

QUALIFIED PERSONAL RESIDENCE TRUST

by Robin Klomprens

Although estate tax only occurs upon one's death, it has in prior years reached almost sixty percent (60%). It is currently thirty-five percent (35%) for two years and will remain at that rate until new legislation is enacted for 2013 and beyond. Upon an individual's death, his or her entire estate over the exemption amount is taxed for estate tax purposes. All assets including securities, retirement plans, insurance, real and personal property, are taxed at their fair market value on death. Since for many individuals a residence is one of their most valuable assets, this asset in and of itself can push an individual's estate into a taxable situation. The estate tax exemption amount is \$5,000,000 in 2011. This means that if a person dies in 2011, the amount of their estate in excess of \$5,000,000 will be taxed for estate tax purposes. In 2013 the credit amount reverts to \$1,000,000. Therefore, for many individuals a technique to remove one's residence or vacation home from their estate can be extremely beneficial.

Such a technique exists that is specifically sanctioned by the Internal Revenue Code ("Code"). It is called a qualified personal residence trust ("QPRT") and is merely a form of a grantor retained income trust ("GRIT"). With the real estate market depressed, QPRTs are an extremely valuable estate planning tool. This technique allows a gift of a residence to be made at a discount while freezing the value of the residence at today's fair market value. These trusts are not without hitches, but for most people the benefits far outweigh the risks.

Basically, the residence is placed into an irrevocable trust for a certain number of years. You, as the person forming the trust, choose the term (time period of the trust). The term can be set at any number of years. Generally, the term starts at five years or more. The term is very important because this is the period of time that you can continue living in the residence rent free. During this time period, you also retain the deductions for mortgage interest and property taxes. At the end of the term, the residence passes to the beneficiaries specified in the trust agreement with no additional estate or gift taxes due since gift tax is deemed paid on the formation of the trust. No gift tax would be paid since a portion of your unified credit would be used.

Upon formation of the trust, a calculation is made using your age, fair market value of the residence at date of transfer into the trust, and the term of the trust. This then allows one to calculate the present value of the gift. To illustrate, a 55 year-old client, a few years ago, transferred a \$1,000,000 residence to a trust, retaining the right to use the residence for 15 years. The present value of this gift was approximately 30 percent (30%) of the fair market value on the date of transfer, or \$300,000. If the estimated fair market value of the residence in 15 years is \$2,000,000, the grantor has saved estate tax on \$1,700,000. If the estate tax rate is 50 percent (50%), estate tax of \$850,000 is avoided. Of course, the actual savings will depend on the fair market value of the residence, other assets in your estate on date of death, the applicable exemption amount, the estate tax rate, and whether you outlive the trust term.

The down side of a QPRT is that if you do not survive the term of the trust, the fair market value of the residence at your death is included in your estate. Even with this risk, however, since this would have happened if you had not made the transfer at all, the QPRT is a valuable estate planning vehicle. In this case the only loss is the legal fees incurred for preparing the trust document.

Some people are also concerned that at the end of the term they will have to move from their residence. There are IRS private letter rulings that state that a lease arrangement between you and your beneficiaries will not nullify the QPRT nor will it cause inclusion in your estate. Additionally, there is even a ruling that allows the lease to be structured in the trust document itself.

One also has to analyze the basis issue. This issue will be relevant depending on the size of your estate. With a QPRT the beneficiary's basis (the person receiving the gift) equals your basis. On death, a beneficiary's basis is equal to the fair market value of the property on the date of death, which is usually higher!¹ One never wants to trade savings of income tax for estate tax, however, since estate tax rates are far in excess of income tax rates, especially considering the currently low capital gains rates.

¹ Note: In 2010 there was limited basis step-up of 1.3 for single persons.