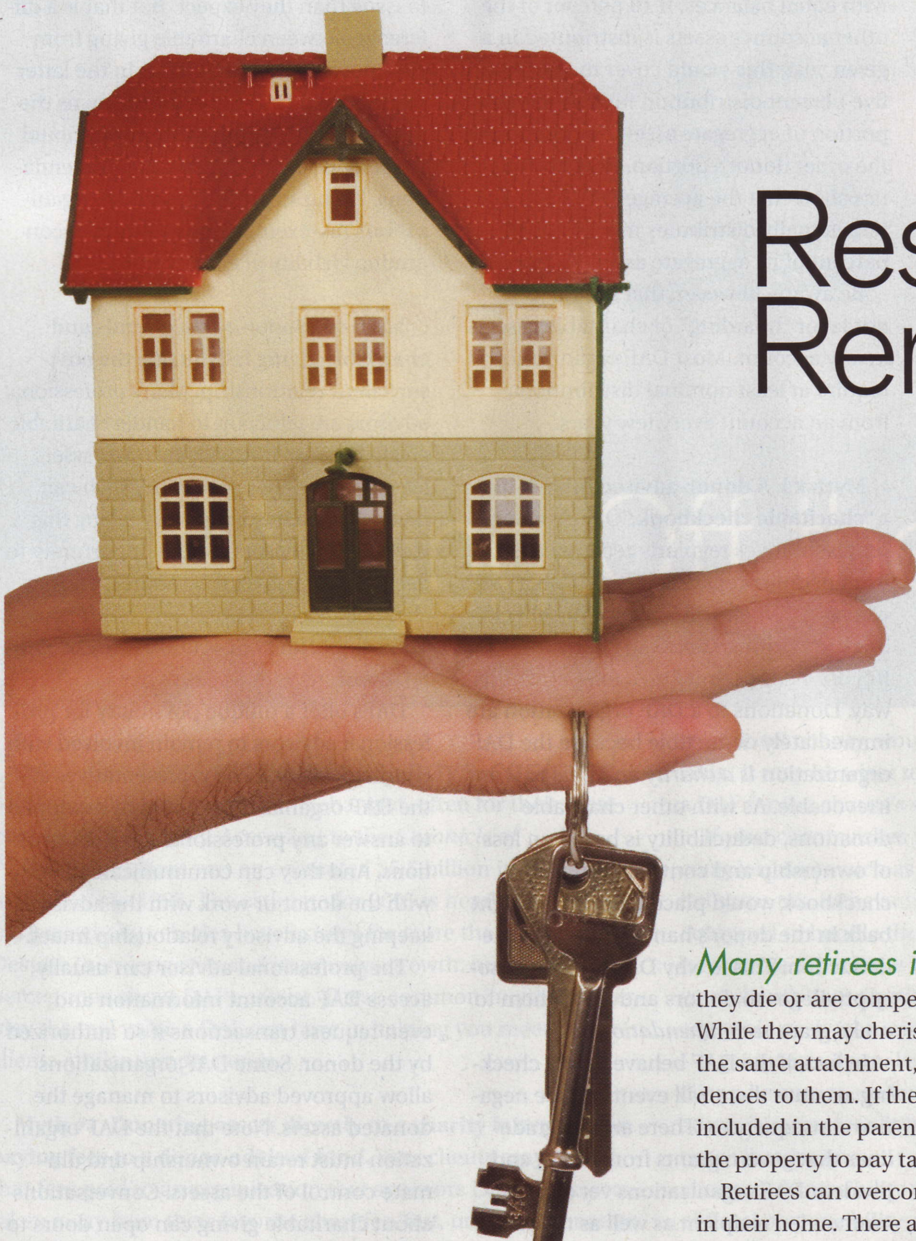
Gifting with a Residential Remainder Interest

Substantial Tax Deductions Are Available

By Michael Dubes



Many retirees intend to live in their residence until they die or are compelled to move to an assisted living facility. While they may cherish their homes, their children may not feel the same attachment, so there is little motivation to leave residences to them. If the homes are left to heirs, the value is included in the parent's estates, and the children are apt to sell the property to pay taxes.

Retirees can overcome this issue by gifting a remainder interest in their home. There are ancillary benefits to the strategy, as well.

Let's assume a retired couple living in a residence worth $1.5 million has already made ample provisions in their will for their children. The children will sell the property and pay estate taxes on the appreciated value. Meanwhile, the couple is active in several charities and would like to make a meaningful gift to their favorite.

This situation is ideally suited to gifting a residential remainder interest. The couple can continue living in their home while removing its appreciated value from their estate. They receive a substantial deduction on current taxes, make a significant charitable gift and ease wealth transfer to their heirs.

REMAINDER INTEREST AND LIFE ESTATE

Ownership of the residence can be divided into two parts: a *remainder interest* and a *life estate*.

Remainder interest is the ownership right of another party after the original owners die. The value of the home's remainder interest is determined by the IRS Code tables; it's based on the owners' ages, the residence value, and prevailing interest rates. The appraised value of the home—less the value of the life estate—equals the value of the remainder interest.

Life estate is the right of an owner to keep a home until death. If the owners are a married couple, the right remains until the second dies. They have full use of the home and can even rent it out if they wish. Of course, they must pay taxes, insurance, and keep the house in good repair.

The gift of a remainder interest can be a primary residence, a condominium, co-op, or even a vacation home, as long as it is a personal residence. A gift of a remainder interest in a farm or ranch is also permissible, even if it is not a residence, if the farm produces agricultural products or the ranch has livestock.

HELPFUL STRATEGY

Laila Pence, CFP and President of Pence Wealth Management, Newport Beach, Calif., has helped many clients with this strategy. She cites an example of how the strategy helped one couple who decided to gift the remainder interest in their home to a favorite charity. Following an appraisal of the home, the couple had an attorney prepare a deed that irrevocably transferred their home to the charity after they were both deceased.

The value of the home's remainder interest, based on IRS tables, was $600,000, which became the basis for sheltering 30 percent of the couple's adjusted gross income for the year. They were unable to use the entire deduction to offset current taxes, but they were permitted to carry the balance of the deduction forward for up to an additional five years. Should they decide to donate their life estate to charity before they die, they can take an additional income tax deduction for the value of the remainder interest at that time. The value of the home is not included in their estate, thereby eliminating any possibility of either state or federal estate tax.

WEALTH REPLACEMENT TRUST

The couple wanted to maintain their current lifestyle but also ensure their children would receive the equivalent value of the home, even though it was going to charity. Pence helped them achieve this goal by using some of their income tax savings to fund a wealth replacement trust (WRT), which replaced the value of the residence with tax-free cash for their children after the couple has passed away.

> LIFE ESTATE IS THE RIGHT OF AN OWNER TO KEEP A HOME UNTIL DEATH

Pence explains that wealth replacement trusts are frequently used to replace the value of assets given to charity. The donor creates a WRT—also known as an irrevocable life insurance trust—which purchases a life insurance policy on the life of the donor or donors. In the case of a remainder interest in a residence, the policy is often purchased using part of the tax savings from the charitable gift income tax deduction, as in the case above.

The death proceeds escape estate taxation because the policy is owned by the WRT. When the donor dies, the WRT proceeds are distributed to the beneficiaries to replace the value of the assets—in this case the residence—that has been donated to charity.

The use of a WRT also alleviates liquidity problems associated with real estate. The life insurance within the WRT replaces the value of the property so that, upon the death of the donor, funds are immediately available to heirs. Donating a residence to a charity and replacing its value with life insurance in the WRT means the heirs can avoid the prospect of liquidating the property, possibly in an unfavorable market.

CAVEATS

A charitable contribution of a debt-encumbered property is not recommended, as it may result in adverse tax consequences for both the donor and the charity, depending on how long the property has been owned and how long the debt has been in place. Alternatives would be to remove the debt or transfer the debt to another property.

Charitable gifts are itemized deductions. The phase out of the itemized deduction may cause families with high incomes to lose some of the benefit of the deduction. The gift is limited to 30 percent of AGI for public charities and 20 percent for private charities. Once made, the gift is irrevocable.

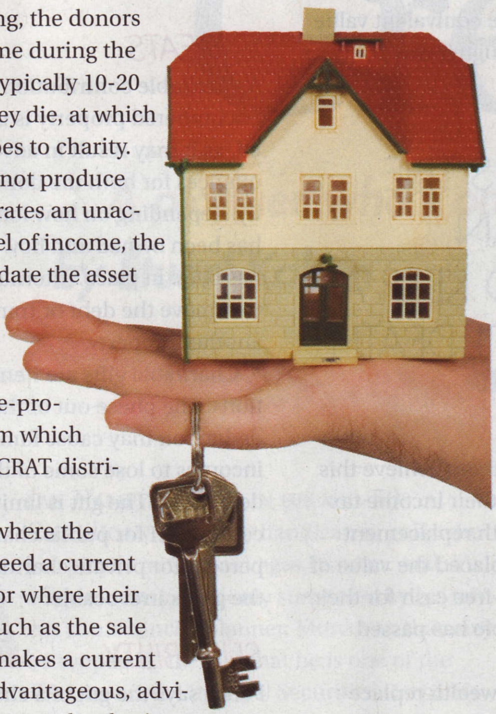
SUITABILITY

Pence says the gift of a charitable remainder in a residence tends to be most attractive to donors in their mid to late sixties, or older, who are interested in making a substantial gift to charity, taking advantage of the income tax deduction, and having the use of the residence during their lifetimes. "These donors may need all their assets to maintain a lifestyle and not have other assets readily available for charitable purposes, yet they want to make a nice gift to charity. The strategy can be used as an effective estate planning tool, even in situations where the property owners have no charitable interests, or where the children would prefer to keep the parent's residence after their death. An appraisal is still necessary and the same IRS tables are used to determine the life estate and remainder interest, but upon the death of the donors, the remainder interest goes to the heirs."

OTHER GIFTING OPTIONS

Pence notes that donors with highly appreciated assets, such as investment property or other income producing assets, who wish to gift to a charity have other techniques available to them. "Donors can simply deed the property ownership rights directly to charity, or they can put the asset in a charitable remainder unitrust (CRUT) or charitable remainder annuity trust (CRAT)."

A CRUT, explains Pence, pays the donors a fixed percentage of the trust assets valued annually; A CRAT pays the donors either a fixed dollar amount, or a fixed percentage of the initial value of the transferred assets.[1] If the asset is income producing, the donors receive the income during the life of the trust, typically 10-20 years, or until they die, at which time the asset goes to charity. If the asset does not produce income, or generates an unacceptably low level of income, the trustee can liquidate the asset within the trust and replace it with a more desirable income-producing asset from which to pay CRUT or CRAT distributions.



In situations where the donors do not need a current income stream or where their tax situation—such as the sale of a business—makes a current tax deduction advantageous, advisors might recommend a charitable lead trust (CLT). Essentially the opposite of a CRUT, a CLT donates the income stream to a charity with the asset reverting back to the donors (or beneficiaries) at the end of the trust period.

USES FOR THE WRT

Eileen Sacco, former Executive Director of the National Charitable Initiative, in Denver, Colo., notes that there other uses for the WRT. Aside from its use in replacing the value of assets given to a charity, the wealth replacement trust can be used to gift to children or grandchildren. Each parent can gift up to $12,000 annually to each child, grandchild, or relative named as a beneficiary within the WRT. The trust uses the annual contribution to pay the premium on a life insurance policy on the parents owned by the trust. Using life insurance within an irrevocable trust keeps the proceeds outside of the donor's estate. A wealthy individual or couple could use the WRT to keep many millions of dollars of life insurance on themselves outside of their estate so their beneficiaries could inherit large sums of money free of estate and income taxes.

USING LIFE INSURANCE WITHIN AN IRREVOCABLE TRUST KEEPS THE PROCEEDS OUTSIDE OF THE DONOR'S ESTATE

....AND FINALLY

The CRT can be an ideal tool for gifting a highly appreciated residence, assuming the donors want to continue to live in the residence and their children have no attachment to it. The donors get a substantial tax deduction which can be carried forward up to five additional years. Neither the CRT nor the charity is required to pay capital gains taxes. Using a WRT to fund a life insurance policy on the donors replaces the value of the donated residence for heirs, removes the value from the donor's estate, provides immediate cash for the heir,s and alleviates illiquidity issues.

If the donor does not want to continue to live in their residence, or if income-producing assets are involved, they can be placed into a CRUT or CRAT where the trustee has the option of selling them and reinvesting the funds in investments better suited to the donor's income needs. Again, since the trust pays no capital gains taxes, the donors receive investment income on the full value of the donated asset and the charity gets the full value of the converted assets when the donor dies. CPAWP

Michael Dubes is a financial writer based in San Diego, Calif. He can be reached at md@front-page-media.com.

1. Giving, Philanthropy for Everyone. Robert Esperti, Renno Peterson and Carol Peskoe Schaner. Quantum Press LLC, Denver CO, 2003.