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*If you have any questions about this Advisory, please contact:*

**VANESSA L. MACZKO**  
203.363.7667  
vmaczko@wiggin.com

**CHRISTOPHER CLARK**  
212.551.2849  
cclark@wiggin.com

#### About the Private Client Services Department

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## GRATS AND INSIDER TRADING

For insiders of publicly traded corporations, there are numerous Securities and Exchange Commission ("SEC") regulations to follow and abide. One set of those regulations comes from Section 16(b) of the Securities Exchange Act of 1934 ("the Securities Act"), sometimes referred to as the "short swing profits rule," which prohibits certain company insiders from making profits off transactions from company securities made within a certain time frame. One perhaps unlikely place this rule has encountered scrutiny is with grantor retained annuity trusts, often referred to as "GRATs," a common and useful estate planning device. Whether a state is entitled to impose income tax on a trust depends on the law of the

### WHAT IS A GRAT?

A GRAT can be a great device for transferring wealth while using little to none of the donor's lifetime gifting exemption. To create a GRAT, a grantor must transfer assets (e.g. publicly traded securities) to a qualifying trust for a certain term of years. Each year during this term of years, the trust will pay an annuity back to the grantor. The amount of these annuity payments is fixed at the GRAT's creation and cannot be changed once the trust is funded. At the end of the term of years and after the final annuity payment is made to the grantor, any remaining trust property will pass to the trust's remainder beneficiaries (e.g. family members, or even another trust).

For gift tax purposes, the value of the gift made by the grantor to the remainder beneficiaries is the value of the assets initially transferred to the GRAT reduced by the present value (as determined by the IRS) of what the grantor regains in annuity payments over the GRAT's term. A GRAT can be drafted where the present value of the annuity payments is only slightly less than the value of the assets initially transferred to the GRAT so that the value of the gift is de minimis. To the extent that, at the end of the GRAT's term, the assets appreciate more than what is needed to satisfy all of the annuity payments, all of such excess appreciation will pass to the GRAT's remainder beneficiaries free of any additional gift tax.

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## GRATS AND INSIDER TRADING

One trust power commonly retained by grantors of GRATs is the ability to substitute assets from the trust with assets of equal value held in the grantor's name. In this way, the grantor could, for example, swap underappreciating assets with those expected to have higher returns or exchange a high-performing but otherwise volatile asset with one whose returns are more steady in order to lock-in growth already obtained.

**Please click [here](#)** for a previously published detailed memorandum detailing the operation of GRATs and how they can be valuable estate planning tools.

**WHAT IS THE SHORT SWING PROFIT RULE?**

The SEC's short swing profit rule provides that a company insider who makes a purchase and a sale, or a sale and a purchase, of company stock within a six-month time frame must disgorge any profits gained as part of such transactions back to the company. Section 16(b) is designed to prevent the unfair use of information by company insiders, defined in the Securities Act as an officer, director, or a person holding 10% or more of company stock. The short swing profit rule is what is known as a "bright line rule," meaning that even inadvertent violations of the rule still require that profits be returned to the company.

**GRATS AND THE SHORT SWING PROFIT RULE**

When a grantor receives company stock from a GRAT, either in the form of an annuity payment or from substituting such stock out from the GRAT in exchange for assets of equal value, these transactions are arguably "purchases" for purposes of the short swing profit rule. Per Section 16(b), for any such stock that was then sold within 6 months of recapture, any profit made on such transaction by a company insider would ordinarily be subject to recovery by the company.

There are, however, exceptions to Section 16(b)'s short swing profit rule. One such exception, SEC Rule 16(a)-13, provides that if a transaction amounts to only a change in the form of a person's beneficial ownership of the security

at issue rather than a change in the person's pecuniary interest in such security, such transaction will be exempt from Section 16(b).

The application of Rule 16(a)-13 in context of a GRAT was the subject of a 1997 SEC No Action Letter. In the 1997 Letter, the requestor, a company insider who was also the grantor, Trustee and lifetime beneficiary of a GRAT, inquired as to whether recapture of company securities by means of an annuity payment from a GRAT would be considered merely a change in beneficial ownership pursuant to Rule 16(a)-13. The SEC replied that, under these facts, it was their view that the annuity payments would fall under the exception of Rule 16(a)-13.

Courts, however, are not bound to positions taken by the SEC in No Action Letters. Below are two recent cases that have addressed Rule 16(a)-13 in the context of GRATs:

a. In *Nosirrah Management, LLC vs. AutoZone, Inc.* (W.D. Tenn. April 14, 2025), the company insider was alleged to have violated the short-term profit rule for having sold company securities within six months of receiving such securities as part of an annuity payment from a GRAT. As was the case in the 1997 No Action Letter, the company insider was the grantor, Trustee and lifetime beneficiary of the GRAT. Here, the court found the change from indirect ownership (securities being held by the GRAT) to direct ownership (securities being held by the company insider) by means of the annuity payment to constitute merely a change in the beneficial ownership of the shares, not a change in pecuniary interest, and thus the Rule 16(a)-13 exception applied.

A possible takeaway here is that annuity payments alone may not trigger the short-term profit rule where the Grantor is also the Trustee and lifetime beneficiary of the GRAT.

b. In *Donoghue v. Smith* (S.D. N.Y. April 26, 2022), the company insider was alleged to have violated the short-term profit rule for having exercised a substitution power, swapping company securities held within a GRAT in exchange for a promissory note, and then selling the

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company securities within six months of recapture. Notably, the company insider was a grantor but not a Trustee of the GRAT. Under these facts, the court reasoned that when the company insider transferred company securities to the GRAT, per the terms of the trust agreement, he relinquished sufficient investment control over the securities, which caused a change in pecuniary interest in the securities from the grantor to the trust, so Rule 16(a)-13 did not apply. When the company insider exercised the substitution power, this, too, was a change in pecuniary interest, and therefore the subsequent sale by the company insider of the company securities was subject to Section 16(b).

A possible takeaway from this case is that where a grantor is not also a Trustee, a court may be less likely to find transactions between the insider and the GRAT to be mere changes in beneficial ownership of the stock. However, in *Morales v. Quintiles Transnational Corp.* (S.D.N.Y. 1998), the court found that the company insider violated Section 16(b) even where the insider was the Grantor, Trustee and lifetime beneficiary of the GRAT. The *Morales* case was similar to the *Donoghue* case (and different from the *Nosirrah* case) in that the insider acquired the securities

not through an annuity payment but rather by exercising the substitution power granted in his GRAT. This creates a possible second takeaway, which is that reacquisition of the stock by the grantor through the exercise of the substitution power may trigger the short-term profit rule if those shares are sold within six months of reacquisition.

### CONCLUSION

The rules concerning both GRATs and the Securities Act are highly complex. If you are a company insider and considering forming a GRAT for estate planning purposes, we encourage you to reach out to a Wiggin and Dana attorney to assist you navigate through the nuances of these areas and ensure your goals are met.

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*This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.*

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