

# Protecting the Family Homestead and Vacation Homes

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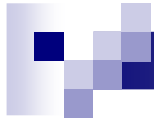
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## I. INTRODUCTION

### Additional Planning Techniques

- After basic estate planning documents are implemented, additional planning techniques might be considered to protect and preserve the family homestead and/or vacation homes.

- Under the Rule of 72s, assets will double in value every 10 years at 7.2%.
- A \$2,000,000 property will be worth \$4,000,000 in 10 years and \$8,000,000 in 20 years.
- Failure to plan likely will result in the need to sell the property to pay estate taxes.

|          |  |                    |
|----------|--|--------------------|
| Example: | \$2,000,000 property will increase in value to \$8,000,000 in 20 Years | \$8,000,000        |
|          | Less: Federal Estate Tax Exemption:                                    | <u>\$3,500,000</u> |
|          | Taxable Estate   | \$4,500,000        |
|          | Rate   | <u>45%</u>         |
|          | Federal Estate Tax Due   | <u>\$2,025,000</u> |

- Will there be sufficient liquidity to pay the estate taxes attributable to the asset without the need to either sell or mortgage the real estate?

### **Non-Tax Considerations**

- Family usually needs a charter to allow for the adoption and enforcement of reasonable rules and regulations, much like a condominium/hotel association.



## II. ESTATE/GIFT PLANNING TECHNIQUES

### General Rules

- Estate tax exemption in 2008 is \$2,000,000. Estate tax exemption in 2009 is \$3,500,000. Uncertainty exists as to where exemptions will settle. Uncertainty exists as to the effective rate.

NOTE: Obama: \$3,500,000 exemption with 45% bracket.  
McCain: \$5,000,000 exemption with 15% bracket.

- Solution, plan now. There are two options, both of which involve current gifting and/or selling property to irrevocable type trust.



## **Option 1: Consider Using the Qualified Personal Residence Trust ("QPRT")**

### A. *Description*

A QPRT is an irrevocable trust, which provides that, for a term certain, the Grantor retains the right to use the property and, upon expiration of the term, the trust distributes the property to designated beneficiaries (usually the children because the trust is ineffective for Generation Skipping Transfer purposes).

- The QPRT is the most popular technique because it is more traditional.
- Numerous disadvantages



B. Advantages

- The QPRT causes a substantial reduction in the value of the gift by taking into account retained term interest.
- Since property is worth more than the gift tax exemption amount, an outright gift will cost \$450,000 in gift taxes computed as follows:

|                               |                    |
|-------------------------------|--------------------|
| Fair Market Value of Property | \$2,000,000        |
| Gift Tax Exemption            | <u>\$1,000,000</u> |
| Taxable Gift                  | \$1,000,000        |
| Rate                          | <u>45%</u>         |
| Gift Tax Due                  | <u>\$ 450,000</u>  |

- To eliminate the gift tax due, a QPRT might be considered to fit a \$2,000,000 property into a \$1,000,000 gift tax window.



C. Example

- Grantor (age 75) transfers the property to QPRT, which provides that Grantor can use the property for 10 years. At end of 10 years, the property is distributed to the children, equally.

- Gift tax computation:


|                               |             |
|-------------------------------|-------------|
| Fair Market Value of Property | \$2,000,000 |
|-------------------------------|-------------|

|                            |                    |
|----------------------------|--------------------|
| Value of Retained Interest | <u>\$1,390,440</u> |
|----------------------------|--------------------|

*(per IRC Tables and 7520 Rate)*

|               |                   |
|---------------|-------------------|
| Value of Gift | <u>\$ 609,560</u> |
|---------------|-------------------|


- The main benefit to the QPRT is to reduce the value of the gift to fit within the applicable gift tax exemptions.



D. Disadvantages

- The Grantor must survive the term of the trust, otherwise the fair market value of the property would be includible in the decedent's estate.
  
- Example:
  - (1) If Grantor died in year 9 and the property is worth \$4,000,000, the full value of the property is includible in the decedent's estate. (No benefit was gained.)
  
  - (2) If Grantor survives term, property is distributed to children
  
  - (3) Grantor must rent property to continue using the property and keep it out of the Grantor's estate. (IRC § 2036).
  
  - (4) Generation Skipping Tax exemption cannot be allocated to a QPRT gift until expiration of the estate tax inclusion period (meaning, the date of the trust termination 10 years later). In this case, the property could be worth \$4,000,000 and it is unclear what the remaining GST exemption will be. If the exemption is \$3,500,000, the GST tax would be \$225,000 ( $\$4,000,000 - \$3,500,000 = \$500,000 \times 45\%$ ).
  
  - (5) No step-up in basis upon death. (Children get carryover basis with corresponding taxable gain if property is sold.)
  
  - (6) QPRTs are limited to a home or a vacation home.
  
  - (7) No distributions are permitted to be made to the children before the trust term ends.





E. Income Tax Consequences

- Grantor continues to pay all expenses associated with ownership and gets to deduct property taxes.

F. Observation

- Technique cannot be used for property subject to a mortgage since each mortgage payment would be considered an additional gift to the trust using up additional exemption. If exemption has been used, each payment of the mortgage will result in a taxable gift.

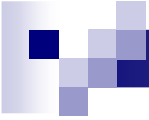


## Option 2: Consider Using Intentionally Defective Irrevocable

### Grantor Trust ("IDIGT")

#### A. Advantages

- Trust is irrevocable and assets are excluded from Grantor's estate.
- Transactions between Grantor and IDIGT are ignored for income tax purposes. (NOTE: Rent can be paid to the trust by the Grantor, which would be nontaxable to the trust (*this would have the effect of significantly reducing the decedent's estate without making any additional gifts*).
- The Grantor can sell appreciated assets to the IDIGT and the trust can sell appreciated assets to the Grantor free of income tax consequences (*this allows the Grantor to reacquire the property from the IDIGT and obtain a so-called step up in basis, if this is the goal*).

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- Add so-called "Crummey" withdrawal powers to expand the class of beneficiaries and take advantage of \$12,000 annual gift tax exclusion for children, grandchildren, and great-grandchildren, regardless of the number of lineal descendants per child.
  - Generation Skipping Transfer tax exemption will be allocated to IDIGT immediately so that the trust property can be held in trust in perpetuity in many states.
  - Consider transferring real estate to Limited Liability Company ("LLC") and gifting/selling LLC shares to a irrevocable trust. (*No requirement that asset be limited to personal residence.*)
  - Include in LLC provisions regarding management, operations, sale, put and all rights, and disposition of property.
  - When property is gifted to IDIGT, the Grantor retains no interest in the property so decedent cannot continue to use property in the absence of a rental payment. Not really a disadvantage since rent paid to the trust is income tax free to the trust (*and therefore does not adversely affect children's income tax obligations and also reduces decedent's estate without constituting a gift of any kind*).
  - Recent Revenue Ruling 2008-22, confirms that grantor trust will not be includible in decedent's estate, eliminating any confusion or concern about estate tax includability.
  - Consider having Grantor reacquire trust property to obtain a step up in basis.



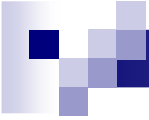
- Example:

- (1) Grantor, who is ill, has \$4,000,000 in cash and the property in trust is worth \$4,000,000 with little or no basis.
- (2) Decedent will die with \$4,000,000 in assets, regardless of whether it is the cash or low basis real estate.
- (3) Low basis assets are re-valued at death and heirs take a so-called step up in basis equal to the fair market value on death. IRC § 1014

Consider transferring cash to the trust and having the trust re-transfer the property to the decedent.

- (1) Decedent will die owning the property (worth \$4,000,000), but the heirs would receive a step up in basis equal to \$4,000,000.
- (2) Potential savings of \$800,000 in income taxes ( $\$4,000,000 \times 20\% = \$800,000$ ).  
*(This cannot be done with a Qualified Personal Residence Trust.)*

**NOTE:** This is such a significant benefit that the IRS issued a Regulation providing that a QPRT must specifically prohibit the reacquisition of the property by the Grantor and is applicable to any trust into which the QPRT property flows after the term of the QPRT.

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- If the property is worth more than the remaining gift tax exemption, consider "selling" the property to the IDIGT in exchange for a promissory note.
    - (1) Rent is paid by the Grantor to the IDIGT and the trust will repay the note with the rent paid.
    - (2) Payment of rent is non-taxable to the IDIGT.
    - (3) Purchase by the trust and the payment of amounts under the note, including interest, are non-taxable to the Grantor.
    - (4) Net effect is to freeze estate at the value on the date of sale to the IDIGT and, in fact, reduce the value of the estate as the note itself is paid down.