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EstatePLANNING

Transferring property? Consider creating a QPRT

For individuals seeking an effective method for transferring their personal residence or vacation home to children, family or others, a Qualified Personal Residence Trust may be the solution.

The creation of a QPRT may reduce the gift and estate tax cost of transferring the property, while also preserving the transferor's use and enjoyment of the property during the term of the trust. One should not enter into a QPRT without due consideration of its benefits and drawbacks, however, as the trust must be irrevocable and cannot be amended upon a "change of mind" by the transferor.

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Daily Record Columnist

The effectiveness of a QPRT as a gift tax avoidance or reduction mechanism stems from an exception to the valuation rules in the Internal Revenue Code. While Section 2702 of the code provides that a donor's gift to his or her descendants will not be discounted by the value of an interest retained by the donor, the statute further provides that these valuation rules do not apply to a trust which only owns one asset: an individual's term interest in a personal residence. Under this exception, the value of a gift to this type of trust will be reduced by the value of the donor's life interest in this residence.

Similar to any conventional trust arrangement, a QPRT has both income and remainder beneficiaries. The individual who establishes the QPRT (the grantor) is the income beneficiary and he or she retains the right to use the residence during the trust term.

During that period, the grantor is responsible for paying all of the expenses of the home, including any real estate taxes, utility expenses and the cost of ordinary repairs. The term of the trust is established when the QPRT agreement is created.

Upon the expiration of the trust term, ownership of the residence passes to the remainder beneficiaries, who are often the grantor's children or other family members. A QPRT agreement typically provides that ownership of the residence will revert back to the grantor if he or she dies during the trust term.

The following example will help illustrate the tax advantages of using a QPRT, as well as provide a framework for the many rules that exist with regard to these trusts.

Example

On Jan. 1, client A (70 years old) transfers her $1 million Florida vacation home to a QPRT. The QPRT agreement provides that the trust term will be 10 years and the remainder interest be distributed to client A's daughter if client A does not survive the trust term.

To determine the value of the gift, client A must refer to the applicable Internal Revenue Service valuation tables, which take into account several factors regarding this transaction, including the trust term, client A's age and the Section 7520 rate, or the applicable discount rate for the month the trust is created. Under this fact pattern, the transfer of client A's Florida home into the QPRT would result in a gift by client A to her daughter in the amount of $535,990. The value of client A's retained interest, therefore, is $464,010.

If client A survives the 10-year trust term, she will have effectively transferred a $1 million asset to her daughter, while only reporting approximately one-half of the value as a gift. Further, the $1 million value of the Florida vacation home will be not be considered an asset of her estate for tax purposes upon her death (although the $464,010 will be reported on her return as an adjusted taxable gift).

At the end of the trust term, client A can continue to live in her Florida home if she pays fair market rent to her daughter. Moreover, by paying rent, client A can transfer additional assets out of her estate to her daughter, although client A's daughter must report such rent as income on her personal income tax return.

Any other arrangement in which client A lives in the property without paying fair market rent to the daughter, however, will be treated as a gift from the daughter to client A. Further, it will likely be treated as a transfer with a retained life interest which will cause the full fair market value of the property at date of death to be included in client A's estate.

In addition to holding one residence, the pertinent rules also allow the QPRT to hold additions of cash for a limited amount of time to pay miscellaneous expenses, such as mortgage payments

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or repairs to the home.

Also, if the property is damaged and insurance proceeds are paid to the trust, such proceeds can be held during the period of time the repairs are being made. Funds should not be used, however, to create an addition to the property, since any such improvement during the trust term will likely be considered a gift to the trust.

Notably, the trustee is permitted to sell the house and purchase a new home. If there are funds remaining after the sale of the initial residence and the subsequent purchase of the replacement home, the trustee has multiple options.

For example, if the trustee sells the property for $1.5 million and purchases another home for $1 million, the difference ($500,000) can be administered as follows:

• First, the difference could be distributed outright to client A, although this might defeat the estate planning purposes of the transaction.

• Second, the trustee is permitted to retain this $500,000 difference in the trust and convert it into a Grantor Retained Annuity Trust, under which client A would receive annual annuity payments for the remainder of the 10-year trust term.

If the Florida home is sold during the trust term and a replacement property is not purchased, the trustee can similarly convert the proceeds into a GRAT. Alternatively, if client A owned another residence outside of the QPRT, she could sell that property to the QPRT in exchange for the cash proceeds (or a portion thereof) realized from the sale of the Florida home. An added benefit to this transaction is that the sale of the "outside" home to the QPRT would not be subject to capital gains tax because the QPRT is a grantor trust and, thus, client A would be deemed to have sold the property to herself for income tax purposes.

Conclusion

Given its statutory foundation, there is comfort in using qualified personal residence trusts in one's estate plan. While the benefits of a QPRT are certainly amplified when interest rates are higher, thereby increasing the value of the Grantor's retained interest in the property and reducing the amount of the applicable gift, this technique could still be beneficial given the current interest rate environment.

More importantly, even though the full value of the property is pulled back into the grantor's estate if he or she does not survive the trust term, there is no real risk to creating the QPRT. Put differently, even if the grantor cannot reduce the value of his or her estate with this transaction, he or she will not be in a worse position for having tried other than having paid the initial transaction costs.

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