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QUALIFIED PERSONAL RESIDENCE TRUST ("QPRT")

A personal residence or vacation home is often a valuable asset with the potential for future appreciation. A relatively new estate planning technique is now available for residential property known as a Qualified Personal Residence Trust (QPRT). The technique enables the owner to:

- Transfer property at a significantly lower gift tax cost.
- Eliminate estate and gift tax on any future appreciation.
- Continue residence for a specified period of years.

QPRT OVERVIEW

There has been a great deal of interest in the Qualified Personal Residence Trust (QPRT) since it came into acceptance in 1990. However, actually setting up a QPRT depends on finding the right situation. This article will address when a specific situation might call for recommending a QPRT, and the general rules for setting one up.

A QPRT is a trust designed to own a person's home or second home. The individual retains the right to use the home for a set number of years (say, 5 or 10 years). At the end of the term, the home passes to the remainder persons (usually the donor's children).

It is NOT designed for use with rental or investment real estate.

When the donor puts the home into the trust, he or she is making a gift of the actuarial value of the remainder interest. The retained interest- usually the larger portion of value- is not a gift. If the donor survives the trust term, the home is out of the taxable estate. The "cost" in terms of unified credit used is usually modest.

BASIC PROVISIONS

A QPRT involves the transfer of a personal residence to a trust by the property owner (Grantor). For a specified period of years (the trust term), the Grantor retains and is entitled to the use and occupancy of the residence. During the trust term, the Grantor continues to be responsible for the ordinary expenses attributable to the residence, including real estate taxes.

At the end of the trust term, ownership of the residence passes to beneficiaries designated by the Grantor- for example, children or other family members. If the Grantor desires to continue to live in the residence, the Grantor can rent the property from the beneficiaries at a then fair market rental.

ELIGIBLE PROPERTY

A QPRT may only be used for a personal residence, which is either a principal residence or one other residence (or a fractional interest in either). It is therefore possible to create two QPRTs, one for the principal residence, and one for another residence such as a vacation home.

A residence, by definition, includes a house, a condominium apartment, or a cooperative apartment, and may include adjacent land which is reasonably appropriate for residential purposes, taking into account the residence's size and locations.

A QPRT may not hold any personal property, such as household furnishings. Likewise, it cannot be used for farm property or acreage.

TRUST TERM

Although the Grantor may select the term of the trust, several factors should be considered. The transfer of the residence to the QPRT constitutes a gift by the Grantor equal to the value of the residence, reduced by the value of the Grantor's retained right to reside in the property. The longer the trust term the greater the value of the retained interest, and, therefore, the lower the value of the gift.

For example, if a Grantor, age 55, transfers a residence to a QPRT for 5 years, the value of the retained interest is approximately 30% of the value of the residence. If the trust term is increased to 10 years, the value of the retained interest is approximately 50%, and at 15 years the retained interest is greater than 60%.

However, in order to realize the tax benefits of a QPRT, the Grantor must survive the trust term. This is so because if the Grantor dies during the trust term, the residence will be subject to estate tax as if the Grantor still owned the property. In selecting a trust term it is therefore beneficial to use the longest period that the Grantor can reasonably be expected to outlive. Factors such as the Grantor's age and health should obviously be considered.

If the Grantor dies during the trust term, and the residence is therefore subject to estate tax in the Grantor's estate, it is advisable to provide in the QPRT that the residence will revert to the Grantor and disposed of under the Grantor's Will. This will further reduce the initial value of the gift to the QPRT because the actuarial value of the reversion is subtracted in determining the value of the gift. For example, in the 5-year QPRT referred to above, the value of the reversion is approximately 4% of the value of the residence; in the 10-year QPRT, the value of the reversion is 9%, and in the 15-year QPRT, it is 13%.

SALE OF RESIDENCE

It is permissible for a QPRT to sell the residence during the trust term. The residence may be sold to a third party. The residence may not be sold to the Grantor, the Grantor's spouse, or an entity controlled by the Grantor or the Grantor's spouse.

The beneficiaries receiving the residence upon the expiration of the trust term obtain a carry-over basis from the Grantor.

If the residence is sold by the QPRT, the sales proceeds may either be used to purchase another residence, or be held in the trust and invested. If another residence is purchased, it will be held on the same terms and conditions as the original residence. If another residence is not purchased, the trust must require that a fixed annuity be paid to the Grantor for the balance of the trust term. The amount of this annuity is actuarially determined and is based on the initial value of the Grantor's retained interest in the trust.

TAX BENEFITS

The value of the interests retained by the Grantor which are subtracted in valuing the gift to the QPRT is based on actuarial calculations using tables and an interest rate (which is adjusted each month) published by the Internal Revenue Service (IRS). Therefore, the specific numbers must relate to the month of transfer.

If a Grantor, age 55, transferred a residence valued at $500,000 in September, 2010 to a QPRT for 5 years and retained a contingent reversion in case of death within the 5 years, the value of the retained right to reside in the residence would be $149,785, the value of the contingent reversion would be $21,685, and therefore the value of the gift is $328,530 ($500,000 less $171,470). If the trust term is increased to 10 years, the value of the retained interest and contingent reversion is $290,230, and therefore the value of the gift is $209,770. A similar QPRT for 15 years results in a gift of only $128,730.

If, instead, the Grantor made a direct gift of the residence to family members, it would be valued at the full $500,000 for gift market value at the time of the Grantor's death. By transferring a residence to a QPRT, the value of the residence subject to tax can be significantly reduced. Another potential benefit is that if the residence appreciates in value after the QPRT is established and the Grantor survives the term, the appreciation will not be subject to gift tax or estate tax.

LEGAL IMPLEMENATION

QPRTs must contain many technical provisions required by law. Although there is some complexity involved, this technique may result in significant tax savings. If you would like to discuss QPRTs, or any other aspect of your estate plan, please contact us.

EXAMINING A WORKING MODEL

For example, let's suppose that Martha Smith, a 65 year old widow, has an estate presently valued at about $2,000,000. She has two children to whom she wants to leave her estate. She wants to make gifts to reduce her taxable estate, but she is unsure she can part with significant assets without strapping herself.

After discussing her long-term plans with her children, Martha decides to put her home, valued at $100,000, into a 10 year QPRT. Martha has the right to use the property for 10 years. At the end of the term, the property passes to her children.

When the property is put into the trust, she is making a gift of about $38,000 (valued using government tables) to her children.

Because this gift is not a present interest, it will not qualify for the annual exclusion. She is using part of her lifetime exemption. At the end of the trust term, the property passes outright to her children without a further gift being made, even though the market value of the home might easily exceed $150,000 at that time.

What happens if Martha dies before the trust term ends? The property is includable in full in her estate. It passes to her children, just as before.

What happens if Martha wants to continue using the real estate after the trust term? She should lease it from her children and pay fair rental. This has the benefit of transferring additional family wealth to the children as she pays rent. The rental income could be offset by depreciation expense.

What were the factors that led Martha to set up a QPRT? She has a taxable estate and it will be difficult for her to reduce it with annual exclusion gifts. She is healthy and expects to live in the house about 10 more years. The house is expected to appreciate significantly in value during the next 10 years. Martha has an excellent relationship with her children and trusts them to rent the house to her at the conclusion of the term, if she still wants to live there, at a fair rental amount.

TREASURY REGULATIONS

There are specific QPRT rules. Some of the more significant ones can be generally summarized as follows:

1. Income must be distributed at least annually to the term holder, and no principal or income can be distributed to anyone else during the term.

2. The trust can hold only one residence and some extra cash; excess cash must be distributed at least quarterly.

3. Under some circumstances, proceeds from the sale of the residence or insurance proceeds may be held in the trust and used for replacement of the residence.

4. The trust must prohibit commutation of the term holder’s interest.

5. The trust must provide that if the term holder stops using the house as a principal residence, the trust must terminate unless the proceeds are used within 2 years to purchase another residence.

6. The trust may or may not permit the Grantor to buy the property back from the trust during the term.

7. The trust may permit that if the house is sold, the trust will be converted to a GRAT.

8. The Grantor may not have more than two such trusts.

9. The Grantor may or may not have a reversion.

10. The trust cannot include adjacent land in excess of what is “reasonably appropriate for residential purposes”.

SELECTING THE TRUSTEE

One major consideration is whether the Grantor-term holder should be the trustee. This creates no problems during the residence term of the trust, but the trustee’s powers must be carefully drafted if the term holder will be the trustee when the term ends.

Another major consideration is how to handle mortgaged property. The best advice is to pay off the mortgage before the trust is created, although the arrangement may be structured so that mortgage payments are loans (rather than additional gifts by the Grantor) and the trustee may execute a mortgage to the Grantor.

DRAFTING CONSIDERATIONS

The trust will be drafted to be a Grantor trust for income and principal purposes for several reasons:

- The Grantor will probably want to be able to deduct certain expenses (such as property taxes) that may be paid by the trust.
- The Grantor may want to take advantage of capital gains roll-over under Revenue Code Section 1034 or the capital gains exclusion under Section 121.

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