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TRUSTS & ESTATES

The newsletter of the ISBA's Section on Trusts & Estates

The Safety GRAT™

By Robert T. Napier¹

Many clients believe that the greatest enemy to their wealth is the federal estate tax. The reality is that very few estates actually pay a federal estate tax and current estimates are that fewer than 20,000 estates annually will actually pay the federal estate tax. Furthermore, it is understood that quality estate planning can materially reduce, if not eliminate, any tax due.

The enemy to a client's wealth is not the estate tax, it is the reluctance in overcoming inertia. It is easy to understand how the current financial environment can make even the most affluent clients feel relatively vulnerable. Furthermore, with the current federal exemption at \$3.5 million per taxpayer, husband and wife can shelter \$7 million from federal estate tax.

But for families with wealth that is taxable, or might be taxable if assets appreciate in the future, this is an opportune time to plan. Too often there is reluctance to engage in planning. This is true even for simple and appealing estate planning strategies such as grantor retained annuity trusts (GRATs).

GRATs are typically built to benefit a

younger generation at the termination of the trust. Clients recognize that the typical Walton GRAT transfers only the appreciation, beyond a hurdle rate, to the next generation. In other words, the client usually retains the assets that were used to fund a successful GRAT, as well as the appreciation up to the hurdle rate. Intuitively, it would seem that clients should be comfortable creating a GRAT to benefit the younger generation. If a client had tens of millions two years ago and now has half that amount, it is understandable that he or she may feel impoverished and less inclined to give up additional assets.²

GRATs can help clients take advantage of historically low interest rates, generous valuations and the current financial markets, including GRATs for the benefit of the grantor's spouse. This can be accomplished by having the remainder

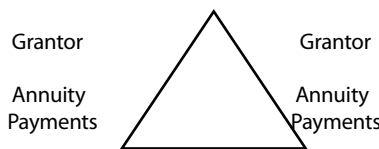
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beneficiary of the GRAT be a trust for the benefit of the grantor's spouse, followed by the next generation. This permits the grantor to retain the principal used to fund the GRAT, plus the appreciation up to the hurdle rate, while the spouse, as primary beneficiary of the remainder trust, enjoys the appreciation of the GRAT assets beyond the hurdle rate. In other words, all of the GRAT assets and their appreciation remain with the older generation. However, the remainder trust is drafted not to be includable in the spouse's estate, nor is it in the includable in the grantor's estate (provided the grantor survives the GRAT term).

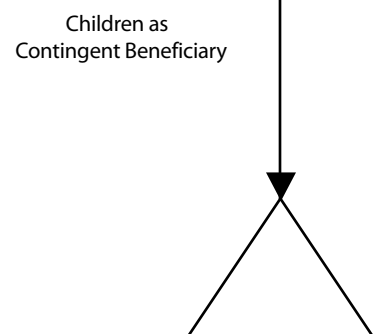
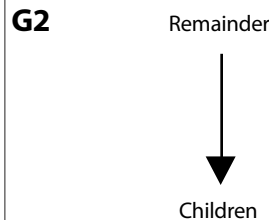
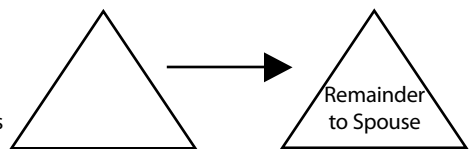
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G1 Traditional GRAT



Safety GRAT



Typically, the remainder trust is crafted as a non-exempt trust for generation-skipping transfer tax purposes.³

We have found that married couples are far more interested in this concept than in the traditional GRAT. It affords the grantor and the grantor's spouse the luxury of keeping all their wealth at their generation, thereby preserving their financial safety, while lessening the future burden of the federal estate tax

by removing the appreciation in excess of the hurdle rate (and all future growth thereon) from their taxable estates. The Safety GRAT helps clients overcome their reluctance to prepare a tax-efficient estate plan.

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2. A recent Barron's article suggested that clients feel disproportionately poorer when they lose half their wealth, as compared to how they would feel if they increased their wealth by half.

3. It is theoretically possible to build this trust as a GST-Exempt Trust if the grantor is inclined to allocate GST exemption at the expiration of the ETIP. This may be prudent in limited situations.