



BarNotes

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Tips on QPRTS

Qualified Personal Residence Trusts Offer Tax Advantages

BY SHEETAL MEHTA FISHER AND MICHAEL HACKMAN



Many of counsel's clients have already created and funded revocable living trusts with their residences. But they may wish to consider qualified personal residence trusts ("QPRTs") as well. QPRTs offer several potential estate tax advantages.

A QPRT is an irrevocable trust to which an individual-grantor transfers a residence. The individual-grantor retains the right to occupy the residence for a term of years and then passes the residence to the beneficiaries. Unlike a revocable living trust, once the QPRT is funded with a residence, the individual-grantor has made a present gift to the beneficiaries.

Notably, because the individual-grantor has retained an interest in the residence and delayed the beneficiaries' receipt of the residence, the value of the property is discounted for federal gift tax purposes. The amount of the gift is calculated as equal to the fair market value of the residence, less the discount, which is based on the term of the QPRT, the individual-grantor's age, and the applicable IRS "7520" rate.

Once a QPRT is established, the residence is removed from the individual-grantor's estate. This allows the individual-grantor to transfer the appreciation to the beneficiaries free of gift and estate taxes.

For example, if a mother, 65, with a home currently worth \$500,000, places the residence in a QPRT for the benefit of her

children, retaining the right to live in the house for a term of 10 years, the present value of the gift (based on the November 2006 7520 rate of 5.6 per cent) is \$220,420.

If the value of the residence in ten years is \$1,000,000, she has successfully passed her residence to her children, reduced the size of her estate by \$1,000,000, occupied the home for 10 years and utilized only \$220,420 of her \$1,000,000 lifetime gift exclusion and the same amount of her estate tax exclusion.

To qualify for a QPRT, the residence must be the individual-grantor's principal residence or another residence used for personal purposes. A vacation home may qualify for a QPRT if the house is not rented out full-time. Only one residence may be transferred to the QPRT.

Although an individual-grantor may transfer a residence with a mortgage to a QPRT, it is best to pay off the mortgage before the transfer. If not, the mortgage payments made after the transfer are also gifts. On this basis, they may be subject to gift tax, or at least further reduce the remaining gift tax and estate tax exclusions.

During the term of the trust, the individual-grantor is treated as the owner of the property for federal income tax purposes. Therefore, the individual-grantor pays the property taxes (and any interest) and claims the deduction.

If the individual-grantor sells the residence, that person is responsible for capital gains tax. But the individual-grantor has several options if he sells the residence during the term of the trust.

For example, the trust may specify that proceeds will be used to acquire another residence. But if the individual-grantor purchases a residence with a lower fair market value or otherwise receives cash back from the sale of the residence, the individual-grantor will waste some of the lifetime gift or estate tax exclusions. The trust holds the remaining sale proceeds to provide an annuity for the grantor for the remainder of the term of the trust.

Although under the appropriate circumstances a QPRT may provide tremendous tax benefits, it does not always work. If the grantor fails to survive the term of the trust, the entire value of the residence is pulled back into the decedent's estate. It may then be subject to estate taxes upon the individual-grantor's death.

If the grantor survives the term of the trust, the beneficiaries will not receive a step-up in basis at the individual-grantor's death.

If the individual-grantor later sells residence, he may be subject to a higher income tax. If he sells the residence during his lifetime, he may not be pleased with the annuity he receives and he may wish to have access to trust principal.

Before creating a QPRT, counsel should carefully consider the benefits and consequences for clients, consulting appropriate accounting experts as well. 🐿

Michael Hackman specializes in tax, estate planning and corporate law at Encino's Lewitt, Hackman, Shapiro, Marshall & Harlan. He is a certified tax specialist. Sheetal Mehta Fisher focuses her practice on estate planning and corporate law at the firm.