Client Alert
TRUSTS AND ESTATES DEPARTMENT | JULY 2009

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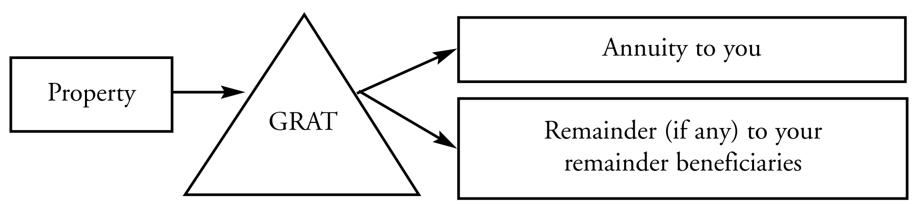
founded 1934

Grantor Retained Annuity Trust

Now Is an Excellent Time To Consider a Grantor Retained Annuity Trust ("GRAT") Because of Depressed Asset Values, Low Interest Rates and Possible Legislative Changes.

OVERVIEW

In a typical GRAT, you transfer property to a trust, retaining the right to receive an annuity payment for a fixed term. At the end of the term, the remaining trust property passes to your children or other family members (called the trust "remainder beneficiaries"). The taxable gift is the total value of the property placed in the trust minus the discounted present value of your retained annuity stream. The discounted present value of the retained annuity stream is valued using a discount rate published by the IRS. The trust is generally structured so that the taxable gift is close to or equal to zero. Any appreciation in the transferred property in excess of the applicable discount rate passes to the remainder beneficiaries gift tax free.



WHY NOW

There are three reasons why now is a good time to consider a GRAT. First, the discount rates published by the IRS are at or near record lows. This means that the average rate of return of the GRAT assets need not be extraordinary for your GRAT to out-perform the IRS assumed rate of return. Second, given the worldwide decline in asset values in 2008 and 2009, the values of your assets are likely depressed. Assets which are undervalued now, but which you expect will appreciate at a rate greater than the IRS assumed rate of return, can be good assets to transfer to a GRAT. The final, and perhaps most important reason to consider a GRAT now, is that Congress is considering legislation that would limit the availability of certain kinds of GRATs in the future. If you are considering a GRAT, we recommend that you act before the law is changed.

SUITABLE PROPERTY FOR A GRAT

The ideal asset to place in a GRAT is property which has high growth or income-producing potential. Typical of the types of property placed in GRATs are high-growth or high-yield publicly traded securities and junk bonds, commercial real estate and closely held stock. A GRAT can be particularly useful as a repository of hard-to-value assets such as closely held stock, commercial real estate or family partnership units because the risks of undervaluation can be minimized or even eliminated.

RISKS OF A GRAT

The risks of a GRAT are minimal. If you die during the term of your GRAT, all or a portion of the GRAT property is brought back into your estate. Of course, you are in no worse position than if you had not created the GRAT in the first place. Some clients buy life insurance to hedge against the mortality risk. A second potential risk is that the assets placed in the GRAT may underperform the applicable discount rate and, therefore, produce no benefit for the remainder beneficiaries. Again, however, underperformance places you in no worse position than you would have been in had you not done the GRAT in the first place.

GRAT ILLUSTRATIONS

Assume that you transfer $1,000,000 to a GRAT in July, 2009 when the discount rate is 3.4%. The value of the annuity that you will receive and the property that will pass to your remainder beneficiaries gift tax free depends on the term of the GRAT and the average investment return. The examples below illustrate how these factors impact the tax benefits of this approach. In all of these examples, the value of the taxable gift is less than $1.

Term of GRAT	Average Investment Return	Annuity to You	Amount Passing Tax Free to Remainder Beneficiaries
2 years	3.4%	$525,652	$0
2 years	4%	$525,652	$9,270
2 years	6%	$525,652	$40,757
2 years	8%	$525,652	$73,044
2 years	25%	$525,652	$379,783
2 years	50%	$525,652	$935,871

Term of GRAT	Average Investment Return	Annuity to You	Amount Passing Tax Free to Remainder Beneficiaries
5 years	3.4%	$220,853	$0
5 years	4%	$220,853	$20,442
5 years	6%	$220,853	$93,257
5 years	8%	$220,853	$173,672
5 years	15%	$220,853	$522,283

Term of GRAT	Average Investment Return	Annuity to You	Amount Passing Tax Free to Remainder Beneficiaries
10 years	3.4%	$119,636	$0
10 years	4%	$119,636	$43,884
10 years	6%	$119,636	$213,953
10 years	8%	$119,636	$425,814

As you can see, higher average investment returns result in a greater amount which passes tax free to your remainder beneficiaries. When choosing the term of the GRAT, considerations such as the type of asset and appreciation potential are important. Specifically, if you expect the value of a particular asset to rise precipitously in the short term, a short term GRAT would likely be the best option. A short term GRAT would also minimize the mortality risk. Alternatively, if you have an asset which you expect to appreciate at a solid rate over multiple years, and you anticipate that the rate of appreciation will be higher than the currently very low IRS-predicted average rate of return, a longer-term GRAT might be more appropriate. We can help you weigh these considerations to create the best approach.

CONCLUSION

There are few reasons to be excited about depressed asset values. However, a GRAT may be your silver lining because the better the investment performs going forward, the more money you can pass tax free to your remainder beneficiaries. In addition, with proposed legislative changes to this technique looming on the horizon, we believe that this is a technique that may be attractive and timely.

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