

UPDATE

JUNE 2009

Administration 2010 Budget Proposal Would Limit Estate Planning Benefits Offered by Grantor Retained Annuity Trusts By Mandating Minimum 10-Year Term

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The Obama Administration's 2010 Budget Proposal could mean big changes are in store for Grantor Retained Annuity Trusts ("GRATs"), an extremely popular estate planning vehicle. A GRAT is a vehicle where a parent creates a trust and funds it with a certain amount of cash or securities. The trust pays the parent an annuity amount for a certain number of years. The annuity amount is set so that, based on the interest deemed to be earned by the trust, there is little or no taxable gift for the parent. At the end of the term of years, any remaining funds in the trust pass to the child free of any additional gift tax. GRAT's are currently especially attractive now because GRATs work best in a low-interest rate environment and the interest rates that are currently in effect are at an historical low. In order for the GRAT to be successful, the total return on the assets must be higher than the IRS interest rate. The interest rate, which is sometimes referred to as the "hurdle rate," changes every month, and the lower the interest rate, the better a GRAT performs. The rate is set at 2.8% for the month of June 2009. Therefore, if a GRAT set up in June has a return in excess of 2.8% every year, the assets in the trust will pass to the beneficiaries without tax.

Under current law, the minimum term for which a GRAT can be established is two years and, for planning purposes, two-year GRATs are often used to minimize the investment risk associated with GRATs. The Obama Administration, acknowledging that a two-year minimum term eliminates risk associated with the use of a GRAT, has proposed to set the minimum term of a GRAT at ten years. If this rule is passed through Congress, then it will take effect immediately. Given the possible enactment of the 10-year mandated minimum term for a GRAT, consideration should be given to establishing a two-year GRAT, particularly given the low interest rate environment.

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