CHAPTER 76

Qualified Personal Residence Trusts

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Tom is in his late 50s, healthy, divorced, with five adult children. His best friend, Doug, passed away several years ago. Finally, after three years of legal work and an IRS audit, Doug's estate was distributed. However, because Doug only had a simple will and no other estate planning in place, his estate was taxed at a devastating 45% tax rate. As a result, Doug's girlfriend and children received less than 50% of the original estate value. Tom, realizing current estate tax rates may sunset and return to an even higher federal estate tax rate of 55% in a few years, is determined to protect his children.

Tom meets with his estate planner to put planning into place for his large estate. Part of his estate includes a ranch in Texas where he spends part of the year, and a condominium in Florida where he spends the remainder. His Florida condominium is valued at $1.8 million dollars and his ranch is valued at $2.5 million. His estate planner suggests a Qualified Personal Residence Trust, commonly referred to as a "QPRT" (Q-pert), for the Florida condominium. Tom is interested but wants to know how a QPRT works.

A QPRT is an irrevocable grantor trust in which the "Grantor" (Tom) contributes a "personal residence" to the trust, and receives the right to "use" the personal residence for a term of years (the "term"). This contribution counts as a gift to the trust subject to gift tax. However, because the Grantor retains the right to live in the personal residence for a term of years, the value of the gift is "discounted" based upon the length of the term retained by the Grantor. At the end of the term, the trust property passes to the beneficiaries of the trust (Tom's living children). During the term, the Grantor continues to pay the expenses and taxes. If, at the end of the term, the Grantor chooses to continue to reside in the personal residence, then the Grantor can "rent" the residence from the trust at fair market rental value. The rent passes through the trust to the beneficiaries. The Grantor may also choose to serve as the Trustee of the trust during the term, enabling him to make all decisions regarding the personal residence. If the Grantor/Trustee decides to sell the condominium during the term, the proceeds of the sale belong to the trust. However, the Grantor/Trustee can use the proceeds to buy another residence on behalf of the trust. The key impediment to a QPRT is that the Grantor must survive to the end of the term for the QPRT to work. If the Grantor does not survive, then the QPRT fails and the personal residence is included in Grantor's estate.

I deleted the words "Question" and "Answer" on these

Although a QPRT appeals to Tom he still has the following questions:

Is the Florida condominium better suited for a QPRT than the Texas ranch?

Yes. The IRS definition of a personal residence is restrictive and may disqualify the QPRT if the property fails to qualify. In Tom's case, because the ranch includes a portion of acreage which is used for raising cattle, his planner is concerned it may fail to meet the criteria. Therefore, if Tom chooses to do a QPRT for the ranch, his planner suggests the ranch be divided into a "residence" share and a "ranch" share.

If Tom sells the residence will there be any capital gain/income tax issues?

The capital gain exclusions ($250,000 for an individual, and $500,000 for a couple) are applicable to the proceeds. Tom should be aware, however, that transferring the property to his children by way of a QPRT, rather than having them inherit the property at his death, will result in his children assuming Tom's cost basis in the property rather than the stepped-up basis they would otherwise receive at Tom's death.

Will Tom have to pay gift tax?

It depends. Because the contribution of the personal residence to the trust is a "gift" there will be a gift tax return (IRS Form 709) filed. The plan is to make the term of the trust sufficient to keep the value of the "gift" under the lifetime exclusion (currently $1 million).

If at the end of the term of the QPRT the property is worth double the value from when I contributed it, will Tom's children have to pay additional gift taxes?

No. Assuming Tom survives the term, the property is valued and taxed at the contribution date. The property is out of the estate at that original value.

How does Tom contribute the property to the QPRT?

By a deed, just as he would any other transfer of real property.

Will Tom lose his homestead and other property tax exemptions?

Generally no, but these exemptions are local. The answer should be investigated by the estate planner with the local taxing authority before transferring the property to the QPRT.

Does a QPRT provide asset protection?

Because a QPRT is an irrevocable trust, people often assume it provides asset protection. However, Tom's life interest in the property is attachable by creditors, meaning a creditor can rent out the property for the term of the QPRT.

Tom decides to implement the QPRT but wants to know what kind of gift he will be making. His estate planner provides him with this illustration using the following values:

Present value of the property:	**$1.8 million**
Term of the QPRT:	**15 years**
Assume 7520 rate:	**3.6%**

The illustration reflects that the value of Tom's retained right to use the Florida condo is $1,100,000, which leaves the discounted value of the gift to the trust equal to $700,000. The gift tax reported is approximately $280,000 (assuming a 45% gift tax rate), and is well within Tom's $1 million lifetime exclusion.

Compare this to the $720,000 gift tax Tom would incur if he gave the Florida condominium outright to the children. So by using a QPRT, there is a tax savings of $440,000. If we assume a 4% growth rate for the Florida condo and a term of 15 years, the condo will be worth $3,250,000. At the current tax rate, the tax savings are $1,200,000!

This illustration does not take into account the rent Tom would pay if he lived an additional ten years (his life expectancy) after the end of the QPRT. Rental payments will further reduce Tom's estate.

If Tom were married, both he and his spouse could create separate QPRTs for their respective shares of ownership of the personal residence, which would increase the chances that one of the Grantors would survive the term. This strategy is especially effective when Grantors had significantly different life expectancies.

Tom believes a QPRT is a valuable technique in his situation and adds it to his estate plan.

QPRTs can be a valuable tool in an estate planners "tool box." However, it is important for a planner to not only take into account what value a QPRT will provide for a client, but also the very strict criteria for contributions, definitions of a personal residence, the size of an estate which will benefit from a QPRT and the age, life expectancy and health of the client(s).

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