CONGRESS DEBATES LIMITING ESTATE PLANNING TECHNIQUE: NOW IS A GOOD TIME TO CONSIDER A GRAT

The grantor retained annuity trust (GRAT) has been a staple vehicle for estate planning since it was first introduced twenty years ago by the Revenue Reconciliation Act of 1990. A GRAT can effectively transfer property from a grantor to a beneficiary, while greatly reducing the amount of tax the grantor would otherwise owe on the gift, if the gift was transferred without a GRAT.

A GRAT is created by transferring property to a trust for a fixed number of years. During the life of the trust, the grantor is paid an annual annuity from that trust. Upon the expiration of the trust, any remaining property in that trust passes to the beneficiary. Tax savings are realized by placing property expected to greatly increase in value into the trust. Tax is then assessed by adding the value of the initial property plus a statutorily fixed interest rate based on the month the trust was created as found in Code Sec. 7520. The current fixed interest rate for August 2010 is 2.6%, according to Rev. Rul. 2010-19. Therefore, as long as the annuity payments over the fixed period of the trust equal the initial property value plus the fixed interest rate, there would be no gift tax assessed on any remaining property left in the trust upon expiration, which would be automatically transferred to the beneficiary.

In other words, if a GRAT is created this month with any type of property expected to appreciate more than 2.6% over the life of the trust, any profits greater than 2.6% would be considered a tax free gift by the IRS to the beneficiary without requiring the donor to utilize a portion of the standard $1,000,000 lifetime gift tax exemption. Currently, the minimum term of a GRAT is two years and there are no restrictions on the structure of annuity payments, effectively allowing a donor to have little to no tax burden if properly created.

Recently Congress has been considering limiting the effectiveness of GRATs. President Obama’s 2010 budget proposal and 2011 revenue suggestions sought to change the minimum term of a GRAT from two to ten years. Additionally, the House attempted to attach a similar curtailment of GRAT to a small business jobs bill and a supplemental spending bill. The Senate’s version of the small business jobs bill did not contain the GRATs provision, and ultimately the House was unsuccessful is attaching the provision to the supplemental spending bill. However, the Senate currently has a GRAT curtailment provision in a proposed

COBRA extension act, S. 3548, to provide funding for the bill, an increasingly common trend for proposed anti-GRAT legislation.

The current Senate bill proposes to (1) raise the minimum GRAT term to ten years, (2) require the remaining interest, as calculated at the time of GRAT creation, to be greater than zero, and (3) prohibit the annuity payments from decreasing in value from the first year until after the initial ten years of the trust. These proposed changes have the potential to significantly alter GRATs as we know it. By raising the minimum term to ten years, a grantor increases the chances that he or she may pass away prior to the GRAT expiring. A GRAT that is ongoing at the time of the grantors death reverts back to the estate of the grantor, along with any appreciation, and does not transfer to the beneficiary. In this scenario, not only does the beneficiary get nothing, but the property is now taxable to the grantor's estate. Furthermore, by disallowing decreased payments, the proposed bill shuts the door on scheduling high initial payments to reduce the amount of the trust that reverts back to the estate. Lastly, the bill creates great uncertainty about exactly how much "greater than zero" the gift must be, meaning that there will likely be disagreements between the IRS and GRAT creators until initial revenue rulings are proposed.

Currently, GRATs are functioning without any of the proposed limitations. However, as the above government actions indicate, that is likely to soon change. Therefore, if you have property that is likely to appreciate more than 2.6% over at least the next two years, and you wish to avoid using part or all of your lifetime $1,000,000 gift tax exemption to transfer that property, now is the time to create and fund a GRAT. Any GRAT created and funded prior to the enactment of any legislation, similar to what is described above, will be grandfathered in to the old GRAT tax laws and you will still receive the significant tax benefits that GRATs currently provide. However, if you wait too long, it is likely that you will miss out on fully capitalizing on one of the best intergenerational wealth preservation techniques currently available.