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GRANTOR RETAINED INCOME TRUST

The Grantor Retained Income Trust ("GRIT") is an estate planning tool that has been around for many years. The enactment of the Revenue Reconciliation Act of 1990 added a new Chapter 14 to the Internal Revenue Code of 1986, as amended (the "Code"), which includes new federal gift tax valuation rules that apply to retained interests in trusts and other split-interest transfers among family members. The new rules apply generally to transfers occurring after October 8, 1990. Section 2702 of the Code significantly limits the situations in which a GRIT will provide transfer tax benefits as hereinafter discussed.

A GRIT is an irrevocable trust established in a written trust agreement whereby the creator of the trust (the "Grantor") transfers assets to the GRIT while retaining the right to receive all of the net income from the trust assets for a fixed term of years (the "initial term"). The net income is distributed by the trustee of the GRIT to the Grantor annually or on a more frequent basis as determined pursuant to the terms of the trust agreement during the initial term. At the expiration of the initial term, the remaining trust principal is either distributed to beneficiaries (such as the Grantor's nieces and nephews) or held in further trust for the benefit of such beneficiaries. If the Grantor survives the initial term of the GRIT, the principal of the GRIT is excluded from the Grantor's estate for federal estate tax purposes.

The primary advantage in establishing a GRIT is that the assets transferred from the Grantor to the GRIT are valued for federal gift tax purposes at a discount. Just how significant the discount will be is dependant upon the length of the initial term of the GRIT, and the applicable federal rate in effect in the month that the GRIT is established.

Because of the provisions set forth in Section 2702 of the Code, a GRIT cannot be effectively established for the ultimate benefit of the Grantor's spouse, the ancestors of the Grantor or the Grantor's spouse, any lineal descendant of the Grantor or the Grantor's spouse, any sibling of the Grantor or the Grantor's spouse, or the spouses of any of the foregoing persons. It can be established, however, for lineal descendants of siblings, (i.e. nieces and nephews) relatives even more distant than nieces and nephews, or for friends of the Grantor or the Grantor's spouse.

The transfer of assets to a GRIT constitutes a gift equal to the total value of the assets transferred to the GRIT, less the present value of the retained income interest held by the Grantor

for the initial term. If the Grantor survives the initial term, the assets comprising the GRIT will pass to or for the benefit of the designated remainder beneficiaries at a reduced gift tax value. For example, assume that a 60 year old individual transfers $100,000 of assets to a 15-year GRIT and retains the right to receive all of the net income from the GRIT, payable annually, during the initial term of the GRIT. Assume also that the applicable federal rate in the month that the assets were initially transferred by the Grantor to the GRIT, as determined pursuant to Section 7520 of the Internal Revenue Code, is 5%, based on applicable Internal Revenue Services tables. The present value of the retained income interest is $66,007, so that the amount of the gift upon creating the GRIT is $33,993. At the end of the initial term retained by the Grantor, if the Grantor is still living, the remainder beneficiaries (or a trust to be administered for the benefit of the remainder beneficiaries) receive $100,0000 plus all capital growth (which is the amount over and above the net income that was paid to the Grantor).

During the initial term, a GRIT will be a "grantor-type" trust with respect to its ordinary income because the Grantor retains a mandatory income interest in the GRIT. Thus, the Grantor will be taxed on all ordinary income of the GRIT, and should be allowed to claim ordinary deductions. In most GRITs, the Grantor will retain a reversion if the Grantor dies during the initial term, because retention of a reversion will further reduce the value of the gift at the time it is made.

In cases where the Grantor retains a contingent reversion in the GRIT, Section 673(a) of the Code may apply to cause the Grantor to be treated as the owner of the principal portion of the GRIT during the initial term if, as of the inception of the GRIT, the value of the reversionary interest exceeds five percent of the value of the GRIT. The Internal Revenue Service has previously ruled that, where the Grantor's contingent reversion in a GRIT exceeds in value five percent of the initial value of the GRIT, the GRIT will be a grantor-type trust as to both ordinary income **and** capital gain. This will result in the Grantor paying capital gains tax on capital gains realized by the GRIT even though none of the capital gains are to be distributed to the Grantor. This further increases the amount of wealth that is shifted to the ultimate beneficiaries of the GRIT at a reduced gift tax value.

If the Grantor retains a contingent general power of appointment, rather than a contingent reversionary interest, Section 674 of the Code will probably treat the GRIT as a grantor-type trust with respect to the principal whereby the Grantor will be taxed on the capital gains realized by the GRIT even though the capital gains are not distributable to the Grantor.

One of the disadvantages of a GRIT is the fact that it is irrevocable, i.e. it cannot be changed. The trust agreement can provide for limited flexibility, but anytime a trust is created that cannot be changed there is always the risk that a change in individual circumstances may make the trust undesirable in the future, not for tax reasons, but for personal reasons. This disadvantage, however, is no different that the risks inherent when making outright gifts, because then the recipients of the gifts are free to dispose of the gifts in any manner they desire.

As with some of the other sophisticated estate tax minimization tools, a GRIT will not result in estate tax savings if the Grantor dies before the expiration of the term during which the Grantor is to receive income distributions from the GRIT. Thus, the Grantor is risking the transactional costs of establishing the GRIT for significant estate tax savings based on the uncertainty of whether the

Grantor will survive the initial term of the GRIT.

In conclusion, although there are certainly some complexities surrounding the establishment of a GRIT, the GRIT can prove to be an extremely viable tool to reduce the size of a potentially taxable estate by allowing for a substantial reduction in the underlying assets for valuation purposes under the gift tax laws. This allows individuals to leverage their unified credit. As with all estate planning tools, a GRIT has some disadvantages, but those disadvantages are minimal when compared to the potential estate tax savings.

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