LOWENSTEIN SANDLER PC NEWSLETTER

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Congress Grapples with GRATs

The Senate is currently considering a bill that would alter the rules governing the creation of grantor retained annuity trusts ("GRATs"), a highly effective estate planning technique. The Small Business Lending Fund Act of 2010 (H.R. 5297) (the "Act"), which the House of Representatives passed on June 17, 2010, would (i) require a minimum ten-year term for all new GRATs, (ii) eliminate the ability to create a GRAT without causing a taxable gift and (iii) require that the annuity amount payable to the grantor not decrease during the first ten years of the annuity term.

The GRAT Technique

A GRAT facilitates the transfer of assets from the grantor of the trust to his or her children or other beneficiaries at little or no gift tax cost. To use this technique, the grantor creates a specially designed trust (the GRAT) and transfers assets to that trust. The grantor receives back an annuity each year during the term of the GRAT, the amount of which is based on the interest "hurdle rate" set by the IRS for the month in which the GRAT was created. The annuity amount typically is structured so that the transfer produces little or no taxable gift. If the grantor survives the annuity term and the assets in the GRAT appreciate at a rate higher than the hurdle rate, at the end of the GRAT term some assets will remain to be distributed to the remainder beneficiaries (typically, the grantor's children), outright or in further trust and free of any estate and gift tax. If the appreciation of the assets in the GRAT does not exceed the hurdle rate, the GRAT fails but the grantor has lost little or nothing. In other words, if structured in this way, GRATs are a "heads-I-win-tails-I-don't-lose" technique. If the grantor does not survive the annuity term, the GRAT fails at least in part, depending on how far into the term the death occurs and the performance of the assets. Again, however, a failed GRAT leaves the grantor (or the grantor's estate) no worse off from a tax perspective than if the GRAT had never been created.

Many of our clients opting to use GRATs prefer to create multiple short-term "rolling" GRATs, rather than one long-term GRAT. The use of short-term GRATs minimizes the likelihood that the grantor will die during the trust term and shifts short-term gains in the value of the GRAT assets to the remainder beneficiaries.

The Act

The Act would eliminate the advantages of short-term GRATs by requiring a minimum ten-year annuity term. The longer term would increase the likelihood of the grantor dying during the annuity term, thereby eliminating some or all of the tax benefit. The Act also would require the value of the taxable gift caused by the creation and funding of a GRAT to be "greater than zero." Although this requirement would eliminate the possibility of creating a GRAT without making any taxable gift at all, the Act does not specify how much greater than zero the gift must be. Thus, it seems a client would still be able to structure a GRAT to generate a minimal taxable gift (e.g., a few dollars). Lastly, the Act prohibits the annual annuity amount payable to the

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grantor from decreasing during the first ten years of the annuity term.

Planning Opportunities

The GRAT legislation appears to have been fast-tracked in Congress, although the situation is fluid. If you would like to discuss whether a short-term GRAT makes sense for you, please contact one of our estate planning attorneys. This technique may not be available much longer in its current form, and we would be happy to help you take advantage of it while the opportunity is still available.

New Health Care Law Hikes Taxes on High Earners

On March 23, 2010, President Obama signed into law the historic—and much debated—Patient Protection and Affordable Healthcare Act (as subsequently amended by the 2010 Health Care and Education Reconciliation Act, the "Act"). The Act, which encompasses extensive health care reform legislation, is expected to raise approximately $100.2 billion over a period of ten years through tax increases on high income taxpayers. The tax increases apply to (i) unmarried taxpayers with income of more than $200,000 per tax year, (ii) married taxpayers filing separate returns with income of more than $125,000 each per tax year, and (iii) joint filers with combined income of more than $250,000 per tax year. The additional tax burden will stem from two tax increases; the Medicare Hospital Insurance Tax and the Medicare Contribution Tax.

Medicare Hospital Insurance Tax

Effective in 2013, an additional 0.9 percent Medicare Hospital Insurance Tax will be imposed on taxpayers with self-employment income or wages from employment exceeding the thresholds specified above. For example, an unmarried taxpayer with self-employment income of $250,000 in a single tax year will face an additional 0.9 percent tax on $50,000 of that income, and joint filers with combined wages of $500,000 in one tax year will face a 0.9 percent tax on $250,000 of their combined wages. If an unmarried self-employed taxpayer has wages in addition to her self-employment income for a particular tax year, then her taxation threshold will be reduced by the amount of her wages. For example: An unmarried taxpayer receives $400,000 of self-employment income and $70,000 of wages in the same tax year. The additional Medicare Hospital Insurance Tax will be assessed against her self-employment income over $130,000 ($200,000 threshold - $70,000 wages = $130,000 threshold; $400,000 self-employment income - $130,000 threshold = $270,000 self-employment income subject to additional tax).

Medicare Contribution Tax

The Act also includes an additional 3.8 percent Medicare Contribution Tax to be levied on unearned income beginning in 2013. Generally, unearned income includes income derived from annuities, capital gains, dividends, interests, rents, royalties, and other income derived from a passive activity with respect to the taxpayer or income from a business of trading financial instruments or commodities. The additional Medicare Contribution Tax will be assessed against the lesser of (i) the taxpayer's net investment income or, (ii) the taxpayer's modified adjusted gross income in excess of the thresholds specified above. For this purpose, net investment income does not include items such as tax-exempt bonds, veteran's benefits and excluded gain from the sale of a principal residence. Therefore, an individual taxpayer with net investment income of $180,000 and modified adjusted gross income of $220,000 would pay additional Medicare Contribution Tax only on the $20,000 by which her modified adjusted gross income exceeds $200,000.

The new taxes impose a significant additional burden on higher-income taxpayers. To discuss their impact on you and possible planning strategies, please contact any of the following members of Lowenstein Sandler's Trusts and Estates Group:

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