire value of the transfer in trust is

subject to transfer tax because no value is subtracted via the retained interest. However, when the retained interest is a “qualified interest,” the retained interest is deemed to have value based on an actuarial calculation determined under IRC § 7520 and such value is subtracted from the value of the transfer in trust to determine the amount of the gift. IRC § 2702(a)(2)(B). One such qualified interest is the right to receive fixed amounts payable at least annually. IRC § 2702(b)(1). These rights to receive fixed payments form the basic building blocks of the Grantor Retained Annuity Trust.

*Note: Other types of qualified interests include the right to receive amounts that are a fixed percentage of the fair market value of the property in trust (i.e., unitrust interests) and certain noncontingent remainder interests. See IRC § 2702(a)(2), (3). This paper will focus almost exclusively on fixed amounts payable (i.e., the retained interest in a GRAT) as opposed to unitrust and remainder interests.*

Treas. Reg. § 25.2702-3(b) mandates the following with respect to a qualified annuity interest:

1. A qualified annuity interest is an irrevocable right to receive a fixed amount. A fixed amount can be either a stated dollar amount or fixed fraction or percentage of the initial fair market value of the property transferred to the trust. In both cases, payment of the fixed amount must be made not less frequently than annually and the fixed amount for a particular year may not exceed 120 percent of the amount payable in the preceding year.
2. If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of Treas. Reg. § 1.664-2(a)(1)(iii) (relating to adjustments for any incorrect determination of the fair market value of the property in trust).
3. The annuity amount may be payable based on either the anniversary date of the trust or the taxable year of the trust.
4. An annuity amount based on the anniversary date must be paid no later than 105 days after the anniversary date. An annuity amount based on the taxable year of the trust must be paid no later than the date by which the trustee is required to file a federal income tax return without regard to extensions.
5. The governing instrument must prohibit additional contributions to the trust.

Treas. Reg. § 25.2702-3(d) mandates the following with respect to a qualified annuity interest:

1. The interest must be a qualified annuity interest in every respect.

2. A holder's qualified interest must be payable in any event to or for the benefit of the holder for the fixed term of the interest.
3. The governing instrument must prohibit distributions to or for the benefit of any person other than the holder of the annuity interest.
4. The governing instrument must fix the term of the annuity and the term of the interest must be fixed or ascertainable at the creation of the trust.
5. The governing instrument must prohibit commutation of the interest of the holder.

### III. FUNDING A GRAT

The governing instrument of a GRAT must prohibit additional contributions for the retained annuity to qualify as a qualified annuity interest. Treas. Reg. § 25.2702-3(b)(5). In practice, this means that all assets used to fund a GRAT should be transferred to the GRAT simultaneously, or, at least, on the same date. This mandate is often referred to as the "single date of funding requirement."

The single date of funding requirement seems fairly straight forward on its face – just transfer everything at the same time. Compliance would be relatively easy if all assets to be transferred to the GRAT could be controlled by a document that could be made effective as of a date certain (*i.e.*, like a partnership interest). However, when multiple disparate assets are involved or, more particularly, when multiple independent actors are responsible for transferring separate assets to a GRAT, breakdowns can occur. If more than one asset or more than one actor are involved in the funding of a GRAT, care should be taken and a plan should be developed to manage the GRAT funding to avoid a violation of the single date of funding requirement.

#### A. Financial Assets

A simple example of this issue can be demonstrated through the different types of financial assets that may be utilized in the funding of a GRAT. Perhaps a single publicly-traded equity position is the asset of choice. This type of transfer is relatively easy – a transfer agent can simply cause the transfer of all of the position simultaneously. Of course, this process becomes more difficult if multiple publicly-traded equity positions at multiple financial institutions are involved. Now, add in the fairly ubiquitous mutual fund. A mutual fund is typically organized as some sort of entity (corporation, partnership, or business trust) and is invariably subject to a re-registration process which can take days (or, sometimes, weeks). In short, the author wishes you good luck in coordinating the simultaneous transfer of multiple mutual funds directly to a GRAT.

#### B. "Pre-GRAT" Revocable Trust

One potential solution is creating a "pre-GRAT" revocable trust to hold assets until all assets have been received and then having the revocation power released or terminated to begin the GRAT. Effectively, the GRAT would be funded all at once at the time it becomes irrevocable and would seem to comply with the single date of funding requirement. This strategy would appear to provide a complete solution for GRATs of three year durations and longer. However, the "pre-GRAT" revocable trust strategy may need additional scrutiny with respect to GRATs of two year durations.

At least some, and often all, of the value of a GRAT during its unexpired term is includable in the estate of its Grantor. *See* Treas. Reg. § 20.2036-1(c)(2)(i). Upon expiration of the GRAT term, this mortality risk is extinguished. Thus, for a two year GRAT, the mortality risk generally is extinguished after two years.

The gross estate of a decedent includes interests over which the decedent relinquished a revocation power within three years of the decedent's death. IRC §§ 2035(a), 2038(a)(1). Transfers from a revocable trust are generally excepted from this treatment. IRC § 2035(e). Whether the termination of a revocable trust to begin or fund a GRAT is a "transfer" that qualifies for the § 2035(e) exception appears to be an untested proposition. This means there is risk that funding a two-year GRAT via the termination of a revocable trust could increase the period the GRAT assets would be includable in estate of the Grantor of the GRAT from two to three years. As such, practitioners may wish to consider whether there is additional mortality risk and whether it is worth the potential convenience of a "pre-GRAT" revocable trust.

#### C. Letters of Direction

Absent the "pre-GRAT" revocable trust or some other mechanism to ensure the funding date, it is imperative to understand the date on which securities or other financial instruments will be transferred. This process would seem to be easy enough – the Grantor's financial institution deducts the securities from the Grantor's account and adds them to a GRAT account. In that case, the transfer is typically reported as complete based on the withdrawal date noted on the Grantor's account statement.

Still, a Grantor may seek to find a way to unequivocally pinpoint the transfer date, particularly when multiple securities or transfer agents are involved. The regulations do provide that if a donor delivers a properly indorsed stock certificate to the donee or donee's agent, the gift is completed for gift tax purposes on the date of delivery (although, conversely, if the donor delivers the certificate to the bank or a broker as the donor's agent, or to the issuing corporation or its transfer agent, the gift is completed on the date the stock is transferred on the books of the corporation).

Treas. Reg. § 25.2511-2(h). It should not be too far of a leap to apply this regulation to the funding of a GRAT. The problem, of course, is that relatively few physical stock certificates remain in circulation.

A potential solution would be to effect a transfer by an irrevocable letter of direction delivered to the financial institution responsible for transferring the financial assets. When a securities intermediary receives an “entitlement order” it shall comply with the entitlement order if the entitlement order is originated by the appropriate person, the securities intermediary has had reasonable opportunity to assure itself that the entitlement order is genuine and authorized, and the securities intermediary has had reasonable opportunity to comply with the entitlement order. *See* Texas Business and Commerce Code § 8.507. An “entitlement order” means a notification communicated to a securities intermediary directing transfer or redemption of a financial asset to which the entitlement holder has a security entitlement. *See* Texas Business and Commerce Code § 8.102(a)(8).

The receipt of a letter of direction (that qualifies as entitlement order) could trigger a duty of compliance by the recipient financial institution. Thus, it would seem at least arguable that a transfer is complete when the direction letter is received by the financial institution even if further administrative tasks to effect the transfer occur sometime after receipt of the direction letter. However, the issue does not appear to have been fully tested. As such, caution should be used if an irrevocable letter of direction is being used to support the timing of the transfer date.

#### **D. Inadvertent or Prohibited Funding**

From time to time, inadvertent non-simultaneous fundings still occur. Some practitioners have taken the position that the additional funding was not properly accepted by the trustee and had the inadvertent contribution returned to the Grantor (frequently, the Grantor of a GRAT also serves as its trustee making this position potentially a bit dubious). Similarly, some practitioners treat the inadvertent contribution as a loan and subsequently document the transaction as such. It does not appear either of these remedies has been fully tested.

##### 1. Contribution to New GRAT

One potential solution to avoid violating the single date of funding requirement would be to include language in the GRAT agreement treating any additional funding as a contribution to a new and separate GRAT governed by the same terms as the initial GRAT. While the new GRAT may have differing gift tax consequences (for example, if the second funding occurred in a month with a different § 7520 rate), at least the value of the gift could be minimized to some extent.

##### 2. Use of Partnership or LLC

Another potential solution would be to fund a partnership or LLC with the assets, wait for all of the assets to settle, and then transfer the entity to the GRAT via a transfer agreement with an effective date certain. This strategy would seem to avoid any non-simultaneous funding issues. However, practitioners would need to pay attention to the valuation of the entity, particularly if partial entity interests are utilized to make required annuity payments. Also, clients may not appreciate the additional complication (and, perhaps more importantly, expense) of the extra entity or entities on their organization chart.

##### 3. Statements

Finally, as a general point of best practice, it is wise to obtain the first statement available subsequent to any funding. Doing so at least provides the maximum amount of time to implement any available remedial measure.

#### **E. Trust Expenses**

Another potential prohibited contribution could occur if the Grantor pays expenses on behalf of the GRAT (or, more specifically, its trustee). While expenses related to the formation of a GRAT and the reporting of the Grantor’s initial contribution are appropriately allocated to the Grantor, expenses related to the annual income tax reporting for the GRAT, the valuation of GRAT assets, and the determination of the amount of and the causation of the annuity payments may be more appropriately allocated to the GRAT trustee and, therefore, paid by the GRAT. Care should be taken to monitor and track all ongoing expenses to avoid a violation of the single date of funding requirement.

#### **IV. CALCULATING THE ANNUITY AMOUNT**

Certain types of assets may be subject to various transfer requirements which potentially cause a delay in the transfer of their legal title. *See* III, A *supra*. Such delays can become problematic in GRAT transactions particularly in instances when a transfer is initiated in one month but is not completed until the next. If the GRAT agreement mandates a sum certain or percentage certain payment based on the then current IRC § 7520 rate, a completed transfer in a following month could result in an increase in the amount of the gift portion if the IRC § 7520 rate increases.

Many GRAT agreements include language that avoids writing in the sum certain or percentage certain by defining the required payment as the amount necessary to reduce the gift portion to a desired number (or zero) based on the IRC § 7520 rate for the month of funding. Another method would be to write in a mathematical formula. One such example is as follows:

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

This formula provides the annual payment necessary to fully zero out a two-year GRAT with level payments in each of its two years. In the formula above, the Funding Amount would be defined as the value of the property transferred to the GRAT and the § 7520 Rate would be defined as the rate in effect for the month of funding. This formula could easily be adapted for increasing payments, longer terms, or different remainders. A proof is provided in [Appendix A](#).

## V. PAYMENT OF ANNUITIES

Luckily, there is not a requirement to pay a GRAT annuity at one time or on a single date. Partial payments may be made over time. However, the transfer of non-cash assets can experience delays similar to those experienced in funding a GRAT. Those delays will not be rehashed here.

There are other challenges in using non-cash assets to make annuity payments, particularly when financial assets are involved. One issue involves transferring assets from a securities account when less than all of the securities will be transferred. A second involves the valuation of the securities used to make the annuity payment. A third involves managing the annuity payment when there is little or no cash in the GRAT account.

### A. Security Accounts

If only one security is involved in the payment of an annuity, the mechanics can be fairly easy. Choose the number of shares needed to make the payment and have them transferred. However, many securities accounts and investment strategies involve multiple (perhaps hundreds) of shares of stock in different companies. That scenario presents additional challenges.

The first issue is the division of the account. As an example, a GRAT may hold a \$100,000 securities account and owe a \$50,000 annuity payment. In that case, it would be tempting to assume that 50 percent of the account (or each security in the account) could be used to pay the annuity. However, it may not be possible to do that if there are not even numbers of each different security. As such, the Trustee of the GRAT often has to become far more involved in picking and choosing the securities used to fund the annuity payment.

The next issue is rebalancing. The Trustee could choose to use uneven percentages of the securities held in the account (e.g., all of security X and none of security Y). However, for certain managed accounts, doing so could trigger an automatic sale of some of the remaining securities to repurchase the securities that were transferred to the Grantor. This type of rebalancing can cause unintended income tax consequences. As such, the Trustee should make sure

to fully understand the consequences of all security transfers before the annuity payment is made.

### B. Valuation

A further issue is knowing how many shares to transfer. Generally, the gift tax value of shares of a publicly traded company is the mean between the highest and lowest selling price on the date of the gift. Treas. Reg. § 25.2512-2(b). However, the data to determine the highest and lowest selling price may not be readily available until the following day. In short, it can be difficult to determine valuation in real time which in turn makes it difficult to determine the amount of shares that need to be transferred.

A formula clause could be employed that causes the transfer of the number of shares as is equal to a sum certain. Again, such a clause could work well if only one security is the subject of the transfer. Where multiple securities are involved, drafting such a formula clause becomes far more difficult. Where numerous securities are involved, it often becomes necessary to make annuity payments in smaller tranches.

### C. Annuity Payment True-Ups

In practice, when a securities account is involved, making the annuity payment can be a two-step of sorts. When there is some available cash in the GRAT, the Trustee could select securities that the Trustee anticipates will have a value that is a large percentage of (but not greater than) the annuity due and have those securities transferred to the Grantor. On the day following the initial partial payment (once final market quotations are available), the Trustee could value the assets transferred and then determine the amount of the annuity remaining. If there is enough cash in the GRAT, the remaining annuity amount could be paid in cash (which avoids having to use additional assets for which some form of valuation is necessary).

If, however, the GRAT does not have any cash, and if it is not prudent to sell assets to raise cash, the Trustee may have to slightly overpay the Grantor in securities. Again, the securities would be transferred and then valued the following day. Any overpayment in value to the Grantor would need to be repaid in cash by the Grantor to the GRAT.

## VI. GRANTOR TRUST STATUS

It seems generally accepted that a GRAT is a grantor trust during the GRAT term. Some investigation of this issue, however, is likely warranted.

### A. Section 673

Under IRC § 673(a), a “grantor shall be treated as the owner of any portion of a trust in which [the grantor] has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds [five]

percent of the value of such portion.” Regulations under IRC § 673 exist; however, they were issued prior to the enactment of the current version of the statute (which implemented the five percent test). The I.R.S. has privately ruled that a reversionary interest that exceeds five percent in the corpus creates a wholly grantor trust. *See* PLR 9152034 and PLR 9519029; *see also* Treas. Reg. § 1.671-3(b)(3) (if grantor is treated as the owner of a portion of a trust due to a reversionary interest in corpus, both ordinary income and income allocable to corpus are included in that portion) (but also promulgated prior to current IRC § 673). However, in absence of further regulatory authority, it may be prudent to rely on other provisions to confirm grantor trust status.

### B. Section 677

Under IRC § 677(a), a grantor “shall be treated as the owner of any portion of a trust, whether or not [the grantor] is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor’s spouse [or] held or accumulated for future distribution to the grantor or the grantor’s spouse[.]” The I.R.S. has privately ruled that a GRAT was a wholly grantor trust where, pursuant to the GRAT agreement, annuity payments were made from both income and principal (where income was insufficient). *See e.g.*, PLR 200001015, PLR 9504021 (ruling issued without regard to additional power of substitution), PLR 9451056, and PLR 9448018. Perhaps, by itself, or combined with IRC § 673, this authority would provide more comfort treating a GRAT as a wholly grantor trust.

### C. Section 675

Under IRC § 675 (flush language) and IRC § 675(4), a grantor “shall be treated as the owner of any portion of a trust in respect of which”...“a power to reacquire the trust corpus by substituting other property of an equivalent value” may be exercised “in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity” (the so-called “power of substitution”). Practitioners frequently grant a power of substitution as a basis (and, in many instances, the sole basis) to create a wholly grantor trust. Perhaps this is unnecessary based on some of the rulings under IRC § 677(a) discussed at VI, B *infra*. However, it may seem prudent, as a “belt and braces” approach, to provide an additional grantor trust trigger.

### D. Post-GRAT Term

Perhaps more important is the status of a GRAT as a grantor trust after the expiration of its term. Since a GRAT annuity cannot be commuted, the final annuity amount necessarily must occur after expiration of the

GRAT term. *See* Treas. Reg. § 25.2702-3(d)(5). Rarely is enough cash available to fully fund the final annuity. To avoid sale or exchange treatment upon payment of the final annuity with non-cash assets, grantor trust treatment subsequent to the expiration of the GRAT term should be confirmed.

Frequently, the remainder of a GRAT passes in further trust which also can be designed as a grantor trust (typically via a power of substitution under IRC § 675). By retaining a grantor trust trigger beyond the GRAT term, the GRAT is likely in the best position to avoid sale or exchange treatment on any payment of an annuity.

But what happens if the GRAT remainder passes outright to an individual taxpayer? Typically, the power of substitution ends upon the expiration of the GRAT term rendering it inapplicable post-GRAT. In that event, outright remainder beneficiaries (who certainly are not entitled to grantor trust status) would be totally reliant on an argument that grantor trust status does not terminate during the winding up phase of the GRAT (and would be reliant on § 677 absent a continuing substitution power) to avoid sale or exchange treatment on the payment of the final annuity with non-cash assets. Frequently, in these cases, a hold-back trust, which includes a power of substitution and does not terminate for some portion or all of the annuity payment period, is included to avoid income taxation on the payment of the annuity. *See* Treas. Reg. § 25.2702-3(b)(4) (105 day grace period to make annuity payment).

## VII. CAPTURING GAINS AND RE-GRATTING LOSSES

After a GRAT is funded, the assets of the GRAT typically begin to change in value. Depending on the volatility of the assets, that change could occur overnight or could slowly occur over weeks or months. Of course, the Grantor of the GRAT is hoping for an increase in excess of the IRC § 7520 rate so that a remainder will be produced for the GRAT remainder beneficiaries. If the assets increase quickly, the Grantor may wish to lock in any gains so that future decreases in market value do not reduce the amounts that otherwise would pass to the remainder beneficiaries. Conversely, if assets perform poorly, the Grantor may wish to be able to use those assets in a new GRAT transaction that begins with the new lower value for those assets.

### A. Exercise of Power of Substitution

One method to lock in gains (or retrieve underperforming assets) is to have the Grantor transfer to the GRAT personal lower volatility assets in exchange for some or all of the assets held by the GRAT (this method is sometimes described as “immunizing” a GRAT). The transfer could take the form of an exercise of a power of substitution (if one was retained by the Grantor) or a more traditional purchase and sale

between the Grantor and the GRAT. Typically, the transaction would involve a transfer of the Grantor's bond portfolio in exchange for an equity portfolio held in the GRAT.

### B. Example: Significant Decrease in Value

For example, assume the Grantor creates a two-year zeroed-out GRAT and transfers to it a \$1 million equity portfolio. The GRAT is created when the § 7520 rate is 10 percent and calls for level annual payments of \$576,191. Within the first year of the GRAT, asset values decrease by 20 percent leaving \$800,000 on the first annuity date. After the first payment, \$223,809 remains in the GRAT. At that point, in order to return any value to the remainder beneficiaries, the assets would need to increase by more than 150 percent before the next annuity payment date. Under most scenarios, it would be highly unlikely for the GRAT to be successful. As such, the Grantor may wish to receive the remaining equity in exchange for bonds or cash and try again. Of course, the Grantor could wait until the next annuity date to receive the assets. However, if asset values do rebound, the first \$352,382 of increase would not provide any benefit to the GRAT remainder beneficiaries.

### C. Substitution of Promissory Note

The "immunization" transaction described above is only available to those Grantors with a sufficient quality and quantity of assets to complete the exchange. If the Grantor's portfolio does not have the quantity of low volatility assets (again, typically bonds) to complete the transaction, other avenues to acquire the remaining GRAT assets would need to be sought.

One method could be to substitute a promissory note from the Grantor for the assets of the trust. By using a promissory note, the Grantor would be able to regain access to the assets (for use in a new GRAT transaction) without the need to have cash, bonds, or other assets to complete the swap. Although not in the context of a GRAT, fiduciary concerns have been raised about this type of transaction. *See In re Condiotti*, 14CA0969 (Colo. App. 2015) (unpublished) and *Benson v. Rosenthal*, 2016 WL 2855456 (E.D. La. 2016).

In the *Condiotti* case, Condiotti created a trust for his minor child and retained a power of substitution with respect to the assets of that trust. The terms of the trust mandated that adequate interest and adequate security be provided with respect to any borrowing of trust property. Condiotti attempted to exercise the power of substitution and substitute a promissory note for the entire value of the trust's corpus. The trustees rejected Condiotti's attempted exercise of power of substitution on the basis that purported exercise was rather an attempt to borrow trust property in contravention of the trust agreement and that the promissory note was not of equivalent value to the property to be substituted out of

the trust. The Probate Court agreed with the trustee on both arguments. The Colorado Court of Appeals affirmed the Probate Court decision and agreed that the purported exercise of power of substitution would have constituted a loan (and thus did not need to reach a decision on whether values were equivalent).

In the *Benson* case, the Court of Appeals for the Eastern District of Louisiana reached the opposite conclusion on similar, but perhaps distinguishable, facts. Benson also had created a trust and retained a power of substitution. Loans were allowable to Benson upon terms and conditions deemed appropriate by the trustee. Benson attempted to exercise the power of substitution by substituting certain land, debt forgiveness, and a promissory note in exchange for the assets of the trust. The trustee rejected the exercise on the basis that the promissory notes were unsecured and thus not a proper trust investment. Benson then granted a security interest in the substituted assets to fortify the proffered exchange. Again, Benson was rejected. Benson brought suit to enforce the exercise of power of substitution and, in connection therewith, included a valuation of the assets prepared by a third-party appraiser. The Court of Appeals distinguished the *Condiotti* case on the basis that assets in addition to the promissory note were included in the exchange and that the notes were both secured and bore adequate interest (based on the appraisal). As such, the Court of Appeals ruled in favor of Benson.

While both *Condiotti* and *Benson* are both fairly fact specific, they do at least tend to indicate that an attempted exercise of a power of substitution where the Grantor returns a promissory note as either partial or full value of the substituted assets may be subject to scrutiny. As such, the valuation of any promissory note substituted and whether such a transaction meets the parameters of any retained power of substitution and the trust agreement should be considered before engaging in this type of transaction.

### D. Short-Term GRATs

The use of short-term GRATs is a method to mitigate potential volatility. If the GRAT assets appreciate at the beginning of the term, a GRAT with a short term will provide less time for the gains to reverse. Conversely, if the GRAT assets decrease at the beginning of the term, a GRAT with a short term will return the assets via annuity payments to the Grantor more quickly permitting a speedier re-GRAT turnaround time.

In some respects, this dynamic begs the question of what is the required minimum term for a GRAT. The definition of qualified interest includes the requirement that the interest consist of the right to receive fixed *amounts* payable not less frequently than annually. IRC § 2702(b)(1). This requirement leads many practitioners to avoid GRATs of less than two-year

durations (or, at least, pushes them to use GRATs with greater than one year durations). This is true even though payments may be made more frequently than annually (so perhaps multiple payments could be made within the same year and meet this prong of the qualified interest definition). Treas. Reg. § 25.2702-3(b)(3). Regardless, certainly a GRAT requiring at least one payment per year for two or more years should meet the definition of qualified interest. And, perhaps, a one-year GRAT with a single annual payment does not meet the definitional requirements. One solution could be to use a term just slightly longer than one year (e.g., 366 days) which at least allows for multiple payments over multiple years. See *Kerr v. Commissioner*, 113 TC 449 (1999), *aff'd*, 292 F. 3d 490 (5<sup>th</sup> Cir. 2002) (366 day GRAT was not challenged by the IRS).

### E. Declining Payment GRATs

For those wanting to avoid the perceived risk of a less than two-year GRAT, a similar result could be achieved through a payment structure that has a high first year payment and low second year payment. While there is a prohibition on increasing the annuity amount by more than twenty percent annually, there does not appear to be any prohibition on decreasing the annuity by any amount from year to year. See Treas. Reg. § 25.2702-3(b)(1)(ii). Thus, as an extreme example, it may be possible to structure a two-year GRAT with ninety-nine percent of its annuity payments due at the end of year one and the remaining one percent due at the end of year two.

#### 1. Example: 99%/1% GRAT

Assume a two-year zeroed-out GRAT is funded with \$1 million at the time the § 7520 rate is 10 percent. To achieve the 99/1 ratio for the first and second year payments, the first year annuity would be \$1,089,991 and the second year annuity would be \$11,010. If, in the first year of the above example, the GRAT did not return almost 9 percent, all of the GRAT assets would return to the Grantor as part of the year one annuity payment. That scenario would allow the Grantor to fully re-GRAT the GRAT assets much more quickly.

#### 2. Example: Poor Year One Returns

Further assume a 5 percent rate of return in year one. The GRAT would have \$1,050,000 at the end of year one all of which would be repaid to the Grantor. Compare that example to the a level payment GRAT with otherwise the same terms. The GRAT would pay \$576,191 back to the Grantor leaving \$473,809 in the GRAT. Since the year two payment is the same, this means that the first \$102,382 of growth would continue to accrue to the benefit of the Grantor and not the Grantor's beneficiaries. So in order for that GRAT to be successful, the assets would need to grow approximately 21.6 percent over the next year. That is

not impossible, but it also is not highly likely. By getting the assets back to the Grantor and allowing the Grantor to re-GRAT the assets, the potential growth has a much better chance of benefiting the Grantor's beneficiaries.

#### 3. Example: Strong Year One Returns

The same structure also has the potential to lock in the return from a great first year. Assume that the first year rate of return is 20 percent. Following the example above, the GRAT would have \$1,200,000 at the end of year one. \$1,089,991 would be repaid to the Grantor, leaving \$110,009 in the GRAT. However, the remaining annuity payment would be only \$11,010 meaning the GRAT assets would need to decline almost 90 percent to lead to an unsuccessful GRAT. The successful GRAT would be almost virtually assured at that point.

In a level payment structure, \$576,191 would be repaid out of the \$1.2 million leaving \$623,809 with a \$576,191 payment remaining. In that case, a just over 7.6 percent drop in the value of the GRAT assets would cause the transaction to be unsuccessful. That scenario is far more likely than a 90 percent decline.

#### 4. Potential Downside

The primary downside financial risk occurs when interest rates are rising. If asset values always continue to rise, less of the excess return from re-GRAT assets will accrue to remainder beneficiaries of a GRAT if the IRC § 7520 rate increases year over year. However, in a flat or decreasing interest rate environment, where asset values continue to rise, the return to the beneficiaries should be no worse in a high first year payment GRAT as compared to a level payment GRAT.

### VIII. CONCLUSION

The basic design of a GRAT transaction may seem fairly simple. However, the process of moving assets into a GRAT at funding and out of a GRAT at the time of an annuity payment can be quite cumbersome, especially when financial assets are involved. Grantors and their advisors should be well informed of some of these issues to manage expectations for the process.



## APPENDIX A

## FORMULA PROOF

The remainder at that end of the first year of a zeroed-out two-year GRAT would be calculated as follows:

$$FA + (\text{Rate} \times FA) - \text{PMT} = \text{EOY1}$$

OR

$$[(1 + \text{Rate}) \times FA] - \text{PMT} = \text{EOY1}$$

The remainder at the end of the second year of a zeroed-out two-year GRAT would be calculated as follows:

$$\text{EOY1} + (\text{Rate} \times \text{EOY1}) - \text{PMT} = 0$$

OR

$$[(1 + \text{Rate}) \times \text{EOY1}] - \text{PMT} = 0$$

Combining these equations and solving for the required payment yields the following:

$$[(1 + \text{Rate}) \times [(1 + \text{Rate}) \times FA] - \text{PMT}] - \text{PMT} = 0$$

$$(1 + \text{Rate}) \times [(1 + \text{Rate}) \times FA] - \text{PMT} = \text{PMT}$$

$$(1 + \text{Rate}) \times (1 + \text{Rate}) \times FA - (1 + \text{Rate}) \times \text{PMT} = \text{PMT}$$

$$(1 + \text{Rate}) \times (1 + \text{Rate}) \times FA = \text{PMT} + [(1 + \text{Rate}) \times \text{PMT}]$$

$$(1 + \text{Rate})^2 \times FA = \text{PMT} + \text{PMT} + (\text{PMT} \times \text{Rate})$$

$$(1 + \text{Rate})^2 \times FA = 2\text{PMT} + (\text{PMT} \times \text{Rate})$$

$$(1 + \text{Rate})^2 \times FA = (2 + \text{Rate}) \times \text{PMT}$$

$$[(1 + \text{Rate})^2 \times FA] / (2 + \text{Rate}) = \text{PMT}$$

### Variables

FA = Funding Amount

PMT = Annual Annuity Payment

Rate = § 7520 Rate for Month of Funding

