The Qualified Personal Residence Trust

Introduction to the Strategy

Grantor Retained Income Trusts (GRITs) had historically been a device to transfer assets to the next generation with minimum use of a person's unified credit through the use of valuation discounts. In 1990 Congress passed legislation which curtailed many past uses of these devices. However, the 1990 tax law carved out a specific exception – the Qualified Personal Residence Trust ("QPRT").

A QPRT is a type of grantor retained income trust allowed by the Internal Revenue Code. It permits you to transfer ownership of your residence to your family during your lifetime and retain the exclusive right to live in the residence, while reducing the size of your estate for estate tax purposes. The residence is transferred to the QPRT for a designated initial term of years. Provided you survive the initial term of years, ownership of the residence will be transferred to your family at a fraction of its fair market value. If you die during the initial term of years the property will be brought back into your estate, but you will be no worse off than had the QPRT not been created.

A QPRT is a legal safe-harbor. It is an Internal Revenue Code sanctioned technique for reducing your taxable estate. You may transfer up to two (2) personal residences into QPRTs.

The QPRT is a particularly noteworthy estate planning tool to reduce federal estate taxes because it permits you to transfer the assets out of your taxable estate while retaining the right to use it during your lifetime. The gift for federal gift tax purposes is based upon IRS published interest rates. The rates used do not take into consideration any future appreciation in the value of the property. Accordingly, QPRTs are particularly useful to transfer residences in which significant future appreciation is anticipated. The QPRT permits you to continue to enjoy your residence, knowing that the value at the date of death will not be included in your estate.

Maintain Control

During the term of years of the QPRT you have the absolute right to remain in the residence rent free. After the initial term you can be granted the right to rent the residence for the balance of your lifetime for its fair rental value.

During the term of years, you can be the sole trustee or a cotrustee of the QPRT with complete control over all decisions of the trust and the assets in the trust. You may also sell the residence and buy another residence during the QPRT term.

Because the QPRT is a "grantor trust" under the income tax laws, during the initial term of years you are treated as the owner of the property for income tax purposes. All items of income, gain, loss and deduction with respect to the QPRT are treated on your personal income tax return. So for example, the deduction for real estate taxes remains available to you. In addition, favorable capital gains treatment, including capital gain rollover and the over 55,

$125,000 one time exclusion of gain are still available to you.

Valuation of the Gift

With a QPRT, gift tax savings are achieved through the use of two valuation discounts. One discount reflects the fact that your children, the remainder beneficiaries of the trust, will not receive the residence for a period of years. The second discount reflects the possibility that you might die prior to the end of the initial term and the residence being put back in your taxable estate.

The application of these discounts results in the transfer of the residence to your family at a fraction of the actual fair market value, provided you survive the initial term. These valuation discounts are calculated by using Tables published by the IRS, which weigh factors such as your age, the value of the residence and length of the initial term of years of the QPRT

Options at the end of the Term

At the end of the term of years you may decide to lease back the residence from the trust at a fair rental. The advantage of renting the residence from the QPRT is that it allows you to make cash payments to the trust i.e., to your family. The cash payments to your family can be made in addition to annual exclusion gifts and are an excellent vehicle to further reduce your taxable estate without using any of your annual exclusions or unified credit. The decision whether or not to rent the residence from the QPRT can be made at the end of the initial term of years.

One decision that must be made at the creation of your QPRT is to designate the beneficiaries at the end of the term of years. The basic planning options are:

- You may grant a life estate to your spouse.
- You may designate your then living children as the remainder beneficiaries.
- You may designate your then living children and the children of any deceased children as the reminder beneficiaries.
- You may designate a specific child or children or other person as the remainder beneficiaries.

The trust can be structured to distribute the assets outright to the remainder beneficiaries, i.e. the residence or the proceeds from the sale of it, or to retain the residence in trust for your lifetime. If you consider renting the residence from the trust after the term of years, it would be preferable to continue the residence in trust.

If you plan to designate descendants of a deceased child as a beneficiary of the QPRT, we must consider generation skipping tax issues since a generation skipping tax may apply to distributions to grandchildren. This would result in the payment of a generation skipping tax unless your estate could allocate exemption from such tax to the QPRT.

In view of the generation skipping tax, we recommend that you consider the following options:

- Provide that only your then living children are the remainder beneficiaries of the QPRT. This planning option avoids any generation skipping tax issues because the children of a deceased child would not be beneficiaries of the QPRT. You may consider adding a make-up provision in your living trust or other estate planning documents to equalize the overall distribution of your estate to your family, should a child die before assets of the QPRT are distributed.

- Grant to your children a general power of appointment to the extent necessary to avoid the generation skipping tax. This should cause the interest of a deceased child to be included in their estate for federal estate tax purposes and avoid the imposition of a generation skipping tax.

Creditor Protection

Even though you retain the right to live in the residence, the residence is no longer owned by you, it is owned by the QPRT. Absent fraud, your creditors should have no right to reach the residence. If the residence is retained in the QPRT for your lifetime after the initial term of years, the residence should also be protected from your children's creditors.

Trustees

Another consideration is the selection of a successor Trustee to serve at the end of the initial term of years. During the initial term of years you may serve as trustee or cotrustee of the QPRT, but at the end of this period you will be required to resign and a successor Trustee must take over. A trusted child or professional advisor would be a good choice, particularly if you intend to rent the residence from the trust after the initial term of years.

Other Considerations

The transfer of your residence to a QPRT is a gift of a future interest and it will be necessary to file a gift tax return reflecting a gift in the amount of the discounted value of the residence. No part of the gift qualifies for the annual exclusion from gift tax.

If the residence is sold during the initial term of years and it is not replaced by another residence, then the QPRT converts to a grantor retained annuity trust (GRAT) and a portion of the proceeds from the sale of the residence will be paid to you for the reminder of the initial term of years with the balance of the proceeds passing to the remainder beneficiaries at the end of the term of years.

If there is a mortgage on the residence at the time of the transfer to the QPRT, then continued mortgage payments by you would be considered additional gifts to the QPRT. Mortgage payments also complicate GRAT calculations if the home is sold during the term of years. If possible you should consider paying off the mortgage prior to the transfer of the residence to the QPRT or enter into an agreement with the QPRT in which you are solely responsible for the mortgage.

Risks of the Strategy

The main risk of this strategy is that you must survive the initial term of years. If you die prior to the end of this period, the residence will be brought back into your taxable estate as if the QPRT had not been established. However, even a short term QPRT can provide significant estate tax benefits and you can minimize the risk of reversion by choosing a term length which you feel comfortable with.

You may not commute the term of the QPRT, i.e., you cannot change the initial term of years after the trust has been established.

The QPRT is an irrevocable trust and it cannot be changed or revoked once it is established. For this reason, your selection of successor Trustees as well as the appropriateness of your remainder beneficiary designation must be carefully considered when establishing the QPRT.

Also, as with any gift of property, if you transfer your residence to a QPRT your beneficiaries receive your tax basis for income tax purposes in the residence. This may result in their payment of capital gain taxes should the residence be sold after the initial term of years. Your tax basis in the residence will be a factor to consider before implementing this strategy, but remember

- Capital gains rates are lower than federal estate tax rates.
- The federal estate tax is payable nine (9) months after death. The capital gains tax is payable April 15 after the year of sale.

You should not gift-split with your spouse for federal gift tax purposes for the year the QPRT is established.

A QPRT should not normally be considered for generation skipping tax purposes because allocation of exemption from generation skipping tax cannot be made until the end of the initial term of years and at the then value of the residence.