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Tax, market conditions ideal for gifting a home

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When Alice (who asked that her real name not be used) and her husband bought their vacation home 1983, they knew it was special: a 4,500 square foot beachfront house in the Crystal River, Florida area, with views of the sunrise, the sunset and the Gulf of Mexico.

After 55 years of marriage, Alice's husband passed away in 1999 — the same year the couple put the home in a Qualified Personal Residence Trust, or QPRT. That way, she could pass it down to her sons and not incur huge hits on estate and gift taxes.

"We told our advisers that we wanted to pass this property down to our children, and for them to their children," says Alice, who is now 91 — and still stays at the home with her family. "They suggested this as a way to get it out of our estate at a reduced value."

Now, estate planners and wealth managers aren't particularly known for displaying irrational exuberance. But that doesn't mean they don't get pumped when they see a chance for clients to have their proverbial cake — a sweet vacation home in Florida, for example — and eat it, too.

They get that kind of rush now with the QPRT, which allows a person or couple to gift up to two homes (in most cases, to children), yet still live there. And while QPRTs have been around for some time, experts say they're making a comeback, largely because the clock is ticking on multimillion dollar IRS exemptions that make this strategy a major tax boon.

In December, Congress extended Bush-era tax cuts, keeping estate and lifetime gift tax exemptions at $5 million. But on Jan. 1, 2013, the extension expires and those limits (along with one for the generation-skipping transfer tax) return to $1 million, unless Congress intervenes. What's more, homes once worth $5 million and up may be worth less today, thanks to the post-2008 real estate slump.

"This is one vehicle to look at right now," says Madaline Creehan, a principal and wealth adviser at BAM Advisor Services in St. Louis. "It's a rare opportunity. Absolutely, this could be the perfect time."

David Bruckman, managing director of Citrin Cooperman Wealth Management in New York, notes that many clients considered QPRTs prior to 2011 but were restricted, either due to the previous $1 million gift exemption limit or large home appraisals.

"The problem is that it's a very complicated technique — the trust owns the house — but it's a very smart strategy potentially," Bruckman says. "A lot of clients are okay with gifting a house away, as long as they don't get evicted."

That is: Make sure you're on great terms with your trustees if you want to keep living in the home. Assuming that's not a problem, QPRTs have considerable advantages, lowering gift and estate taxes in one tidy package.

QPRTs can also be structured so that the property is divided between two grantors — a husband and wife, for example — thus driving down a home's book value further. Thus properties that would otherwise sell for far more than $5 million can fall below that gift tax threshold. (Yes, the IRS tax code supports all this.)

In a QPRT, the grantor transfers up to two residences into an irrevocable trust and retains the right to use the home for a pre-determined period, or trust term. Terms can vary widely — 10 years is typical, but can run for 40 — and the idea is to make sure grantors outlive the term.

"The longer you live in the residence, and retain the right to use the property, the less that it's worth," says Beth Tractenberg, a partner at Katten Muchin Rosenman LLP in New York who concentrates her practice in estate planning, "It's like saying, 'I'll give I'll give you a dollar today, or I'll give you a dollar 35 years from now.'"

To put it in hard numbers, let's take a $750,000 home. If that home appreciates 3 percent a year, it will be worth more than $950,000 in 8 years. "If it's in your name while it is appreciating, it's your financial liability," says Travis W. Freeman, a certified financial planner with Four Seasons Wealth Management in Creve Coeur, Missouri. "But if an asset is in the legal name of the QPRT and the grantor survives the gifting period, the assets are now out of the estate of the grantor. … It's not your worry."

Once the term concludes, the grantor then pays rent to the trust. The beneficiaries become landlords, and open a brokerage-type vehicle to receive payments titled to the trust. There's no income tax on those payments, a big plus for beneficiaries.

But QPRTs have a big downside: Die before the term's up and your property reverts to the estate and takes an estate tax hit. That's why planners stress picking a term you and your spouse expect to outlive.

"Estate taxes are so heavy, about 55 percent, that any time you have an opportunity to avoid that, you should look at a QPRT," says Daniel Walker, chairman of Farmers & Merchants Bank of Long Beach, California. "More times than not, the house is sold to [pay] the tax. It's always an emotional piece. But if we can move those items to the next generation prior to the death or aging of the individual, that's a great thing."

There's a death of another sort to consider: whether Congress and President Obama will extend the $5 million gift tax ceiling. While some observers bet that will happen, it's also possible the new limit will drop — or that the same lawmakers now quarreling over the national debt ceiling won't get their act together before the extension expires in less than 18 months.

"It's an unknown, and that's a difficult part for this profession: How do you predict it?" Freeman says. "The ceiling certainly could drop down again, though it probably wouldn't be for long. Then again, who can say what Congress is going to do?"

In the meantime, consider the payoff for Alice. Her home, which had a market value of $500,000 in 1999, had a discounted value of $243,000 when it entered the QPRT. She survived the six-year term and today pays $2,000 a month rent on a home now valued at $1.5 million, having realized huge tax savings along the way. Her sons now own the property and set up an LLC and use Mom's rent to pay expenses.

"It was a great move," said Alice, who still gets to decide which family members can visit and when. "It provided a continued recreational property for the whole family, and it did what I wanted to accomplish."