A Qualified Personal Residence Trust (QPRT) is an excellent tool for persons with large estates to transfer a principal residence or vacation home at a reduced gift tax value. By way of example, assume a father, age 65, has a vacation residence valued at $1 million. He transfers the residence to a QPRT and retains the right to use the vacation residence (rent-free) for 15 years. At the end of the 15 year term, the trust will terminate and the residence will be distributed to the grantor's children. Alternatively, the residence can remain in trust for the benefit of the children. Assuming a 2.4% discount rate for the month of the transfer to the QPRT (this rate is published monthly by the IRS), the present value of the future gift to the children is only $433,040. This gift, however, can be offset by the grantor’s $5 million lifetime gift tax exemption (see below). If the residence grows in value at the rate of 5% per year, the value of the residence upon termination of the QPRT will be $2,078,928. Assuming an estate tax rate of 35%, the estate tax savings will be $576,061.

The net result is that the grantor will have reduced the size of his estate by $2,078,928, used and controlled the vacation residence for 15 additional years, utilized only $433,040 of his $5 million lifetime gift tax exemption, and removed all appreciation in the residence's value during the 15 year term from estate and gift taxes. Even though the grantor must forfeit all rights to the residence at the end of the term, the QPRT document can give the grantor the right to rent the residence by paying fair market rent when the term ends. Moreover, if the QPRT is designed as a “grantor trust” (see below), at the end of the term, the rent payments will not be subject to income taxes to the QPRT nor to the beneficiaries of the QPRT. Essentially, the rent payments will be tax-free gifts to the beneficiaries of the QPRT - further reducing the grantor's estate.

The longer the QPRT term, the smaller the gift. However, if the grantor dies during the QPRT term, the residence will be brought back into the grantor’s estate for estate tax purposes. But since the grantor's estate will also receive full credit for any gift tax exemption applied towards the initial gift to the QPRT, the grantor is no worse off than if no QPRT had been created. Moreover, the grantor can “hedge” against a premature death by creating an irrevocable life insurance trust for the benefit of the QPRT beneficiaries. Thus, if the grantor dies during the QPRT term, the income and estate tax-free insurance proceeds can be used to pay the estate tax on the residence.

The QPRT will be designed as a “grantor trust”. This means that the grantor is treated as the owner of the QPRT for income tax purposes. Therefore, all property taxes on the residence will be deductible to the grantor. For the same reason, if the grantor’s primary residence is transferred to the QPRT, the grantor would qualify for the $500,000 ($250,000 for single persons) capital gain exclusion if the primary residence were sold during the QPRT term. However, unless all of the sales proceeds are reinvested by the QPRT in another residence within two (2) years of the sale, a portion of any “excess” sales proceeds must be returned to the grantor each year during the remaining term of the QPRT. It should be noted that a QPRT can hold property in any state.

A QPRT is not without its drawbacks. First, there is the risk mentioned above that the grantor fails to survive the set term. Second, a QPRT is an irrevocable trust – once the residence is placed in...
trust there is no turning back. Third, the residence does not receive a step-up in tax basis upon the grantor’s death. Instead, the basis of the residence in the hands of the QPRT beneficiaries is the same as that of the grantor. Fourth, the grantor forfeits all rights to occupy the residence at the end of term unless, as mentioned above, the grantor opts to rent the residence at fair market value. Fifth, the grantor’s $13,000 annual gift tax exclusion ($26,000 for married couples) cannot be used in connection with transfers to a QPRT. Sixth, a QPRT is not an ideal tool to transfer residences to grandchildren because of generation skipping tax implications. Finally, at the end of the QPRT term, the property is “uncapped” for property tax purposes.

The mechanics for establishing a QPRT are comparatively simple. An appraisal is required to establish the fair market value of the residence. The residence is deeded to a QPRT which names the persons who are to receive the residence at the end of the stated term, usually a child or children of the grantor. A term is set that the grantor is likely to survive, but long enough to result in a substantial reduction in the gift tax value of the residence. The grantor is the trustee of the QPRT and maintains control of the assets of the trust until the term ends. During the QPRT term, the grantor usually continues to pay the normal and customary expenses for maintenance, repairs, property taxes, utilities, etc. While it is permissible to transfer mortgaged property to a QPRT, it is not practical since the principal portion of each mortgage payment is treated as an additional gift to the QPRT beneficiaries.

A single person can use a QPRT for two residences as long as one of them is his/her principal residence. A married couple can make gifts of three residences as long as one spouse gifts both a principal residence and a vacation residence. Property owned jointly by spouses can be retitled as tenants-in-common and each spouse can then contribute his/her undivided one-half interest in the residence into his/her own QPRT, warranting a further discount on the gift tax value because of the lack of marketability and lack of control associated with fractional interests in real estate. Alternatively, property owned jointly by spouses can be first transferred to the spouse with the longer life expectancy who then transfers the property to a QPRT. Finally, it is possible for the grantor of a QPRT to give his/her spouse a “life estate” in the residence at the end of the QPRT term before it passes on to the children. As such, the grantor will have indirect access to the residence as his/her spouse’s “guest”.

The QPRT also provides an excellent asset protection vehicle since the grantor no longer owns the property once the trust is established. Thus, creditors cannot lien the residence. Yet, the grantor stays in complete control as the trustee of the QPRT, and retains all the income tax benefits of home ownership such as property tax deductions and the $250,000/$500,000 capital gain exclusion discussed above. If the grantor sells the residence, the sales proceeds are protected as is any replacement residence purchased by the QPRT.

**Summary**

As a result of the Tax Relief Act of 2010, the estate and gift tax exemption is $5 million per person with a top tax rate of 35%. However, without further Congressional action, on January 1, 2013, the estate and gift tax exemption decreases to $1 million per person, and the top tax rate increases to 55%. Thus, for at least 2011 and 2012, QPRTs may not be as favored when donors can make gifts of up to $5 million without paying gift taxes and without using sophisticated planning strategies such as QPRTs. But QPRTs still have the advantage of being able to move future appreciation (above the IRS’ published interest rate) without having to use up much of the grantor’s gift tax exemption (thereby allowing the grantor to leave a greater amount estate tax free at death).

**THIS ARTICLE MAY NOT BE USED FOR PENALTY PROTECTION.**