Transferring Assets from Your Estate to Reduce Tax Costs

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LAST MONTH, I DISCUSSED THE advantages of investing in a pooled income fund. This month, I will discuss how you can transfer assets to the next generation at a reduced tax cost though a Grantor Retained Annuity Trust.

Q. *If I have an estate which is large enough to be subject to the federal estate tax, is there a way that I may transfer assets to the next generation and reduce my overall tax exposure?*

A. Yes, several methods are available to you for reducing your tax exposure while permitting assets to be transferred to your intended beneficiaries. One of the most popular methods is transferring assets through a Grantor Retained Annuity Trust (GRAT). A GRAT is an irrevocable trust which is funded when you make a gift of property (generally stock or securities) to the trust. Under the terms of a GRAT, you will receive an annuity interest in return, either for a fixed term of years, for your lifetime, or for the shorter of these two periods. At the end of the trust term, whatever assets are left in the trust (the remainder interest) will go to your designated beneficiaries, who can be your children, other relatives or unrelated parties.

The annuity interest is paid at least annually (or if you desire, quarterly or monthly) and is either paid as a percentage of the trust's initial value or as a fixed dollar amount. The fact that you retain an annuity interest in the trust reduces the amount of the gift that will go to your children for federal gift tax purposes at the end of the trust term. The longer the property remains in the trust, the smaller the remainder interest, and the smaller the gift that is considered for gift tax purposes. The trust is valued at inception for gift-tax purposes; therefore, if the trust assets appreciate over time, the appreciation is not taxable to you.

This type of trust has several advantages, including providing you with a fixed income, removing income-producing assets from your estate at a discounted value, and removing the appreciation that would occur in the transferred assets from your estate. You should be aware, however, that to the extent the annuity amount paid each year exceeds the amount of income generated by the trust—some of the trust assets would have to be liquidated to pay the balance of the annuity amount. If you were to die during the term of the trust, there could be an inclusion of a large portion of the trust assets in your estate. Accordingly, you would preferably pick a term for the trust that is shorter than your predicted life expectancy.

A GRAT is generally treated as a so-called "Grantor Trust" for income-tax purposes. This means that you would be taxed on the income and the gains recognized on sales of the trust's assets, notwithstanding the fact that these amounts may exceed the actual annuity payments that you receive in a year. While this may be viewed as a disadvantage, it can also be viewed as an advantage, in that it is a method of shifting assets between family members. You are paying the income tax on the trust income assets that the remainder beneficiaries receive. The payment of these taxes is not treated as a gift, and is therefore not taxable for gift-tax purposes.

In order to determine whether a GRAT would be appropriate in your specific situation, you should consult your professional tax advisor.

In my next column, I will explain how short-term GRATs may be useful to transfer assets from your estate. ■

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