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QUALIFIED PERSONAL RESIDENCE TRUSTS

What is a Qualified Personal Residence Trust?

A Qualified Personal Residence Trust (a "QPRT") is an irrevocable trust in accordance with which the creator of the trust (the "grantor") transfers title to a personal residence to the trustee of the trust but retains the right to live in the residence rent-free for the term of years specified in the trust agreement. The grantor continues to pay all ordinary expenses relating to the residence. If the grantor is still living at the end of the term, the residence passes to the remainder beneficiaries (typically the grantor's children or trusts for their benefit) designated in the trust agreement. Thereafter, the grantor may wish to lease the residence from its new owners (e.g., his or her children).

If the grantor dies prior to the end of the term, the residence is included in his or her gross estate for federal estate tax purposes. This is, however, essentially the same result that would occur if the grantor had not established the QPRT.

Tax Benefits of a QPRT

Gift Tax Savings. A QPRT allows the grantor to potentially transfer his or her personal residence to others (e.g., his or her children) at a reduced gift tax cost.

A QPRT is a split interest trust. The "split" is that the grantor retains the present right to use the residence, and the QPRT beneficiaries receive the remainder interest in the residence. For federal gift tax purposes, the original transfer of the residence to the QPRT will be treated as a taxable gift of the remainder interest to the remainder beneficiaries. The value of the retained use of the property for the initial term, however, is not subject to gift tax even though the full value of the residence is distributed to the remainder beneficiaries at the end of the term.

The gift of the remainder interest does not qualify for the $11,000 gift tax annual exclusion. Therefore, the full value of the gift, determined as described below, may be subject to gift tax. If the value of the gift is less than the grantor's unused gift tax exemption ($1,000,000 in 2002 and thereafter), the grantor will not have to pay any gift tax on the transfer of the residence to the QPRT.

The value of the gift for gift tax purposes is based on the present value of the right of the QPRT beneficiaries to receive the residence at the end of the term of years. In determining the present value of the residence, a number of factors are considered, such as the grantor's age, the initial term of the QPRT, and the federal interest rates in effect for the month of the transfer. Because the QPRT beneficiaries must wait until the end of the term to receive the residence, the present value of the gift of the residence is essentially "discounted." In other words, the present value of the gift is substantially lower than the actual value of the residence at the time of transfer. Therefore, the older the donor or the longer the term of years, the lower the present value of the gift. This "leverages" the grantor's gift tax exemption by leaving much more of the exemption for other assets.

The effective discount on the gift of the residence to the QPRT can be quite substantial, as illustrated in the following chart. Obviously, the actual tax savings will vary depending upon the particular circumstances.

Assumptions:	Grantor Age:	50
	IRS § 7520 Rate:	6.2%
	Annual Growth Rate	4%

QPRT TERM	INITIAL VALUE OF PROPERTY	ASSUMED VALUE OF PROPERTY AT END OF TERM	TAXABLE GIFT (REMAINDER INTEREST)	PROJECTED ESTATE TAX SAVINGS @ 50% ESTATE TAX RATE
20 years	$300,000	$657,337	$69,588	$293,875
25 years	$300,000	$799,751	$43,638	$378,057
30 years	$300,000	$973,019	$25,161	$473,929

Estate Tax Savings. If the grantor survives the QPRT term, the full fair market value of the residence, including any appreciation in the value of the residence during the term of the trust, will not be included in the grantor's estate for federal estate tax purposes, because at the grantor's death, the grantor did not own it.

Further, if the grantor or his or her spouse leases the residence (which lease must be at fair market value) from the remainder beneficiaries after the end of the QPRT term, the residence will not be subject to estate tax upon either spouse's death. Paying rent also will save estate tax on the rental payments that would otherwise be included in the grantor's estate at death and will move assets from the grantor to the new owners free of estate or gift tax.

If the grantor dies during the term of the QPRT, the full value of the residence is included in his or her gross estate for estate tax purposes. Any gift tax exemption used at the time of the gift to the trust is restored. Consequently, the result for federal gift and estate tax purposes is the same as if the QPRT had never been established. The only "cost" if the grantor dies during the term of the QPRT is the expense of creating and operating the QPRT, unless the creation of the QPRT required the grantor to pay an out of pocket gift tax.

Income Tax Savings. A QPRT allows the grantor to take advantage of certain income tax savings normally available to individual taxpayers.

A QPRT is designed to be a "grantor trust," which basically means that the trust will be ignored for income tax purposes. Therefore, the grantor can still deduct all real property tax payments on the residence in the QPRT on his or her personal income tax returns as long as the QPRT owns the residence. Further, if the home is the principal residence and is sold during the QPRT term, the grantor can take advantage of the capital gain exclusion for the sale of a principal residence that is available to an individual.

If the property is sold after the term of the QPRT has expired, even though the grantor may be leasing the property, the capital gain will not be taxed to the grantor, but rather to the persons who received the property when the QPRT ended (e.g., the grantor's children).

It should be noted that a residence held in a QPRT that ends before the grantor dies does not get a step-up in basis at the grantor's death. Instead, the grantor's cost basis in the residence will carry over to the beneficiaries. Therefore, if the residence is eventually sold, the capital gains tax could be higher than if the grantor had owned the residence at his or her death. The beneficiary may still be able to use his or her own $250,000 or $500,000 exclusion, however, but only if the property is the beneficiary's principal residence for the required length of time.

Administration of QPRT Property

During the term of the QPRT, the grantor is responsible for all expenses relating to the residence, including upkeep, maintenance and repairs. If any major repairs or improvements are made, the grantor must transfer additional cash to the trust (or borrow against the trust property) to finance the repairs or improvements. Any such transfers will constitute additional gifts, similar to the gift of the residence itself at the inception of the trust. If there is a mortgage on the property, the grantor will be responsible for the payments, and all payments of principal will be additional gifts to the trust. The grantor will not pay any rent for the use of the residence during the trust term, however.

The QPRT instrument can include a "lease-back" provision. Pursuant to such a provision, if the grantor survives until the end of the term of the QPRT and the trust holds the residence at that time, the residence will continue to be held in trust for the benefit of the beneficiaries, subject to the grantor's right to lease the property for fair market value from the remainder beneficiaries. If the trustee at any time decides to sell the residence, any sale would be subject to the grantor's continuing right to lease the property.

What Property Should Be Held by a QPRT?

An individual can establish up to two QPRTs. While transferring a primary residence is permitted, vacation homes are often the preferred choice for several reasons. The primary reason is that when the QPRT term ends, the grantor must vacate the residence unless the instrument permits him or her to lease the residence. Additionally, the residence chosen to be held in the QPRT should be one that the QPRT beneficiaries are unlikely to want to sell in the foreseeable future, because a sale could generate capital gains tax, as discussed above.

Mechanics of Creating a QPRT

Determination of QPRT Term. The appropriate term for the QPRT will be based on factors such as the grantor's individual risk tolerance, actuarial life expectancy and potential estate, gift and income tax savings under various scenarios.

Trust Agreement. A QPRT trust agreement based on current law and the grantor's choice of Trustee, beneficiaries and ultimate distribution pattern will be drafted.

Transfer Property to QPRT. After the grantor has signed the QPRT trust agreement, the grantor must transfer title to the residence to the Trustee of the QPRT.

Gift Tax Return. By April 15 of the year after the transfer of the residence to the QPRT, the grantor must file a federal gift tax return in order to report the value of the gift. If the value of the gift is less than grantor's remaining gift tax exemption, no gift tax will be due.

Appraisal. As discussed earlier, the discounted value of the gift will depend on the residence's fair market value at the date of transfer. In order to support the reported value of the gift, it will be necessary to obtain an appraisal of the residence as of the date of transfer. This appraisal must be attached to the gift tax return when it is filed.

Update Insurance & Mortgage. After the transfer of the residence to the QPRT, the grantor should notify his or her insurance agent so the homeowner's policy can be updated to reflect the trust as the new owner of the residence. Similarly, if the residence is secured by a mortgage, the grantor should notify the bank of the transfer so the mortgage documents can be updated and to make sure the transfer does not accelerate the mortgage.

Conclusion

Supplementing an estate plan with a QPRT can be an effective tool to transfer property to the next generation in a tax-beneficial manner. A QPRT is an irrevocable technique, however, that should be carefully examined before it is implemented.

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Please contact Albertson & Davidson, LLP at (951) 686-5296 for further information regarding Qualified Personal Residence Trusts or any other estate planning options.

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