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## Trusts & Estates, Tax & Business Law


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### GENERAL NEWS

#### [New Bill Would Dramatically Alter GRAT Planning](#)

#### **Now is the Time to Establish GRATs**

For years, GRATs ("Grantor Retained Annuity Trusts") have offered clients a convenient estate planning tool. GRATs are irrevocable trusts which offer an essentially zero-risk transfer tax savings opportunity. Due to legislation Passed by the House of Representatives in late March and pending before the Senate, anyone that has considered using a GRAT in his or her estate planning should act now while many of the benefits are available.

#### **Background on GRATs**

A GRAT is a technique where the client retains an interest for a defined period, and the client's family receives whatever is left at the end of the period. Typically, clients create short-term GRATs, which are designed to distribute to themselves a payment at the end of the 1<sup>st</sup> and 2<sup>nd</sup> years that on a present value basis equals 100% of the value of the contribution to the GRAT. For example, a client could fund a GRAT with \$1 million and based on current interest rates (which are still quite low – which is favorable) take back a payment of approximately \$525,000 at the end of the 1<sup>st</sup> and 2<sup>nd</sup> years. Actuarially, on a present value basis, the value of that payment stream (the annuity) equals the value of what the client contributes - \$1 million. As a result of the retained interest being equal to the value of the contributed assets, no gift tax is due on the formation of the GRAT.

GRATs "work" if the assets in the trust appreciate at a rate that exceeds the government's assumed interest rate – which is presently 3.2%. Any excess growth during the GRAT term is paid to the "remainder beneficiaries" (typically an irrevocable trust for the client's spouse and/or children) at the end of the term. Because the value of the retained annuity is worth 100% of the value of the assets contributed to the trust on formation, this remainder passes tax-free to the beneficiaries.

GRATs are essentially a zero-risk technique because if the assets don't appreciate over the government's assumed rate, the "worst" result is the trust pays all of the assets back to the client/grantor of the trust - which is exactly where the client would have been had he/she not formed the GRAT in the first place. Thus, because the client pays no gift tax on formation some call it a "heads I win, tails you lose" proposition.

Short term GRATs are preferred for two reasons. First, if the client dies during the GRAT term, the assets in the trust come back into her/his estate for estate tax purposes, and therefore any transfer tax savings would be lost. Accordingly, short term GRATs help to minimize the estate inclusion risk. Second, short term GRATs allow the client to either succeed or fail quickly. If the GRAT fails, the client receives the funds back quickly and can create a new GRAT to try to succeed again. On the other hand, if the GRAT assets have a positive growth year (in excess of the presumed federal rate), a short term GRAT helps lock in that success by passing the positive growth to the remainder beneficiaries before a bad investment year can sap the positive performance. Thus, short-term GRATs offer a better chance for success.

#### **Recent Developments**

On March 24, 2010, the House of Representatives passed the "Small Business and Infrastructure Jobs Tax Act of 2010" - H.R. 4849 - a bill that would eliminate the low-risk, zero-gift GRATs.

Essentially the new bill would require a minimum 10-year term for GRATs; would require some taxable gift (the bill just says the remainder must be greater than zero, but this minimum gift level may be sorted out as the bill moves ahead); and would not permit decreasing payments during the 10- year term.

If these rules eventually do become law, it will still be possible to use GRATs, but they will become less attractive due to the need to have some gift component and the inherent risks of long-term GRATs: the estate tax inclusion risk and the dilution of investment performance risk.

Thus, while GRATs would remain a tool for shifting wealth, they would be less attractive to many clients wishing to favor future generations. However, because the current bill states the new rules won't be effective until enactment, there is still a window of opportunity to create short-term GRATs.

For now, it is still possible to create a 2-year GRAT, in which the remainder is valued at zero, and thus on formation there is no taxable gift. Moreover, the federally assumed interest rates are still at very historically low levels. 3.2% is approximately half the average rate for the past 10 years. Thus, clients interested in transfer tax savings should consider locking in the low interest rates along with short-term, zeroed out GRATs.

Further adding to the "perfect storm" of estate planning opportunities, many clients hold depressed value assets which may appreciate over the next few years. Other clients may own companies which have been "on the sidelines" during the recent credit crunch, but may soon attempt to sell the companies or attract merger opportunities. Whether due to the recovery of value for depressed assets or springing value for clients planning business transactions, funding GRATs with appreciating assets increases the likelihood of a GRAT's success.

Finally, for clients who already have GRATs in existence, or for clients with other advanced estate planning techniques (like Dynasty Trust sales), now is a great time to review those existing plans. If the assets in the plan have declined in value, but the client expects the assets to recover in value, it might be wise to try to take those assets out of the GRAT (by swapping cash for example), and creating a new GRAT. Clients can achieve meaningful wealth transfer with a new short-term GRAT by locking in the current GRAT rules and low interest rates.

For many reasons, now may be the best time to consider GRATs. If you would like to learn more about how a GRAT could fit into your estate plan, please contact us.