Practical Tax Strategies/Taxation for Accountants
Volume 84, Number 06, June 2010

USING A PERSONAL RESIDENCE DGT TO CAPITALIZE ON REDUCED PROPERTY VALUES

By Clay R. Stevens[*]

While the continued "repeal" of the estate tax for 2010 is uncertain, it is almost guaranteed that some form of estate tax will reappear in 2011 if not sooner. Whether the amount an individual can pass estate tax-free[1] returns in 2011 to $1,000,000 as currently legislated, is set at the $3,500,000 allowed previously in 2009, or is negotiated to another number, it is very clear that the estate tax is not going away anytime soon.[2] Therefore, taxpayers with estates over $5,000,000 should expect some form of estate tax to apply to them.[3] For such taxpayers with large personal residences or vacation homes as part of their overall net worth, rare opportunities exist today to utilize some excellent planning tools to reduce or eliminate a good portion of such estate tax.

While most homeowners see the substantial reduction in residential real estate value across all areas of the country[4] as only a detriment, these reduced values do provide great estate planning opportunity. By transferring some or all of the real estate to an irrevocable trust, the taxpayer is able to "freeze" the value of the real estate at today's value and allow all future appreciation to pass tax-free out of the estate.

QPRT

One common strategy often employed for residential real estate is the Qualified Personal Residence Trust ("QPRT"). With that vehicle, the grantor transfers his residence to an irrevocable trust and retains the right to occupy the residence rent-free for a period of years.[5] By retaining the right of occupancy, the gift tax value of the transfer is reduced by the present value of the retained interest.[6] To the extent the residence is transferred to multiple QPRTs or transferred separately by a husband and wife, the appraised value of the residence may be reduced by fractional interest discounts.[7]

For example, by retaining a 25 year term on a $2,000,000 residence, the value of the transfer for gift-tax purposes is reduced by more than $1,400,000 to $600,000. This assumes the interest rate used for valuing the income interest is 3.4% (the rate as of February 2010) and the taxpayer is 50 years old. If the undiscounted value of the residence was $2,400,000[8] and the residence appreciated at only 3% for 25 years, the entire residence worth $5,000,000 would pass tax-free to the taxpayer's children.[9] As a

[*] Clay R. Stevens is the Director of Strategic Planning at Aspiriant, providing estate planning, income tax, and philanthropy consulting services for high net worth families. Mr. Stevens is also a Shareholder of the law firm Primiani & Stevens, a tax firm specializing in the estate planning and serves as an adjunct Professor of Law at Chapman University Law School. Mr. Stevens received his LL.M. in Taxation from New York University and his J.D. from Pepperdine University, graduating magna cum laude.

result, by utilizing $600,000 of the taxpayer's unified credit equivalent upfront, the estate tax savings on the $5,000,000 transfer could be $2,000,000 or more.[10] This also assumes only 3% growth on the residence and to the extent the value is depressed, the estate tax savings could be much higher.

While the QPRT can provide substantial benefits, there are four potential drawbacks with its use:

1. The taxpayer must survive the retained term for the entire value of the residence to be excluded from his or her estate.[11] Therefore, if the taxpayer is elderly or in poor health, the taxpayer should select a shorter term for the QPRT that the taxpayer is likely to outlive. However, the shorter the term of the QPRT, the greater the amount of the taxable gift of the remainder. For example, the taxable gift in the above 25 year term example doubles from $600,000 to almost $1,300,000 with a 10 year term.[12] Life insurance may be used in certain circumstances to minimize the risk of an early death to the extent the taxpayer is insurable.

2. The trust is irrevocable and the residence must pass either outright or in trust to the taxpayer's children at the end of the term. To the extent the taxpayer would like to remain in the residence, he or she will need to rent back the residence from the children or the irrevocable trust.[13] While the payment of rent effectively provides the taxpayer an opportunity to make additional tax-free gifts to his or her heirs,[14] some taxpayers would prefer the option of recovering the residence at the end of the term – which is no longer permitted in a QPRT.[15]

3. Unlike many other estate planning strategies, the current low interest rate environment is a detriment to the QPRT as it reduces the value of the retained right to occupy the residence. For example in the above scenario, if the interest rate used for valuation increased from 3.4% to 6% (as it was in early 2007), the taxable gift on the $2,000,000 residence would be only $304,000 and save over $295,000 of unified credit.[16]

4. Because the grantor retains an "interest" in the QPRT for the initial term, the generation-skipping transfer ("GST") tax rules prevent the taxpayer from allocating his or her GST exemption to the initial gift to the QPRT.[17] As a result, the QPRT does not give the taxpayer the ability to do GST planning with the residence and hold the property for the benefit of multiple generations tax-free.

DGT Sale

These drawbacks can be overcome by using a common technique, a sale to a defective grantor trust ("DGT Sale")[18], instead of a QPRT for the residence. Typically, a DGT Sale is a technique whereby the grantor creates an irrevocable trust and funds it with a small taxable gift.[19] Then, the grantor sells property to the trust in exchange for a promissory note. To the extent the property is income producing, some or all of the income is then used to repay the note over time. Once the note has been repaid, the value of the property is retained by the irrevocable trust and not subject to estate tax. Because

the grantor retains a promissory note and not a retained interest in the trust, a premature death only causes the outstanding balance of the note to be included in the grantor's estate for estate tax purposes.[20] Therefore, unlike the QPRT, the estate tax benefit is not conditioned on the survival of the grantor.

A personal residence is not often considered a prime asset for a DGT Sale since the asset is not typically income producing and the trust would not have sufficient assets to repay the promissory notes. However, assuming the grantor continues to reside in the residence after contribution to the DGT, the grantor can continue to reside in the property and pay fair market value rent to the irrevocable trust.[21] The trust includes specific provisions that require all transactions between the grantor and the trust to be ignored for income tax purposes.[22] As a result, the original "sale" of the residence to the trust in exchange for the promissory note, all rental payments made by the grantor to the trust, and all interest and principal payments made by the trust to the grantor have no income tax effect.[23] Essentially, the grantor will make rental payments to the trust and the trust can utilize some or all of those rent payments to make interest and principal payments back to the grantor in satisfaction of the note. Depending on the fair market rental rates for the residence, the notes can often be repaid in 12-20 years. At the minimum, the value of the residence will be "frozen" at the current value.

Using the same assumptions from the QPRT example above, the undivided residence worth $2,400,000 was valued at $2,000,000 for transfer tax purposes due to minority and marketability discounts associated with transfers of fractional interests.[24] Assuming the grantor gifts cash or property worth $200,000 to seed the trust,[25] the balance due on the note would be $1,800,000 and bear interest at 2.82%.[26] Assuming the fair rental value of the residence is $10,000 per month[27] and increases at the same 3% per year as the value of the residence, the balance of the note could be completely repaid in 16 years.[28] Since rent can continue to be paid to the trust between years 16 and 25 (which was the final year of the QPRT term) and the rent and any reinvested accumulation grows income tax-free to the trust,[29] Chart 1 illustrates that the net amount to the trust at the end of the 25 years can be more than $2,900,000. As a result, the Residence DGT would produce a greater result than the QPRT with a lower initial gift.

Chart 1: Result to Residence DGT

Client: Joe Smith

Date: 12.31.09

Year	(1) Share of Distribution from Entity	(2) 8% Growth from Accumulation	(3) Payments Due on Note	(4) Income Tax Attributable to DGT	(5) Net After-Tax Cash Available to DGT	(6) Accumulated After-Tax FMV to DGT
2010	120,000	0	(120,000)	0	0	0
2011	123,600	0	(123,600)	0	0	0
2012	127,308	0	(127,308)	0	0	0
2013	131,127	0	(131,127)	0	0	0
2014	135,061	0	(135,061)	0	0	0
2015	139,113	0	(139,113)	0	0	0
2016	143,286	0	(143,286)	0	0	0
2017	147,585	0	(147,585)	0	0	0
2018	152,012	0	(152,012)	0	0	0
2019	156,573	0	(156,573)	0	0	0
2020	161,270	0	(161,270)	0	0	0
2021	166,108	0	(166,108)	0	0	0
2022	171,091	0	(171,091)	0	0	0
2023	176,224	0	(176,224)	0	0	0
2024	181,511	0	(181,511)	0	0	0
2025	186,956	0	(43,303)	0	143,653	143,653
2026	192,565	11,492	0	0	204,057	347,710
2031	223,235	112,415	0	0	335,650	1,740,833
2034	243,935	201,253	0	0	445,188	2,960,853
Totals:						2,960,853

One of the main reasons the result is better with the DGT sale is the ability to capitalize on the low interest rates.[30] As an example, if the interest rates rose to 4.0% per year, the note would not be completely repaid for almost 18 years.[31]

One of the other benefits of the DGT Sale to the QPRT is the increased flexibility. Unlike the QPRT, the grantor retains the ability to exchange the residence with any property of equivalent value in the future.[32] As an example, if the irrevocable trust repays the promissory note issued in year 15 and the residence is valued at $3,500,000, the grantor might choose to exchange cash or other property equal to $3,500,000 to the trust for the residence so that he can continue to reside there rent-free until death. This also provides the grantor the potential opportunity to exchange cash or other high basis assets with the residence prior to death and receive a full step-up in basis on the residence to fair market value upon death.[33]

Lastly, if the grantor would like the property to remain in the family and pass from children eventually to grandchildren, the DGT Sale is a better option. Because the grantor retains only a promissory note, in the above example, he or she may allocate $200,000 of his GST exemption to the initial gift and the residence can be held in trust for the benefit of children, grandchildren, and even great-grandchildren. This is not an option with the QPRT where the property must be subject to estate tax upon the death of the grantor's children.[34]

As an added non-estate tax benefit of both the QPRT and the DGT Sale, the transfer of the personal residence to the trusts may help protect the residence from seizure or sale by a future creditor of the grantor.[35] One of the easiest assets for a creditor to attach is real estate held in the grantor's personal name. With both the QPRT and DGT Sale, however, the grantor no longer owns the home and instead retains the right to occupy the home or a promissory note. While a creditor has access to the grantor's right

to occupy the home or can obtain the grantor's interest under the promissory note, the creditor may not be able to force a sale of the property. This potential benefit exists whether the grantor uses the QPRT or the DGT Sale.

In sum, using both a standard QPRT and a DGT Sale to "freeze" the value of one's personal residence can yield beneficial estate tax results. The QPRT, which is legislatively permitted under the Internal Revenue Code, is often considered the primary estate planning technique for personal residences. However, in many circumstances, the sale of the personal residence to an irrevocable grantor trust provides better estate tax results. At the minimum, it provides additional flexibility to the grantor to re-acquire the personal residence trust, permits the residence to be held in the family for multiple generations, and does not require the grantor to survive the entire term to be effective. Therefore, in current times when real estate values are substantially depressed, using the DGT Sale to capitalize on the low valuations for estate planning purposes is like turning lemons into lemonade.

---

[1] The amount one can pass estate tax-free is the "unified credit equivalent" under Code Section 2010.

[2] Kathleen Pender, "Death of estate tax leaves some worse off," SF Chronicle (January 10, 2010) (noting that the estate tax was repealed for taxpayer's passing in 2010, but returns to 2001 rates in 2011 without further legislative change).

[3] While the estate tax may apply to an estate valued at as little as $1,000,000 if no changes in the tax law occur before the end of 2010 and the 2001 rates are restored, the largest unified credit equivalent currently being seriously considered in Congress is $5,000,000 per person. Melinda Merk and Andrew Prior, "Estate Tax Limbo: Three Steps To Take Now," Forbes (February 4, 2010).

[4] Pat Mertz Esswein, "Glimmers of Light on Home Prices," Kiplinger's Personal Finance, Vol. 64, No. 1 (January 2010) (noting that home prices declined on average 30% from mid-2006 to mid-2009 in the United States).

[5] Reed Easton, *Transfer Residential Real Estate Free of Gift or Estate Tax*, Practical Tax Strategies (January 2010).

[6] See Treas. Reg. § 25.2702-2.

[7] See Dennis A. Webb and Gerald E. Lunn, Jr., *Realistic Discounts for Undivided Interests in Real Property,* Estate Planning Journal (July 1999) (providing that discounts for "costs of partition" in transfers of fractional interests in real property are accepted by the IRS and that greater discounts may also be applicable).

[8] This assumes that the home was divided into shares and fractional interest discounts of 16.66% applied to the appraised fair market value of the entire property.

[9] Estate planning calculations, including for the QPRT, can be performed by software such as NumberCruncher (http://www.leimberg.com) to determine both the initial gift to the QPRT and the resulting growth of the property at the end of the tern.

[10] This assumes an estate tax rate of 45% on the difference between the $5,000,000 value and the initial $600,000 gift. The estate tax savings is over $2,420,000 if the 2001 estate rates are restored in 2011.

[11] Lawrence P. Katzenstein, *Regs. Clarify Estate Tax Inclusion of Trust Property, but Issues Remain*, Estate Planning Journal (June 2009) (noting that death during the term of a QPRT causes some or all of the trust assets to be included in the grantor's estate under Code Section 2036).

[12] See *infra* note 9.

[13] Rev. Rul. 70-155, 1970-1 CB 189 (providing that absent the payment of the rent, the property could be included in the original transferors estate under Code Section 2036).

[14] To the extent the grantor rents the residence from the trust for fair market value, the rent payment can accumulate in the trust or be distributed to the trust beneficiaries without incurring a taxable gift. To the extent the QPRT includes provisions causing it to be a grantor trust following the initial retained term, the payment of such rent will also be income tax-free to the trust. *See* Rev. Rul 85-13 1985-1 CB 184.

[15] Prior to May 17, 1996, the Grantor of the QPRT could retain the right to reacquire the residence held in the QPRT either before or after termination of the QPRT term by purchase or exchange. Treas. Reg. § 25.2702-7. After May 17, 1996, all QPRT are required to prohibit the trust from transferring the property back to the grantor, his spouse, or an entity controlled by the grantor or spouse as long as the trust remains a grantor trust. Treas. Reg. § 25.2702-5(c)(9).
[16] See *infra* note 9.
[17] Treas. Reg. § 26.2632-1(c)(2)(i) (providing that GST exemption may not be allocated to a trust during an "estate tax inclusion period").
[18] See Michael D. Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, Estate Planning Journal (Jan. 1996) (popularizing the technique as a method to transfer wealth in a gift tax efficient manner after the IRS issued Private Letter Ruling 9535026 on the subject).
[19] It is often suggested that 10% of the net fair market value of the property to be sold be gifted to the trust as "seed" money. See Milford B. Hatcher, Jr., and Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, Jour. Tax'n (Mar. 2000). It is also suggested that a lower gift may be acceptable to the extent the beneficiaries of the trust guarantee a portion of the loan balance. See *id*.
[20] Because the grantor does not retain an interest in the trust and instead transferred the property in exchange for adequate and full consideration, Code Section 2036 does not apply. Treas. Reg. § 20.2036-1(a).
[21] See *infra* note 14.
[22] The trust would include "grantor trust" provisions such as the right to remove and replace assets of the trust with other assets of equal fair market value. IRC § 675(4)(C).
[23] Rev. Rul. 85-13, 1985-1 CB 184.
[24] See *infra* note 7.
[25] See *infra* note 19 (discussing the guideline to gift 10% of the overall amount to the trust prior to the sale).
[26] The mid-term rate on a note for February 2009 is 2.82% per year. Rev. Rul. 2010-6.
[27] This assumes a triple-net lease and is dependent on comparable rental values for similar properties in the same locale.
[28] While the author relies on self-created software to prove the results, the results can be shown using basic loan calculation software such as Time Value Software (www.timevalue.com).
[29] See Rev. Rul. 85-13, 1985-1 CB 184 (illustrating that all income tax consequences of the trust are required to be borne by the grantor during the term instead of the trust).
[30] The minimum interest rate prescribed by the I.R.S. on a 9 year loan for February 2010 is 2.82%. For notes longer than 9 years, the minimum interest rate for February 2010 is 4.44%. In a situation where the repayment plan is likely to last more than 9 years, the parties could enter into a 9 year fixed note and a new note could be issued (or the existing note renegotiated) to current interest rates at the end of the term. Often, a short-term note can be used after the end of the 9 year term and the minimum rate for such new note is typically less than mid-term rates. The minimum rate for a note of 3 years or less for February of 2010 is only .72%.
[31] See *infra* note 28.
[32] See *infra* note 22 (discussing the replacement right power added to insure grantor trust status).
[33] By exchanging cash or high basis assets with the residence in the grantor trust, the grantor can qualify to increase the basis in the residence to fair market value under Code Section 1014(b) and the high basis assets in the trust can pass estate tax-free to the beneficiaries.
[34] See *infra* note 17.
[35] See Jeremy T. Ware, *Using QPRTs to Maximum Advantage for Wealthy Clients*, Estate Planning Journal (November 2005) (discussing the asset protection benefits of a QPRT).

This Article was published in Practical Tax Strategies/Taxation for Accountants, Volume 84, Number 06, June 2010, a monthly journal published by Thomson Reuters/RIA and cannot be copied or distributed without the publisher's permission.

© 2010 Thomson Retuers/RIA. All rights reserved.