

Qualified Personal Residence Trust

By Arthur H. Kroll

Arthur Kroll explains why the use of qualified personal residence trusts is a good estate planning strategy for clients with a large, taxable estate.

Introduction

The qualified personal residence trust or (QPRT) is an estate planning trust that is widely used.¹ It allows an individual to irrevocably transfer his future ownership in his personal residence to his children at a significantly reduced gift tax cost. In addition, after the transfer, he and his spouse may continue to enjoy the use of the home for the set period of years stated in the trust.

Establishment of Trust

To establish a QPRT, the owner gifts his home, whether it is a personal residence or a condo or coop, to a QPRT. Under the provisions of the trust the grantor and his spouse retain the right to live in the house for a specified period of time (the so called term of the trust). At the end of the term the beneficiary becomes the outright owner of the house. If the donor is still alive and wants to live in the house he must pay rent.

Key Provisions

During the trust term the trust is disregarded for income tax purposes, which allows the grantor to continue to deduct his real estate taxes. The goal is that the retained right to live in the home will

reduce the value of the gift (the residence) and also any appreciation in the house subsequent to the time of the gift. So the residence is removed from the grantor's estate and if the plan works properly there is little gift tax although the lifetime exemption may be partially used. At the end of the term the grantor or his spouse may agree to rent the property from the children at fair market value so they can continue to live in the home. The rental payments allow the grantor to pass additional wealth to his children in a gift tax free manner. If the residence continues in trust for the grantor's children and the trust is created as a grantor trust the rental payments will not only be gift tax free they will be income tax free to the children.

What is the Risk?

The risk is in the term and in this market immediate appreciation in residences are unlikely. If the grantor dies before the end of the term the gift tax planning does not work. In that case, the value of the home will be included in the estate for estate tax purposes. That obviously raises a question of how long a grantor should retain the use of the property. Remember that a longer term will result in a smaller taxable gift but then you are running a greater estate planning risk that grantor will not survive the term of the trust and then the whole plan will not work. This requires careful planning and discussion but usually can be addressed. Obviously if the grantor survives the term of the trust, the property will be excludable from the grantor's estate and therefore it will pass to the grantor's children without any further transfer tax. However, if the gift declines 20 percent subsequent to the gift it may be desirable to wait.

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How Do You Value the Gift?

In valuing the gift, you have to use the IRS prescribed interest rate. The higher the interest rate the smaller the resulting gift. The reason is that a higher interest rate increases the value of the grantor's retained term interest. Secondly, as previously described, the length of the QPRT term reduces the gift value if it is longer. So the greater the term of the trust, the less the value of the gift. The third factor is the grantor's life expectancy. If he is older this will reduce his gift so the QPRT gift is lowered. Reduction is made when the term is longer, when interest rates are higher, and when the grantor is older.

Assume a grantor is 55 and he would otherwise be subject to estate tax.

He has three children and transfers the vacation home in Aruba to a QPRT the interest rate is five percent and the term that the grantor has the right to live in the house is 15 years. The value of the gift will be \$765,000 under these terms, which is less than the lifetime gift tax exemption. The greater the appreciation on the property is the greater the savings that will be realized. Even if the house was just to appreciate four percent over the 15-year period it would appreciate to \$3.6M and save a significant amount of taxes. Now could be a good time for a QPRT because the housing downturn may have reduced the gain and value on the house. Presumably at the end of the term the housing downturn will be over and the value of the house will have gone up from the date of the gift.

Traps

If there is a mortgage on the home then it should be paid off prior to the gift. Otherwise each mortgage payment will be treated as an additional gift to the trust that would have to be reported and this is just too difficult to deal with. In addition, on the date of death there is no step up in basis to the current fair

market value because the children had received the remainder interest. Thus there could be a capital gains tax on the eventual sale of the house. This is usually not a big problem. The most significant problem is the emotional one that parents are uncomfortable giving up the future control over their residence and do not like the idea of having to pay rent on a house that they have gifted.

The client that is ripe for a qualified QPRT is one that is wealthy and has a large taxable estate. He

would obviously have to be financially secure. By far vacation homes make the best gift rather than personal residences but remember you must own the house. Time shares do not qualify. The grantor should have attained a good age because the

older the grantor is the larger the gift tax valuation discount for mortality and the less the risk that the grantor will die before the end of the term. In addition, if you are just 50 then the transfer tax savings are likely to be great especially if you live to your normal life expectancy. The person should be in sufficiently good health to survive the term of the trust. The person should be in sufficiently good health to survive the term of the trust and should be able to forgo living in the vacation or second home.

Conclusion

QPRTs are time tested and approved. They do not involve IRS challenges and used in the right circumstances they are a great way of passing gifts if the client is emotionally sanguine with giving up a personal residence. There usually is some concern so a vacation home or a second home is the best residence to give away.

ENDNOTES

¹ Code Sec. 2702.

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