CLIENT ALERT

A Trust Substitution Could Provide Income and Transfer Tax Benefits

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As the end of the year approaches, we recommend that you consider if it is an appropriate time to take advantage of the substitution power in your irrevocable grantor trusts. Many trusts include a provision that allows the grantor to substitute individually-owned assets for trust-owned assets of an equivalent value. This substitution power is often included in a trust agreement to make the trust a grantor trust for income tax purposes (meaning that the trust's income is taxable to the grantor). However, this power can also enable you to plan to minimize or eliminate future capital gains taxes.

Under current law, when an individual dies, the assets that he or she owns individually get a "step-up" in basis to fair market value on the date of death. Thus, if you, for example, purchased stock 20 years ago for $100,000 and you die owning such stock when its value has increased to $1,000,000, the basis of the stock in the hands of your heirs would be $1,000,000. Accordingly, when your heirs subsequently sell the stock, the capital gain, if any, would be on only the stock's post-death appreciation. In contrast, assets that you give to an irrevocable trust during your life typically do not receive a step-up in basis on your death. Thus, if the stock were given to an irrevocable trust, the basis would remain $100,000 at your death, and a significant capital gains tax would be due if and when the trust sells the stock.

The substitution power allows you to exchange high-basis assets that you own individually for low-basis assets held in the trust, resulting in the assets with the largest unrecognized appreciation receiving a step-up in basis when you die and thereby minimizing the overall capital gains tax eventually paid (because the trust is a grantor trust, there is no income tax triggered by the substitution itself). Receiving back low-basis assets from a trust can also be a good option for individuals planning to make charitable contributions; if you donate an in-kind asset to charity, no capital gain is assessed upon the donation, and you may qualify for a charitable deduction for income tax purposes equal to the full fair market value of the asset.

In addition, the substitution power can be beneficial for managing a grantor retained annuity trust ("GRAT"). A GRAT is a type of irrevocable trust in which the grantor retains the right to receive annuity payments for a set number of years. If the assets held by the GRAT appreciate greater than the "hurdle" rate used to calculate the annuity payments, the excess appreciation passes to the remainder beneficiary (typically a family trust for the benefit of descendants) at the end of the annuity term. If the assets currently held in the GRAT have thus far outperformed the hurdle rate and there is uncertainty about future performance, the substitution of cash or other stable assets into the GRAT for the rest of the annuity period will lock in the current gains. Conversely, if the assets held in the GRAT have performed poorly but it is expected that there will be future appreciation, a substitution can freeze the current losses and allow you to contribute the assets received from the GRAT to a new GRAT.

As noted above, the exchanged assets must have an equivalent fair market value. In addition, there are other factors to consider when determining whether to exchange assets and what assets to exchange, such as expected future appreciation and cash flow. We are available to assist you with evaluating whether you may benefit from effecting a substitution.

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