Have your cake and leave it to your kids, too

A trust that lets you move assets out of your estate now without losing the income for years to come? You bet. And there are two of them.

By David J. Schiller, J.D.

Giving your hard-earned assets to a trust may not be the most appealing prospect. But *not* giving the assets to a trust is an open invitation for Uncle Sam to snatch up to 55 percent of what you still own when you die.

The bill could be especially high if you own assets that are likely to appreciate. A 53-year-old man I'll call Dr. Kelly recently came to me with just such a dilemma. He owned a rental property worth $800,000. If it appreciates by only 5 percent a year, it will be worth more than $1.6 million 15 years from now. If he were to die then with that property still in his estate, his family would face a $600,000 federal estate tax bill on the rental property alone. If the appreciation were greater and Kelly's estate exceeded $3 million, his family would pay the maximum 55 percent tax on it.

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Kelly wanted to get the property out of his estate as soon as possible, but he was reluctant to sacrifice the income it generated. He still had two children to put through college and was counting on the income to help pay those bills.

The solution that suited him best was a type of trust known as a GRAT, or grantor retained annuity trust. It's one of the few remaining trust vehicles that allow you to shelter assets and all their future appreciation from estate taxes, without completely giving up their income. A similar trust–the personal residence GRIT (grantor retained income trust)–can dramatically reduce your tax burden if you plan to leave your home to your kids. But it's severely limited. Let's look at the pluses and minuses of each trust.

Grantor retained annuity trust. In the eyes of the IRS, placing an asset in a GRAT essentially splits it into two parts. You, the "grantor," keep the annuity interest–the right to receive income from the property for a set period you specify. After that, the trust ends and your heirs receive the remainder interest–the property itself. During the trust's term, a trustee of your choosing manages the assets.

Since the trust must pay you income annually, you can place only income-generating assets–an office building, stocks or bonds, rented land–into a GRAT. You specify a fixed percentage of the trust's value that you want to receive as income each year. Regardless of how much income the assets actually earn, the trust must pay you this fixed percentage or owe you the money if the income falls short. The trustee can make up the shortfall in later years if the assets generate sufficient income, or he can sell the property if necessary to pay you off.

Your heirs' remainder interest is considered a taxable gift. But because you're reserving income for yourself and postponing their inheritance, the IRS discounts the taxable value of the gift. Thus, the higher the percentage of income you choose and the longer the trust's term, the smaller the value of your heirs' interest and the lower your gift tax.

In Kelly's case, for example, putting $800,000 of property into a 10-year GRAT paying him 5 percent a year would result in a taxable gift to his children of $538,712–still a sizable sum. But by increasing the term to, say, 20 years, and his annuity interest to 8 percent a year, he could reduce the taxable gift to $198,733 (see page 73). That would use up only about a third of his

$600,000 lifetime estate and gift tax exemption.

Choosing a long term and a high annuity rate can dramatically reduce your gift tax liability, but there are several catches. First, you must outlive the trust's term to get the tax benefits. If you die before the trust ends, the entire value of the assets will be included in your taxable estate. You can lessen this risk if you're married and put the trust in both your name and your spouse's. Using your combined lifespans doubles your chance of meeting this requirement.

Another potential drawback: If you take more income from the trust than you can use during your lifetime, you'll wind up putting that unspent money back into your taxable estate. The trick is to find a realistic balance of the trust's term and an annuity rate that will maximize your savings without entailing too much risk. For Kelly, who won't need the extra income for longer than 10 years, the best combination was a 10-year trust paying him 8 percent. This will give him income of $64,000 a year while his kids are in school, and he can offset the resulting $381,939 taxable gift against part of his $600,000 estate and gift tax exemption.

Before you decide to set up a GRAT, remember that you must completely give up control of the assets going into the trust. And since GRATs are irrevocable, you can't take the assets back later if you find you need them. Make sure, then, that losing those assets won't endanger your financial security later on.

What does a GRAT cost? You can expect attorney's fees in the neighborhood of $3,000 to $4,000 to set one up. You'll also pay a fee for the detailed appraisal of the property that's required. Subsequently, you'll have annual fees for preparing tax returns. But these costs are minimal when you consider the potential estate tax savings GRATs offer.

If your beneficiaries sell the property after the trust ends, they'll also owe capital gains tax on the difference between the price they get and your original cost (adjusted for any capital improvements or depreciation that apply). But that bite will be much smaller than the estate tax they'd owe if the property remained in your estate.

Personal residence GRIT. Instead of passing on rental properties or other income-generating assets, suppose you want to leave the kids your house. Let's say it's currently worth $500,000, and you're planning to retire in 10 years and move out of state.

Rather than giving them the house when you retire and incurring a sizable gift tax on its appreciated value, you could get it out of your estate now. You'd put it into a

How a GRAT can lower your estate tax

When you set up a grantor retained annuity trust, you retain income from the trust property for the length of time you choose. When the trust ends, the property passes to your beneficiaries. The longer the trust's term and the higher the percentage of the property's value you receive (the annuity rate), the greater the potential estate tax saving.

This table shows how varying the term and annuity rate of a trust containing Dr. Kelly's $800,000 rental property (see main article) would change the gift taxes he'd owe.

	5% annuity rate		
Trust term	Annual income	Retained interest	Taxable gift
10 years	$40,000	$261,288	$538,712
15 years	40,000	330,184	469,816
20 years	40,000	375,792	424,208

	8% annuity rate		
Trust term	Annual income	Retained interest	Taxable gift
10 years	$64,000	$418,061	$381,939
15 years	64,000	528,295	271,706
20 years	64,000	601,267	198,733

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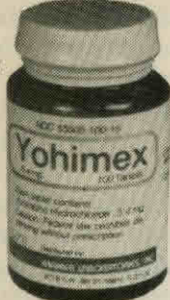

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personal residence grantor retained income trust naming your children as beneficiaries. Although tax-law changes in 1990 put an end to most GRITS, they left one exception: that for personal residences.

As with a GRAT, a GRIT will freeze the value of the house at $500,000 for tax purposes, and any subsequent appreciation will escape estate taxes. When the trust ends, the house will go to your kids. Meanwhile, you can still live in it. The IRS treats this right just as it does the annuity interest you'd get from a GRAT.

According to IRS tables, your right to live in the house for 10 years is worth $280,885. That means only $219,115, your children's remainder interest, is subject to gift taxes, and you can use part of your $600,000 lifetime estate and gift tax exemption to offset this gift.

The drawbacks of a personal residence GRIT are similar to some drawbacks of a GRAT. Although the kids won't get the house for another 10 years, you must effectively give up control of it now. That means you can live in the house but can't rent it to someone else or sell it.

Moreover, you must live in the house throughout the trust's entire term. If you were to retire after, say, eight years and move out, the house and all the appreciation would revert to your estate. The same would happen if you were to die before the trust's term ends (or if both you and your spouse died, assuming the trust is in both your names).

What if, after 10 years, you decide not to move after all? In that case you'd have two options. You could buy the house back from your kids at fair market value. This would bring the house back into your estate, of course, but your kids would get its equivalent in cash, minus capital gains tax on the difference between your adjusted basis and the sale price. And you'd remove that money from your estate. Or you could rent the house from them at fair market value. However, your children would owe income taxes on the rent you pay them.

Some additional limitations: The personal residence GRIT protects only the actual building and its land–not the furnishings. Moreover, the amount of land must be reasonably related to the size and location of the house, or the IRS might think you're trying to shelter investment property. You could run into trouble, for example, if you put in a home with 5 acres of land when similar houses in your area are on 1 acre.

Setting up a personal residence GRIT costs $2,000 or so in attorney's fees plus a few hundred dollars for a detailed appraisal, including photographs, dimensions, and a history of the premises.

Should you consider a GRAT or a personal residence GRIT? If your estate is worth $750,000 or more and you own one or more appreciating properties that you don't mind passing on to your family now, you should discuss the possibilities with your tax adviser. Although the trusts aren't appropriate for everyone, under the right circumstances they can save hundreds of thousands of dollars in unnecessary estate taxes. ■