AQR Quick Clips Q&A

Estate Tax Planning and GRATs

Grantor Retained Annuity Trusts (GRATs) are a popular way for U.S. taxable investors to transfer wealth to the next generation. Hear from AQR's Portfolio Solutions Group and Specialized Investments Group on the benefits of these estate planning tools, as well as potential ways to maximize their efficiency. To learn more about AQR's approach to tax aware investing, visit aqr.com/tax.

What is a GRAT, and how does it work?

A GRAT is an estate tax planning tool used to transfer assets to beneficiaries in an estate-tax-efficient manner. The Grantor, a taxable investor, contributes assets to a GRAT with the goal of seeing these assets appreciate over the life of the GRAT. Any assets remaining in the GRAT after the Grantor receives all the statutory annuity payments are transferred from the GRAT to the Grantor's beneficiary without incurring gift tax. The beneficiary can be a person or a trust. Note that if the assets in the GRAT fail to appreciate enough to overcome the stream of annuity payments, no transfer will occur, and the assets will be returned to the Grantor through the annuity payments. If a transfer does occur, the transferred assets will be outside of the Grantor's estate and will not be subject to future estate tax.

GRATs address the burden of estate taxes and thereby increase estate-tax-efficiency. However, it is important for investors using GRATs for estate tax planning to also consider the role of income tax efficiency. A GRAT does not pay taxes on gains and income generated by its underlying assets. Rather, the Grantor is responsible for these taxes. So, while income tax burden does not directly reduce the value of the GRAT assets, it reduces the wealth of the Grantor and, therefore, the total amount of wealth he or she is able to ultimately transfer to the descendants.

How can taxable investors maximize the efficacy of a GRAT?

1. *Shorten the length of the GRAT term:* Drawing an analogy to baseball, each GRAT represents one "at bat," or opportunity to score. Shorter-term GRATs create more at bats, or opportunities to transfer wealth.

2. *Increase the volatility of the investments in the GRAT*: Higher volatility increases an upside and, therefore, the amount of wealth ultimately transferred to the beneficiary.

3. *Contribute distinct assets into separate GRATs:* Lowly correlated assets tend to appreciate and depreciate at different times which increases the chances that at least some of the GRATs will be enjoying an upside.

4. *Invest in assets that are income-tax-efficient*: GRATs directly address the burden of estate taxes. However, AQR research has shown that the magnitude of tax savings from income and estate tax planning can be similar. The Grantor can potentially preserve more wealth by becoming tax efficient with respect to both income tax and estate tax.

What types of investments might work best in a GRAT?

Single name stocks, tax inefficient hedge funds, and other volatile but correlated asset classes, like private equity and venture capital, may not be ideal investments for GRATs. However, tax-efficient, lowly-correlated, high-expected-return hedge funds can be helpful in designing an optimized GRAT approach. Contact the AQR U.S. Wealth Group to learn more about GRAT design or about finding potential opportunities to improve the transfers of an existing portfolio.

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A Grantor Retained Annuity Trust may be referred to as a GRAT in this presentation. AQR does not establish GRATs nor does AQR currently manage assets in GRATs or any GRAT methodology described in this presentation for external investors. There is no guarantee that any of the approaches described in this presentation will be successful. All information shown is based on hypothetical simulations and not actual investments or GRATs. AQR does not provide tax advice or estate planning and does not establish or maintain GRATs. In considering this material, please work with a tax advisor before making any decisions.

Risks of Tax Aware Strategies (Not Exhaustive)

1. *Underperformance of pre-tax returns*: tax aware strategies are investment strategies with the associated risk of pre-tax returns meaningfully underperforming expectations.
2. *Adverse variation in tax benefits*: deductible losses and expenses allocated by the strategy may be less than expected.
3. *Lower marginal tax rates*: the value of losses and expenses depends on an individual investor's marginal tax rate, which may be lower than expected for reasons including low Adjusted Gross Income (AGI) due to unexpected losses and the Alternative Minimum Tax (AMT).
4. *Inefficient use of allocated losses and expenses*: the tax benefit of the strategy may be lower than expected if an investor cannot use the full value of losses and expenses allocated by the strategy to offset gains and income of the same character from other sources. This may occur for a variety of reasons including variation in gains and income realized by other investments, at-risk rules, limitation on excess business losses and/or net interest expense, or insufficient outside cost basis in a partnership.
5. *Larger tax on redemption or lesser benefit of gifting*: gain deferral and net tax losses may result in large recognized gains on redemption, even in the event of pre-tax losses. Allocation of liabilities should be considered when calculating the tax benefit of gifting.
6. *Adverse changes in tax law or IRS challenge*: the potential tax benefit of the strategy may be lessened or eliminated prospectively by changes in tax law, or retrospectively by an IRS challenge under current law if conceded or upheld by a court. In the case of an IRS challenge, penalties may apply.

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