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How To Avoid Estate Taxes On Residence Transfers

By Stephen M. Margolin, J.D.

Many are troubled that so little family wealth passes to the next generation. Everyone realizes the inevitability of taxes, but our transfer tax system can reach confiscatory proportions. One-half of a taxable estate over $2.5 million can be lost through taxation.

There are ways, however, to relieve your client's heirs of much of the estate tax burden. With careful, timely planning they can preserve more than they realize, because a variety of tax-saving remedies are built into the tax code.

A qualified personal residence trust (QPRT) allows owners to transfer either or both their principal residence or vacation home to their children with little or no tax burden while continuing to reside in them. Considering the substantial value of such residences it is appropriate to explore a means of passing them on at low or no taxes.

A QPRT is a trust in which the owner, as grantor, transfers the residence, though he retains an interest for a term of years. Thereafter, the property goes to his spouse for life and then to the owner's children. The parties to the QPRT are the grantor (the owner), the term holder (the owner), the trustee (someone independent), the life tenant (the spouse) and the remaindermen (the owner's children).

FEDERAL ESTATE/GIFT TAX

Under Chapter 14 of the Internal Revenue Code, the estate/gift value of QPRT is determined through actuarial tables published by the Internal Revenue Service (IRS). The ultimate gift for federal estate/gift tax purposes is the determined remainder interest.

Keys To Assisting Sale

- Apprise clients of high estate taxes
- Show the need to protect the home
- Explain how a QPRT can reduce the burden significantly
- Suggest funding with life insurance

Assume the owner is 55 years old and owns a $600,000 residence. He transfers the residence into a QPRT with a 20-year term for himself, a life interest for his wife and all remainder interest for his children. The residence reverts to the owner's estate if he does not survive the 20-year term. Using the 7.6 percent interest rate mandated by the IRS for February 1993, the retained income interest is $413,387 and the retained reversionary interest is $97,476. The owner's total retained interest in the QPRT is $510,863 ($413,387 + $97,476).

The remainder interest (the gift) is $89,137. This is the difference between the value of the home at the transfer date into the QPRT ($600,000) and the grantor's retained interest ($510,863). Through a QPRT, the owner uses up only 14.86 percent ($89,137) of his $600,000 lifetime estate/gift tax exemption, rather than the full amount.

A QPRT could be drafted to accommodate the residence being sold, replaced, damaged or destroyed. Even under those circumstances, tax-saving advantages are realized.

WHEN THE TERM EXPIRES

After the expiration of the owner's term estate, the residence is held for his spouse for life and then transferred to his children in the relative ownership percentages that the owner establishes for them. If he outlives his wife's life estate, he can buy the residence back from his children for its fair market value or he can rent it from his children. Either way, the owner's estate is further depleted for federal estate/gift tax purposes while he continues to live there for life.

It is important that the owner survive the term. If he does not, the transferred value of the residence is included in his estate. There's still a way to avoid this situation, however. An insurance policy can be purchased as a hedge with the policy discontinuing at the end of the term. However, our experience has been

that more insurance is needed at the end of the term because of growth in the owner's other assets.

The trust term can be longer or shorter than 20 years. A residence in trust for a longer term will result in a lower remainder interest (gift). Even if the owner wishes to sell the residence during the QPRT's term, this does not disturb the integrity of the trust. Any excess proceeds can be returned to him or converted into a Grantor Retained Annuity Trust with the proceeds from the sale.

The significance of this transaction is dramatic in light of the 50 percent marginal tax rate on estates over $2.5 million for 1993 and thereafter. Even if the value of the residence increases over the term, the value of the remainder interest (gift) to the children does not correspondingly increase for federal estate/gift tax purposes. If the $600,000 home value appreciates by 4 percent per year over the 20-year period, for example, its value then equals $1,314,674. Even so, this amount is entirely out of the owner's estate. The only taxable transfer is the $89,137, which was offset by his lifetime tax exemption. The taxable transfer difference is $1,225,537.

The QPRT is a viable concept when looking for ways to protect and conserve an owner's estate for his family. With the trust arrangement backed by life insurance, the owner can transfer his interest in his residence to the next generation at slight or no tax burden, while maintaining the residence as his home. He has not relinquished anything, but look at the dramatic savings! ■

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