



THE WEALTHY RETIREE | ESTATE PLANNING

Congress Grapples with GRATs

The use of GRATs to beat estate and gift taxes still offers some benefits but a new bill could eliminate those advantages

BY WARREN K. RACUSIN

Even with the federal estate tax repealed in 2010, savvy taxpayers are continuing to do estate planning because the tax will roar back to life in 2011, with a new maximum rate of 55%, which is higher than

before, combined with a new exemption of only \$1 million, lower than before.

The Senate is currently considering a bill that would cut back on the tax savings generated by one technique that is especially

popular with sophisticated individuals and their advisors: The grantor retained annuity trust, or GRAT. The Small Business Lending Fund Act of 2010, which the House of Representatives passed earlier this summer,

requires a minimum 10-year term for all new GRATs, eliminates the ability to create a GRAT without causing a taxable gift and requires that the annuity amount payable to the grantor not decrease during the first 10 years of the annuity term.

The GRAT Technique

A GRAT enables an individual to transfer assets 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. That amount is based on the length of the trust and the interest “hurdle rate” set by the IRS for the month in which the GRAT was created. For instance, GRATs created last month have a hurdle rate of 2.8%.

The annuity amount typically is structured so that the value of the annuity coming back to the creator equals the value of the property contributed to the GRAT, so there is 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, the 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.

For example, say in July 2010 an individual puts \$5 million into a GRAT that lasts for three years. Say he receives an annuity of \$1,760,863 per year for each of the three years. Assume the assets in the trust grows at 10% per year. The result: \$826,510 will go to the individual’s children at the end of the GRAT, free of any gift and estate tax, which is a savings of over \$450,000 in tax.

If the appreciation of the assets in the GRAT does not exceed the hurdle rate,

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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” proposition. 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.

Legislative Complications

Many people opt 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.

But the Small Business Lending Fund Act would eliminate the advantages of short-term GRATs by requiring a minimum 10-year annuity term. This longer term

increases the possibility that the creator of the trust will die during the annuity term, thus 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). Finally, the Act prohibits the annual annuity amount payable to the grantor from decreasing during the first 10 years of the annuity term. This would eliminate an advantageous variation on the GRAT theme in which GRATs made large payments to the creator of the trust in the early years, and smaller payments in the later years.

Planning Opportunities

Individuals owning assets that have lost value because of the economy but have the potential to recover and grow in value over the long-term should consider GRATs. GRATs work particularly well when interest rates are low, as they are now. As long as the assets in the GRAT grow more than the hurdle rate (again, 2.8% in July) the excess growth escapes estate and gift tax. The GRAT legislation appears to have been fast-tracked in Congress, although the situation is fluid. In short, creation of a short-term GRAT is an opportunity to save estate and gift taxes for your family that may not be available much longer. **OWS**

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