The Death Tax Is Likely To Live On, So High-Net Worth Individuals Might Consider a Qualified Personal Residence Trust

The Obama Administration has indicated its plans to block the estate tax from disappearing in 2010, though to offer a bit of relief, it might freeze it at the rate and exemption levels that took place this year.

That would mean that estates worth up to $3.5 million for individuals and up to $7 million for couples would be exempt from any taxation and those above those amounts would be taxed at 45 percent. (At the end of the Clinton Administration, estates of less than $1 million would be excluded with the rest taxed at a 55 percent rate.)

Even with the downturn in the real estate and stock markets, it's a good time for high net-worth individuals and couples to look at ways to shelter their estates from the possibility of taxes going forward. One possibility for couples who have a substantial investment in real estate they consider a residence is the Qualified Personal Residence Trust (QPRT). A QPRT is a trust that owns the home at a discounted value for a specific term while allowing the parents to continue living in the home.

The QPRT works best for those people who expect to live another decade or so. The longer the term of the trust, the greater the benefit to the kids. Yet you're essentially playing a game of chicken with the Grim Reaper—if one or both of the parents die before the trust expires, the heirs have to pay the estate tax on the value of the house at the time the parent died.

A good first step in finding out if a QPRT makes sense is a trip to see your financial planning professional or estate planner. Such a trust has to be set up carefully with a thorough review of actuarial tables and a discussion of each parent's financial history.

Technically, QPRTs make the most sense when interest rates are high, because the higher the interest rate, the greater the discount applied to the property, which, in turn, increases the tax savings. A QPRT is based not on the current value of the house at the time the trust is being written, but what is determined to be the present value of a future gift, which is actually a discount to the current value. When a home is put into the trust its value is not the current value of the house, but what is called the "present value" of the future gift - a decrease of 25-50 percent in value. The Internal Revenue Service calculates these formulas, so ask your expert how current calculations will affect the value of your estate.

Another potential benefit of the QPRT is that if the parent runs into trouble with high hospital or medical bills, the hospital cannot demand any money gained by refinancing or selling the house, since the occupant does not have any right to that money.

If the rough real estate market has devalued your home at least a little, chances are that the market may rebound sometime during the term of the trust and if you outlast the trust at its expiration, the strategy may work out very well for your heirs.

Obviously there are a number of considerations here, not the least of which involves the current value of the property. Your adviser should help you consider all these issues, and you should keep an eye on the news for what eventually happens with the capital gains tax as well as what ends up happening with the estate tax.

Oh, and if the parent outlives the trust, the parent can continue to live in the house by paying the kids fair-market rent. There's one more wrinkle to try if the kids want to avoid income taxes on the rent they'll receive from their parents—they can form a grantor trust for the property so the rent is paid to the trust.

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