CUMMINGS & LOCKWOOD LLC

WHAT ARE THE TAX IMPLICATIONS OF THE GRAT?

Gift tax.

The goal of the GRAT is to transfer wealth to the designated beneficiaries without the imposition of gift or estate tax. It is similar to an outright gift in that it avoids estate and gift tax on the future income and appreciation on the gifted property. Unlike an outright gift that uses up lifetime gift tax exemption equal to the value of the gifted property on the date of the gift, a “zeroed out GRAT” will use up only a nominal amount of gift tax exemption. Also, unlike an outright gift, a GRAT gift will result in either a “win” or a “tie”, but never a “loss”. An outright gift on the other hand can have a negative result if the property declines in value after the gift is made.

Income tax.

During the term of the GRAT, the GRAT is treated as a grantor trust for income tax purposes. This means the Donor will be taxed on all of the income and capital gains earned by the trust, without regard to the amount of the annuity paid to the Donor.

At the end of the GRAT term, the beneficiaries’ tax basis in the trust property will be equal to the Donor’s tax basis at the time the assets were transferred to the GRAT. Therefore, if appreciated property is gifted to the GRAT and the beneficiaries sell the property after the GRAT terminates, any capital gains tax on the difference between the sales price and the Donor’s tax basis will reduce the net value of the property transferred. If the property instead were included in the Donor’s estate at death, the beneficiaries would receive a “step?up” in the property’s tax basis to the fair market value of the property at the Donor’s death. As long as the federal capital gains tax rate is less than the combined federal and state estate tax rate (up to 50%) which otherwise would have been due had the property transferred to the beneficiaries by the GRAT been retained until death, a GRAT will result in lower tax exposure for transferred assets.

However, it is important to note that, if, after the termination of a GRAT, the appreciated property is sold while it continues to be held in a trust that is treated as a grantor trust for income purposes, the grantor will pay the capital gains tax.

Estate tax.

If the Donor dies before the GRAT annuity payments cease, the trust assets will be taxable in the Donor’s estate. Consequently, it is important to consider the Donor’s life expectancy in selecting the GRAT term. Also, if the Donor is married, careful consideration should be given as to whether and how to qualify the GRAT for the estate tax marital deduction if the Donor does not survive the GRAT term in order to avoid paying estate tax at the death of the Donor that could otherwise be postponed until the surviving spouse’s death.