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Examining a few creative ways around estate taxes



Imagine giving your family a significant portion of your estate without estate taxes and before your death. If that sounds enticing, you don't just have to imagine. There actually is a type of trust created to allow you to do just that. A qualified personal residence trust allows you to transfer your home into an irrevocable trust, eliminating it from the personal estate you will leave.

You may live in your home for a specified time rent-free to use a qualified personal residence trust. After that, you must pay rent at the fair market value. If you die before the specified time — usually 10 to 20 years — the tax savings are not realized and the house converts from the trust back into your estate.

For example, Dan and Susan set up a qualified personal residence trust for their million-dollar home. Their two daughters are the beneficiaries of the trust.

Dan and Susan retain the right to live in their house for 12 years. The house belongs to their daughters at the end of the 12 years. While a gift tax must be paid, that tax only will be on the value of the house when the gift was given 12 years before, minus depreciation because Internal Revenue Service rules assume that a dollar given now is worth more than a dollar given in 12 years.

This may be true with a dollar, but the opposite usually occurs with a home, as that typically appreciates in value. Assuming the house has merely doubled in value, it is now worth \$2 million, but the gift tax is only paid on the value of \$370,460.

Please note that an individual might be able to make gifts of as much as \$1 million without incurring federal gift tax using the applicable exclusion amount. That exclusion goes to \$2 million for married couples.

A longer trust reduces the amount the house is valued at even more; so the longer the trust holds the house, the greater the tax savings. As a tax savings vehicle, this is a strong choice because tax is only paid on a fraction of what the home will be worth when it is distributed out of the trust.

The major benefit to a qualified personal residence trust is estate taxes are avoided on the home. Since the primary residence is a large part of many estates — particularly in Southern California — this enables a substantial portion of the estate to escape taxation.

Furthermore, if your home value would push your estate value over the \$2 million exemption from estate taxes, a qualified personal residence trust enables you to pass other assets to beneficiaries, tax-free. Keep in mind the \$2 million limit will increase to \$3.5 million in 2009, so this specific benefit may decrease for you. Congress continually changes the tax code, so this is no different than any other tax avoidance strategy. You should consult a tax attorney before making any final decisions.

Then again, the capital gains tax may erase all tax savings when the house is sold. Although this is a potential problem, keep in mind the capital gains tax is less than the applicable estate tax. The highest capital gains rate is 28 percent, while the estate tax rate is as high as 55 percent. Additionally, this is paid only when your beneficiaries sell the home. Many beneficiaries decide to keep the home as a vacation home; therefore this disadvantage does not apply to them.

There are some considerations. The trust is irrevocable. Once you sign on the dotted line, you can't take it back. If you are unsure what your beneficiaries will do with the house, be sure to discuss that with them first.

If you want to continue living in your home after the time period has expired, you can as long as you pay rent at the fair market value. However, the home is no longer yours.

Despite your wishes, your beneficiaries may evict you and sell your home before you are ready to leave. As a result, be sure you have examined every possibility, and discussed it thoroughly with your advisors and beneficiaries.

Additionally, keep in mind to carefully consider the length of the trust period. Ideally, you want to choose a term you are confident of surviving, but will produce substantial tax savings.

If you die before the time period expires, the home will be included in your estate at the value of your death date, thereby destroying any tax savings. However, if the trust is a very short period, the discount on value calculated for gift tax purposes will be very small. Furthermore, if you live much longer than the time period and this is your primary residence, you will be paying rent.

Gifting can make great sense from an asset-protection and estate planning perspective. The qualified personal residence trust is very specialized. Keep many considerations in mind when deciding whether to use it.

The tax savings is a significant advantage that must be weighed against the irrevocable nature, capital gains concerns, and the uncertainty of choosing a time period.

Be sure to consult a good attorney and tax professional before deciding. The attorney will be able to advise whether this is a good choice.

John Schooler is president of Western Financial Advisors and WFP Securities. He can be reached at (858) 677-0477.