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QPRTs act as smart wealth-transfer tool

As discussed in my August column titled "Creative transfers of wealth may disappear by end of calendar year," many changes are scheduled to take place in the new year as the Bush-era tax cuts are set to expire. Namely, the $5.12 million estate tax exemption and lifetime gift exemption is scheduled to drop to just $1 million. While there has been tremendous buzz on Capitol Hill that the tax code will be revised to increase the estate tax exemption (and possibly the gift tax exemption) to $3.5 million or possibly $5.12 million, until the legislation is passed, no one can be certain. While I have been advising clients that the $1 million exemption is unlikely to stay, none of us expected the 2010 unlimited estate tax exemption to become reality.

Before we meet the infamous fiscal cliff, many high net worth clients are rushing to utilize some, if not all of the $5.12 million lifetime gift exemption before year end. But clients with modest estates are also looking to make gifts. If new legislation is not passed, the estate tax exemption of $1 million will subject far more clients to taxable gross estates and at a higher rate as the federal tax rate is scheduled to increase from 35 percent to 55 percent.

Since the election results were announced, there has been an influx of clients with modest estates interested in making gifts before year end who are reluctant to take a wait-and-see approach. The question then becomes, "What to gift?" For many clients with modest estates, the following assets are not appropriate for gifting:

- Retirement plan assets — although a Roth conversation may be beneficial, if a client does not have sufficient funds to pay the tax on the conversation it does not make sense;
- Investment portfolios — with clients living longer, many are reluctant to gift portions of their long-term investment portfolios out of fear that they will need the assets; and
- Life insurance — may be an appropriate fit for an Irrevocable Life Insurance Trust but not necessarily for an outright gift.

Even in today's depressed real estate market, for many clients, one of their most valuable assets (both from a quantitative and qualitative perspective) is a prime asset for wealth transfer — their home.

A qualified personal residence trust (QPRT) is a tried and true estate planning tool which freezes the value of the home at the current level and effectively transfers the asset at a discounted value for gift tax purposes. Furthermore, the transaction has a minimal effect on one's lifestyle. A QPRT is an irrevocable split-interest trust that is designed to hold and own a client's personal residence or vacation home and remove its value from the estate. A QPRT is created when the grantor, the person who creates the trust, transfers the grantor's interest in the residence to the trust. The grantor retains the right to occupy the residence for a fixed term of years. During the fixed term, the grantor would be responsible for all expenses associated with the property — real estate taxes, maintenance and ordinary repairs. At the end of the QPRT term, the residence passes to the beneficiaries of the trust (typically children and grandchildren).

> *"(N)one of us expected the 2010 unlimited estate tax exemption to become reality."*

THE BUZZ

Lindsey Paige Markus

Lindsey Paige Markus, a principal at Chuhak & Tecson P.C., draws on her early career in business, finance and clinically applied neuroscience to communicate with clients and develop creative solutions to fit their estate planning and asset protection needs. Lindsey was named an Illinois Super Lawyers Rising Star in 2010, 2011 and 2012. She is licensed in Illinois and Florida.

The calculation of the gift takes into consideration the grantor's retained interest. In this way, the valuation reflects a discount relative to the fair market value of the property. The calculation of the gift value depends on myriad factors, including the age of the grantor at the time the QPRT is created, the Internal Revenue Code Section 7520 applicable federal rate in the month of the transfer and the specified term. Generally, the longer the trust term, the larger the value of the retained interest, the smaller the value of the remainder, and the smaller the taxable gift.

In this way, the QPRT allows a client to effectively leverage use of her lifetime gift exemption. By funding the trust with the residence, the grantor is essentially making a gift of the residence to the beneficiaries of the trust. However, the gift is a gift of future interest and thus does not qualify for the annual gift tax exemption of $13,000, which requires the recipient to have a present interest.

Upon the expiration of the term, the property is effectively transferred to the beneficiaries of the trust. At such time, the grantor would enter into a lease agreement with the beneficiaries where the grantor pays fair market value rent. As an added bonus, the rental payments are for consideration of living in the property and are therefore not considered gifts to the beneficiaries, allowing for additional wealth transfer.

Suppose Kim, age 65, owns a home valued at $1 million. If Kim decides to make an outright gift of the property, the gift will use up $1 million of her lifetime gift exemption. Technically, Kim should not live rent-free and she should begin paying monthly rent to the owners of her home.

Alternatively, Kim can transfer her home to a QPRT for a 10-year term. Because Kim retains an interest in the property for 10 years, the value of the gift is not $1 million, but rather $696,890 (assuming an applicable federal rate of 1.2 percent). Although no gift taxes would be owed, Kim would file a gift tax return for informational purposes to advise the IRS that she utilized a portion of her lifetime gift exemption. And the three-year statute of limitations begins to run.

Valuation discounts on the property itself may also be available if a fractional interest in the home is transferred. Even in today's low interest rate environment, QPRTs continue to be incredible wealth transfer tools.