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## Proposed Legislation Threatens Grantor Retained Annuity Trusts (GRATs)

2009-06-30

The Obama Administration and members of Congress are currently debating various tax reform measures. One such measure would require a lengthy minimum term for GRATs.

### **What is a GRAT?**

A GRAT is a type of irrevocable trust. If you establish a GRAT, the value of the property that you transfer to the GRAT will be returned to you via annual annuity payments over a predetermined time period that you select when you create the GRAT. In addition, you will also receive annual interest payments at a set IRS rate (the so-called "hurdle rate"). As a result, the IRS assumes that you will receive back everything you contributed, plus interest.

The benefit of a GRAT is that, if the property in the trust appreciates at a rate higher than the hurdle rate, all of such additional appreciation can pass free of gift tax to your children or to other beneficiaries, and such property will also be excluded from your estate at your death. Furthermore, there is very little downside risk: if the trust property does not appreciate at a rate higher than the hurdle rate, the trust property is simply returned to you,

leaving you in essentially the same position as if you had never created the GRAT.

## **Potential Legislative Changes**

In May of this year, the Treasury Department released "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals," which contains various tax proposals endorsed by the Obama Administration. One such proposal would require that any newly established GRAT have a minimum term of ten years.

Currently, GRATs are typically designed to exist for only two or three years. There are two reasons for such a short time frame. First, GRATs are typically funded with assets that are expected to "pop" in value over the short term (e.g., due to the sale of a company). If you design your GRAT to exist for a long time period, you run the risk that, even if the assets do "pop" in value, they may subsequently decline in value over the remainder of the GRAT term, leaving less value to your beneficiaries. Second, if you create a GRAT and then die during the GRAT term, in almost every case all of the trust assets must be included in your estate for estate tax purposes, thereby eliminating any tax benefit from creating the GRAT. A shorter GRAT term minimizes that risk.

Congress is strongly considering legislation requiring a minimum ten-year term for GRATs. While no legislative proposal has yet been passed by either the House or the Senate, it is possible that any new restriction on GRATs could become law within the next few weeks or months. Furthermore, it is too early to tell whether any such legislation will follow the Treasury Department's recommendation that new requirements apply only to GRATs created after the date of enactment, or whether such requirements

will be imposed retroactively to some earlier date.

## **Conclusion**

The current combination of undervalued assets and low interest rates provides an excellent opportunity for many of our clients to generate substantial tax savings by establishing a GRAT. However, the window of opportunity for this estate planning technique may be closing rapidly. If you wish to discuss whether a GRAT makes sense for you, please contact WilmerHale.

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