Price & Farrington's

Estate Planning Tools and Tips

Timely Information for Advisors About Advanced Estate Planning and Family Wealth Strategies

Q & A:
Qualified Personal Residence Trusts

Estate taxes on the family home could be a problem if the value of all of your assets is more than the amount excluded from estate tax, ($1 million in 2003; $1.5 million in 2004-5).

If you are concerned about estate taxes gutting your estate and eating up your children's inheritance, there may be a way for your to have your cake and eat it too.

You can transfer your house to your children in a tax-approved way with the following benefits…

- You can continue to live in the house for as long as you want.
- The transfer tax costs are greatly reduced if you transfer the house now rather than leave it to your children later.

The way to achieve these objectives is with a Qualified Personal Residence Trust (QPRT). The following Q&A will help you understand how this powerful estate planning tool works.

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QUALIFIED PERSONAL RESIDENCE TRUSTS

What is a qualified personal residence trust?

A qualified personal residence trust (QPRT) is an irrevocable trust in which the grantor (donor)--usually parents--gives a personal residence to family members--usually children--while retaining the right to live in the home for a period of years (the personal-use period, or initial term of the trust).

What is the purpose of a qualified personal residence trust?

By placing your residence in a QPRT, you can *reduce* its value for federal gift tax purposes and *eliminate* its value, along with its growth in value, from your estate for federal estate tax purposes while still retaining the right to enjoy and live in the home.

What residences qualify for a QPRT?

A personal residence of the grantor is either:

- The principal residence of the grantor
- Another residence considered to be used for personal purposes (e.g., a vacation home)
- An undivided fractional interest in either of the above

To qualify for a QPRT, the residence must be occupied as a residence by the grantor. Rulings by the IRS permit residences with appurtenant structures such as small guest houses or coach houses to also qualify.

Can we transfer our house on our working farm to a QPRT?

You can establish a QPRT for your house but only if you can separate the house from the farm. This will require a survey and title work.

If my house has a mortgage on it, can I transfer my house to a QPRT?

Yes, but if you keep paying the mortgage, the IRS may take the position that you are making a taxable gift to the QPRT and its beneficiaries every time you make a mortgage payment. It would be preferable to pay off the mortgage before you transfer the property to the QPRT.

Do I have to have an appraisal?

Yes, otherwise, the IRS may scrutinize the transaction and later successfully dispute the value used. It is important to retain a qualified appraiser.

Does the gift to my children qualify for the annual exclusion?

A gift to a QPRT is a gift of a future interest, so it does not qualify for the annual gift tax exclusion.

Can we use our applicable exclusion amount?

The gift to the QPRT can be applied against your applicable exclusion amount ($1 million in 2003; $1.5 million in 2004-5). You will not have to pay any gift tax unless you have exhausted your applicable exclusion amount in making prior gifts or the value of the gift to the QPRT exceeds your remaining applicable exclusion amount.

Does the initial term of the trust affect the value of my gift?

The longer the term of the QPRT, the less the value of the remainder interest passing to the beneficiaries; consequently, the gift amount and the gift tax will be lower.

How is the value of the gift calculated?

The value of the gift for gift tax purposes is determined by referring to the U.S. Treasury Department valuation tables.

Can you give me an example of how a QPRT saves federal estate or gift tax?

A father, age 65, has a home with a fair market value of $500,000. He transfers the home to a QPRT and retains the right to live in the home for 10 years, with the remainder interest going to his children. Assuming an 8 percent applicable federal interest rate, the present gift value of the remainder interest to the children is $170,600. At the end of the trust's initial term, the value of the residence is $1 million.

By means of the QPRT, the father reduced the size of his estate by $1 million, used the home for 10 additional years, and utilized only $170,600 of his applicable exclusion amount by transferring ownership to his children.

Can you provide another example?

Let's assume the following facts:

- A 72-year-old father owns a home worth $500,000 and believes he will live more than 10 years.
- He has an estate in excess of $3.5 million, which places it in the 50 percent federal estate tax marginal bracket.
- He expects that his residence will increase in value at approximately 4 percent per year and that it will be worth $700,000 at the time of his death, sometime after 10 year

The value of the gift at the time of the creation of the trust is $139,650 ($500,000 less his 10-year use valued at $360,340 using an applicable federal rate, or AFR, of 7.6 percent). Thus the federal estate tax savings for having used the QPRT amount to $280,170 (50 percent of the difference between $700,000 and $139,660).

The gift of $139,660 does not qualify as a gift of a present interest and must be reported as a taxable gift. If the donor has not used his applicable exclusion amount, the value of the gift would reduce the exclusion amount and no gift tax would be payable.

Will an outright gift of my residence accomplish almost the same tax consequences?

If you give your home directly to your children, two things will happen immediately:

- You will lose the legal right to continue to live in your home
- The house will be valued at full fair market value for gift tax purposes rather than at the discounted rate permitted to the QPRT.

What happens if the donor dies before the initial term is completed?

The fair market value of the home is *included* in the donor's estate as if the trust never existed. The donor is no worse off than he or she would be if the trust had never existed. Some commentators have referred to this as "Heads you win; tails you tie."

To protect against this risk, the grantor may purchase life insurance in an amount equal to the projected taxes on the residence.

What happens if the donor survives the term of the trust?

If the donor survives the personal-use period, the full value of the home is *excluded* from the donor's estate.

What is the amount of the discount the donor receives?

The discount available depends upon: (1) the actuarial life expectancy of the donor; (2) the prevailing official IRS interest rate, based on 120 percent of the applicable federal midterm rate, and (3) the term of the QPRT.

Who should be the trustee of a QPRT?

During the initial term, the grantor may be the sole trustee of the QPRT, with complete control over the trust and the residence. If desired, the grantor may also designate a cotrustee to serve.

After the initial term, the grantor cannot be a trustee of the QPRT. However, the grantor may designate in the trust agreement a chain of trustees to serve in the event of his or her disability during the initial term and during his or her lifetime after the initial term.

Is appreciation in the value of the residence still subject to federal estate tax?

All appreciation in the value of the residence after the time the QPRT is established is removed from the grantor's estate provided the grantor survives the initial term. Transferring a residence to a QPRT freezes the value of the residence at its value at the time of the transfer.

Who's entitled to the income tax deduction for the property taxes?

Because the QPRT is a "grantor trust" under the Internal Revenue Code during the initial term, the grantor is treated as the owner of the property for federal income tax purposes. If the grantor pays the real estate taxes on the residence, the grantor is entitled to the income tax deduction for such taxes.

Who pays expenses of the house during the trust's initial term?

During the initial term of the trust, the grantor typically pays the normal and customary expenses of repair and running the house.

Can the residence be sold during the initial term of the QPRT?

Yes. You can create the trust so that it will dissolve upon the sale of the trust property and the proceeds will be distributed to you. Or you can specify that your trustee acquire another residence for you, of your choice, with any excess proceeds from the sale of your original property to be placed in a special investment account which will pay income to you until the end of the initial term. At the end of the initial term, both your new residence and the capital in the investment account will become the property of your beneficiary.
The trust may also prohibit the sale of the residence during the initial term without the consent

of the grantor.

Is the grantor entitled to the exclusion of $250,000 of gain on sale?

If the residence is sold, the grantor is entitled to the exclusion of gain on sale.

Can a QPRT residence be rented?

A residence in the trust cannot be rented full-time. The grantor must use the house more than 10 percent of the amount of days rented or a minimum of 2 weeks per year, whichever period is longer.

When do the trust beneficiaries get the use of the residence?

The beneficiaries, usually family members, have the right to possess the home only after the retained personal-use period of the donors has expired.

What if my spouse and I want to live in our residence after the initial term has expired?

If you want to continue to live in the house after the initial term has expired, you will pay the remainder beneficiaries--usually the children--a fair market value rent. The benefit is that your rental payments over time represent a transfer of assets out of your taxable estate into the hands of your intended beneficiaries.

Will my heirs lose the stepped-up basis on my home if it is in a qualified personal residence trust?

Yes. Your heirs assume your original basis in your home. They will pay tax on the appreciation of your home in excess of your original basis at the capital gain rate when and if they sell the property. That rate is dramatically lower than the marginal estate tax rate.

If the property is not in a QPRT and is still includable in your estate, your heirs will pay federal estate tax of between 37 and 50 percent on the value of the property at your date of death and the tax will be due 9 months later. They will, however, receive a step-up in basis.

Can you summarize the benefits and drawbacks of a QPRT?

A QPRT provides a number of tax benefits to its maker:

- The donor can transfer the ownership of the personal residence to his or her beneficiary in the future without paying taxes on the appreciation on the personal residence.
- The residence is transferred today at a discounted value from its appraised value for gift tax purposes.
- The donor is allowed to live in the house.
- The value of the house is removed from the donor's taxable estate.

There are two potential disadvantages to using qualified personal residence trusts:

- The grantor must survive the personal-use period or the value of the home will be included in his or her estate.
- The beneficiaries do not receive a step-up in basis on the gift of the home and thus may pay a higher income tax when the home is sold.

Where do I go from here?

If you would like to discuss whether a QPRT is an appropriate option for your estate planning, please call our office to schedule a private consultation. We would be pleased to discuss this powerful planning tool with you.

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