QUALIFIED PERSONAL RESIDENCE TRUSTS (QPRTs)

A personal residence trust is a technique which enables a person to transfer his or her personal residence, including a vacation home, to younger family members at a significantly reduced transfer tax cost while retaining the right to live in the residence for a specified period of time.

A. Typical Transaction

The Grantor transfers his or her personal residence or vacation home to an irrevocable trust and reserves the right to live in the residence, rent-free, for a specified term. During the term the Grantor can be the trustee of the trust. After the specified term of years has expired, the Grantor may continue to live in the residence provided the Grantor pays a fair market rate of rent to the trust. The net rental payments that accumulate in the trust may be periodically distributed free of gift tax to family member beneficiaries at the discretion of the trustee. Upon the death of the Grantor, trust assets are distributed to, or held in trust for, the family member beneficiaries.

B. Benefits of a QPRT

1. Gift Valued at a Substantial Discount The value of the gift is equal to the value of the remainder interest. In addition, the value of the gift is further reduced if the Grantor retains a contingent reversionary interest (i.e., the residence reverts to the Grantor's estate or living trust if the Grantor doesn't survive the term).

2. Removes Future Appreciation from Grantor's Estate The amount of the taxable gift is computed based on the equity in the residence at the time of the transfer. If the Grantor survives the term, all subsequent appreciation is removed from the Grantor's estate.

3. Gift Valuation Not Based Upon Subjective Discount Valuations Unlike discounts based upon lack of marketability and minority interest discounts, which are subject to IRS attack, the discounts obtained by QPRTs are determined by using actuarial tables published by the IRS.

4. Rental Payments Treated as Tax-Free Transfers Under current law, the rental payments paid by the Grantor after the end of the trust term results in cash transfers being made to family members which are not applied against the Grantor's gift tax annual exclusion or unified credit amount and if properly drafted the payments are not taxed as rental income to the family members.

5. Creditor Protection A personal residence may provide substantial creditor protection for trust assets provided the Grantor is willing to allow someone else to be the trustee.

C. Example - Click here for Graphic

Facts: Age of Grantor 61 Value of residence $1,000,000 Trust provisions: Term 15 years Trustee during term Grantor Remainder beneficiaries Grantor's children Value of residence at Grantor's death (age 70)

$1,557,560 Result: Value of gift (assuming 2.2% applicable federal rate) $516,820 Percentage of value excluded from gift tax 49% Estate savings $416,459

D. Tax Consequences

1. Income Tax Consequences

   a. During the Grantor's term, the Grantor will be treated as the owner of the property for income tax purposes. Therefore, during such term:

      (1) The Grantor may reside in the premises rent-free.

      (2) The Grantor may continue to deduct, on his or her personal tax return, any property taxes and mortgage interest payments made by the Grantor.

      (3) The trust can continue to take advantage of favorable income tax treatment allowed taxpayers on the sale of personal residences (such as deferral or possible exclusion of any gain on the sale of such residence.)

   b. After the Grantor's term expires, if the property remains in trust of which the Grantor is treated as owner and the Grantor continues to live in the residence, any rental payments received by the trust may not be considered as taxable income to the trust.

2. Gift Tax Consequences

   a. The Grantor has made a gift of the property transferred into trust but the value of the gift is only a fraction of the fair market value of the property.

      (1) The amount of the gift is the fair market value of the property transferred reduced by

         (i) the value of the Grantor's term which value is determined by IRS tables (i.e. the longer the rent-free period the smaller the gift) and

         (ii) the probability that the Grantor will not survive the term thereby causing the property to revert back to the Grantor.

      (2) The gift takes place at the time the property is transferred into the trust. No further gift occurs when the property is distributed to the family member beneficiaries, regardless of any increase in the value of the property at that time.

      (3) Generally, no gift tax will be payable although a portion of the Grantor's unified estate and gift tax credit will be used.

   b. Any rental payments made by the Grantor after the Grantor's term has expired may pass to the family member beneficiaries free of transfer taxes.

3. Estate Tax Consequences

If the Grantor survives the term, the entire value of the trust, including any appreciation, will be excluded from his or her estate at death.

a. If the Grantor dies during the term, the value of the property will be includable in his or her estate.

b. Even if the property is includable in the Grantor's estate because the Grantor does not outlive the term, a marital deduction may be available to postpone taxes until the death of the Grantor's spouse.

E. Caveats

1. Loss of Benefits If Don't Survive Term

a. If the Grantor does not survive the term of the trust, the value of the residence will be included in the Grantor's estate.

b. However, if the Grantor does not survive the term, the portion of the Grantor's unified estate and gift tax credit that was used when the initial transferral was made is fully restored.

2. Loss of Step-Up

The basis of the residence transferred to family members at the end of the trust term is the Grantor's carryover basis (i.e., the residence does not get a step-up in basis at the Grantor's death).

3. Doesn't Qualify for Annual Exclusion

Transfers to a QPRT do not qualify for the $10,000 annual gift tax exclusion. The Grantor can be the only beneficiary during the trust term, therefore the remainder beneficiaries cannot be given "crummy" withdrawal rights.

4. No Leverage for Generation-Skipping Tax Exemption

QPRTs should not be used to transfer the residence below one generation. Special rules prevent the Grantor from allocating the Grantor's generation-skipping tax exemption to a QPRT until the expiration of the trust term.

5. Loss of Ability to Use Refinancing Proceeds for Personal Use

Once a residence is transferred to a QPRT, the Grantor may lose the ability to refinance the residence and use loan proceeds for personal purposes. However, loan proceeds can be used for remodeling the residence held in the trust.

F. Frequently Asked Questions

1. Can the Residence Be Sold?

During anytime that a residence is held in the trust, the residence may be sold and the sale proceeds used to purchase a replacement residence that becomes the trust corpus. Excess proceeds from the sale of a residence not reinvested in a replacement residence may be distributed, in whole or in part, to the Grantor

(provided the decision is not made by the Grantor) or held in the trust and used to provide an annuity to the Grantor during the remaining portion of the Grantor's term.

2. Are the Income Tax Benefits of Selling a Residence Still Available?

If the residence held in the trust is sold, the income tax exclusion that home owners receive from the sale of a primary residence is still available.

3. May a Vacation Home Transferred to a QPRT be Rented?

As long as the property qualifies as a "vacation home" under the provisions of IRC §280A , the rental property may be transferred to a QPRT. A "vacation home" defined under IRC §280A is property which the Grantor uses as a residence for the greater of (i) 14 days a year or (ii) 10% of the number of days each year that the property is rented at a fair rental. For example, if the Grantor owns a condominium in Aspen that the Grantor rents to third parties for 6 months (180 days) during the year, the Grantor must use the condominium at least 18 days a year (180 days x 10%) for it to qualify as a vacation home.

4. How Many QPRTs May an Individual Establish?

An individual may establish up to two QPRTs as long as one of the QPRTs holds the individual's primary residence. Each QPRT may only hold one residence.

5. May a Residence With a Mortgage be Transferred to a QPRT?

A residence with a mortgage may be transferred to a QPRT. The initial gift will be calculated based upon the equity in the residence. Subsequent principal payments will be treated as further gifts to the remainder beneficiaries. The value of such gifts will not be the full reduction in principal for the year, but rather the value of the gift will be equal to the present value of the increase in the remainder interest due to the increase in the equity of the property.

6. Are Mortgage Interest and Property Taxes Deductible by the Grantor?

The Grantor of a QPRT is able to deduct home mortgage interest and property taxes to the same extent as if the residence had not been transferred to a QPRT.

7. Must the QPRT File a Separate Income Tax Return?

Although the QPRT is a separate legal entity, because it is a "grantor trust," a QPRT does not file a separate income tax return.

G. Planning Tips

1. Create Separate Trusts for Each Spouse

By creating separate trusts for each spouse, one-half of the gift and estate tax benefits of the QPRTs can still be preserved if one spouse does not survive the term of his or her trust.

2. Keep the Residence in Trust for Lifetime of Grantor and Spouse

Grantors want assurance that he or she will be able to live in the residence (or a replacement residence) for the Grantor's entire lifetime. Therefore, QPRTs should be drafted so that the residence stays in trust even after the expiration of the Grantor's interest in the trust. To avoid inclusion of the residence in the Grantor's gross estate, the Grantor then must rent the residence from the QPRT beneficiaries on an arm's length basis. Several private letter rulings have approved the lease-back transaction at fair market value, even when the lease-back provisions are included in the QPRT governing instrument.

3. Planning for Proceeds From Sale Not Reinvested in Replacement Residence

A QPRT may provide that any sale proceeds not reinvested in a new residence be distributed to the Grantor. However, from an estate tax standpoint, it is more advantageous to let the excess proceeds remain in the trust. If the excess proceeds remain in the trust, the Grantor will receive an annuity for the remaining term of the trust based upon the amount of such excess proceeds and the applicable federal rate. Keeping the excess proceeds in trust allows such proceeds and income earned on the proceeds in excess of the annuity payments to eventually pass to the remainder beneficiaries free of estate and gift tax.

4. Use of an Independent Special Trustee

After the expiration of the Grantor's interest in the trust, the Grantor may no longer be the Trustee (however, family members, such as the Grantor's children, may be Trustee). Therefore, it may be desirable to provide for an independent person to be a Trust Protector with the power to remove a Trustee.

5. Planning for Premature Death

The longer the QPRT term, the lower will be the value of the gift. The risk of not surviving the term can be lessened by:

a. Transferring the Residence to Younger Spouse. Married couples can transfer the residence to a QPRT created by the younger or healthier spouse.

b. Insurance. Purchasing life insurance on the Grantor's life can protect against the event of the Grantor's death before the end of the trust term.