Insight on Estate Planning

Year End 2009

Home in on tax savings with an RPM trust

If you wish to transfer a personal residence to the next generation at a low tax cost, a remainder purchase marital (RPM) trust is worth a look. Although a qualified personal residence trust (QPRT) is a more common vehicle for transferring a home, an RPM trust offers several advantages, including increased flexibility and the elimination of mortality risk.

QPRT pros and cons

A QPRT is a type of grantor retained income trust. You transfer your home to an irrevocable trust, retaining the right to live in the home for a specified term. At the end of the term, ownership of the home goes to your children or other named beneficiaries. (You can, however, arrange to continue living in the home by paying fair market rent.)

Your children's future interest in the home (called a remainder interest) is considered a taxable gift. To calculate the gift's value, the present value of your right to live in the home is subtracted from the fair market value of the home at the time you establish the trust.

If you're married, using an RPM trust to transfer a home eliminates mortality risk and can offer greater flexibility than a QPRT.

Present value is calculated using IRS tables that take into account your age, the length of the trust term and the current Section 7520 discount rate. The older you are, the longer the trust term and the higher the Sec. 7520 rate, the lower the value of the taxable gift to your beneficiaries.

A QPRT allows you to transfer your home at a reduced tax cost because gift tax liability is based on your beneficiaries' remainder interest, which is a fraction of the home's current value. Plus, it freezes the value of your home for gift and estate tax purposes: Any appreciation in value in excess of the Sec. 7520 rate goes to your beneficiaries tax free. Also, QPRTs are specifically authorized by the Internal Revenue Code, thus providing some peace of mind that the IRS won't challenge its tax benefits.

QPRTs aren't without their drawbacks, though. The most significant is mortality risk: If you don't survive the trust term, the home's full value will be pulled back into your taxable estate.

In addition, QPRTs are subject to several restrictions that limit their flexibility. For example, they generally can't hold assets other than a

personal residence. They also lose their tax-favored status if the home ceases to be used as a personal residence or is sold and not replaced with another personal residence within two years.

The RPM alternative

If you're married, using an RPM trust to transfer a home eliminates mortality risk and can offer greater flexibility than a QPRT.

The main downside may be that, unlike QPRTs, RPM trusts aren't specifically authorized by law and have not been fully tested in the courts, so there's less certainty about whether they'll withstand an IRS challenge. But as of this writing, there's no indication from the courts that a properly structured RPM trust won't achieve its intended purposes.

Here's how an RPM trust works: You transfer a personal residence (or other property) to a trust. (If you own the home jointly, your spouse will have to transfer his or her interest to you first, but the transfer can qualify for the marital deduction.) At the same time, you give your spouse an income interest (while the trust holds the home, this would mean the right to live in it) in the trust for life or for a term of years and *sell* the remainder interest to your children or other beneficiaries. (You receive the proceeds from the sale and might recognize a gain or a loss, depending on how the transaction is structured.)

Because you retain no interest in the RPM trust, the property is immediately removed from your estate — eliminating the mortality risk. (Remember, this is unlike a QPRT, where you must survive the trust term for the property to be removed from your estate.) And, if the RPM trust is designed properly, your spouse's interest should qualify for the estate tax marital deduction without being included in his or her estate.

So long as your beneficiaries pay adequate and full consideration for their remainder interest (based on Sec. 7520 tables), there's no gift or estate tax. You can even design an RPM trust that terminates if you die during the trust term. That way, if you don't survive the term, your beneficiaries will receive the property early. (Be aware, however, that your spouse's income interest will terminate when the trust terminates, so to continue to live in the home, he or she will have to rent it from your beneficiaries.)

If your beneficiaries have the resources to buy their remainder interests, you can fund an RPM trust without generating gift taxes. Otherwise, you may have to make taxable gifts to finance their purchases.

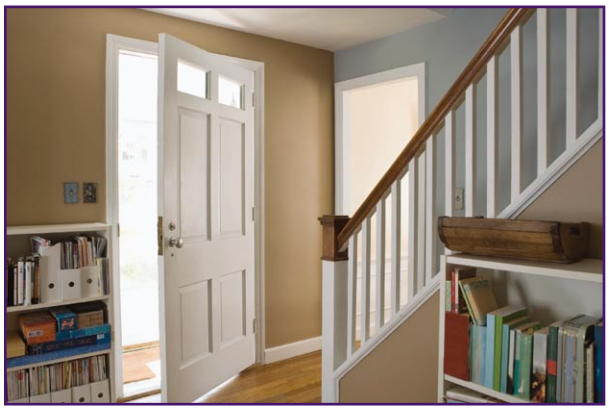
Comparing prices

Suppose that Bob, age 65, wants to transfer his $1 million home to a trust for the benefit of his son, Gary. Assuming a Section 7520 rate of 5%, if Bob transfers the home to a 10-year QPRT, he'll make a taxable gift of about $467,000. Alternatively, if Bob uses an RPM trust, the cost of Gary's remainder interest will be about $614,000.

The "price tag" of the remainder interest is higher because Gary will receive the property even if Bob doesn't survive the term, so it's more valuable than the QPRT's contingent remainder interest. If the RPM trust provides for the property to be transferred to Gary early if Bob dies during the term, the cost of the remainder interest will be even higher, approximately $652,000.

Bob can reduce the cost of an RPM trust by increasing the term. For example, the cost of a remainder interest in a 20-year RPM trust would be about $377,000 ($509,000 for a trust that permits early transfers). In other words, Bob can fund a 20-year RPM trust for less than a 10-year QPRT. A 20-year QPRT, of course, would be even less costly, but mortality risk would likely make it impracticable.

It's important to note that, all else being equal (the home's value, the trust term and the Sec. 7520 rate), the remainder interest in an RPM trust will be worth more than the remainder interest in a QPRT because of the elimination of the mortality risk. So an RPM trust can be more costly than a QPRT.



On the other hand, because the mortality risk is eliminated, you can use a longer trust term to reduce the purchase price. (See "Comparing prices" on page 3.) Also, at least a portion of any gifts you make to fund your beneficiaries' purchase of the remainder interest may qualify for the annual exclusion; the gift of a remainder interest in a QPRT won't qualify.

As mentioned, an added benefit of RPM trusts is flexibility. For example, a home held in an RPM trust could be rented out, and your income-beneficiary spouse would receive the rent. Or the home could be sold and the proceeds used to buy, for example, income investments such as bonds and dividend-paying stocks. Either option could be beneficial if the home no longer meets your needs. The cash flow from the trust could be used to pay rent on a more suitable home or to pay other expenses.

You get what you pay for

RPM trusts can cost more than QPRTs, and they aren't officially sanctioned by the Internal Revenue Code. But by eliminating mortality risk and providing the flexibility to rent out or sell your home, they may well be worth it. ▮

A formula for estate planning success?

An important goal of many estate plans is to optimize use of the unlimited marital deduction, which allows you to leave any amount of assets to your spouse estate-tax free, so long as he or she is a U.S. citizen. In many cases, however, leaving too much to your spouse can cause you to waste your estate tax exemption amount ($3.5 million for 2009) and overpay estate taxes.

To achieve the best tax result regardless of what the future holds, many people incorporate a marital deduction formula into their estate plans. But bear in mind that formulas aren't right for every situation, and their impact can change over time, such as when net worth or tax laws change. If your plan includes a formula, it's a good idea to periodically review it to ensure that it won't produce unexpected results.

How do formulas save taxes?

Let's say, for example, that your estate is worth $7 million. If you die this year — when the exemption amount is $3.5 million — and leave your entire estate to your spouse, there's no estate tax because of the unlimited marital deduction. But now your spouse has an estate worth $7 million (or more). If your spouse dies and the exclusion amount remains at $3.5 million, his or her estate will owe at least $1.575 million in estate taxes (assuming a 45% marginal rate).

By leaving everything to your spouse, you've wasted your exemption amount. You could have avoided this result by placing your exemption amount ($3.5 million in this case) in a credit shelter — or bypass — trust, which provides your spouse with benefits for life and, on your spouse's death, transfers the remaining assets to your children or other beneficiaries. This trust would take full advantage of your exemption amount and would *bypass* your spouse's estate, eliminating the $1.575 million tax hit.

Because it's difficult to predict what the exemption amount will be years or even decades down the road, a formula may be desirable to ensure the optimal tax result. Essentially, a formula provides that the largest amount that can pass tax free by virtue of the exemption goes into a bypass trust. That way, you make the most of your exemption amount, whether it's $1 million or $5 million.

Which formula is best?

There's no easy answer to that question. Marital deduction formulas generally fall into two categories: pecuniary and fractional. A pecuniary formula calls for your estate to go to your spouse and to a bypass trust in amounts that will make the most of your exemption amount and minimize estate taxes. A fractional formula distributes assets between your spouse and a bypass trust according to a fraction in which your spouse receives the smallest fraction of your estate (as of your date of death) that minimizes estate taxes.

A full discussion of the tax and planning issues raised by these formulas is beyond the scope of this article. But, in general, pecuniary formulas offer greater flexibility to distribute assets through postmortem planning in a manner that achieves your estate planning goals. On the other hand, fractional formulas allow your spouse and children to share in any postdeath appreciation or depreciation in the value of your estate. This may result in higher taxes, but may be better for family harmony.

Who needs a formula?

A formula can be an effective tool for minimizing estate taxes, but not everyone needs one. For example, a formula may not be appropriate if you have other estate planning goals that are more important than saving taxes, such as ensuring that control of a family business or other assets is maintained by particular family members.

If your estate plan includes a formula, review it with your advisors to be sure it continues to meet your estate planning needs. ▮

Land, sweet land

Preserve it (and reap tax benefits) with a conservation easement

It's obviously a beautiful piece of land, what with the lake and mountains in the distance, but you know the area is prime real estate for developers. You'd love to keep the land untouched for future generations to enjoy. With a conservation easement, you can.

And it gets even better: A conservation easement also offers significant tax benefits.

Conservation easement in action

A conservation easement is an agreement to *permanently* restrict some or all of the development rights associated with your land. You grant the easement to a qualified conservation organization and record it so it's binding on future owners, not just you. The organization monitors the use of the land and enforces the easement.

You and your family continue to own the land and may use it in any way you see fit, so long as it's consistent with the easement's terms. In addition, you may sell the property, give it away or leave it to your family — subject to the easement.

To preserve the easement's tax benefits, select a conservation organization that's either a government entity or a public charity, such as a land trust, that's committed to protecting the easement's conservation purposes and has the resources to enforce the easement. You also need to obtain a qualified appraisal to establish the value of the land and the easement.

The easement must be granted exclusively for one of the following conservation purposes:

- To preserve open spaces for the public's scenic enjoyment or pursuant to a governmental conservation policy in a way that yields a significant public benefit,
- To protect a relatively natural habitat of fish, wildlife or plants, or
- To maintain land for outdoor public recreation or education.

The easement must be carefully drafted to avoid misunderstandings over which uses of the land you're giving up and which you're retaining.

Income and estate tax benefits to be had

If you grant a conservation easement during your life, you can take a charitable deduction for the value of the easement for the year you grant it. The easement's value is the difference between the land's value before and after you grant the easement.

But the charitable deduction generally is limited to 50% of your adjusted gross income (AGI). The excess can be carried forward and deducted during the following 15 years, but if the easement's value is large relative to your AGI, much of the charitable deduction may go unused. One solution is to grant a conservation easement on a portion of your land, take the charitable

deduction over the allowable years and then grant an easement on another portion of the land. Also note that, as of this writing, after 2009 the rules become more restrictive.

A conservation easement also can provide you with estate tax benefits in two ways. First, the easement depresses the land's value, reducing the size of your taxable estate. Second, the tax code allows a portion of the land's value (based on a complex calculation) to be excluded from your estate by making an irrevocable election with the IRS. To qualify for the exclusion, you or a family member must have owned the land for at least three years prior to your death.

Good for you, good for your family

You were lucky to have the opportunity to buy or inherit such a pristine piece of land, and you want future generations to have the opportunity to enjoy it. A conservation easement may help you achieve that goal while also enjoying significant income and estate tax savings. ▮

Estate Planning Pitfall

You're keeping your trust a secret

If your estate plan includes one or more trusts, you may have a good reason for wanting to keep them a secret. For example, you may be concerned that, if your children or other beneficiaries knew about the trust, they might spend recklessly or neglect educational or career pursuits.

Despite your good intentions, however, the law in many states requires trustees to disclose certain information to beneficiaries. More than 20 states, for example, have adopted the Uniform Trust Code (UTC), which requires a trustee to provide trust details to any qualified beneficiary who makes a request. The UTC also requires the trustee to notify all qualified beneficiaries of their rights to information about the trust.

Qualified beneficiaries include primary beneficiaries, such as your children or others designated to receive distributions from the trust, as well as contingent beneficiaries, such as your grandchildren or others who would receive trust funds in the event a primary beneficiary's interest terminates.

One way to avoid the disclosure requirements is by not naming your children as beneficiaries and, instead, granting your spouse or someone else a power of appointment over the trust. The power holder can direct trust funds to your children as needed, but because they're not beneficiaries, the trustee isn't required to inform them about the trust's terms — or even its existence. The disadvantage of this approach is that the power holder is under no legal obligation to provide for your children.

If you wish to keep a trust secret, be sure to consult an attorney about the law in your state. Some states allow you to waive the trustee's duty to disclose, while others allow you to name a third party to receive disclosures and look out for beneficiaries' interests. In states where disclosure is unavoidable, you may want to explore alternative strategies.