

## Planning Ideas—Qualified Principal Residence Trusts

Although home sales to first time buyers qualifying for the \$8,000 income tax credit have picked up, residential real estate prices have remained depressed in many areas of the country. Despite the persistence of relatively low interest rates, the currently depressed housing market may make this a good time to discuss a planning tool that's been around for some time, the Qualified Personal Residence Trust (QPRT).

### How it Works

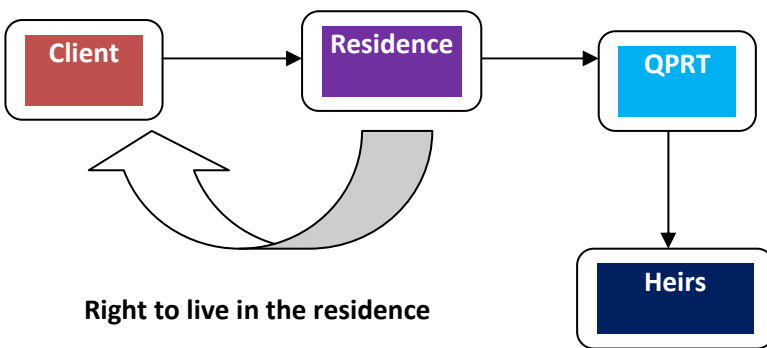
A QPRT is an irrevocable trust that allows a grantor to transfer a residence and any future appreciation thereon to children at a discounted value. The grantor retains the right to live in the residence for a term of years. At the end of the term, the residence passes outright or in trust to the remainder persons. The value of the remainder interest is equal to the value of the property transferred less the value of the income interest retained by the grantor as determined under IRC Section 7520. The longer the term of the retained interest, the lower the value of the gift. Also, the higher the Section 7520 rate, the lower the value of the gift.

Consider the following example:

#### *Example 1*

Dan C., a widower, is age 70 and in good health. He establishes a QPRT with a ten-year term and transfers his home, currently valued at \$1 million, to the trust. As recently as three years ago, the home was valued at \$3.2 million. Under the trust, Dan has the right to live in the residence during the term of the trust. If Dan dies during the trust term, the residence reverts to his probate estate. If Dan survives the trust term, title to the residence passes to his children. Based on the current Section 7520 rate of 3.4 percent, which is the applicable rate for September 2009, and taking into account Dan's contingent reversionary interest, the value of the remainder interest is only \$486,356. If Dan survives the trust term and the property appreciates in value to its previous value of \$3.2 million, the value transferred to his children, free and clear of the transfer tax, is \$2,713,644. Assuming a marginal estate tax rate of 45 percent, that's a tax savings of \$1,221,140.

Figure 1



A major advantage of a QPRT over other planning alternatives is its certainty—QPRTs are specifically authorized under IRC Section 2702. Disadvantages include the administrative restrictions placed on QPRTs by the statute. These include the following:

1. The QPRT may hold not only one residence to be used as a personal residence by the term holder. However, the term “personal residence” is defined more broadly than appears on the surface. It includes the principal residence of the term holder, one other residence of the term holder, or an undivided interest in either. This means that a “second” or vacation home may qualify. The trust will lose its favored status as a QPRT if the grantor ceases to use the residence as a personal residence during the retained term.
2. The QPRT must prohibit the sale or transfer of the residence to the grantor, the grantor's spouse, a trust treated as owned in whole or in any part by the grantor or grantor's spouse under the “grantor trust” rules, or any entity “controlled” by the grantor or grantor's spouse. The trust will cease to be a QPRT if, during the trust term, the personal residence is sold to an eligible third party and a new personal residence is not purchased within two years.
3. Additions of cash to the QPRT are limited to those required to pay trust expenses or for improvements already made or to be paid within six months from the date of the addition.
4. The trust will cease to be a QPRT if the personal residence is damaged or destroyed and the insurance proceeds received are not used to replace or repair the residence or to purchase a new residence within two years.
5. If the trust ceases to be a QPRT, it must terminate and within 30 days the trustee must either distribute all trust property outright to the term holder or convert it to a qualified annuity trust for the remainder of the term.

## Federal Income Tax Considerations

A QPRT is a grantor trust under IRC Section 677 (this section relates to a retained income interest, which in this case is the retained right to live in the transferred residence), or perhaps under IRC Section 675 (this section relates to a retained reversionary interest that exceeds five percent of the trust value).

One consequence of a QPRT being a grantor trust is that if the residence is sold, the gain (or loss) flows through to the grantor.

## Federal Gift Tax Considerations

The remainder interest in a QPRT is a future interest gift and does not qualify for the annual gift tax exclusion. However, the value of the gift, as illustrated in the example above, is the current fair market value discounted by the value of the retained term interest. Assuming the grantor has not fully utilized his or her gift tax exemption, the taxable gift will be sheltered by the exemption, which is currently \$1 million per donor.

## Federal Estate Tax Considerations

Retention of the right to live in the transferred residence causes the value of the residence to be included in the grantor's gross estate should he or she die during the retained term. This "mortality risk" presents a challenge for the advisor. The longer the trust term, the lower the gift tax value, but the higher the risk that the grantor will die during the term and the anticipated QPRT benefits will be lost. In structuring the QPRT, the advisor should take into account several factors including the grantor's current health and family medical history.

On the other hand, it should be pointed out that even if the grantor dies during the QPRT term he or she is no worse off than if the gift had not been made (ignoring planning, drafting, and appraisal fees). The worst that happens is that the residence is included in the estate, which would have been the result if the donor had never created the QPRT.

Furthermore, assuming the grantor is in good health, life insurance could be purchased and maintained at least for the duration of the retained interest. The life insurance should be sufficient in amount to pay estimated estate taxes due to inclusion of the appreciated value of the residence in the gross estate.

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In light of the fact that the residence is included in the grantor's estate should he or she die during the retained interest term, the trust should include a contingent reversionary interest. Under this provision, the residence is distributed to the grantor's probate estate if death occurs during the retained term.

The reversionary interest has no adverse estate tax impact, but does contribute to a lower gift tax value for the reason that it creates the possibility that the remainderpersons will never receive the residence. Thus, in Example 1 above, the gift tax value of the remainder interest reflects a discount for both time value of money and the mortality risk of the grantor dying between ages 70 and 80.

*What makes QPRTs attractive at this point in time of relatively low interest rates is that many homes are primed to appreciate to at least their pre-recession values in a relatively short time. So long as the appreciation rate exceeds the current interest rates and grantor outlives the trust term, the QPRT is a winning strategy.*

### **Federal Generation Skipping Transfer Tax Considerations**

In general, QPRTs are not considered to be effective against the generation-skipping transfer tax. The reason is that the GSTT exemption is not allocated to the gift until after the close of the "estate tax inclusion period." In the case of QPRTs, the inclusion period does not close until expiration of the trust term, at which time no valuation discount is available and the residence may have appreciated in value.

The implication is that caution should be exercised in drafting the trust to prevent generation-skipping transfers from occurring. For example, the trust should specify distribution to children rather than to heirs or issue.

### **Financial Considerations**

Advisors usually consider the use of QPRTs during times of relatively high interest rates. This is because a high interest rate translates into a lower gift tax value for the remainder interest. In Example 1, the discount factor for determining the value of the remainder interest (which reflects both the ten-year retained term and the possibility of the grantor dying during that term), was .486356 (70 year-old male, 3.4 percent Section 7520 rate). If the Section 7520 rate increased to 7 percent, the discount factor would be reduced to only .345399. Assuming a residence valued at \$1 million, the gift tax value of the remainder interest would be only \$345,399 using the 7 percent rate as compared to \$486,356 using the 3.4 percent rate.

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long as the appreciation rate during the retained term exceeds the current interest rate and assuming the grantor outlives the trust term, the QPRT is a winning strategy.

### **Bottom Line**

No planning strategy is perfect, and the administrative restrictions associated with QPRTs make them inappropriate for some clients. However, for those clients seeking the clarity provided by statutory guidance, a QPRT can be just the ticket. Currently depressed residential real estate values make this the time to act.

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