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# Legal Matters®

## Real estate downturn creates an estate planning opportunity

**R**eal estate prices have been falling all over the country. While no one likes to think that their home is worth less than it used to be, the downturn has created an opportunity to give your home to your eventual heirs while saving a large amount of estate and gift taxes.

This can be done with a “Qualified Personal Residence Trust,” or QPRT. The idea is that you put your home into a trust for a certain period of time – five years, 10 years, 15 years or whatever period you choose. At the end of that time, the trust expires and ownership of the home goes to the beneficiaries you name.

There are two big advantages to this idea:

- The value of your home for estate and gift tax purposes will be its value *now* – not its value at the end of the trust term or when you eventually die, when presumably it will be worth a lot more.
- The value of the gift is further reduced by the value of your right to live in the home for the duration of the trust.

It's possible using this technique to reduce the taxable value of a home by 50% or more. So if you have a \$500,000 house, you might be able to give it to your children while reducing its value to \$250,000 for tax purposes. If the home increases in value to \$750,000 by the time you pass away, you will have reduced your taxable estate by half a million dollars.

QPRTs can be especially valuable at times like these when real estate values are depressed, because you can

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“lock in” today’s lower house prices for tax purposes.

A QPRT can be an excellent way to pass along a vacation home, too, as well as a primary residence. If you want, you can have two QPRTs, one for each home.

When you create a QPRT, you incur gift tax on the current value of the home minus the value of your being able to live there for the term of the trust. However, you might not have to pay anything to the IRS at the time. Generally, you can make up to \$1 million in lifetime gifts and defer any gift tax until you die, at which point the amount of the gifts simply reduces the portion of your estate that can pass to your heirs without incurring the estate tax. So if the value of the home minus the value of your right to live there is less than \$1 million, you’ll likely have to pay nothing at all right away.

During the term of the trust, you’ll still have to pay real estate taxes on the property, but you can also continue to take a deduction for these on your income tax.

When the term of the trust is up, your children will own the house. One issue is that if you want to continue

living in it, you’ll have to pay fair-market rent to your children (or risk problems with the IRS). However, this can also be an advantage. You can think of your rent payments as a gift to your children that gets additional money out of your estate without being subject to the gift tax. The rent payments will not reduce your ability to also give your children up to \$13,000 a year tax-free.

There’s one big drawback to QPRTs, which is that if you die before the term of the trust is up, the tax benefits are lost. So you need to think carefully about the length of the trust – a longer term means more tax benefits, but it also increases the risk that you’ll die before the trust ends.

On the other hand, if you die before the term is up, your heirs haven’t lost anything. They will be no worse off than if you had done nothing, so a QPRT is generally a no-lose bet.

Of course, for a QPRT to work, you have to be willing to relinquish ownership of your house. So a QPRT is ideal if you’re planning to move somewhere else when you retire, if you want a smaller home when you get older, or if you don’t mind having your children as your landlords.

## This is a good time to make family loans

With interest rates at historic lows, this can be a good time to make loans to your children so they can buy a home, start a business, or invest.

Giving your children an outright gift can subject you to the gift tax, but giving your children a loan doesn’t have any effect on estate or gift taxes as long as your children pay you back at an interest rate set by the IRS. Right now, the IRS rate is extremely low – and considerably lower than the rate banks usually charge for a mortgage or business loan.

In effect, the difference between what your children pay you in interest and what they would have to pay a bank amounts to a completely tax-free gift from you. Plus, any appreciation in their investment is an additional gift on which you don’t have to pay a gift tax.

This can be an especially good idea for children who would have trouble getting a bank loan because they don’t have a good credit score, don’t have a sufficient credit history, or don’t have enough of a down payment for a home.

## No tax break if you sell stock and buy it for an IRA

The IRS has clamped down on the practice of selling shares of stock in your taxable account in order to claim a capital loss, while buying shares in the same company for a non-taxable account such as an IRA.

In most cases, if you sell shares of stock you own through a regular brokerage account at a loss, but you have your IRA buy shares in the same company within 30 days, the IRS will consider this a “wash” sale, which means you won’t be able to treat the sale in your brokerage account as a loss for income tax purposes.

This could be a problem for people who own stock that has lost value over the past year because of the recession, but still believe the company has good prospects and is likely to rebound. These people might like to do some tax-related selling of their shares, but also hold the shares for the long term in another account.

Under the IRS ruling, this is no longer possible unless you wait more than 30 days between the two transactions.

Giving your children an outright gift can subject you to the gift tax, but giving your children a loan doesn’t have any effect on estate or gift taxes as long as your children pay you back.

# Take advantage of the recession to lock in estate planning gains

Nobody likes a recession, but any time when real estate values, stock prices and interest rates are low is a great time to do estate planning. You can transfer assets to your heirs now at a low value, and save them a huge estate tax bite later.

One way to do this is with a “grantor retained annuity trust,” or GRAT. The idea is that you create a trust and fund it with income-producing assets, while keeping the right to receive a certain amount of income from the trust each year. When the trust expires after a certain number of years, the assets go to whatever beneficiaries you choose.

When interest rates are low, as they are now, a GRAT can dramatically reduce estate and gift taxes.

Let’s say you put \$1 million worth of assets into a 10-year GRAT, and at the end of that time the value of the assets has increased to \$2 million. If you simply kept the property for 10 years and then gave it to your heirs, you’d be subject to gift tax based on the \$2 million. But if you put the assets into a GRAT now, your gift tax is based on the present value, or \$1 million.

But even better, that \$1 million is further reduced by the present value of the income stream you’ll receive over the 10 years.

How that present value is determined is based on an IRS interest rate, called the 7520 rate. The lower the rate, the better. And right now, the 7520 rate is the lowest it’s been in a generation – making this an excellent time to take advantage of this technique.

There’s one large drawback to a GRAT, which is that if you die before the trust expires, the trust assets are added back into your estate and the tax advantages are lost. For this reason, choosing the term of the trust requires some thought. The longer the term, the greater the tax savings, but the greater the risk that you will pass away first.

You can protect against this risk somewhat by using “layered GRATs.” For instance, instead of setting up a single 10-year GRAT, you could put 10% of the assets into a one-year GRAT, 10% into a two-year GRAT, and so on until there are 10 GRATs. If you died after the fifth year, your heirs would still get the

tax benefits from five of the 10 GRATs – and you could lock in today’s low 7520 rate for all the GRATs.

Some clients create short-term GRATs with very high payouts to lock in any investment gains quickly for the beneficiaries.

Another option is to “zero out” a GRAT. That means you set up the trust so that when it expires, the amount paid out is equal to the value of what you originally put in. As a result, no gift or estate tax is owed at all, and any appreciation goes to the beneficiaries completely tax-free.

A variation on the GRAT is a “charitable lead annuity trust.” The idea is the same, but instead of the trust income being paid to you each year, it goes to charity.

If you set up a charitable trust, you can take a deduction right away for the value of the gift to charity. This can be a great way to reduce income taxes if you have a large tax bill in the first year – for instance, if you cashed out a lot of stock options or have some other windfall.

If you take a charitable deduction, though, you will then have to pay tax each year on the trust’s investment gains. As a result, many people forego the first-year deduction in order to avoid paying tax later on.

Both kinds of trusts can also be set up as “unitrusts.” Instead of paying a fixed amount of income each year, a unitrust will pay a percentage each year of the total value of the trust.

Any time when real estate values, stock prices and interest rates are low is a great time to do estate planning.



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## Law that relaxes IRA distributions creates confusion

Ordinarily, people over 70½ are required to receive a minimum distribution from their retirement plan each year. But this minimum payout won't be required in 2009, thanks to a law passed by Congress.

However, this law is creating widespread confusion, and if you're concerned, you might want to ask for advice quickly on how to handle your particular situation.

Under the law:

- If you turned 70½ *before* 2009, you would ordinarily have to take money out of your IRA, 401(k), 403(b) or similar retirement plan by December 31, 2009. But now, you won't have to do so.
- If you turn 70½ *during* 2009, you would ordinarily have to start taking money out of your retirement plan before April 1, 2010. But now, you won't have to do so.

If you don't need to take money out of your account for living expenses, this is good news. It means you can leave more money in your account, where it will hopefully grow tax-deferred. If you plan to leave your retirement account to your heirs,

it may result in a larger bequest.

But here are some of the problems people are running into:

- Some IRA custodians and 401(k) administrators are automatically mailing checks to owners this year unless the owners specifically ask them not to. If you get an unwanted check, you have a limited time to roll it back into your account tax-free.
- Some custodians and administrators are *not* mailing checks unless the owner specifically asks for the money. So you if want a check this year, you might have to ask for it.
- If you don't take a required distribution this year, some custodians and administrators will require you to submit a written request to get automatic distributions started up again the following year.
- If you're the beneficiary of a trust that holds an inherited IRA, and the trust is supposed to pay you only the "required" distribution, it's not clear if you'll get paid anything in 2009.

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