Residential Remainder Interests: A Good Way to Gift*

By Laila Pence, CFP®

Laila Pence discusses ways in which the use of a residential remainder interest allows a donor to maintain residence in the home, realize a tax deduction and make a charitable gift.

Retirees often cherish residences they want to live in until they die or are compelled to move to an assisted living facility. Their children and grandchildren may not have an attachment to the homes, however, and so there is little motivation for parents or grandparents to leave residences to their heirs. If they do, the value is included in their estates and the children likely will sell the property to pay taxes. Seniors with one or more residences can address this issue, and gain other benefits, by gifting a remainder interest in their home.

For example, Bill and Barbara are married, retired and in their late sixties, and they still live in the home where they raised their four children. The couple loves living in the home and would like to continue to do so for as long as possible, while their children have no similar emotional attachment to the residence. The couple has made generous provisions for their children in their estate plan. Three of the offspring live in other parts of the country and all four are doing well financially. Bill and Barbara could benefit from a current tax deduction. Their home, which continues to appreciate, is worth about $1.5 million. When they die, the children will sell the property and pay estate taxes on the appreciated value. Over the years, the couple has been active in several charities and ultimately would like to make a meaningful gift to their favorite charity.

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This may be a situation ideally suited to gifting a remainder interest in a residence. It allows older clients to continue living in their home while removing the appreciated value of the property from their estate. It provides a substantial deduction on current taxes, a significant charitable gift and facilitates wealth transfer to heirs.

Two Components

A residence ownership can be divided into two parts: a life estate and a remainder interest. A life estate is the right of an owner to keep a home until death. If there are two owners, such as a married couple, a life estate is the right of both owners to keep the home until they die. They are allowed full use of the home and can even move out and rent it to others. They must keep the house in good repair and pay taxes and insurance.

A remainder interest is the ownership right of someone else after the original owners die. IRS Code tables determine the value of the home's remainder interest. The value is based on the ages of the owners, 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.

The gift of a remainder interest is not limited to a primary residence. It can be a condominium, co-op or 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.

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Tax Benefits

When Bill and Barbara decided to gift the remainder interest in their home to a favorite charity, they were required to have their home appraised. Following the appraisal, the couple had their attorney prepare a deed that irrevocably transfers their home to the charity after both have died.

The value of the remainder interest, based on IRS tables, is $600,000 and can be used to shelter up to 30 percent of their adjusted gross income this year. They were unable to use the entire deduction to offset current taxes, but they can carry the balance of the $600,000 deduction forward for up to an additional five years. Should they decide later 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 either Bill or Barbara's estate, reducing any state or federal estate tax that might be due at death.

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Wealth Replacement Trust

The couple wanted to maintain their current lifestyle but also ensure that their children would receive the equivalent value of the home, even though it was going to charity. They used their income tax savings to fund a wealth replacement trust (WRT) which replaces the value of the residence with tax-free cash for their children after the couple has passed away.

A wealth replacement trust is 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(s). 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. 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 that have been donated to the 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

Charitable contributions of 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. An alternative 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 other charities. Once made, the gift is irrevocable.

Suitability

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 not have other assets available for charitable purposes. Donors interested in this kind of planning usually have no children or have children who are uninterested in keeping the residence.

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

If donors have highly appreciated assets, such as investment property or other income producing assets,

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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 that 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.

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.

There are many techniques for charitable giving. Advisors should evaluate individual circumstances and needs to ensure that the appropriate vehicle is used. 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 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 heirs 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. The charitable 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.

Endnotes

* This article was prepared with the assistance of Eileen Saco, former Executive Director of the National Charitable Initiative, Denver CO.

1 Robert Esperti, Renno Peterson and Carol Peskoe Schaner, GIVING, PHILANTHROPY FOR EVERYONE (2003).