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Qualified Personal Residence Trusts

A Qualified Personal Residence Trust ("QPRT") is a technique that enables a donor to remove a residence from the donor's estate at a reduced transfer tax cost, while retaining the enjoyment and benefits for a stated period of time. The benefits are greatly enhanced when the residence is anticipated to appreciate in value.

Structure of a QPRT. To establish a QPRT, a donor transfers his or her interest in a residence to an irrevocable trust in which the donor retains the right to use and occupy the property for a specified number of years (the "use period"). At the expiration of this period, the property passes to the remainder beneficiaries (generally, the donor's children and more remote descendants). If the donor desires to remain there after the use period expires, the expectation is that the children will lease the property back to the donor at a fair market rent. To facilitate this lease, the trust might provide that the property will continue to be held in trust for the children after the use period.

If a residence is owned jointly (or as community property) by one or more individuals, each individual may create his or her own QPRT by contributing that individual's interest to a separate QPRT. Conversely, the individuals (particularly married couples) may create a QPRT by each individual transferring his or her interest to a single QPRT. Unfortunately, the tax benefits of the QPRT are achieved only if the donor or donors survive the use period. That is, if one spouse transfers a residence into a QPRT created by both spouses and then fails to survive the use period, the survivor will lose all of the potential tax savings. An alternative method that is particularly useful for married couples is for one spouse to transfer ownership of the property to the other so that it is wholly owned by one spouse, who would then transfer the entire property into the QPRT. We generally recommend that each spouse transfer his or her interest to separate QPRTs. This way, if one spouse fails to survive the term, at least one-half of the benefits can still be achieved through the surviving spouse's QPRT. The risk of surviving the use period can be further diversified by each spouse creating multiple QPRTs of varying use periods for that particular residence. Naturally, though, the QPRTs with shorter use periods will achieve smaller tax benefits.

Gift Tax Consequences. Generally, transfer tax is assessed on a gift's fair market value at the time of the gift. The transfer tax cost of creating a QPRT is reduced, however, because the donor is giving to others only the remainder interest, which is the interest passing to the donor's children (the remainder beneficiaries) at the end of the use period. In other words, the gift's value is the fair market value of the residence *less* the value of the rights the donor retains to occupy the residence during the use period (as determined by reference to the appropriate Internal Revenue Service valuation tables).

For example, assume a 50-year-old donor owns a residence with a fair market value of $2,000,000. The following chart demonstrates the approximate value of the gift to the remainder beneficiaries (assuming the donor establishes the QPRT with a use period of 10, 15, 20, or 25 years at a time when the applicable rate issued by the IRS is 2% or 7%).

QPRT Use Period	***Value of Gift to Children at 2% Rate***	***Value of Gift to Children at 7% Rate***
10 years	$1,535,580	$951,560
15 years	$1,305,540	$636,680
20 years	$1,075,620	$413,040
25 years	$840,940	$254,200

If the donor decides to create a QPRT with a 20-year use period when the applicable rate is 7%, a gift of $413,040 would be made; whereas, if the donor had created the QPRT when the applicable rate is 2%, a gift of $1,075,620 would be made.

Assuming the fair market value of the residence remains constant throughout the use period, the QPRT would generate tax savings between $366,954 and $611,030 in overall transfer tax if the applicable rate is 7%. If the applicable rate is 2%, then the same QPRT would generate tax savings between $162,547 and $405,671. (These calculations depend on the amount of prior taxable gifts made during lifetime.)

Moreover, the transfer tax savings will be greater if the property appreciates after the time of the gift. For example, if the property has a fair market value at the donor's death of $4,000,000 (which would be conceivable if the donor died after the 20-year use term), the transfer tax savings would exceed $1,250,000. If the applicable rate is 2%, the donor would still save over $1,000,000 in transfer taxes. (Because these calculations are based on IRS discount rates that are updated monthly, these figures are accurate only for a month in which the appropriate interest rate is 7% or 2%, respectively).

While both interest rates result in a reduced transfer tax cost than if the donor had gifted the residence to his children outright (a $2,000,000 gift), these values show that the QPRT creates a smaller gift, and thus greater tax savings, when the applicable rate is higher.

Estate Tax Consequences. If the donor does not survive the use period, however, the entire transaction is essentially unwound. The property then reverts to the donor's estate and passes under the terms of the donor's will, causing the property's value as of the donor's date of death to be included in his or her estate. Any gift tax paid on the gift to the QPRT would be credited against the donor's estate tax liability. In other words, beyond the time and cost incurred in establishing the QPRT, and having somewhat restricted control of the property after the use period, there is relatively little risk associated with this planning option.

Income Tax Consequences to Beneficiaries. Another consideration in deciding whether to pursue this technique is the income tax consequences to the remainder beneficiaries (presumably, the donor's descendants). Upon the QPRT's termination, the remainder beneficiaries' basis in the property will be equal to the donor's original basis, which is generally the cost of acquiring the property, plus any adjustments. Assuming that the remainder beneficiaries sell the residence shortly after the QPRT terminates, they will realize a taxable gain on the sale. If, instead, the donor does not utilize a QPRT, and the property passes to those same beneficiaries at the donor's death, they would receive a "step-up" in basis, that is, their basis would be equal to the fair market value as of the date of the donor's death. Thus, no gain would be realized if the property were sold shortly after the donor's death.

Despite the potential gain on the property's sale, use of a QPRT will still benefit the remainder beneficiaries (assuming the donor outlives the use period) if the transfer tax savings are greater than the potential income tax liability. This factor will depend on the beneficiaries' income tax rates, the donor's marginal estate tax bracket, and the donor's basis in the property. But given the fact that, historically, capital gains have been taxed at rates significantly less than the estate tax rates, there should be a substantial net benefit to the remainder beneficiaries.

Miscellaneous Issues.

1. Donor Cannot Reacquire Residence. During the QPRT's term and any other period in which the trust is classified as a grantor trust (meaning that all of the trust's income is taxed to the donor), the trust instrument must prohibit the donor from purchasing or otherwise reacquiring the residence from the QPRT. Thus, the only way the donor can subsequently own the residence is to survive the QPRT's term and then make sure that the trust is no longer being taxed as a grantor trust.

2. Sale of Residence. During the term of the trust, the trustees of the QPRT may sell the originally contributed residence. Within two years from the sale, the proceeds must be used to purchase a replacement residence. Note that, if the property is sold, the donor should be able to exclude up to $250,000 of capital gain on the sale, since the trust is a grantor trust (meaning that the donor is treated for tax purposes as owning the residence or his or her share of the residence).

3. Termination of QPRT Status. If a replacement residence is not purchased within 2 years or if the trust ceases to hold a residence during the term, then the trust will cease being a QPRT and must convert to a grantor retained annuity trust (GRAT). Using the example above, where the donor contributes a $2,000,000 to a QPRT for a 20-year term at a time when the grantor is 50 and the relevant rate used by the IRS is 7%, the trust would have to pay an annuity to the donor of approximately $150,000 per year for the remainder of the QPRT's term.

4. Appraisal. Before pursuing this project, we recommend that a donor obtain a formal real estate appraisal of the residence. A professional appraisal is important to defend the value placed on the gift of the remainder interest should it be called into question by the Internal Revenue Service.

5. Mortgaged Property. It is generally not advisable to transfer mortgaged property to a QPRT. So if there is any outstanding debt on the property, the use of a QPRT will have to be carefully considered.