

OAK STREET LAW GROUP, PLLC

QUALIFIED PERSONAL RESIDENCE TRUSTS OFFER LARGE POTENTIAL ESTATE TAX SAVINGS

A married couple or an individual can dramatically reduce the overall tax costs of passing property to children or other beneficiaries by transferring a personal residence to a qualified personal residence trust ("QPRT"). In a QPRT, the creator retains the right to occupy the residence for a fixed period of years, at the end of which it will be retained in trust for the benefit of others or will be distributed outright to the children or other designated beneficiaries. Importantly, a couple or an individual can transfer a principal residence, a vacation home or both, to a QPRT. (Each individual can create up to two QPRTs.)

QPRT DESCRIPTION

A QPRT is an irrevocable trust to which an individual (the "grantor") transfers a personal residence, reserving the right to occupy the residence for a term of a certain number of years. At the end of the term, the trustee of a QPRT either distributes the residence to the designated beneficiaries - usually the grantor's children - or retains the residence in trust for the beneficiaries' benefit. If the trust continues, the trustee can lease the residence back to the grantor at the then fair market value rate without causing the residence to be included in the grantor's estate.

MINIMAL GIFT TAX COST

For federal gift tax purposes, the transfer of a residence to a QPRT involves a gift by the grantor of the actuarially determined value of the right to receive the property at the end of the term. Therefore, the amount of the gift is generally far less than full value of the residence. Instead the amount of the gift is the value of the residence reduced by the value of the grantor's retained right of occupancy.

Here the grantor gets a tremendous break - the value of the grantor's retained right of occupancy is calculated by applying the current federally prescribed rate of interest to the value of the residence. In essence, the interest retained by the grantor is treated as having a value equal to the present value of the right, for the term of years, to receive interest at a fixed rate on the full value of the residence at the time the QPRT is established.

POTENTIAL ESTATE TAX SAVINGS - LITTLE OR NO DOWNSIDE RISK

If the grantor survives the term of a QPRT, none of the value of the residence is includible in his or her estate for federal estate tax purposes. There is essentially no downside tax risk: If the grantor dies during the term, the tax position of the grantor is no worse than if the QPRT had not been established. In such a case, the full value of the residence is includible in his or her estate. Below is an example illustrating how creating a QPRT can reduce the grantor's estate tax liability by almost \$1 million:

Example: Parent (P), age 60, transferred his vacation residence, worth \$1 million, to a QPRT. Under the terms of the QPRT, P retained the right to use and occupy the residence for 12 years, after which the trustee was to distribute the residence to P's daughter (D). Assuming P's retained interest was worth \$620,000, P made a gift to D of less than one-third of the present value of the residence - only \$380,000. The gift tax cost of the gift would be offset by applying part of P's \$1,000,000 lifetime gifting exemption tax. If P outlives the QPRT's 12-year term, the residence will not be included in his estate for tax purposes, even though its value may have increased to \$1.5 or \$2 million. On the other hand, if P dies during the 12-year term, the value of the residence will be included in his estate for estate tax purposes.

If P does not create a QPRT and retains his residence until his death 12 years later, when the residence is worth \$2 million and he owns other assets worth \$5 million, about \$1,925,000 million in estate taxes will be due from his estate. On the other hand, if P transfers his residence to the 12-year QPRT described above, lives for more than 12 years, and dies leaving \$5 million in other assets, the estate tax due on his death will be about \$1,000,000 million, or about \$925,000 less than if he had retained outright ownership of the residence. Of course, if the residence were included in P's estate for estate tax purposes, its income tax basis would be increased in the hands of the beneficiaries to its federal estate tax value in P's estate - \$2 million. If the residence is transferred to a QPRT and not included in P's gross estate, the basis of the residence would not be increased by reason of P's death.

RULES REGARDING QPRTS

The present law allows each individual to transfer no more than two residences to QPRTs, one of which must be his or her principal residence. A personal residence subject to a mortgage can be transferred to a QPRT, but the tax consequences are more complicated (additional gifts that require gift tax returns to be filed may take place each year in which the grantor makes payments on the mortgage), and, with new lending regulations generally results in a higher interest rate mortgage. Overall, the tax and practical results are simpler and better if an unencumbered residence is transferred to a QPRT

In general, a QPRT cannot hold any property other than one personal residence, which may include related buildings that are used for residential purposes and land reasonably appropriate for residential purposes. Thus, furniture and furnishings cannot be transferred to a QPRT. If a residence held in a QPRT is sold during the grantor's retained term, the proceeds must be (1) reinvested in a new residence within two years, (2) converted to a qualified annuity payable to the grantor for the remaining term, or (3) distributed to the grantor. If a residence is sold during the term of a QPRT, the grantor is treated as having made the sale for income tax purposes. In most cases, the grantor, who is treated as the owner of the residence for income tax purposes, can exclude up to \$250,000 (or \$500,000 for married couples) of gain on the sale of a personal residence held in a QPRT.

QPRTS ARE NOT FOR EVERYONE

Before entering into a QPRT, an individual or couple should carefully consider both the tax and nontax issues. Particular consideration should be given to the economic and emotional aspects of a QPRT. Among the nontax issues, prospective grantors should consider whether suitable living arrangements can be made at the end of the term if they will no longer be able to occupy the residence. On this score the IRS has provided significant help - several private letter rulings indicate that the grantor of a QPRT can retain the right to lease back the personal residence at the end of the term, provided the grantor pays fair market value rent.

GENERAL STEPS IN ESTABLISHING A TAX EFFICIENT QPRT

1. Draft Trust Agreement (one for each spouse if married couple);
2. Complete Deeds to transfer the residence from your community property to each of your separate property (only if married couple);
3. Obtain a real estate agent's appraisal of the fair market of the property;
4. Obtain a fractional interest appraisal for the value of a 50% interest in the residence (only if married couple);
5. Draft Deeds to transfer the properties to the QPRT; and
6. File a Form 709, gift tax return, on April 15 of the year following the gift.