PUBLICATION

GRATs: Another Congressional Assault

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Grantor Retained Annuity Trusts (GRATs) have been generally discussed in our previous Alerts, including the reference to legislative modifications for GRATs as proposed in the Department of the Treasury's *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (Green Book). GRATs are considered in many situations to be an effective low-risk transfer tax planning technique. The Green Book proposals are designed to limit the use and effectiveness of GRATs. These proposals are now part of the Small Business Jobs Tax Relief Act of 2010, H.R. 5486 (Tax Relief Bill) recently passed in the House on June 15th by a vote of 247 to 170.

General Background

A GRAT is a trust into which a person transfers assets and receives an annuity over a term of the trust in exchange for the asset transfer. Short term "zeroed-out" GRATs are a popular transfer tax planning technique because there is generally very little gift tax risk associated with implementation of the technique provided the trust is properly drafted and administered. GRATs are often prepared on a short-term basis of 2 to 5 years for several reasons, including hedging against mortality risk of the transferor since the transferor must survive the term established for the GRAT in order to achieve a possible favorable result. The value of the annuity retained by the transferor is computed based upon the value of the assets transferred to the GRAT and an assumed hypothetical interest rate provided by the Treasury on a monthly basis known as the Section 7520 Rate. The June and July rates are at historical lows. Low 7520 Rates are beneficial for GRAT planning. To the extent that the income and appreciation of assets within the GRAT exceed the 7520 Rate the remaining value in the trust at the end of the term will pass to remainder beneficiaries, typically children or a trust(s) for their benefit, free of gift or estate tax if the transferor survives the GRAT term.

House Proposals in H.R. 5486

The Tax Relief Bill passed by the House contains tax relief and loan opportunities for small businesses. Provisions relating to GRATs are part of the revenue enhancement efforts in the Tax Relief Bill to offset revenue loss from its small business tax relief measures. One such GRAT provision would eliminate the use of short-term zeroed-out GRATs by requiring a GRAT to have a remainder value of no less than zero calculated at the time of creation of the GRAT. The intent of that provision is to eliminate zeroed-out GRATs in which no taxable gift is made, and, instead require the transferor to make a taxable gift when creating a GRAT. One thought is that the Treasury may provide in regulations that the present value of the remainder interest be as high as 10% of the value of the assets initially contributed to the trust.

Another provision of the Tax Relief Bill requires a GRAT have a term of at least 10 years. This would end short term GRAT planning. Long term GRATs have increased risks of failure due to possibility of the transferor's mortality during the term of the GRAT.

The final provision of the Tax Relief Bill relative to GRATs requires that the annuity payments not decrease in any year during the first 10 years of a GRAT. This provision is generally intended to prohibit structuring a GRAT to provide for higher annuity payments in early years of the GRAT that could effectively achieve the same economic result of a GRAT with a term of less than 10 years. If the House's current version of the Tax Relief Bill is enacted, the GRAT provisions will apply to transfers occurring on or after the date of enactment.

Senate Counterpart

At this writing, the Senate counterpart to the House's Tax Relief Bill does not contain the above-referenced GRAT provisions. That counterpart is Senate Finance Committee Substitute Amendment to an unrelated House-passed bill (H.R. 5297). Should the Senate version proceed through the legislative process without such GRAT provisions, then this topic will likely become an item for Conference Committee deliberations between the House and Senate over the final version of small business tax legislation.

Summary

Questions certainly remain as to whether these onerous provisions on the use of GRATs will be enacted, if at all, as proposed in the House's Tax Relief Bill. However, there can be little doubt that the House has initiated a serious assault on the future availability of short term zeroed-out GRATs. In fact, substantially identical GRAT provisions have also been inserted in the House version of H.R. 4899, the FY 2010 Iraq/Afghanistan Emergency Supplemental Appropriations Act. Thus, the House apparently does not intend to cease its efforts to eliminate short term zeroed-out GRATs.

Individuals seriously considering engaging in this effective and cost-efficient transfer tax planning technique should implement a GRAT sooner rather than later, but only after consulting with your tax professional. Should you have questions regarding any of the foregoing, please contact any one of the attorneys in the Firm's Tax Department.