Insight on Estate Planning

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You own assets jointly with others

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Home economics: A QPRT can help you save taxes

Planning for the disposition of your home can be a challenge. From a gift and estate tax perspective, the earlier you transfer an asset to your children or other beneficiaries, the lower the tax cost. But what if you want to continue living in your home indefinitely?

An effective solution to this dilemma is a qualified personal residence trust (QPRT). When you transfer your home to a QPRT, its value for gift tax purposes is heavily discounted and any future appreciation is removed from your taxable estate. Plus, you retain the right to stay in the home for many years.

Do you need a QPRT?

With gift and estate tax exemptions currently at record-high levels — $5 million for 2011 and 2012 — a QPRT may seem unnecessary. But even if your total estate is well within the exemption amount now, it's difficult to predict whether it will be within the exemption in, say, two years, let alone in 10 or 20 years.

Keep in mind that, unless the law is changed, the exemptions will drop to $1 million in 2013. In addition, as the economy rebounds and home and other asset values grow, there's an increasing chance that gift and estate taxes will become an issue for you down the road. And if your estate is already at or near the $5 million level, strategies like the QPRT will be valuable even if current exemption amounts are extended.

Regardless of your estate's size, there also are nontax reasons for using a QPRT. For example, it provides your home with some protection against creditors.

How does it work?

To take advantage of a QPRT, you transfer your home to an irrevocable trust, retaining the right

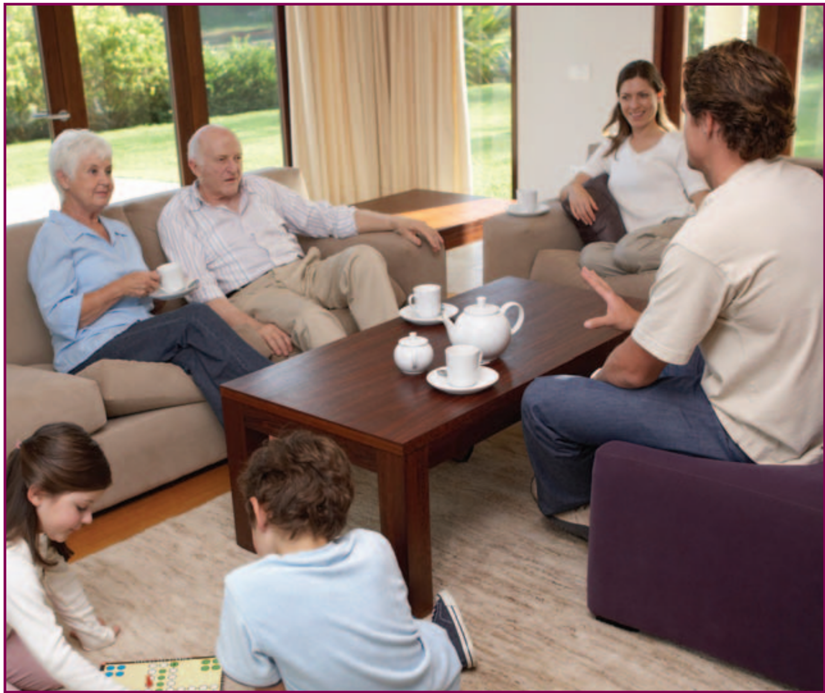
Fair market rent: Put it in writing

In a recent U.S. Tax Court case — *Estate of Riese* — a woman transferred her home to a three-year qualified personal residence trust (QPRT) for the benefit of her children. She and her children followed all the rules and agreed that at the end of the term the mother would rent the house from the kids. But when the time came, no lease was signed nor was any rent paid. Six months after the QPRT expired, they still had not negotiated a fair market rent or signed a lease, and the mother died unexpectedly.

The IRS said the home's value should be included in the mother's estate, arguing that she and her children had an "implied agreement" to allow the mother to stay in the house rent-free for life. But the Tax Court disagreed based on testimony by the children and their mother's attorney that the parties had agreed that the mother would pay fair market rent.

The taxpayers in this case were fortunate that the court found their self-serving testimony to be credible. To avoid the expense and risk of litigation, however, it's best to sign a written lease when the trust term expires or soon thereafter.

to live there for a specified period. At the end of the trust term, the home goes to your children or other beneficiaries. But even after the term ends, you can arrange to continue living there in exchange for fair market rent.



QPRTs must meet several technical requirements. Most important, they're prohibited from holding assets other than a personal residence, insurance and enough cash to cover the trust's expenses. A QPRT is considered a "grantor trust," so you pay the mortgage, taxes and other expenses (and, if appropriate, deduct them on your income tax return).

What are the tax benefits?

Transferring your home to a QPRT is a taxable gift to your beneficiaries, but the value of the gift isn't the home's current market value. Rather, it's the present value of your beneficiaries' *remainder interest* in the home. That value is only a fraction of the home's current value, and at the end of the term your beneficiaries receive the home tax-free, regardless of how much it has appreciated.

To determine the remainder value, you take the home's current fair market value and subtract the present value of your right to live in the home during the trust term. The value depends on several factors, including the current market value of the home, your age, the length of the term and the IRS-published "discount rate" in effect when the QPRT is established.

Generally, the lower the home's current value, the older you are, the longer the trust term and the higher the discount rate, the lower the value of the remainder interest. Real estate values are generally depressed now, so it may be a good time for a QPRT — even though discount rates are also low.

What are the pitfalls?

QPRTs require careful planning to preserve their tax advantages. One critical consideration is mortality risk. For a QPRT to work, you must outlive the trust term; otherwise the home's full value will be included in your estate. So selecting the right trust term is a delicate balancing act. A longer term reduces the size of your gift but a shorter term minimizes mortality risk.

Another pitfall involves what happens when the trust term ends. If you continue to live in the home but don't pay fair market rent, the IRS may treat the transaction as a transfer with a retained life estate and include the home in your estate. The best way to avoid this result is to sign a written lease and follow its terms. (See "Fair market rent: Put it in writing" on page 2.)

A safe bet?

If you plan to stay in your home indefinitely, a QPRT is worth a look. It has the potential to produce significant tax savings and, with careful planning, has little downside. Before you take action, discuss with your estate planning advisor whether a QPRT is right for your family's situation. ∎

Semantics matter

When using ascertainable standards, precise language is a must

How a trust works is fairly straightforward: You place assets in a trust for the benefit of your heirs. The key to keeping the trust assets from being taxed as part of your estate is not retaining too much control over them.

What isn't so simple — in fact, it's quite complex — is the trust's language. And if your trust includes the use of ascertainable standards (which limit distributions to amounts needed for a beneficiary's health, education, support and maintenance), how the standards are drafted is critical to its success.

When to use ascertainable standards

Suppose you place stock and other assets into an irrevocable trust for the benefit of your children. To ensure that the assets are managed properly, you appoint yourself trustee. The danger here is that, if you have too much control over the trust assets, they may be pulled back into your estate and be subject to estate taxes.

Internal Revenue Code (IRC) Section 2036, for example, provides that assets are included in your estate if you retain "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

One way to avoid this problem is to have the trust provide for mandatory distributions of specific amounts at specific times. But that means beneficiaries will receive distributions even if they don't need them, depleting the trust and making it harder to preserve its assets for future generations.

A better solution may be to authorize distributions based on ascertainable standards. The idea is that ascertainable standards are objective, so they limit the trustee's discretion and allow a court to determine whether distributions are appropriate or should be compelled. Because you, as trustee, have little control over the amount and timing of distributions, it's difficult for the IRS to argue that the assets should be included in your estate.

Another alternative is to appoint an independent trustee who can have even greater flexibility to make distributions based on changing circumstances and your beneficiaries' specific needs. Still, it may be a good idea to use ascertainable standards or other guidelines to ensure that the trustee acts in accordance with your wishes.

IRC-recognized ascertainable standards

The IRC recognizes several ascertainable standards, including support, support in reasonable comfort, maintenance in health and reasonable comfort, support in one's accustomed manner of living, education (including college and professional education), and health.

Whichever language you choose, careful drafting is important. Seemingly subtle differences can have significant implications. For example, "maintenance in health and reasonable comfort" would be a legitimate ascertainable standard, while "comfort, welfare or happiness" would not.

For extra protection, most trusts also contain a "savings" clause. This clause "saves" the trust in the event that the IRS or a court determines that the trust's distribution provisions aren't based on an ascertainable standard. A typical savings clause expressly prohibits the trustee from making discretionary distributions other than for a beneficiary's health, education, support or maintenance and from making distributions that would benefit the trustee.

Even IRS-endorsed ascertainable standards can lead to disputes among beneficiaries and make the trustee's job difficult. For example, if your trust allows distributions for education, does it make a difference if the beneficiary goes to a state university or an Ivy League school? If the trust provides for "support in one's accustomed manner of living," is that fair to beneficiaries who are students or work in low-paying jobs? To avoid disputes and ambiguity, consider including more specific language in the trust.

Ascertainable standards are objective, so they limit the trustee's discretion and allow a court to determine whether distributions are appropriate or should be compelled.

Pass the pen to your advisor

Including ascertainable standards in a trust provides flexibility in how assets are distributed to your beneficiaries while preserving estate tax savings, but great care must be given regarding the trust's language. Your estate planning advisor can help you determine the ascertainable standards that are right for your estate plan. ■

Leveraging the $5 million exemption

An installment sale to a defective trust is a powerful strategy

For affluent families, the $5 million gift and estate tax exemptions — which are scheduled to drop to $1 million after 2012 — provide an opportunity to transfer a great amount of wealth tax-free. It's possible Congress will extend the current exemptions into 2013 and beyond, but there are no guarantees. So now is a good time to explore strategies for making the most of this opportunity.

One strategy to consider is a combination of two effective estate planning vehicles: the installment sale and the intentionally defective grantor trust (IDGT). Ideal for assets expected to appreciate significantly, such as an interest in a closely held business, an installment sale to an IDGT has the potential to transfer substantial value at little or no tax cost. And because this technique requires

a gift of "seed money," it's most effective when the gift tax exemption is high.

Designing the trust

Here's how the strategy works: You set up a trust to purchase the property, and you name your children or others as beneficiaries. The trust is "defective" because it's designed so that contributions are completed gifts for transfer tax purposes but it's still treated as a "grantor trust" for income tax purposes. To accomplish this, you reserve certain powers — such as the right to substitute trust property with property of equal value — that cause the trust to be a grantor trust without pulling the trust assets back into your estate.

After the trust has been established, you contribute funds to "seed" the trust. This is important because, to ensure that the IRS will recognize an installment sale, the trust must have economic substance apart from the property you sell to it. Generally, seed money equal to at least 10% of the property's value is considered sufficient.

Ideally, your gift tax exemption will allow you to avoid tax on the seed money contribution. The higher the exemption, the more property you can transfer tax-free, which is why now is a good time to consider this strategy.

Next, you transfer business interests or other property to the trust in exchange for a promissory note. To avoid being deemed a partial gift, this installment sale should have terms that are commercially reasonable. Among other things, the interest rate should be at least as high as the applicable federal rate (AFR).

The key to transferring wealth tax-free is for the value of the property sold to the trust to grow faster than the AFR. That way, at the end of the trust term, the value your beneficiaries have received will exceed what the trust paid back to you in the form of installment payments. That's why this strategy is most effective for property expected to appreciate rapidly.

An IDGT is "defective" because it's designed so that contributions are completed gifts for transfer tax purposes but it's still treated as a "grantor trust" for income tax purposes.

Selling to your alter ego

Grantor trust status is important for two reasons. First, as grantor, you're required to pay taxes on trust income. This is beneficial because it allows the trust assets to grow without being eroded by taxes. Essentially, your tax payments are additional tax-free gifts to the trust beneficiaries.

Second, a grantor trust is treated as your "alter ego" for tax purposes. Selling property to a grantor trust is the equivalent of selling it to yourself, so you won't owe any taxes on the installment payments you receive. This is an advantage over a straight installment sale, which generates a combination of capital gains and ordinary income taxes with each payment.

Now's the time

An installment sale to an IDGT can be an effective estate planning tool anytime, but it's particularly powerful now. With the gift tax exemption at $5 million, you can transfer larger amounts of property — which require larger contributions of seed money — without triggering gift taxes. ∎

Estate Planning Pitfall

You own assets jointly with others

There's a common misconception that owning a home or another asset jointly with your spouse or child is an effective way to transfer the asset. It's true that, when people own property as joint tenants with rights of survivorship and one owner dies, the deceased owner's interest is automatically transferred to the survivor without going through probate. But joint ownership can have significant tax disadvantages.

For a married couple, it can waste one spouse's estate tax exemption. Suppose that you and your spouse jointly own a home. When you die, your interest automatically goes to your spouse tax-free under the marital deduction. Let's say that, when your spouse dies, the home is worth $10 million. Assuming a $5 million estate tax exemption and a 35% marginal rate, the home will generate $1.75 million in tax liability. You can avoid this tax by owning the home in equal shares as tenants-in-common and leaving your share to a credit shelter trust.

Adding your child's name to an asset's title as joint owner also can be a costly mistake. For one thing, it's considered an immediate, taxable gift of half of the property's value. What's more, joint ownership doesn't remove the home from your taxable estate (though an adjustment is made in computing the estate tax liability that offsets any prior gift tax reporting, so there's no double tax). Finally, it gives your child control over the property and exposes it to claims by the child's creditors.

Income taxes can also be a concern, especially if a jointly owned home is your principal residence and you sell it, which would normally qualify for special tax treatment. If you own only 50% of the property, only that percentage is eligible (unless the joint tenant also resides in the home and meets the other requirements). Before adding a joint tenant to your property, consider alternative ways to hold the property and still accomplish your objectives.

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Upcoming Changes to Washington Trust Law

Effective January 1, 2012, Washington trust law will include a specific duty for the trustee to provide administration information to trust beneficiaries. The new law may affect you if you are a trustee or a beneficiary of a trust.

For all irrevocable trusts, regardless of the date that the trust was created, the new law provides that the trustee must keep all beneficiaries reasonably informed about the trust administration. The new law includes a guideline for proper compliance with this standard in the form of an annual report to all beneficiaries. The annual report must include a listing of: (1) all receipts and disbursements from the trust, (2) all assets and liabilities of the trust, (3) the trustee's compensation, (4) all agents hired by the trustee and their compensation, if paid from trust assets, (5) any transaction that binds trust property for at least a five-year period, and (6) any transaction with trust assets that involved the trustee personally. Additional requirements may be necessary, depending upon the circumstances of the trust administration.

For irrevocable trusts that are created after January 1, 2012, the new law requires the initial trustee and each successor trustee to provide an initial notice to all trust beneficiaries that includes: (1) the name of the trust; (2) the identity of the person who created the trust; (3) the trustee's contact information; and (4) notice of the beneficiary's right to request administration information from the trustee. This new notice must be given within 60 days of the date that the trustee begins to serve.

If you would like to learn more about the new law or have estate planning questions in general, please contact a member of the Stokes Lawrence, P.S. estate planning team at (206) 626-6000 in Seattle or (509) 853-3000 in Yakima.

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