



Lowenstein Sandler's Trusts & Estates Podcast: Splitting Heirs

**Episode 23:
Putting the Gratitude in GRATs—
Understanding the Financial Planning
and Psychological Effects of This and
Other Tax Saving Ideas**

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Warren Racusin: What do Donald Trump, Michael Bloomberg, Mark Zuckerberg, and Jeffrey Epstein all have in common? The answer, of course, is that they've all created grantor retained annuity trusts. From the law firm, Lowenstein Sandler, this is *Splitting Heirs*. I'm Warren Racusin, and I know what you were all thinking, but this is a family podcast, so please get your heads out of the gutter.

Well, while we're shamelessly dropping names here, let's talk about Laurene Powell Jobs, widow of Apple founder Steve Jobs. Powell Jobs is called dangerous for a society, the early 20th century fortunes of the Mellons, Rockefellers, and others. I'm not interested in legacy wealth building, and my children know that, she told the New York Times some time ago. "If I live long enough, it ends with me." Except for the series of grantor retained annuity trusts, GRATs, she used to pass on around \$500 million estate tax-free to her children, friends, and other family, according to tax records and published reports.

By using the GRATs, she avoided at least \$200 million in estate and gift tax. Now, her lawyer did say that the game plan is for her kids to use the dough from the GRAT to pay the estate taxes on nostalgic assets that they will also inherit. Including art and their 260-foot yacht, the Venus. So, her kids will at the end of the day be down to their last \$300 million or so, plus the yacht, etc. So, for all of you trying to figure out how to get money to your kids to pay estate tax on your yachts, let's talk about these GRATs. But let's also talk about what inheriting these vast sum does to the people who get them. Is it good for their psyches, bad, or some combination? What impact does the receipt without having worked for it of enormous wealth have on these folks?

Fortunately, we have with us today, two experts who can talk to both the tax rules and the real world impact of those plans. Paul Hokemeyer is the founding principal of Drayson Mews, a mental health advisory firm that counsels wealthy individuals and families on mental health issues. He's the author of *Fragile Power: Why Having Everything is Never Enough* and

Fragile Power 2.0: Wealth, Narcissism, and Mental Health. In addition to his PhD, Paul, did you practice law at some point?

Paul Hokemeyer: I did. I practiced in Columbus, Ohio. I was a corporate bankruptcy lawyer and actually a judicial law clerk for a State Supreme Court judge as well.

Warren Racusin: Oh, so you were what we would call a recovering lawyer. My colleague here at Lowenstein Sandler, Michael Goen designs and implements wealth transfer plans including wills, trusts, other estate planning instruments for families and privately owned businesses. Many of Michael's clients are successful professionals with first generation wealth. Unlike old money families for whom estate planning is already an integral part of the culture, these clients are thinking about wealth transfer for the very first time. They frequently face the issue with some discomfort. And so, Michael's thought about this from the perspective of how a lawyer counsels your clients on those issues, as well as pure tax advice. Thank you both for being here. Michael, what is a GRAT and how does it work?

Michael Goen: Okay, Warren. A GRAT's an acronym that stands for Grantor Retained Annuity Trust. We'll get into what those four elements are in a second. But the best way for a layperson to understand a GRAT is as a casino game where the player either wins or breaks even every single time. The grantor, that's the person who contributes the asset, creates the trust. That's what receives the asset. And the key to the technique is the retained annuity. If the grantor puts in an asset, say, worth \$10 million, the grantor will retain a payment stream over a specified period of years. Can be as few as two years, can be as long as the grantor likes. But the technique only typically works if the grantor survives the GRAT term. So you have to be careful about that, especially depending on the age and the health of the grantor.

But let's assume the grantor is going to pick a three-year term. The grantor puts in the \$10 million asset, and with the help of some qualified professionals, the grantor takes back a payment stream that is using current IRS interest rate assumptions. For April where we are now, that's 4.6%, and present values that interest income stream. So, when the dust settles, the grantor's put in a \$10 million asset and the grantor has taken back a payment stream with the present value of \$4.51 less than the present value of \$10 million, resulting in a \$4.51 gift. Gift tax on that, 40%. So, you're looking at a tax bill of maybe a little less than three bucks.

So not a bad day at the office, not a big risk to take. One of two things is going to happen over the term of this GRAT. The grantor's going to take three payments. They don't have to be level payments, but they can't go up by more than 20% per year. So, let's assume that the grantor starts by taking a \$20,000 payment, and that that number goes up by 20% a year. The number works out to almost exactly \$11 million over the term. That's \$10 million plus that IRS assumed return.

One of two things is going to happen to the asset. Either it will grow in value by more than the assumed rate of return or it won't. If it doesn't, the grantor breaks even. The grantor's back in the same position as if the

grantor had never done anything. Gets all of the asset back and the GRAT vanishes as if it were a non-recourse debt instrument. On the other hand, if the GRAT wins, if the asset grows by more than the IRS's hurdle rate, there is no limit on how much value can pass to the remainder beneficiaries of the GRAT, this trust. That can be individual family members. It can be a continuing trust for family members.

One thing you don't want to do is have it go to grandchildren or other people, two generations or more down below the grantor on the family tree. But otherwise, you can have assets pass like Laurene Jobs' assets passed to children. And there will be no further tax, income tax, estate tax, gift tax at that point. So if the \$10 million turns into 20 or 30 or 100, all of that extra value accretes to the remainderman free of tax. The grantor has won, won very big and all for the cost of the gift tax on \$4.51.

Warren Racusin: So, what you're really giving away is the future potential growth in the value of the assets?

Michael Gooen: That is correct. It is an internal revenue code and regulation sanctions way to give away upside while keeping the base value of the note, plus that modest return.

Warren Racusin: And you just made a point that I was going to make also, which is that this is not some crazy wild-eyed gray area. This is right in the Internal Revenue Code.

Michael Gooen: No, it is formally sanctioned by the government. And to make matters even better, if you don't know the exact value of what you're putting in, instead of saying, I'm putting in a \$10 million asset and I'm taking back these dollar denominated payments. What I can take back is a percentage of whatever the actual gift tax fair market value is. So that if the IRS and you disagree, the GRAT payments automatically adjust and there's no additional tax liability for that.

Warren Racusin: So, if I put an asset that I say is worth \$10 million into the GRAT and I'm going to get \$10 million back plus the IRS return. And the IRS audits the return because you'll have to report this on a gift tax return. The IRS says, "No, no, no, that's not worth \$10 million. It's worth \$15 million." What happens is?

Michael Gooen: What happens is that the payments automatically adjust by 150%, and so you're just or by 50% you're up and you simply take back more. More comes back into your estate. But since you're not dead yet, there is no additional tax. Now, one big caveat about that. You can't be cavalier in valuing hard to value assets. If you take a wildly aggressive position, the IRS could crack down and say that the entire technique is a sham and they will attack you for not having created a GRAT, but for having made a gift of everything, ignoring what you've retained. We don't know yet whether they're going to prevail on that position, but they've been pretty aggressive in recent audits.

Warren Racusin: There are a couple of rulings that say that, right? So that is somewhere you've got to be a little bit careful. So, it certainly sounds like the kind of assets that are the best ones to put into a GRAT are assets that you think are going to grow in value, right?

Michael Gooen: Correct. Although if you're not sure, the GRAT is a nice hedge. I mean, contrast, if you have an asset that you believe is worth \$10 million and you're not sure whether it's going to go up or down, if it goes down or doesn't grow, you have blown through \$10 million of your \$15 million lifetime gift exemption. Or you've triggered a gift tax as high as \$4 million. If you're not sure and you create a GRAT, as I said at the beginning, you either win or you break even. It's a conservative technique in that regard, but it also captures all the potential upside.

So, one thing to remember when you're selecting assets for GRATS is that GRATS love volatility. The biggest mistake you can make, other than failing to follow your own rules with the GRAT, is to combine assets inside a GRAT where volatility can offset each other. So, I have a client who had seven different marketable securities, public stocks, and he created seven different GRATS. That way, if one wins and one loses, the other, the loser doesn't drag down the winner. He simply gets back all of the losing stock. The winning stock accretes to the benefit of his family. If you do that enough, over time, you can create a very large pool of tax-free assets for the benefit of your family. That's what he's trying to do.

Warren Racusin: What happens at the end of the GRAT? After the three years in the example that we've been talking about, what happens, and you put assets in and they've grown in value and that's great? What happens to the assets after three years?

Michael Gooen: So, after three years, what happens is whatever you said happens. Typically, you're going to create a continuing trust for the benefit of family members. As I mentioned, grandchildren, you don't want to do that. But it can be a trust that's just for your children. Or it's a trust that could be for the benefit of your spouse and children. It can be for friends. It could be for whomever you want, whatever your estate planning goal is to pass this value onto, that's what you do with the remainder.

Warren Racusin: Well, wait, so that means that if I put assets into a GRAT for the benefit of my wife, or they go to my wife at the end of the three-year GRAT term in this example. We're happily married, at least I think I am. So, I basically get the money back, right?

Michael Gooen: I wouldn't say it's that simple. It's a trust for the benefit of your wife and presumably for other people, including your kids. Now, it's possible that your wife and kids and you all like each other. We're willing to suspend disbelief on that front, Warren. But even so, you have to follow the rules. And the trustee of the trust has fiduciary obligations to your spouse, to the remainderman, your kids, and not to you. So you can't simply take the assets whenever you want them. You have to color inside the lines.

But for instance, if your spouse needs the money out of the trust to satisfy a joint federal income tax obligation, that is something that the trust can be availed of to help you accomplish. Similarly, if the trust ends up acquiring a home that your spouse lives in, you could end up living there as your spouse's guest. There's case authority that supports that. It's not 100% safe. And my advice to clients is when you make irrevocable gifts, including through a GRAT, even to a trust that benefits your spouse, assume that you will never get it back and you'll be safe.

Just make sure you have reserved enough. Don't be King Lear. But the ideas for these assets to be effectively an advance on everybody's inheritance. And if you do it this way, you eliminate the 40% federal estate tax. And if you live in a state that imposes estate taxes, could be 50% or even higher.

Warren Racusin: So, as we were talking about yesterday, the old saying bulls make money, bears make money, only pigs get slaughtered. And you should keep that in mind when you run one of these GRATs.

Michael Gooen: Correct. And that's not just for the remainder trust. That is especially true during the GRAT term. The disadvantage of creating GRATs is that you have to color inside the lines. You're allowed to create as many GRATs as you want. I mentioned my client who's got seven going simultaneously and that's not far from a record. But you cannot make additional contributions to a GRAT directly or indirectly once you've created one. You can't have the GRAT pay you back with an IOU. If it doesn't have cash, it has to pay you back with whatever it has.

And you have to make these payments precisely to the penny, I argue, within a 105-day window each year. You have to be able to have a plan for satisfying all these requirements when you do the GRAT. And if you can't follow those rules, don't create one. Because again, the IRS can unwind everything and start arguing that you've made a fully taxable gift at the beginning.

Warren Racusin: So, we basically talked about some of the things that can go wrong. You don't run the GRAT correctly, you take money back after the GRAT is over. You don't follow the rules. I guess the other major risk in a GRAT is that you don't survive the GRAT term, right? Is there any way to hedge that risk?

Michael Gooen: Well, it depends on where you are in the course of your planning. I mean, if you're worried about it as a relatively young and insurable person, you can have insurance purchased on your life. If that's owned in a trust, that will pay off if the GRAT doesn't. If you're in your 80s or 90s and you want to create a GRAT, I would say check with your doctor first and make sure you keep the term nice and short. And then don't ride motorcycles, don't go skydiving.

Warren Racusin: Look both ways before you cross the street.

- Michael Gooen:** Exactly.
- Warren Racusin:** Right. And I guess the last question, we go back to what happens at the end. What happened if people say, because I think you and I have both encountered situations where a GRAT has been too successful. That is, it was successful beyond the wildest dreams of the grantor, and hundreds and hundreds of millions of dollars are going to their kids that unless you jigger it differently, you don't want to have happen for a whole lot of reasons that we could talk about with Paul in a moment. Is there a way to hedge that risk? Like for example, can you say the first X number of million dollars of upside goes to my kids? The rest of it comes back to me. Can you say that?
- Michael Gooen:** Yes, you can. I analogize that to hitting a ball over a fence in baseball and stopping on second base. But unlike in baseball where you undoubtedly want to score as many runs as possible, you can say, "I want this back or I want the rest to go to charity." You can set these rules up. It just means that your success will be capped. One reason to consider doing that are the continued income tax consequences of a continuing trust.
- If you're just giving assets straight to your kids, you don't worry about that. But if the trust continues and if you as the grantor of the continuing trust remain liable for the GRAT's success, if the GRAT has a big liquidity event. You need to understand that you're paying not just your taxes out of whatever portion of this big asset you've retained, but also the taxes on the GRAT. And you need a plan in advance.
- It is very, very important with every grant you create to have a robust financial model created so that there are no surprises, including the possibility of too much success. Now, I will defer to Paul on the non-tax issues of what too much success means. And we can talk about how one draws trust provisions that makes it so that the money is a good thing in the family's life and not necessarily a negative thing.
- Warren Racusin:** Right. Because GRATs from an income tax point, they're an estate tax play. But from an income tax point of view, point of view, they're what known as a grantor trust. Meaning that the grantor pays the income taxes on the winnings of the trust, even though they're not pouring back into the grantor's pocket, right?
- Michael Gooen:** Correct. And one way to look at that is that that's additional estate planning. That does not count as an additional gift to the GRATs. So you're simply turbocharging the GRAT's return. That is true of every grantor trust. It's true of a GRAT as well, but you have to have a plan for paying those taxes. If you don't, then it becomes a big sore spot.
- Warren Racusin:** Paul, F. Scott Fitzgerald once said, "The very rich are different than you and me." And Ernest Hemingway responded, "Yeah, they have more money than we do." Who's right?

Paul Hokemeyer: Well, I think they both are. I think that the one leads to the other. I think having enormous amounts of wealth does make a person different from the rest of society. It puts them in a distinct minority where they look at themselves differently, they're looked at differently by other people. And they exist in a society and a culture that has very clear ideas and views about what it means to be a person of wealth.

Warren Racusin: So, what are some of the specific challenges that you've seen show up frequently in these ultra-high net worth populations? What kind of issues did they deal with on a regular basis?

Paul Hokemeyer: I think the primary issue is being really isolated from the majority of humanity. And we know from a science standpoint that isolation leads to a host of negative health outcomes. And people who live in the world in positions of uber wealth live in a pretty rarefied existence. They fly private. They don't have to fly commercial. They don't go to a bank. The bank comes to them. And so, the world tends to get smaller and smaller. And so, the work that I deal with, I work as a marriage and family therapist. So, I work relationally and I work with these clients to help them understand how their wealth impacts who they are, understand how their wealth impacts their relationships. And how they can use their wealth in society and culture in ways that are constructive and healing as opposed to damaging and destructive.

Warren Racusin: And so, your clients often feel isolated, even if they have a social network, they feel isolated. Is that right? Or sometimes feel isolated?

Paul Hokemeyer: Well, sure. And sometimes the isolation comes from the network is of other people in their social class who tend to be very competitive. And so we need to sort of split the difference here between people who have earned their wealth and people who have inherited their wealth. And so it's based upon something called locus of control. So, people who have earned their wealth have a much stronger internal locus of control. They feel much more in charge of their lives, captains of their destiny. In contrast to people who have inherited their wealth, who really are unsure of their capacity to survive in the jungle. They're okay in the zoo, but getting out into the jungle causes them some fear and trepidation. And who are they independent of their wealth? And in many cases, the second and third generation kids live under the shadow of their parents who have made incredible fortunes. And being able to replicate that level of financial wealth is almost impossible. The first time, the second time, it becomes really hard. And so how the person manages all of that in the context of finding meaning and purpose and direction in a life can be challenging.

Warren Racusin: And is that how you counsel clients to deal with these kind of issues, to find meaning, purpose, a goal in life? Is that how you counsel clients? Or is that one of the things that you counsel clients about?

Paul Hokemeyer: A lot of the things we have in our society and culture, we have this dominant cultural narrative that money is ipso facto evil. And yeah, money can be used to evil purpose and we see it out there a lot. The other thing is that money is a really good thing, and money can be used to such positive purposes. And for people who have earned their wealth, it's helping them transition from a scarcity mindset, which really enabled them to have the fuel and the ambition and drive to attain such heightened levels of success.

And from people who have inherited their wealth, it's helping them overcome kind of the guilt and shame that comes from having possession of this extraordinary abundance and privilege. And feeling in many ways undeserving of it, or in many cases, overwhelmed by it. We all think that, you know, I grew up in a middle class and suburban Maryland and an aspirational household that the dominant message was, money solves all the problems that you have.

And people, once you get to a place where you have all the money more than you ever thought that you have and you still have problems, you begin to kind of question a lot in your life. And it's understanding how to use your wealth and your privilege in ways that heal as opposed to hurt.

Warren Racusin: So how do you keep these people grounded and humble? Because you certainly have the issue that people feel shame and guilt and not deserving of this. Well, there's certainly, and Michael, I'm going to take a wild guess that you've seen some of these also. People whose egos become quite inflated when their bank account becomes very inflated as well. How do you deal with that side of the equation?

Paul Hokemeyer: I work as a clinician, and so patient has to be motivated. They have to have enough insight to be able to really want to change. And for a lot of people who have earned extraordinary wealth, they don't really see a problem with the way that they live. Sometimes they do. They have things that are called external motivations to change, which is their kids don't like them, their spouse wants to divorce them, and all of a sudden there's a crisis in their being that is causing them to take a look at how they are in the world.

And the process really involves helping the client understand what drove them to make the wealth that they made? And then helping them sort of see that if they would use the drive and the focus and the dedication to invest in some of the qualitative aspects of their life, that they can diversify their portfolio. And you guys are like masters in helping your clients diversify portfolios and mitigating risks. And it's a similar analysis. It's just not in the quantitative realm, but it's in the qualitative areas of their lives.

Warren Racusin: Right. Michael, you had a thought about this.

Michael Goen: Yeah. Paul, I'm curious how much time you spend counseling families multi-generationally. Because one of the things I've seen is considerable friction based on the distinction that you mentioned. Between the wealth

creation generation and the subsequent generations where the wealth creation generation, it almost disrespects or simply isn't sensitive to the challenges that the kids face. It's like, "I created this for you. I did this for you and there's not enough gratitude in the world for you to be able to give back to me."

Whereas what I've tried to explain is, no, your kids are disadvantaged in a different way. They don't get to have your origin story. They're starting on third base. So, they can't hit the home run, at least in playing the same game that you played. They need to find their own way. And typically I'm looked at when I say that as if I have two heads.

Paul Hokemeyer:

Yeah, beautifully said, very well articulated. And yes, I mean, I basically start the conversation by saying, "Look, we're dealing with an apple and an orange here. You have an internal locus of control. Your kids have external locus of control. This isn't anything that you did. This is empirically based." And grounding the work in the science. And then really understanding, helping both sides understand that mom and dad made a lot of money and are giving a lot of money to their kids because they love them. And because they want them to be safe and secure in the world. This is the thing that all parents want for their children, right?

Kids, and typically they have grown up in this schema of scarcity, so there wasn't enough. And so, they learned early on that the only way to be safe and secure in the world was to be on the top of the heap. To make as absolute much money as you can, because money protects in a lot of ways. And so they were very driven and focused on that. Their children come into the world in a place of material abundance, but perhaps emotional scarcity. Because dad or mom was out making the fortune that they wanted to pass on to their kids. To demonstrate their love and their concern and their ability to protect their kids.

And so, they're basically speaking kind of French and Russian at each other. And how this gets communicated is through money, right? Because if I ask you, you guys are very clever. If I say money equals X, right? We have three top examples. Money equals power, money equals freedom, money equals happiness. But there's also another thing that money tends to communicate, which is love. And so if dad is giving more money to my brother, then clearly dad must love my brother more than me, right?

And if there's in the family, if I happen to suffer from a behavioral health issue. Or if I have an addictive disorder, or if I suffer from depression, or if I have paralyzing anxiety that's prevented me from launching out into the world, dad may be giving money to my brother because my brother ticked off all the right boxes, right? And went to the Ivy's and is now making money down on Wall Street.

And so, it's basically having communications around these particular issues and calling a spade a spade. Saying, "Look, what we're talking about here is love and we're talking about safety and security. How that's manifesting is through dollars and cents. And so, let's calibrate, let's have a recalibration of that conversation." And it's a bumpy ride. It can be really a bumpy ride. But it's a ride that's worth doing and engaging with and sticking with so that people, A, have the opportunity to talk about how

they feel and how they perceive this situation. And be heard and not criticized or condemned or questioned.

And then being able to calibrate on a reality of the fact that dad's an apple and I'm an orange, and we're both fruits. We both kind of want to nourish and propagate our species and carry on and provide good in the world. And yeah, there are ways that we can do that.

Warren Racusin: And you've kind of put a ribbon on this by underscoring one of the great themes of this podcast series, which is the importance of communication. Having the parents, the grandparents, the children communicate and talk to each other. People may or may not like what they hear, but if they've heard it and they've been heard, as you said, that makes it more likely that ultimately from our end of town in administering estates and trusts things will go as smoothly as possible.

We see lots and lots of trust and estate litigation. And the biggest driver of litigation in families about trust and estates is lack of communication, is not knowing what people did, why they did it, what their thoughts and feelings were. And so, if you can have that communication, as you're saying, that makes our lives a little bit easier. Maybe it doesn't make our litigators happy, but it's good for the family.

Paul Hokemeyer: But it's also recognizing too that in the dominant culture, money is still a very taboo topic. We're comfortable talking about sex and sexuality, but money is still very taboo. And it's something that families culturally through religions just don't talk about. Because if you talk about it, then you are perceived as being an evil rich person. And subject to a host of negative stereotypes that our society and culture holds around people of wealth.

Michael Gooen: Yeah. Paul, the two, the carrot and stick that I use, the stick is echoing Warren's point. I explain to them that fiduciary litigation is the most expensive and inefficient form of family therapy I've ever seen. Nothing is more destructive to family wealth, including taxes than families fighting over money. And they tend to do that after the wealth creator is gone, and there's no one left to point the finger at but each other.

The flip side of that is that if the wealth creator is able to achieve a level of intergenerational diplomacy, to be able to go to his family or her family and say, "These are my hopes, these are my wishes." And do a lot of listening and explain the game plan and get buy-in from everybody. Not only does it increase the peace and reduce the chances of that horribly destructive friction. They're also likely to get some affection and return, a thank you. And that's frequently more valuable to them than the tax savings.

Paul Hokemeyer: Right. And it gets back to sort of our good friend, Nietzsche, who said that man can endure anyhow if there's a why. And if people understand why a plan is what it is, then it opens up the possibility for a positive connection as opposed to anger and resentment and hostility.

Warren Racusin:

Well, we now know a lot more about GRATs. We know a lot more about the lifestyles of the rich and maybe famous. And thank you so much to Michael and Paul for taking us on that road. It's very much appreciated. Thanks to everyone at Lowenstein Sandler who makes these podcasts possible. Most of all, thanks to all of you for listening. We'll see you next time. Until then as we say in these parts, have a good one.