GRATs and Dynasty Trusts in the Crosshairs

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On February 14, 2011, the Obama Administration issued its Fiscal Year 2012 Revenue Proposals. One of these proposals, which would require a minimum term for Grantor Retained Annuity Trusts ("GRATs") and would technically preclude "zeroed-out" GRATs, has appeared in recent budgets and revenue proposals, and in several unsuccessful bills in Congress last year. See our June 30, 2009, March 31, 2010 and November 1, 2010 e-alerts. It could well be that these restrictions will, sooner or later, become law. Furthermore, the Section 7520 rate (which affects the success of GRATs–a lower rate is better) is climbing (3.0% for March 2011, up from a historic low of 1.8% in December 2010). Therefore, if you are considering establishing a GRAT, especially a short-term GRAT, you should consider doing so immediately.

In addition, a new proposal would affect the long-term tax efficiency of perpetual trusts, often referred to as "Dynasty Trusts." Generation-skipping transfer ("GST") tax applies generally to transfers made to grandchildren or further descendants ("skip persons"). For gifts in trust, the GST tax applies (1) on funding, if the trust beneficiaries are all skip persons (i.e., a "direct skip"), (2) upon an event (such as the death of a beneficiary) that results in all remaining beneficiaries being skip persons (i.e., a "taxable termination"), or (3) upon distribution to a skip person (i.e., a "taxable distribution"). Under

current law, each taxpayer may exempt, in the aggregate, up to $5 million of gifts from application of the GST tax. If a taxpayer applies GST exemption to a gift to a trust, generally distributions from that trust will never be subject to GST tax, even if property is subsequently distributed to a very remote descendant.

The GST tax is intended as a backstop to the gift and estate tax, to ensure that property is taxed at each generational level. Under traditional law, trusts were required to expire and distribute out all trust property in a finite amount of time (known as the "Rule Against Perpetuities"), generally about 80 to 100 years. GST-exempt property, once distributed to a beneficiary, would again become subject to gift or estate tax, which meant that generally no more than two or three generations were "skipped" by application of GST exemption to a trust.

However, a growing number of states have repealed or extended the Rule Against Perpetuities, in many cases allowing trusts to continue indefinitely. Under current law, if GST exemption is applied to such a trust, distributions to skip persons will *never* be subject to GST tax, regardless of how many generations have passed since the trust was originally established.

The Obama Administration's new proposal would provide that on the 90th anniversary of the creation of a trust, the GST exemption would essentially expire (with some limited exceptions). After that point, distributions to skip persons would be subject to GST tax.

Under the current proposal, this new rule would not apply to pre-existing trusts, but would apply only to trusts established after the rule is enacted. Therefore, taxpayers who wish to establish GST-exempt Dynasty Trusts may wish to consider acting soon.

Because of recent legislation, this is a particularly good time to establish a Dynasty Trust. The Taxpayer Relief Act of 2010 (discussed in our December 23, 2010 e-alert) increased both the GST exemption and the unified gift and estate tax exemption amounts to $5 million per taxpayer. In other words, until this new proposal is passed by Congress (and barring future retroactive changes in the law), a married couple could potentially contribute up to $10 million (combined) to a Dynasty Trust that should be exempt from GST tax in perpetuity.