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PRIVATE WEALTH MANAGEMENT



Planning with Real Estate

The gift tax exemption drops from \$5.12 million to \$1 million per person if current tax cuts are allowed to expire at the end of 2012. For your family or your favorite charity, now is the time to take advantage of these tax benefits without hurting your liquidity. Think: gifting real estate. Just be aware of all the many considerations in passing on a piece of property—the right structure, the terms, the tax benefits and who should pay for the broken china.

“The Big House felt like home I wanted my children to know the feeling,” says George Colt, author of *The Big House: A Century in the Life of an American Summer Home*.

Real Estate and a “Gift It While You Can” Strategy

In *The Big House: A Century in the Life of an American Summer Home*, author George Colt lovingly describes not only his extended, yet close-knit, multi-generational family, but the fixed point to which the family migrates each summer—a large, but fraying, 100-year-old family home on Cape Cod, the long-time center of the extended family’s universe. And also a center whose spokes have drifted away into their own nuclear units, even as the house needs a major infusion of money (and attention) to keep it from falling apart—or falling to the wrecking ball. As Colt describes it, his 42 summers in The Big House were “beloved for the stability, continuity and predictability I found nowhere else. The Big House felt like home I wanted my children to know the feeling.”

In many ways, this is a typical scenario for affluent families—a first generation wants to pass down and keep a treasured property in the family for subsequent generations to enjoy. Fortunately, there are comprehensive estate planning tools that can help families achieve this goal. There are also good reasons to consider ways to gift real estate in 2012, while gift tax rates are low and the gift tax exemption is high. Consider this: The gift tax rate is currently 35% and is scheduled to increase to 55% if the Bush tax cuts expire at the end of 2012. The gift tax exemption is currently \$5.12 million per person and is

scheduled to decrease to \$1 million per person if the Bush tax cuts expire at the end of 2012, and if either presidential candidate has his current tax proposal enacted by Congress in 2013. For many people, though, gifting considerations include the issue of a negative effect on liquidity and cash flow needs.

A gift of real estate—especially a property that a family considers to be part of its unique heritage and family identity—is a smart way to achieve numerous goals, including maintaining liquidity, according to Scott Thompson, Atlantic Trust managing director. “The term ‘real estate’ encompasses everything from a working farm to a beach cottage to a commercial office building. But when families begin thinking about gifting property, they should also consider the many emotions and family legacy considerations inherent in real estate that aren’t usually found in financial assets such as stocks,” Thompson says. “Considering our current environment, all the pieces line up for many clients—a discounted asset, an asset with a strong family connection, a very attractive tax environment and creative planning tactics—to take advantage of present conditions. Not that the options are not complex, because they are, if for no other reason than the fact that you have to be respectful of and flexible about family dynamics.”

QPRTs: A Closer Look

The qualified personal residence trust (QPRT) is an effective way to take advantage of 2012 gift tax rates and the gift exemption rate, while keeping a valuable property in the family.

If you are the grantor, these are a QPRT's advantages:

- The residence is no longer in your estate.
- Appreciation in excess of the IRS assumed rate is transferred to children at minimal gift tax cost.
- You retain the right to live in the home during the term of the QPRT and you may rent the residence from your child or children, or the trust, at the end of the term.
- You may exclude tax on capital gains.

And here are some disadvantages you should consider:

- If you die before the end of the QPRT's term, the value of your interest will be included in your estate—this mortality risk can be offset by varying the length of the QPRT.
- The IRS may challenge the value of the discount in addition to the value of the remainder interest.
- The stepped-up basis at your death will be lost if your children sell the residence post-death, for liquidity or other reasons.

Now and Later: QPRT Sales and Leases

A **qualified personal residence trust (QPRT)** is a common choice for achieving numerous goals. In particular, QPRTs take maximum advantage of the current exclusion amount and significantly reduce gift taxes on the transfer of the property. The QPRT also takes advantage of the valuation discounts that result from splitting an interest in property. Its biggest benefit is that parents can transfer their interest in a personal residence, including a legacy vacation home, to a trust for the benefit of the children, while retaining the right to live in the residence for the term of the trust. When the trust terminates, the residence becomes the children's property. "Because the initial transfer of the residence is subject to the parents' retained right to use the house, the value of the gift to the children is reduced," says Thompson. "The right to own and use the house sometime in the future is not as valuable as the right to own and use the house immediately. So valuation discounts apply, resulting in a reduced transfer tax on the property. If the property continues to appreciate, that appreciation passes to the children free of any additional transfer tax." The estate tax savings for the parents can be considerable depending on the value of the home at the end of the QPRT's term.

Property can also be transferred to a **limited liability corporation (LLC)** or **limited partnership (LP)**, with the children owning equal shares of the LLC or LP that actually owns the property. While the LLC or LP exists, the parents are actually tenants of, and pay rent to, the entity. "The rent can be used toward the ongoing upkeep of the property," says Thompson. "In addition, the LLC can own life insurance on the parents so that when the second parent dies, the LLC becomes the beneficiary—creating an endowment fund for both upgrades and maintenance or for liquidity if a sibling needs to be bought out by others." Most important is to build flexibility into the structure of the transfer so that it makes sense for the longer-term harmony of a multi-generation family, as well as from a tax and estate planning standpoint.

Sometimes the planning tactic can include a piece of property that has value, but no "connection" for the next generation. In these cases, it makes sense to remove the property from the estate, but it also requires a frank discussion with the client about expectations. "One of our clients who is a physician owns the building where he houses his medical practice," says Paulina Mejia, managing director and senior wealth strategist. "The property is in an area that was once depressed, but is now showing signs of significant development and appreciation in the future, and he plans to keep his practice at that location; this being said, it would be to his advantage to remove it from his estate. In this case, **a gift to a trust with lease back** probably makes the most sense. Although the tax advantages are there, it's a type of transaction that has a different flavor than gifting the family vacation home to the next generation."

Another exit strategy for clients who own commercial property—particularly a sizeable portfolio of numerous properties acquired as an investment—is to sell the portfolio to a **real estate investment trust (REIT)**. "Managing commercial properties requires a lot of cost and expertise," says Thompson, who has advised clients in similar situations on selling to a REIT. "It's frequently not something clients' children are either interested in doing or equipped to do. At Atlantic Trust, we're often involved in planning strategies for both commercial real estate and family legacy properties. Although there is a big contrast between the two, we have to think creatively about how to transfer the properties and their value to subsequent generations."

The Gift That Keeps on Giving—or Requiring: Who Pays?

Once a real estate gift strategy is put into place, the big question many clients ask themselves is, “Okay, now what?”

“Answering this question involves a critical set of family decisions,” says Art Graper, managing director and senior wealth strategist. “Ultimately, these decisions need to accomplish two goals: explain how each family member is going to continue to use the property and clarify the financial responsibilities associated with the property—including which family members will ultimately be held accountable.” Graper advises families to set up and manage a calendar of usage. This calendar should answer some of the following questions:

- Can non-family members rent the property, and if so, who will receive the rental income if one child gives up his or her week and rents the property to a friend?
- Does usage of the property have to be equal for all parties?
- Should we implement a family “lottery” for the most desirable weeks?
- How are repairs, taxes and insurance going to be paid for and renewed over time?

Ideally, the trust would be established with a foundation of cash to pay for ongoing expenses and upkeep to avoid situations that would put one child or grandchild in a financial bind. “Certainly there are cases where a young family member may feel house-rich but cash-poor,” says Graper.

While each family, and each piece of real estate to be gifted, is unique, there are common emotional land mines that go along with transferring heritage property. “Let’s put it this way,” says Thompson, “There are very different issues for a family whose property actually appears on a state map and is in an area named after them than for a family passing on a city residence—even if the property is extremely valuable and is the home where the kids grew up.” Strong feelings are especially common with mountain or lakeside “camps”—places where generations connect and reconnect, where holidays are spent and where there’s a palpable sense of safety and family unity. Family discussions guided by an advisor need to go deep and include the following questions:

- Do all of the children feel equally attached to this property?
- How well do the children and grandchildren get along and do they communicate with each other well?
- Is each heir of somewhat equivalent earning power or asset base?
- What happens if one of our children divorces and wants to sell his or her interest?
- Who decides on the need for remodeling?

“There are sound ways to handle most of the ‘what if’s’ involved in gifting real estate,” says Mejia. “Certainly, a part of our job as trusted advisors is to encourage and facilitate family discussions to ensure as many questions are addressed as possible. When children are too young for that, parents can express very specific feelings in a trust document.” For one client, language was included about the parents’ “hope”—but not requirement—that the children retain the vacation home when the trust terminates and the assets are distributed. It even outlined provisions for handling options to buy from siblings who do not wish to retain their interest, including “drawing straws” to decide which of the other siblings can go first on purchasing another’s interest.

Real Estate and Donor Advised Funds: A Checklist

A typical opportunity for real estate and donor advised funds (DAFs) is this: Your family owns appreciated, debt-free residential real estate, such as a vacation home, is philanthropically inclined, and would like to support various charitable causes over time. You're interested in eliminating the capital gains tax liability and in taking a charitable tax deduction.

Considerations and Solutions:

- The property will ideally be "highly marketable," debt-free and, ideally, highly appreciated.
- Some charities will consider a commercial property with an income stream, but the due diligence process is considerably more involved.
- You must be willing to irrevocably transfer the property to the charity that sponsors the DAF, which will exclusively control the sale, including negotiating the sale price.

Benefits:

- You unlock the philanthropic value of a seemingly illiquid asset while also eliminating any capital gains tax on the appreciation of your property.
- You can take a tax deduction for the fair market value of the property up to 30% of your adjusted gross income (AGI). If the fair market value of your contribution is greater than 30% of your AGI, you may be able to carry the deduction forward for five years.
- You can invest the balance in your DAF for potential tax-free growth—and more dollars to charity.

In some cases, transferring real estate to children and grandchildren carries a price that needs to be carefully considered for those receiving the property. Think of a producing vineyard or working ranch. In cases like those, the romantic notion of keeping the lovely home with the small winery attached suddenly becomes a career in agriculture. Graper worked with a family whose patriarch strongly desired for his three children to "keep the family together" by involving all of them in not just usage of a home on the family farm but in actively working the farm. Of the three, only one actually lived on the farm, while the other two lived a considerable distance away. "This patriarch's desire meant literally working the fields and fixing barns," says Graper. "Although it's been a struggle for each of them, they've finally come together under one unifying purpose: Dad wanted us to keep the farm as a viable entity in order to preserve the property and the family's farming tradition for future generations."

Donating Real Estate to Charity

Another reason many families want to gift property is to achieve charitable giving goals. Giving more, and giving more efficiently, is a big reason to consider donating real estate to your favorite charitable organization, according to Ryan Boland, director of the Complex Asset Group at Fidelity Charitable in Boston. "Very often, people donate appreciated securities, but for some people, donating real estate can be even more tax efficient and, therefore, very advantageous for both giver and receiver," says Boland.

Let's assume that a couple with a large primary residence that is mortgage-free and now worth several million dollars is ready to downsize after 25 years in the home. Actively philanthropic, they assume that their best course of action is to sell the home and donate the profit to charity. But a direct donation of the home to a public charity allows a full, fair market value tax deduction (not just the original cost basis), while eliminating the capital gains tax they would pay on the sale—which could be quite sizeable on a long-held home in an area with significant appreciation. "The bottom line is that by donating a piece of highly appreciated real estate, you're not only being tax-efficient, but you're also able to give more to the causes and organizations you care about deeply," says Boland.

Along with donating other "complex assets"—private company stock, LLC and LP interests—a gift of real estate requires careful consideration by both the individual and the charity. In some cases, options for donating may be limited—for example, when the favorite charity is a small organization with a local focus. "It's not that these organizations don't want a contribution of this value, it's just that many charities are not equipped to handle this type of donation," says Boland. "Even before they can sell it, the charity would need to consider numerous administrative issues such as insurance, taxes, utilities and security, to name a few. And if the donated real estate is far away from the charitable organization's location, they may be very reluctant to accept it."

One strategy gaining favor is to donate complex assets such as real estate to a charity that offers a **donor advised fund (DAF)** program. This type of structured giving vehicle has grown in popularity—more than 688% between 1995 and 2011.* With a DAF, the donor/client would make an irrevocable contribution of real estate to the sponsoring charitable organization. The charity would coordinate the sale of the property and allocate the proceeds into a the donor's DAF. "One of the biggest benefits of structuring a donation this way is that the client receives

*The Chronicle of Philanthropy, December 1995 and May 2012 issues.

the tax deduction when the property is given, but can use the proceeds to provide support to charities now and in the future,” says Boland. It gives the donor time to strategize thoughtfully about diversifying giving. “Many want to give to several organizations, but it would be very cumbersome to contribute one-third of a house to each of your alma mater, your church and your local free medical clinic,” Boland notes. “In the case of a small, local ‘soup kitchen,’ periodically receiving smaller cash amounts may be easier for the organization to handle.” In addition, some organizations that offer DAFs allow grants as small as \$50, an opportunity for a multi-generational family to let grandchildren learn and participate in decisions on where the gifts go.

Whatever the ultimate goal—keeping a family’s “Big House” intact and improved, putting it in the next generation’s hands or donating it to help a favorite cause—recognizing family dynamics and managing your family’s expectations are important parts of the process. If, for example, something starts with Mom and Dad—the lake cottage they’ve lovingly maintained over the years—Mom and Dad will be the constant touchstone and reference point. Healthy family discussions that accompany the set-up of a QPRT or other tactic may help avoid touchy issues in the future. The hope is to avoid a conversation years down the road in which one sibling says to another, “Not only did you and your friends break Mom’s favorite lamp at the lake house, who said you could rip out the 100-year-old gardenia bushes and put in an herb garden?”

Please speak with your Atlantic Trust relationship manager about how these real estate planning options could benefit your estate plan.

Conservation Easements: What You Need to Know

An income tax deduction up to 30% of adjusted gross income, significant estate tax benefits, a donation to a worthwhile organization—what’s not to like about a conservation easement (CE)? In simple terms, a CE is a voluntary encumbrance that creates a legally enforceable land preservation agreement between a property owner and a government agency or a qualified land protection organization. It’s often used to restrict real estate development on a family’s “heritage” property. In general, a CE can be used to protect any type of land whose conservation is in the public interest—wood land, wetlands, historic areas. The premise that a landowner can convey certain rights on his or her land while retaining other rights is rooted in English common law, on which the U.S. legal system is based. The financial benefit to the property owner who donates the CE to a qualified organization is a federal income tax deduction as long as the easement is perpetual. While a land trust should help ensure that donations of land or CEs meet federal and state tax law requirements, in the long run, it’s the donor’s responsibility to make sure the requirements are met.

An extremely important point that can’t afford to be overlooked: While the real estate remains the private property of the owner after the CE is donated, the terms of the CE “run with the land” and are binding on all future owners of the property. Paulina Mejia, Atlantic Trust managing director, worked with a family with a lovely historic home on the East Coast, whose owner put a CE on it as a result of her fondness for a local charity. She was able to take a sizeable income tax deduction while also satisfying her desire to align with the mission of the charity. “The problems came on the back end,” says Mejia. “Although the location of the home was highly desirable, the house needed updating and the CE was so restrictive that after the client’s death, her children couldn’t find an interested buyer when they decided to sell. What seemed like a great idea done for the right reasons turned into a difficult situation for a later generation who didn’t feel as strongly about the home. This is a lesson in thinking very carefully about a planning technique’s long-term effects.

Real Estate Transfer Matrix

Key real estate transfer techniques have been analyzed and presented in matrix form by the Wealth Strategies Group. This matrix addresses general considerations and should not be construed as legal or tax advice. Please consult your Atlantic Trust relationship manager for more information on your specific application.

	Outright Gift	Qualified Personal Residence Trust (QPRT)	Intentionally Defective Grantor Trust (IDGT)	Split Purchase	Remainder Sale
Basics	Gift of interest in real estate directly to an individual or trust.	Type of split interest trust which allows the grantor to transfer property to an irrevocable trust and retain the right to use the property for a specified number of years. At the end of the term selected, the property is distributed to family members, or a trust for their benefit.	Grantor gifts an interest in his home (or other assets) equal to at least 10% of the value of the property to be sold to a trust. Grantor then sells the remainder of his ownership interest to the trust in exchange for a promissory note equal to the fair market value of the portion sold. Note can provide for interest only and a balloon payment or principal. Trust is a grantor trust for income tax purposes.	Trust (or individual) purchases a home. Trust provides parent with a life estate and child a remainder interest. Parent's contribution to trust is equal to actuarial present value of lifetime interest. Child's contribution is equal to actuarial value of remainder interest. The trust should comply with the QPRT regulations to avoid Section 2702 application.	Grantor sells a remainder interest in the property carving out a life estate or term of years. If a trust is used it should comply with the QPRT regulations to avoid Section 2702 application.
Gift Tax	Gift value will be calculated based on the FMV of the property at the time of transfer, less applicable discounts if a fractional interest gift is made.	Gift value is calculated by determining the excess of the value of the property transferred over the value of the retained interest. The value of the retained interest is determined by multiplying the principal by the present value of an annuity factor for the number of years of the trust term. Retained value is greater if applicable federal rate is higher, grantor's age is older or term is longer.	The portion of the home (or other asset) that is gifted to the trust will be subject to gift tax. The value of the gift will be based on the fair market value of the property adjusted for appropriate fractional interest discounts.	No gift has been made if both parties are paying full and adequate consideration. IRS may dispute valuation based on <i>Gradow v. U.S.</i>	No gift has been made if purchaser of remainder interest pays full and adequate consideration. IRS may dispute valuation based on <i>Gradow v. U.S.</i>
Generation Skipping Transfer (GST) Tax	GST exemption can be applied or allocated if transfer is a direct skip gift or a transfer to a GST trust.	GST exemption cannot be allocated until the end of the QPRT term when the property value is likely to be significantly higher. If a continuing trust is used after the QPRT term, the grantor may need to opt out of an automatic allocation under new GST regulations.	GST exemption can be allocated to the entire trust based only on the gifted portion, resulting in significant GST benefits of transaction.	Joint purchase can be made with funds owned by GST exempt (dynasty) trust.	Remainder interest can be purchased with funds owned by a GST exempt (dynasty) trust.
Estate Inclusion	If death occurs within three years of the transfer, any gift tax paid will be included in grantor's gross estate.	Full value of property transferred is included in the estate under Section 2036(a) if the grantor does not survive the term.	Residence will not be included in the estate, as long as grantor does not retain rights to possession or enjoyment of trust property. The remaining principal of note will be included. There may be income tax consequences if the note is outstanding at death.	If the purchaser has paid full and adequate consideration as determined by IRS tables, there should be no estate inclusion. Be careful if joint purchaser obtained funds from parent as IRS may argue Section 2036(a) inclusion.	If the purchaser has paid full and adequate consideration as determined by IRS tables, there is no estate inclusion. Be careful if purchaser obtained funds from parent as IRS may argue Section 2036(a) inclusion.
Rent	Grantor can pay fair market value rent if grantor desires to live in residence. Donee will recognize income for rental payments.	The grantor has the right to use the residence during the QPRT term. After the term, the grantor must pay a fair market rent if he would like to continue to occupy the residence.	The grantor can rent the residence from the trust without income tax consequence to grantor or trust. Note payments can be timed to correlate with rental payments due.	No rent required with this strategy.	No rent required with this strategy.
Sale Back	There is no prohibition if grantor would like to repurchase the residence.	Grantor may not purchase the residence back after termination of the QPRT to obtain a stepped-up basis in property at death.	Grantor can re-purchase residence with no income tax consequences (or substitute assets of equivalent value) to achieve stepped up basis at death.	Parent is able to purchase remainder interest for full and adequate consideration without income tax consequences (or substitute assets of equivalent value) if remainder interest is held in a grantor trust. Parent will then achieve stepped up basis at death.	Parent is able to repurchase remainder interest for full and adequate consideration without income tax consequences (or substitute assets of equivalent value) if remainder interest is held in a grantor trust. Parent will then achieve stepped up basis at death.

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