HOW QUALIFIED PERSONAL RESIDENCE TRUSTS CAN BE USED TO REDUCE OR ELIMINATE THE ESTATE TAXES OF HOMEOWNERS

by Neil R. Lubarsky, Esq.

Estates in excess of whatever the federal estate tax exemption is at the time your death will be taxed at very steep rates. Individuals owing assets and insurance in excess of this federal estate tax exemption amount will face potentially confiscatory estate taxes, given combined federal and state estate tax rates that can exceed 50%.

There are still, however, a number of ways to effectively minimize these estate taxes. One of those that is best suited to the needs of Westchester County's and Fairfield County's residents, who often own homes of substantial value, is the "Qualified Personal Residence Trust" also known as a "QPRT". Qualified Personal Residence Trusts are so effective at reducing estate taxes that having them eliminated was once placed by the Treasury Department's "hit list". Fortunately for individuals with valuable residences, the Treasury Department shifted its focus elsewhere. A Qualified Personal Residence Trust enables a person to significantly reduce the value of a residence, for estate and gift tax purposes, while simultaneously enabling such person to continue living in such residence rent free for many years after giving it to a trust. Fortunately, Qualified Personal Residence Trusts are still legal.

The trust works as follows:

You set up a trust with your children as beneficiaries. You then make a gift of the house to the trust, but retain the right to live in the house rent free for the entire term of the trust, which is usually a specific number of years. You can make the term of the trust any number of years that you wish. Assuming that you are alive at the end of the trust term, the property will pass to the trust beneficiaries, who most likely would be your children.

The value of the interest being transferred to others through the trust, which is commonly referred to as the remainder interest, is frozen, for gift and estate tax purposes, at a reduced percentage of the house's current value, as long as you outlive the term of the trust. Not only is this reduced amount generally far less than the true value of the property, but the freezing of this value also avoids any further appreciation on the property from being included in your estate.

Let's look at the following two examples:

Suppose that you have a $2,000,000 house and that you are currently seventy-five years old,

and you wish to live in such house rent free for 10 years. In this case, the remainder interest, depending on the prevailing interest rates, will be valued at approximately $800,000, or 40% of the home's true current value. By establishing such a trust and living for its 10 year term, you would have made $1,200, 000 "disappear" from your estate, potentially saving $600,000 of estate taxes.

Now suppose that over the 10-year period the house doubles in value, so that the house becomes worth $4,000,000. Had you not set up a Qualified Personal Residence Trust, you would have had a $4,000,000 asset in your estate. With the trust, the house (technically what the IRS refers to as the remainder interest) was treated for gift and estate tax purposes as if it was worth $800,000, effectively removing $3,200,000 of value from your estate. Assuming a 50% combined federal and state estate tax rate, setting up this trust will have potentially saved you about $1,600,000 in estate taxes.

This technique works as well for vacation homes as it does for primary residences, works as well for condominiums as it does for single family homes, and has the advantage of not changing the beneficial income tax aspects of home ownership during the trust term.

The establishment of a Qualified Personal Residence Trust should be considered by anyone who owns a mortgage-free home and who is concerned about potential federal estate tax exposure.

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