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Estate Planning with Residence Trusts

## in a Down Market

*By Jeffrey M. Zabner*

The decline in real-estate values, while unfortunate, does offer a unique opportunity for older homeowners (especially those whose estates may still become subject to the estate tax) to give real property to their children with very large savings on gift and estate taxes. In fact, this may offer one of the best opportunities in years to transfer wealth to younger generations, without triggering much, or any, inheritance tax along the way.

To capitalize on this opportunity we utilize a Qualified Personal Residence Trust, or QPRT (pronounced "CUE pert"), which, when properly structured, allows homeowners to give away their personal residence (and/or second or vacation home) to their heirs and still reserve to themselves the exclusive right to live in the property for many years before ownership and control over the residence passes to the next generation. Since it appears increasingly clear that the estate tax will not be repealed, there are several reasons to consider this planning now:

1. The decline in real estate values and low and apparently stable interest rates environment allow very favorable calculation of the gift value of the QPRT.
2. Creating a QPRT now ensures your estate won't contain a high value piece of real estate -- your home -- down the road when values appreciate that could result in the payment of estate taxes on your home upon your death.
3. Creating a QPRT now and transferring your home (or vacation home) effectively locks in a lower gift-tax amount, making this an especially efficient wealth transfer technique.

An example is helpful:

Suppose Sam and Sally Homeowner are 69 and 67 years old, respectively. They own a home in California currently valued at \$1 million. They would like to leave the home to their children when they've passed away, but they still want to reside in the home now. They know that when values again appreciate, the property will jack up the value of their estate, perhaps pushing it high enough to trigger the estate tax. (The basic federal estate-tax exemption is \$2 million per person for 2008, and \$3.5 million per person in 2009 -- with the top estate-tax rate at 45%).

To move this valuable asset out of their estate, Sam and Sally put the home into a QPRT for a term which they elect to be 10 years (terms can be longer or shorter, depending on the exact situation). For those 10 years, they reserve the exclusive right to live in the house -- their living arrangements don't change at all -- and they continue to pay all the expenses, including property taxes. The QPRT is a gift trust and in April of the following year, they will file a Gift Tax Return to report the value of the gift they made to the children. Using the complex IRS formula that discounts the value of the gift amount when the home went into the QPRT, Sam and Sally will report a gift of \$640,460 instead of \$1 million. The formula, among other things, considers their age, the IRS' current applicable federal rate (3.6% in November 2008), which is the federal interest rate used to set up trusts or loans to relatives, and the length of the trust, in this case 10 years. (If the trust term was 12 years, the gift would be reduced to \$563,930). Assuming the home appreciates at 4% a year for the life of the trust term, they will have passed a \$1,480,000 asset for the value of a \$640,460 gift. Since they can each gift \$1 million during their lifetimes without actually paying any out of pocket gift tax, they have achieved a significant estate planning goal at little cost or inconvenience to themselves.

After the 10-year term, the home transfers, pursuant to the terms of the QPRT that they designed, to the remainder beneficiaries (normally, children) either by distribution to them or by having the property held in trust and controlled by the named Trustee. At that point, the ownership has transferred and, and since it is now outside of their estate, Sam and Sally won't be subjected to estate taxes on this asset. In this example, when the QPRT expires, the home is worth nearly \$1.5 million. Assuming both Sam and Sally live well into their 70s or 80s, it's likely to be

worth even more.

If they wish to remain in the home after the trust term, they have to pay fair market rent to their kids (or to the trust for their kids), or risk running afoul of the IRS which could scrutinize the children for allowing rent-free use of the property. When Sam and Sally do pass on, the children keep the house and don't have to pay estate or inheritance taxes.

These trusts do have some quirks. If you die before the trust term expires, the home reverts to your estate, nullifying any potential estate-tax savings. Because of this rule, it is essential to take stock of your age and health when drawing up the QPRT.

Also, remember that a QPRT is an irrevocable trust, meaning you have to give up the home when the term ends. That type of planning can be tricky -- it's sometimes hard to predict what your relationship with your children will be one or two decades down the line, and there's no guarantee your beneficiaries will let you stay in the house.

Lastly, when the children do end up owning the home, they will have your income tax basis. When they sell the house, they may have capital gains tax to pay, but even if that rate rises, it will still be less than the estate tax rates currently in effect.