TRUSTS USED FOR TAX REDUCTION

By Brian D. Reynolds, Esq.

I. TYPES OF TRUSTS AND KEY TERMS

A. Inter Vivos vs. Testamentary – an inter vivos trust is one that is created by an individual while they are alive. By contrast, a testamentary trust is created pursuant to an individual's Last Will and Testament.

B. Revocable vs. Irrevocable – a revocable trust can be revoked or amended by the Settlor while an irrevocable trust generally cannot be changed.

C. Grantor/Settlor – the individual who establishes the trust.

D. Trustee – the individual or institution that is charged with overseeing the management of the trust (but not necessarily its assets). The Trustee owes a fiduciary duty to the beneficiaries of the trust.

E. Trust Protector - A trust protector is someone who is appointed to watch over a trust that will be in effect for a long time and ensure that it is not adversely affected by any changes in the law or circumstances.

   a. There are a number of reasons for appointing a trust protector. Having a protector allows a long-term trust to be more flexible and adapt to factual and legal changes. For example, beneficiaries may get divorced or die prematurely or the law may change. A protector can also be helpful if you believe there may be conflict among the beneficiaries and the trustee or if you are concerned that the trustee may not fulfill your wishes.

   b. The trust document should dictate the trust protector's powers including any or all of the following:

      i. Remove and replace a trustee

      ii. Allow the trust to be amended due to changes in the law

iii. Resolve disputes between trustees (if there is more than one) or between beneficiaries and the trustee(s)

iv. Change distributions from the trust based on changes in the beneficiaries' lives

v. Allow new beneficiaries to be added if there are additional descendents

vi. Veto investment decisions

F. Beneficiary – the person or entity for whom the trust is established.

a. Lifetime/Current

b. Remainder

II. <u>THE BENEFIT OF TRUSTS</u>

A. Many (but not all) trusts are created to accomplish one of two goals…control or tax reduction

B. The balance of this outline will discuss some of the more common types of trusts that are used for estate planning purposes

C. While there are many other types of trusts, each of which has many alternatives and concepts, this outline will focus on four types of trusts (not counting so-called Grantor Trusts that are being covered by a different speaker) that are most prevalent in my practice. The four trusts that will be covered are:

a. Credit Shelter Trusts

b. Irrevocable Life Insurance Trusts

c. Grantor Retained Annuity Trusts (GRAT)

d. Qualified Personal Residence Trusts (QPRT)

III. CREDIT SHELTER TRUSTS

A. So-called Credit Shelter or Bypass Trusts are perhaps the most common type of trust used in estate planning for married couples. The purpose of this type of trust is to "shelter" all or a portion of an individual's assets from estate tax at the surviving spouse's death.

B. To understand the benefits of a credit shelter trust, some background information on federal and State estate tax law is necessary.

C. Federal Estate Tax

a. Beginning on January 1, 2010, the federal estate tax was repealed. Prior to repeal, there was a federal estate tax on estates that exceeded $3.5 million. Starting in 2011, the federal estate tax exemption was $5,000,000. Today, the federal estate tax exemption is $5,120,000.

b. The following chart illustrates the federal gift, estate and generation-skipping transfer tax changes over the past few years:

	2009	2010	2011 & 2012	2013[1]
Estate Tax Exemption	$3,500,000	All Exempt	$5,000,000[2]	$1,000,000
Estate Tax Rate	45%	0%	35%	55%
Gift Tax Exemption	$1,000,000	$1,000,000	$5,000,000[3]	1,000,000
Gift Tax Rate	45%	35%	35%	55%
GST Exemption	$3,500,000	$3,500,000	$5,000,000[4]	$1,030,000

[1] Subject to future legislation.

[2] $5,120,000 in 2012

[3] $5,120,000 in 2012

[4] $5,120,000 in 2012

GST Rate	45%	0%	55%	55%

NOTE: For purposes of this outline, we will assume the federal estate tax exemption is $5,000,000 (not $5,120,000).

D. New Jersey Estate Tax

a. An estate tax is imposed on the estates of New Jersey resident decedents when the inheritance and death taxes paid to New Jersey and other states is less than the maximum credit allowed to the estate under the Internal Revenue Code as it existed on December 31, 2001

b. Imposed on estates greater than $675,000 with a maximum rate of 16%

E. Marital Deduction - All amounts bequeathed to a surviving United States citizen spouse pass tax-free of both federal and New Jersey Estate Tax

F. Examples:

a. The "Sweetheart" Will – Husband dies in 2012 with assets valued at $10,000,000. His will provides that his entire estate is to pass to his Wife. No federal or New Jersey estate tax will be due because of the unlimited marital deduction. However, if the $10,000,000 grows in value and is worth $15,000,000 at the time of Wife's death, approximately $1,750,000 ($5,000,000 x 35%) of federal estate tax will be due and approximately $1,900,000 ($15,000,000 x 16%) of New Jersey Estate Tax will be due.

b. The Planned Estate – The facts are the same as in the above example except this time, Husband's Will provides that the maximum amount possible for federal estate tax purposes passes to a credit shelter trust for the benefit of his Wife. This amount ($5,000,000), and all future appreciation on it, will be exempt from federal and New Jersey estate tax upon Wife's death. Accordingly, if the $5,000,000 originally placed in the trust is worth $7,500,000 at Wife's death, the family will realize a federal estate tax savings of $875,000. However, approximately $400,000 of New Jersey Estate Tax will now be due upon Husband's death.

c. CAUTION - In light of the new federal estate tax laws, a Credit Shelter Trust may receive all assets passing under a will resulting in unnecessary New Jersey Estate Tax being due.

i. EXAMPLE: Husband dies with assets valued at $5,000,000. His will, which was drafted in 1999 (when the federal estate tax exemption was $650,000), provides that the maximum amount possible without creating a federal estate tax should pass to a credit shelter trust for the benefit of his spouse. Accordingly the trust is funded with $5,000,000 million and approximately $400,000 in New Jersey Estate Tax is due. If Husband's Will had instead provided that only the maximum amount possible that could pass free of *New Jersey Estate Tax* should fund the credit shelter trust and that the balance of his estate should pass outright to his spouse, no tax would be due.

G. PLANNING POINT: In planning for New Jersey residents, the key is to strike a balance between taking full advantage of the federal estate tax exemption and the payment of New Jersey Estate Tax

H. The use of a trust(s) for the benefit of the surviving spouse also offers other, non-tax advantages such as:

a. Protection from creditors

b. Protection from subsequent marriages

c. The appreciation in value of the assets in the trust also escapes taxation

d. The guarantee that the remainder interest will pass to the beneficiaries named by the testator.

I. Portability

a. Beginning in 2011, for the first time, the concept of "portability" applied to the federal estate tax. By way of background, under prior law, if an individual died and failed to utilize all of his/her gift and estate tax exemption, this exemption was forever lost. Under portability, a surviving spouse would be able to utilize the unused exemption of his/her "deceased spouse" if the deceased spouse died after 2010. This means that, with respect to a typical husband and wife, if, in 2011, the husband dies and does not fully use his estate tax exemption, the unused exemption is then attributed to the wife, so that when she dies, her estate plan can use both her estate tax exemption and her late husband's unused exemption.

EXAMPLE: If, in 2011, the first spouse to die has a $5,000,000 estate and utilizes only $1,500,000 of exemption at death, the estate of the surviving spouse will have an $8,500,000 ($5,000,000 + $3,500,000) exemption available at his or her subsequent death.

b. Portability does not apply to New Jersey Estate Tax.

c. Practitioners should not automatically rely on portability since doing so will eliminate the ability to shelter appreciation of assets from estate tax. Furthermore, the non-tax benefits of the credit shelter trust will not be realized.

d. In order to claim portability, the estate of the first spouse to die must file a Form 706 even if it is not otherwise required to be filed.

J. Lifetime Credit Shelter Trusts

a. The significant increase in the lifetime gift tax exemption has created an opportunity (until 2013) for individuals to make large gifts. Spouses collectively could give up to $10 million without having to pay gift taxes. Clients may have a concern that gifts of $5 million ($10 million from a couple) are too much for their children (or trusts for their children) to receive. Furthermore, few couples can afford to give $10 million without potentially impacting their lifestyle in later years. A primary concern will be "Will I have enough left to live on?"

b. The donor may wish to make gifts in a way that the donor (or the donor's spouse) could retain some use of the assets in case they are needed as a "rainy day" fund. A popular way of using increased gift exemption may be for a donor to make gifts to a "lifetime credit shelter trust" for the benefit of the donor's spouse (and possibly children). The trust would likely be designed to give as much control and flexibility as possible to the surviving spouse without creating tax or creditor concerns.

c. The trust would be for the benefit of the donor's spouse, containing very similar terms as in standard credit shelter trusts created in wills. The trust may allow very broad control to the spouse but still not be included in the spouse's estate for estate tax purposes and may be protected against claims of both the donor's and spouse's creditors. In some ways, this is the ideal kind of trust for the spouse. Possible terms could include:

   i. Spouse as a discretionary beneficiary (perhaps with children as second beneficiaries)

   ii. Spouse as trustee (distributions to the spouse would be limited to HEMS)

   iii. Spouse could have a "5 or 5" annual withdrawal power

   iv. Spouse could have limited power of appointment (exercisable at death or in life)

   v. In case the donee-spouse predeceases, the power of appointment could be broad enough to appoint the assets back to a trust for the donor.

K. More Examples

a. Married Couple with $2 million and 2 children

   i. Sweetheart Will

   ii. Mandatory Credit Shelter Trust – federal exemption formula

   iii. Disclaimer Will

   iv. NJ-Only Credit Shelter Trust

v. All assets are jointly owned

vi. Spouse with no assets dies first

b. Married Couple with children from a prior relationship

i. Sweetheart Will

ii. Q-tip Trust

c. Married Couple with $10 million and 2 children

i. Portability – no growth

ii. Portability – with growth

IV. IRREVOCABLE LIFE INSURANCE TRUSTS (ILIT)

A. Life insurance is often a significant asset that individuals and practitioners fail to consider when putting together an estate plan.

B. This is particularly true since the client often does not consider a life insurance policy on their life to be an asset.

C. However, without proper planning, life insurance that is owned by the insured is included in their estate and potentially subject to estate tax. This will be the case if the decedent possesses any “incidents of ownership” in the life insurance policy including the right to borrow cash value, change the beneficiary or assign the policy to another person.

D. Irrevocable Life Insurance Trusts or ILITs are designed to remove life insurance proceeds from a person’s taxable estate.

E. The Logistics

a. Planning with an ILIT involves either (i) the transfer of an existing life insurance policy to an ILIT or (ii) the purchase by the ILIT of a new life insurance policy.

b. If a new policy is being acquired, the Trust should be designated as the owner and the beneficiary on the life insurance application.

c. If an existing life insurance policy is being transferred to the ILIT, a Change of Ownership Form and Change of Beneficiary Form will need to be procured from the insurance company.

   i. Where an existing policy is transferred to an ILIT, the transferor must survive the transfer by three years.

   ii. Failing to do so will cause the policy to be included in his estate and the benefits of the ILIT will not be realized.

d. Once the life insurance policy is owned by the ILIT, the Trustee should open a checking account in the name of the trust using the ILIT's Employer Identification Number which is obtained from the Internal Revenue Service.

e. The checking account should be funded with approximately one years' premium on the policy.

f. When the premium notice is received by the Trustee, he should request the funds needed to pay the premium from the Grantor. For reasons discussed below, these funds should then be deposited into the ILIT's checking account for a period of no less than thirty days.

g. Gift Tax Considerations

   i. Whether an existing policy or cash needed to purchase a new policy is transferred to the ILIT, there is the potential for gift tax consequences.

   ii. While a term life policy generally does not have significant value, whole life policies often do.

   iii. In either event, a Form 712 should be obtained from the life insurance company.

   iv. Finally, in addition to the initial transfer to the trust, the payment of premiums on any life insurance policy that is owned by the trust is a taxable gift.

1. The contribution of funds to an irrevocable trust in which the beneficiary's enjoyment is postponed is a gift of a future interest and therefore does not qualify for the annual exclusion.

2. That said, each premium payment could result in the use of the grantor's lifetime gift tax exemption or the imposition of gift tax.

3. To avoid this problem, the ILIT should be drafted to contain certain provisions that make transfers to the trust present interests for the beneficiaries.

v. Withdrawal/*Crummey* Powers.

1. In general, the ILIT should provide that each time a contribution is made to the trust, the beneficiaries have the right to withdraw an amount not to exceed the current annual exclusion.

2. Upon making a deposit into the ILIT, the Trustee should send each of the beneficiaries a so-called Crummey letter advising them of their right of withdrawal.

3. The Crummey letter should provide, in pertinent part, the following language:

This letter serves as formal notice to you that on ____________, ______, a transfer having a value of $_____________ was made to the above-captioned Trust (hereinafter the "Trust"). Please be advised that you have the right, upon written request to the undersigned Trustee of the Trust, to receive payment from the principal of the Trust in an amount equal to $__________ with respect to this transfer. This right to receive payment generally lapses thirty (30) days after the date of the above contribution to the Trust.

Please confirm that you have been notified of such right by signing the enclosed copy of this letter in the space *provided. After the enclosed copy of this letter is fully executed, please return it directly to the undersigned at the above address. Additionally, please inform the undersigned in the event you wish to exercise your right to receive payment with respect to all or a portion of the above transfer to the Trust.*

V. GRANTOR RETAINED ANNUITY TRUST (GRAT)

A. A Grantor Retained Annuity Trust ("GRAT") is one of the estate planning techniques based primarily on interest rate assumptions. Clients create GRATs using assets that are likely to earn more than the Internal Revenue Service's measuring standard (the Section[5] 7520 interest rate) during the GRAT term in an effort to pass the appreciation in the assets to the beneficiaries of the trust free of gift and estate tax.

a. Interest rates are at historic lows.

b. The September 2012 Section 7520 rate is 1.0%.

B. The Logistics

a. A grantor creates a GRAT by transferring assets to an irrevocable trust for the benefit of one or more noncharitable beneficiaries and retains an annuity interest for a term of years.

b. For transfer tax valuation purposes, the amount of the taxable gift is the fair market value of the property transferred minus the value of the grantor's retained annuity interest.

c. At the end of the term reserved by the grantor, the trust assets are distributed to the beneficiaries selected by the grantor.

d. If the grantor dies during the GRAT term, the value of the remainder interest in the trust is included in the grantor's taxable estate under either Section 2036 (retained income, possession, or

[5] All references to "Section" are references to a section of the Internal Revenue Code of 1986, as amended.

enjoyment of property) or 2039 (retained right to receive annuity in transferred property).

e. If the trust instrument meets the requirements of Section 2702 of the Internal Revenue Code, the IRS assumes that the trust assets will produce a return equal to the Section 7520 rate applicable to the month of transfer.

f. The annuity amount is paid to the grantor during the term of the GRAT, and any property remaining in the trust at the end of the GRAT term passes to the beneficiaries with no further gift tax consequences.

g. Thus, if the GRAT assets produce a return in excess of the 7520 rate, the increase in value above the Section 7520 rate is passed to the beneficiaries free of gift tax.

h. The actuarial value of the amount of the remainder interest passing to the beneficiaries of the GRAT upon its termination is a gift to the remainder beneficiaries subject to gift tax.

E. Example

a. Assume that a parent who is 60 years old funds an irrevocable trust with $1,000,000 in September of 2012. Under the terms of the trust, parent receives an annual annuity for 10 years of $50,000. If the Section 7520 rate is 1.0 percent, the value of parent's retained interest is valued at $443,265 and the remainder interest is valued at $556,735. Thus, the right to receive a $50,000 annuity for 10 years is worth $443,265 and the right to receive the remainder at the end of 10 years is worth $556,735. The value of the remainder interest, $556,735, would be subject to gift tax upon creation of the GRAT. Assume further that the trust earns 3% per year and grows at a rate of 7% per year. After 10 years, the remainder interest that passes to the beneficiaries will be $1,817,713.

b. Under the above funds, the parent would have transferred $1,817,713 to the beneficiaries at a gift tax "cost" of only $556,735.

F. Governing Instrument Requirements of a GRAT.

a. The most important element in structuring a GRAT is to make sure that the governing instrument (irrevocable trust) meets the requirements of Section 2702 so that the grantor's retained interest may be subtracted in determining the grantor's gift to the remainder beneficiaries. Otherwise, the grantor's retained interest is valued at zero and the gift made by the grantor to the remainder beneficiaries is the entire value of the trust assets.

b. Under Section 2702, a "qualified interest" is valued under Section 7520. If the grantor retains an interest that is not a qualified interest or does not meet one of the exceptions to Section 2702, the retained interest is valued at zero. Thus, if the requirements of Section 2702 are not met, a GRAT could result in a taxable gift equal to the entire value of the trust assets regardless of the interest retained by the grantor.

c. Section 2702(b) defines a "qualified interest" to be:

i. Any interest which consists of the right to receive fixed amounts payable not less frequently than annually, and

ii. Any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually).

d. The term of the annuity in a GRAT must be a fixed amount of time equal to the life of the annuitant, a specified term of years, or the shorter of those two periods.

e. The trust instrument must require that the annuity amount be payable to the holder of the annuity interest at least annually.[6]

f. The annuity must be paid to the grantor regardless whether the trust has produced income equal to the annuity. If trust income is insufficient, the trustee must be required to invade principal to pay the annuity. A note, other debt instrument, option, or similar

[6] Treas. Reg. § 25.2702-3(b)(1).

financial arrangement may NOT be used, directly or indirectly, to pay the annuity amount.[7] Therefore, the assets in the GRAT must produce a sufficient annual cash flow to pay the annuity amount, or must be sufficiently liquid that the trustee can sell or distribute a portion of the assets each year to satisfy the annuity amount.[8]

g. The annuity amount must be a fixed amount expressed either in the terms of a fixed dollar amount or a fixed percentage of initial fair market value of the property transferred to the trust as finally determined for federal tax purposes.[9]

h. The trust instrument must prohibit:

   i. Additional contributions to a GRAT.[10]

   ii. Commutation, or the prepayment by the trustee of the grantor's annuity interest.[11] The purpose of prohibiting commutation is to prevent termination of a GRAT when the grantor's life expectancy is short. If a grantor dies during the term of the GRAT, a portion of the GRAT will be included in the grantor's estate under Section 2036. This amount could be reduced if the trustee could terminate the GRAT before the grantor's death by paying the grantor an amount equal to the actuarial value of the grantor's remaining interest and delivering the balance of the trust assets to the remainder beneficiaries.

   iii. Payments from the trust before the expiration of the qualified interest to or for the benefit of any person other than the annuitant.[12]

---

[7] Treas. Reg. § 25.2702-3(b)(1)(i)

[8] *See* Howard M. Zaritsky, *Y2K--A Vintage Year for GRATs*, 28 Estate Planning 144 (March 2001).

[9] Treas. Reg. § 25.2702-3(b)(1)(ii)

[10] Treas. Reg. § 25.2702-3(b)(5)

[11] Treas. Reg. § 25.2702-3(d)(4)

[12] Treas. Reg. § 25.2702-3(d)(2)

iv. For trusts created on or after September 20, 1999, issuance of a note, other debt instrument, option, or similar financial arrangement in satisfaction of the annuity payment obligation.[13]

G. Zeroed Out GRAT.

a. A zeroed-out GRAT is a GRAT in which the value of the grantor's retained interest is equal to the value of the property transferred to the trust, resulting in a remainder (and a gift-tax value) of zero.

b. Under IRS Regulation Section 25.2702-3(e), Example 5, the computation of the taxable gift made upon creation of a GRAT always has a mortality component. In such case, the value of the GRAT remainder could never be "zeroed out" (have a value of zero) and thus not result in a taxable gift -- even where the annuity was payable for a fixed term without a reversionary interest and was expected to exhaust the trust principal by the end of the term under IRS annuity valuation tables.[14] Walton v. Commissioner, 115 T.C. 41 (2000), appears to resolve the question of whether a zeroed out GRAT is possible. Before Walton, IRS Regulations provided that even if a grantor retained the right to receive an annuity over a fixed term in a GRAT, the value of the qualified annuity interest was determined as though the right to the annuity was retained for the shorter of the fixed term or until the grantor's death.[15] Pre-Walton, the right to receive an annuity for the shorter of an individual's life or a fixed term was considered by the IRS to be worth less than the right to receive an annuity for the entire fixed term. The IRS allowed the retained annuity interest to be valued only if the grantor would receive it during life. Any interest that would pass to the grantor's estate if he or she died during the term of the GRAT would not be included in the value of the retained annuity interest. Therefore, the amount of the annuity was reduced by the probability of the individual's death before the end of the term and that amount is

[13] Treas. Reg. § 25.2702-3(d)(5)(i)

[14] Deborah V. Dunn, *Coming to a Wal-Mart Near You: Tax-Free GRATs*, Trusts & Estates (April 2001) p. 10, 12.

[15] Treas. Reg. § 25.2702-3(e), Example (5).

considered a remainder interest taxable as a gift to the remainder beneficiaries.

c. Under Walton, the value of an annuity payable over a term to the grantor and to the grantor's estate if the grantor dies during the GRAT term is not reduced by the value of the contingent interest that the grantor's estate if the grantor dies during the GRAT term because a fixed annuity payable to the grantor or the grantor's estate does constitute a "qualified interest" under Section 2702. Therefore, a fixed GRAT period may be established in the trust document that will not terminate if the grantor dies during the GRAT term. A GRAT that pays the annuity amount to the grantor during his or her lifetime, and to his or her estate if the grantor dies during the term of the GRAT will be included in the value of the retained annuity interest. This removes the decrease previously required to be made to the retained interest to account for the possibility of the grantor's death during the term and allows the GRAT to be zeroed out leaving a remainder of zero. It should be noted that The Internal Revenue Service has not acquiesced in the Walton decision and thus its position on this issue remains uncertain.

H. Transfer Tax Aspects of GRATs.

a. Under Section 2702(a)(2)(B), the value of a qualified annuity interest is determined under Section 7520. Thus, the value of a gift to a GRAT will be determined by subtracting from the value of the assets transferred to the GRAT an amount equal to the actuarial value of the retained annuity. If the annuity would exhaust the trust funds before the last annuity payment is to be made, the annuity is not considered payable for the entire period.

b. A GRAT is a more attractive technique when the Section 7520 rate is low. As the Section 7520 rate decreases, the value of the retained interest in a GRAT will increase. This occurs because a decrease in the assumed rate of return makes the right to receive fixed amounts in the future more valuable.

c. There should be no gift tax consequences upon the termination of the GRAT. Because the grantor's gift was complete for gift tax purposes when the trust was created, the trust assets remaining in the GRAT upon the expiration of the annuity term are paid to the remainder beneficiaries without any additional gift tax imposed on the grantor. If the trust property generates income and appreciation in excess of the Section 7520 rate used to value the annuity interest when the GRAT was created, property will be transferred to the remainder beneficiaries without being subject to gift tax.

d. If the grantor dies during the term of the GRAT and has the right to receive further annuity payments, a portion of the GRAT will be included in the grantor's gross estate for federal estate tax purposes. The value of property transferred during the transferor's life is included in the transferor's gross estate if the transferor retained for life or for a period that did not end before the transferor's death, the right to receive the income from the transferred property.[16]

e. Under a GRAT, the grantor does not explicitly retain the right to receive income, rather, the grantor retains the right to an annuity. The Internal Revenue Service treats an annuity as if it were the right to receive the income from a portion of the principal of the trust. The included portion is that fraction of the trust which would be required to be invested at the Section 7520 rate in effect on the date of the grantor's death to produce income equal to the required annuity payment.

f. A GRAT is NOT an appropriate device to use in a generation-skipping transfer. The transfer of assets to a GRAT is a transfer to a trust and not to a grandchild. The generation-skipping transfer occurs when the grantor's interest in the GRAT terminates. Thus, GST exemption must be applied when the GRAT terminates and the ability to leverage the client's GST exemption is lost.

g. If the grantor dies during the GRAT term and the right to the remaining annuity payments passes to a surviving spouse, in order to ensure that the value of the remaining annuity interest qualifies for the estate tax marital deduction under Section 2056, the grantor's estate planning documents should provide that if the grantor's spouse survives the grantor, the annuity payments

[16] Internal Revenue Code Section 2036.

will either (1) pass outright to the surviving spouse or her estate or (2) pass to a marital trust over which the spouse has a general power of appointment.

I. Situations Where a GRAT Should Be Considered.

a. Leverage Unified Credit Gift With No Downside Risk. A GRAT allows a client to leverage transfers to children. As long as the asset appreciates more than the Section 7520 rate, the children win. If the asset does not outperform the Section 7520 rate, then the client receives back the asset with no tax repercussion.

b. Client Has Made Unified Credit Gift and Does Not Want to Pay Gift Tax. Some clients have made unified credit gifts and are reluctant to make additional gifts because of the aversion to paying gift tax. The client in this situation should consider a zeroed-out GRAT. A zeroed-out GRAT does not result in a taxable gift to the remainder beneficiaries and the client does not pay gift tax. If the trust assets outperform the Section 7520 rate, the client has made a transfer to children or other beneficiaries outside the transfer tax system.

c. Asset With Significant Appreciation Potential in Short-Term. A GRAT may be an ideal vehicle for the transfer of significant appreciation on an asset. Assume the client owns an interest in a business that may go public in the near future. If the client transfers the business interest to a short-term zeroed-out GRAT, most of the appreciation will be transferred tax free. If the client has more than one asset with this potential, it is wise to use a separate GRAT for each asset so as not to dilute the appreciation.

d. Client Has Portfolio That Will Outperform the Section 7520 Rate and Wants to Minimize Transfer Taxes. The key to using a GRAT to leverage transfers is selecting assets that will outperform the Section 7520 rate. Today's historically low Section 7520 rate make this a likely outcome.

J. Conclusion.

a. The potential transfer tax advantages of a GRAT derive from the assumptions used to value the income and remainder interests under Section 7520. In determining the present value of the split interests, Section 7520 assumes that the transferred property will produce income equal to a prescribed interest rate and the principal value of the property will not increase or decrease.

b. If the total of the income and appreciation from the property is greater than the Section 7520 rate, the remainder interest will have been undervalued for federal transfer tax purposes and any excess value passes to the remainder beneficiaries free of transfer tax. If the income and appreciation from the property do not outperform the Section 7520 rate, the taxable gift is greater than the remainder interest passing to the remainder beneficiaries. If the GRAT is structured so that the remainder interest is relatively small, the downside of a GRAT is slight and the upside is large.

c. Today's historically low interest rates make GRATs a very popular and effective estate planning vehicle.

VI. QUALIFIED PERSONAL RESIDENCE TRUSTS (QPRT)

A. In general, a qualified personal residence trust ("QPRT") is a technique which allows the owner of a personal residence to give the residence in trust for the ultimate benefit of children or other beneficiaries in a way so that the gift tax value of the residence is significantly below its fair market value.

B. Under the terms of the QPRT, the owner, as grantor of the trust, retains the right to use the residence for a specified period of years. At the end of that term of years, the residence passes to the beneficiaries named in the trust instrument.

C. How to Create a QPRT.

a. An irrevocable trust is created by the grantor, and the grantor then transfers a personal residence to it. In creating the trust, the grantor specifies the number of years during which the grantor may live in the residence. At the end of the specified period, if the grantor is living, title to the residence is transferred from the trust to the beneficiaries designated in the trust instrument - typically, children or trusts for their benefit.

b. If the grantor dies before the end of the specified period, the residence is transferred back to the grantor's estate. In that event, there is no benefit from the QPRT, because the residence is included in the grantor's estate at its value at death, and the result is the same as if the QPRT had not been created. Any gift tax exemption used by the grantor in creating the QPRT is restored.

D. What Makes a QPRT Attractive?

a. The grantor's retained occupancy right lowers the value of a gift of the residence by the actuarial value of the grantor's retained interests. If the grantor lives beyond the specified number of years, then the property and its appreciation is excluded from the grantor's estate. As a result, the difference between the gift tax value of the property and its fair market value, and all appreciation subsequent to the time of the gift, escapes both gift and estate tax.

b. The actuarial value of the retained use is based on a number of factors. The first is the assumed rate of return, which the federal government determines monthly. The second factor is the period of years for the grantor's retained use. The final factor is the grantor's age. Accordingly, the longer the period specified for the retained right to use the residence, the higher the interest rate, and the older the grantor, then the more the value of the gift is reduced - and, the greater the potential tax benefit.

c. The potential for long term benefit from a QPRT may be illustrated in the following example:

d. Example: Client is 70 years old and has an un-mortgaged vacation home worth $1,000,000. He establishes a QPRT and transfers the vacation home to it. The QPRT provides that client retains the right to live in the home for 10 years at which time the home passes to his children. At the time the QPRT is established and funded, the Section 7520 rate is 1%. The actuarial value of client’s retained interest in the property is $384,900 and the taxable gift is $615,100. Assuming the value of the property grows 4% per year, it will be worth $1,480,244 at the end of the 10-year term. Accordingly, client's children will receive an asset with that value but client will have only used $615,100 of his gift tax exemption.

E. Gift and Estate Taxes Concerns.

a. The gift made when the QPRT is created does not qualify for the annual exclusion ($13,000 in 2012). Therefore, the gift uses a portion (or all) of the grantor's available lifetime gift tax exemption ($5,120,000 in 2012) which has not already been used. If the value of the gift combined with other post-1976 gifts exceeds the available credit amount, then gift tax will be due.

b. A longer trust term decreases the value of the gift on which gift tax potentially must be paid, but a longer trust term also increases the risk that the grantor will not survive the fixed QPRT term of years. The value of the gift is also affected by the IRS interest rate applicable at the time when the QPRT is created, which fluctuates based on monthly market interest rates.

c. If the grantor dies before the end of the period selected, it is as if no gift had been made and there is no benefit from the QPRT, because the residence is included in the grantor's estate at its value at death. Any lifetime gift tax exemption used, however, would be restored.

d. The residence may not be sold (directly or indirectly) to the grantor or the grantor's spouse (or to an entity controlled by either of them) at any time after the QPRT is created. The residence may, however, be sold to other persons (including family members), in which event the proceeds may be invested in a new residence. Any proceeds not invested in a new residence are converted into an annuity for the grantor until the end of the fixed QPRT term.

e. If the grantor survives the trust term, then the residence passes at the end of the trust term for the remainder beneficiaries without any additional gift or estate tax cost, even if the property has appreciated substantially from its value at the time of its transfer into the trust.

F. Distribution Upon QPRT Termination.

a. After the specified number of years has passed and the residence is distributed out of the trust, it will no longer be held for the grantor's benefit. If the grantor wishes to continue to use the residence, the tax law makes provision for the grantor to rent it from the beneficiaries (if agreeable) at a rent that is not below fair market value.

b. When the QPRT is created, there should be no agreement or understanding (oral or written) about the renting of the residence by the grantor once the fixed term is reached. Accordingly, it is important that the grantor understand he or she cannot be certain of continued use of the residence at the end of the period.

c. It is possible to direct that the residence remain in continuing trust at the end of the specified period. Children are typically designated as beneficiaries of the continuing trust, and one or more of the children may act as trustee. If the grantor is married, the grantor can provide for a continuing trust which gives his or her spouse a life use of the residence.

d. An additional income tax planning advantage may be available through provision for flexibility to subject the grantor (rather than children or the trust) to income taxation on the trust under the grantor trust income taxation rules.

G. Other QPRT Issues.

a. The fact that a residence is subject to a mortgage does not affect its status as a personal residence. During the trust term, the grantor will be treated as the owner of the income and corpus of the trust for federal income tax purposes and therefore will be entitled to deductions for mortgage interest, taxes and other deductions applicable to the property during the trust term. For purposes of determining the value of the gift of the remainder interest, the mortgage must generally be taken into consideration. Each time a mortgage payment is made and a portion of the principal loan balance is reduced, the grantor would be treated as having made an additional gift to the QPRT.

b. Based upon the above, this could create additional accounting, tax, and administrative burdens. It is typically advisable not to use a mortgaged property for a QPRT - or, if a mortgage exists, to enter into an agreement at the creation of the QPRT whereby the grantor is to be personally liable for the mortgage debt.

c. The tax law strictly limits the assets, other than a residence, that a QPRT can hold, as well as the uses that may be made of the QRPT property (including insurance proceeds due to damage to the residence). Also, where a grantor no longer makes use of the residence (due to placement in a nursing home, or for some other reason), the trust may cease to qualify as a QPRT if the property is rented to others.

d. In some situations, it may be advantageous for a QPRT to be created for a partial interest (say, an undivided one-half) in a residence. This may be helpful in planning for a married couple to use each spouse's available gift tax exemption amount ($5,120,000 in 2012). Use of a partial interest may also permit a valuation discount to reduce the amount of the taxable gift.

e. Example. Husband and wife are both 70 years old and own a residence valued at $1,000,000 as joint tenants. They want to transfer the property to a QPRT at a time when the Section 7520 rate is 1% but also want to retain the right to live in the residence for a period of 10 years. Counsel should first prepare a new Deed for the residence so it is owned by Husband and wife as tenants-in-common. A valuation discount appraisal should then be obtained to determine the discount available for a 50% tenant-in-common interest. Assuming the valuation discount is 15%, the “net value” of the residence is decreased to $850,000 ($1,000,000 x 85%). Husband and wife then each create 10-year QPRTS and fund them with their respective interest in the residence which is valued at $425,000 ($850,000 ÷ 2). The value of the interest retained by Husband and wife is $163,583 each and each of husband and wife make a taxable gift of $261,417. Assuming the residence appreciates 4% per year, at the end of the 10-year term, the residence will be worth $1,480,244. Thus, as asset valued at that amount will have passed to the children and husband and wife will only have used $261,417 each of their gift tax exemption.

f. Although a low interest rate environment is not ideal for QPRTs, today's depressed real estate values make QPRTs a viable and effective estate planning tool.

g. Finally, the current $5,120,000 gift tax exemption amount is scheduled to decrease as of January 1, 2013 to $1,000,000 and remain at that level, unless Congress enacts legislation to put it at a different level (e.g., $3,500,000). Accordingly, it is important for taxpayers considering a QPRT to determine whether to move forward and put it in place before calendar year end 2012.