

Enhance Your Estate Planning: Diversification, GRATs and Putting in One Egg per Basket!

by Mark R. Parthemer, Esq.

Abstract: We find out how one can structure and manage GRATs to allow for a successful wealth transfer without the need for skyrocketing growth, thus enabling more mundane assets, such as publicly traded stocks, to be effective GRAT assets. The secret? Isolating assets within GRATs to expose their raw volatility and then capturing that volatility through the power of substitution.

If you had funded a two-year GRAT with \$1 million of International Paper stock on 11/1/2007 and “let it ride,” the GRAT would have failed (stock price went from \$35.42 to \$22.31). However, had you swapped in bonds on 3/6/2009 (\$4.09) and contributed the depressed valued IP stock into a new GRAT, by 10/30/2009, the IP shares rebounded to \$629,878, putting the GRAT “ahead” by over \$500,000. Same stock, same strategy—one a significant winner, one a clear loser.

Of course, this is using hindsight to pick a perfect example, but think about it. The primary goal of estate tax planning is to shift wealth from one generation to another. To that end, let’s focus on a specific form of integrating financial investment engineering to enhance the effectiveness of estate tax

planning strategies. Specifically, we will explore an often-used wealth-transfer device—the grantor retained annuity trust (GRAT). For good reasons, historically advisors have recommended clients fund GRATs with assets that might “pop” in value, such as pre-IPO stock. Below we find out how one can structure and manage GRATs to allow for a successful wealth transfer without the need for skyrocketing growth, thus enabling more mundane assets, such as publicly traded stocks, to be effective GRAT assets. The secret: isolating assets within GRATs to expose their raw volatility, and then capturing that volatility through the power of substitution.

Let’s attack this topic in four steps: 1) GRAT Basics, 2) Potential Law Change, 3) Diversification and GRAT Structure, and 4) The New Frontier—Managing GRATs to Capture Volatility.

GRAT Basics

A GRAT is an estate planning vehicle designed to transfer most of the future income and appreciation of assets that are given to the trust; that is, the income and appreciation on the assets in excess of the IRS-prescribed hurdle rate,¹ which was 3.2% for April 2010. A GRAT works as follows. A donor transfers assets to a GRAT and the donor receives “annuity payments” for a period of years (usually two years). The annuity payments can be set high enough so that the present value of the payments almost equals the value of

the assets contributed to the GRAT. The resulting difference is the taxable gift value and often is less than \$100. At the end of the GRAT term, any remaining assets pass to the donor’s family members without any gift tax. If the donor dies during the term, the remaining assets in the GRAT typically would be included in the donor’s estate for estate tax purposes.

A common way of structuring GRATs has been to establish a series of short-term “rolling” GRATs. For example, a donor creates a two-year GRAT. At the end of the first year, about one-half of the initial value contributed will be distributed back to the donor as the first annuity payment. The donor can then contribute the returned assets into a new two-year GRAT. One advantage of this strategy is that losses in one GRAT would not offset the gains in another. In addition, there is a lower actuarial risk that the donor will die before the end of a short-term GRAT.

Potential Law Change

As I write this column, the House of Representatives on March 24, 2010, has approved H.R. 4849, the Small Business and Infrastructure Jobs Tax Act of 2010 (the “Bill”). The Bill includes two significant changes to GRATs: 1) GRATs would be required to have a 10-year minimum term, and 2) declining payments in GRATs will not be permitted.

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By requiring a 10-year minimum term, the Bill would change the common two-year rolling GRAT approach. It is likely that fewer GRATs will be implemented because of the obviously increased risk of the grantor dying during the term and because donors may be more cautious about assets being “tied up” in the GRAT for a much longer period of time. Finally, the prohibition on declining payments forecloses an idea discussed by some commentators: to provide steeply declining annuity payments during the 10-year term so as to effectively make a 10-year GRAT “act” like a short-term GRAT by emptying it out in the early years.

No one can predict exactly when or if the Bill will become law. However, if the Bill becomes law in its current form, these changes would become effective for any GRAT created after the date of the enactment. Thus, clients may have only a limited window of time during which to create a GRAT using the existing rules.

Diversification and GRAT Structure

Manage Risk, Not Return

The adage: “Don’t put all of your eggs in one basket!” captures the wisdom that concentrated investments unnecessarily expose investors to risk. Risk to an investor is a reflection of the expansiveness of the band within which the trading value of an asset fluctuates—the wider the spread between the potential highs and lows, the greater the risk of selling at a low price. Such risk is referred to as “volatility.”

Risk is not a statistical abstraction. Unfortunately, investors and planners often focus solely on measuring return.

Return is a consequence over which the investor has little or no control; what the investor can manage is risk. Think of it this way: Would you rather your 401(k) have a 10% chance of a 50% loss in value, or a 50% chance of a 10% loss? Let’s highlight this point another way. Suppose you were an attorney with a passion to teach, and you determined you would leave the practice of law and teach full time as soon as your investment account was worth \$1 million. The day your account hits this prized target, a prodigal billionaire offers you a legitimate flip of a coin: heads, she will give you \$10 million; tails, you give her your \$1 million. A silly wager on her part, no doubt. But, your decision will encompass far more than just the 50/50 odds of your being a winner. You will intuitively and immediately grasp the huge volatility of the potential return, i.e., 50% chance of an entire loss. After all, your long-deferred passion to teach, now realizable, hangs in the balance.

One also quickly will recognize the impact of path dependency. That is, an investment may achieve a certain return, but the pathway it takes to get to that return is critical. Here is another test: Would you rather invest in a portfolio that averages 8% or one that averages 10%? The answer, like the old riddle of how can one drown in a body of water that averages only 6

inches in depth, requires pausing to consider what average means (pun intended). For investors, average return ignores that which cannot be ignored, the volatility of interim performance.

Amazingly, differing returns can generate virtually equivalent value, and equivalent returns can generate vastly disparate results. Table 1 highlights (1) how an investment that earns 8% every year returns the same value as a 10% growth rate with the volatility of 21%, which approximates that of the typical stock in the S&P 500, and (2) how two investments with the same 10% return can have significantly different ending values.

But Why Is Diversification Counterproductive for GRATs?

Diversification is both fundamentally prudent and deceptively simple in concept.² It is in part achieved by owning a basket chock full of uncorrelated investments. Doing so dampens volatility by minimizing the spread between the ups and the downs. The impact of combining uncorrelated assets is to, on balance, narrow the band between the portfolio’s peaks and troughs.

Recall that, in essence, assuming the grantor survives the term, what transfers to beneficiaries of nearly zeroed-out GRATs is investment performance in excess of the 7520 rate. We know diversification is prudent, largely because it reduces various forms of investment risk, including moderat-

TABLE 1

Return & Volatility	Initial Investment	Ending Value 10 Years	Ending Value 30 Years	Ending Value 50 Years
8%, 0%	\$1,000,000	\$2,192,440	\$10,538,610	\$50,656,929
10%, 21%	\$1,000,000	\$2,192,448	\$10,538,721	\$50,657,826
10%, 0%	\$1,000,000	\$2,593,742	\$17,494,402	\$117,390,853

ing volatility. While this is a positive benefit to mitigate losses, it likewise mutes gains of the highest performing components, thus making diversification anathema to GRATs.

Of course, this inherent tension does not make diversification wrong or even bad; analytics prove value in diversification. However, it doesn't necessarily follow that each "pot" of your investments must be an exact microcosm of your entire asset allocation. Instead, concentrated, correlated, or sector positions within separate GRATs increase the likelihood of more wealth transfer. This can be achieved without forfeiting the benefit of diversification by using multiple GRATs, perhaps one for each stock or asset class.

This example illustrates this point. Assume it was possible to do a one-year³ nearly zeroed-out GRAT, with a 4% 7520 rate and two stocks, each worth \$5 million. During the year Stock A increases 20% to \$6 million from \$5 million, and Stock B decreases 20% to \$4 million from \$5 million.

- **Option 1—"Diversified" GRAT: If Stock A and Stock B are in the same GRAT, the GRAT will fail and no wealth transfers.** This is because \$10.4 million (funding value plus the 7520 rate) must be returned to the grantor at the end of the year to achieve zeroed-out status. However, the portfolio is worth only \$10 million. Thus, no wealth transfers and so the GRAT failed.
- **Planning Option 2—Separate GRATs: If Stock A and Stock B are contributed into separate GRATs, then \$800,000 transfers gift, estate, and income tax free!** This is because GRAT #1 with Stock A shares worth \$6 mil-

lion returns \$5.2 million to the grantor, leaving \$800,000 to heirs. GRAT #2 with Stock B fails (all is returned to the grantor). Yet, by having separate GRATs, the deficit in GRAT #2 does not diminish the positive performance in GRAT #1. Further, there is no downside tax risk with nearly zeroed-out GRATs. If the assets underperform the 7520 rate, they return to grantor without tax penalty.

Almost every investor recognizes the inherent benefit of diversification. The lesson here is that for GRATs and other estate tax planning strategies, each technique can be funded with a concentrated part of the overall diversified portfolio. The result is to maintain the protection of diversification on the entire investment allocation, yet take advantage to the upside potential of concentration. In other words, by isolating the components of a diversified portfolio and funding segments into separate GRATs, each separate GRAT will have a higher alpha that will not be offset by the other segments.

So, it remains prudent for investors to avoid putting all of their eggs in one basket. When funding GRATs, however, more wealth likely will transfer tax free to children or other beneficiaries by placing the investment "eggs" into separate GRAT "baskets."

The New Frontier—Managing GRATs to Capture Volatility!

"Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."

—Winston Churchill

Now that this structural concept has been embraced and mastered, it opens the door to more sophisticated

management of GRATs. As we all know, GRATs permit income-tax free substitution of assets by the grantor, so long as they are of equivalent value.

An exciting and powerful next step is to take further advantage of the volatility of the now "separate asset GRATs" by capturing interim swings in asset values. An approach I support is to set a range when funding a GRAT. The range is typically one standard deviation of an asset's expected volatility. Next, vigilantly monitor the GRAT assets.⁴ Any time the asset's value is outside one standard deviation, consider substitution to "lock in" gains or "get a fresh start" off a downturn.

For example, assume the expected range of value on a \$5 million position is between \$4.2 million and \$5.8 million, but during the GRAT term (say within 6 months of funding), the stock shoots to \$6 million. It might be wise to swap out the stock to "lock-in" the \$1 million gain (and re-GRAT if there is belief that the stock has more room to move up). By doing so, the \$1 million of growth can be protected against potential decline or reversion to the mean. In addition, re-GRATing the stock will be almost seamless unless the 7520 rate has changed dramatically (or there has been a law change). So, the gain from the interim outsized return can be "taken off the table" without hampering future additional success and without exposing the GRAT to any "give back."

With one client, for example, we funded some GRATs in 2008. Over the next two years, the markets went down (radically), and came roaring back. Had we simply left the GRATs alone, they would have failed. However, by fortuitous substitutions throughout, each

GRAT transferred almost 50% of the original funding value.

The fun doesn't stop with substitution, of course, as there is value to tailoring the investment orientation of the substituted assets given their role and the type of trust in which they are held. It can be as simple as when a stock has outperformed expectation, substituting for it with bonds or a fixed-income portfolio. The gain should be protected through management of the swapped-in bonds. Further, often clients are holding municipal bonds. While the number one goal will be to preserve value, since the GRAT is a grantor trust for income tax purposes, one next can determine whether the yield be enhanced by introducing, say, taxable bonds, with-

out increasing volatility.

The opportunity is that the client's entire team of wealth advisors—the attorney, CPA, insurance and financial advisor—together can take a wonderful strategy and make it even more effective to the ultimate goal of any such planning—efficient transfer of wealth from one generation to another. ■

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(1) The 7520 rate, which is 120% of the midterm AFR, rounded to the nearest two tenths of 1%.

(2) Many very smart, highly educated professionals will no doubt cringe at this oversimplification; divining correlations to construct a portfolio is sophisticated work.

(3) Even under the current law, GRATs must be for a term of more than one year.

(4) This GRAT program results in many GRATs, so my firm has designed a proprietary software program to monitor asset values. It sends an e-mail alert when a stock's price is outside the determined range.