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Qualified Personal Residence Trusts

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What is a Qualified Personal Residence Trust? A qualified personal residence trust (QPRT) is a type of trust often used to remove an asset from a client's estate at a transfer tax cost which is well below the asset's fair market value.

With a QPRT, the settlor transfers ownership of his or her primary or secondary personal residence (or a fractional interest in the residence) to the trust for a specified term of years (or until his or her earlier death). An individual may transfer up to two residences, or fractional interests in those residences, to a maximum of two QPRTs, regardless of the value of those residences. During the term, the settlor must continue to use the property as his or her personal residence. After the term expires (assuming the settlor is still living), the residence either will be distributed to the remainder beneficiaries or continue to be held in trust for their benefit.

If the QPRT provides for the creation of a new trust upon the expiration of its term, the new trust should be administered by an independent trustee. This trustee must be an institution or individual who is not the settlor or a beneficiary of the new trust (usually the settlor's spouse and children). It need not be a bank. The trustee can continue to hold the personal residence and rent it back to the settlor for the payment of fair rental value. The trustee may be given the discretion to distribute trust income (i.e., the settlor's rental payments net of costs associated with the residence) among the settlor's spouse and children. If the settlor's spouse is living, the rent payments can be recycled back out to the spouse if needed. If not, they can be a form of gift tax-free transfer which will be available for distribution (immediately or in the future) to the settlor's children. If the settlor dies after the expiration of his or her rent-free term and is survived by his or her spouse, the surviving spouse can have the rent-free occupancy of the residence for his or her remaining lifetime.[1] The children will wait to receive the residence until the deaths of the survivor of the settlor and his or her spouse.

What Are the Tax Consequences of a QPRT? The settlor's initial transfer of the property into the QPRT is a taxable gift to the remainder beneficiaries for gift tax purposes. The settlor must file a gift tax return reporting the gift to the QPRT and consume unified credit equal to the amount of the taxable remainder interest. The

[1] If both the settlor and his or her spouse are living, there is an alternative to paying full fair rental value to the trustee after the expiration of the settlor's rent free term. The settlor's spouse can be given the right to rent-free occupancy for his or her lifetime, and the settlor can continue to live in the residence as the spouse's guest. The settlor's obligation to pay rent would only commence upon the spouse's death.

IRS allows the settlor to discount the value of this gift for gift tax purposes. Two factors combine to allow this discount: (1) the remainder beneficiaries must wait until the expiration of the settlor's rent-free term before they receive any benefit from the arrangement; and (2) they will receive that benefit only if the settlor survives beyond the expiration of the rent-free term. The IRS has established mathematical formulas for determining the exact amount of the discount. Generally, as the length of the rent-free term increases, the value of the future gift to the remainder beneficiaries decreases. The older the settlor is on the day he or she creates the trust, the shorter his or her actuarial life expectancy, the greater the risk of the his or her death during the rent-free term (and the remainder beneficiaries getting nothing from the trust), and the lesser the value of their future interest.

The following examples illustrate the gift tax calculations under various circumstances for QPRTs created in September 2003, assuming a contribution of a $500,000 personal residence.

Age of Settlor	Length of Settlor's Rent-Free Term (in Years)	Discount Factor in Determining Gift to Remaindermen	Taxable Gift to Remaindermen
40	25	70.19%	$149,045
50	15	53.56%	$232,215
60	10	44.72%	$276,425
70	5	31.04%	$344,815
80	3	28.68%	$356,620

The potential estate and gift tax advantages are obvious. Take the 40 year old settlor illustrated in the above table as an example. If she survives beyond the expiration of the 25 year rent-free term, and the personal residence having an initial value of $500,000 has appreciated during that period to $1,000,000, she will have had her cake and eaten it too: she retained the full use and enjoyment of the residence for a substantial period of time, while ultimately transferring it to the remainder beneficiaries at a gift tax value of approximately 15% of the estate tax value of the residence had she retained it and allowed it to pass to her children upon her death. While a longer term will maximize the gift tax discount, the settlor should choose a term which he or she reasonably expects to outlive.

During the rent-free term, the settlor (and not the trust) is treated as owner of the residence for federal income tax purposes. If the residence is mortgaged, the settlor can deduct the interest he or she pays on his or her federal income tax return.[2] The settlor also should be able to deduct any real estate taxes he or she pays. The settlor can arrange for the sale of the residence and arrange for the sales proceeds to be "rolled over" tax-free into the trust's purchase of a replacement residence.

[2] Note, however, that certain adverse gift tax consequences can result from contributing a mortgaged residence to a QPRT.

During the rent-free term, the settlor can be the sole trustee of the trust. As indicated above, the trust is a transparency for income tax purposes; no separate income tax return is required. The settlor need not provide any accounts to any beneficiaries and can pay all carrying charges (mortgage payments, real estate taxes, etc.) directly and not through the trust. As long as the settlor remains a trustee, he or she is not required to obtain a separate taxpayer identification number or establish a separate checking account for the trust. This will change, however, after the expiration of the rent-free term if a "further trust" is created for the remainder beneficiaries (see above). In that case, an "independent" (generally, someone other than the settlor) trustee must be appointed to administer the trust in a more formal manner.

While the trust is technically irrevocable, the settlor can retain an indirect power of revocation during the rent-free term by arranging the sale of the property. If there is a sale, and the settlor does not wish to "roll over" the proceeds into the purchase of a replacement residence inside the trust (see above), the trust document must direct that the sales proceeds be handled in one of two alternative ways: (i) either be distributed outright to the settlor, or (ii) converted into an "annuity" which would make annual payments of income to the settlor for the remainder of the rent-free term.[3] The law does not require the settlor prospectively to make the choice when he or she creates the trust. This flexibility to "collapse" the trust later if appropriate takes much of the sting out of the trust's irrevocability. After the expiration of the rent-free term, assuming the independent trustee agrees, the residence can be sold, with the sale proceeds distributed to the remainder beneficiaries in the independent trustee's discretion.

The QPRT generally protects the settlor's residence from his or her creditors, assuming the initial transfer of the residence to the QPRT cannot be considered "fraudulent" as to the settlor's existing creditors.[4] As of January 1, 2004 New Hampshire's homestead exemption is limited to the first $1,000,000 in equity in the residence. Placing the residence in a bona fide QPRT can, practically speaking, make up in part for the lack of homestead protection. A creditor or trustee in bankruptcy can stand in the settlor's shoes and attempt to reach the settlor's right of rent-free occupancy during the rent-free term, but they cannot force a sale of the residence, or "break" the trust and eliminate the remainder beneficiaries' future interest in the residence.

If the settlor dies during the term of the trust, the personal residence is included in his or her gross estate for federal estate tax purposes. Any unified credit which the settlor consumed when the residence was transferred to the QPRT will be restored to his or her gross estate. The settlor will be placed back to "square one":

[3] However, if the settlor wants to allow for a distribution of the sale proceeds to himself or herself, he or she should not be the QPRT trustee when the sale occurs. Also, a distribution of the sale proceeds to the settlor may forfeit the benefit of any gift and estate tax credit he or she consumed when the QPRT was funded.

[4] The settlor's creditors can "break" the QPRT and attach the full value of the residence if they can demonstrate that the settlor was insolvent when he or she initially transferred the residence to the QPRT, the transfer rendered the settlor insolvent, or the settlor made the transfer with the actual intent to hinder or delay his or her creditors.

he or she will be no better or worse off (gift and estate tax-wise) for having used this strategy. There are, however, two other factors the settlor should consider:

- If the settlor survives the rent-free term and successfully escapes estate taxation of the residence, the remainder beneficiaries will not receive a step up in basis to the fair market value of the residence as of the date of the settlor's death, as they would have had the property been subject to taxation in the settlor's estate[5]. For example, if a settlor successfully employs the QPRT, and his or her federal income tax cost basis in the appreciated $1,000,000 residence is $200,000, the remainder beneficiaries (or the trust) will use that low basis in calculating its capital gain should the property later be sold.[6] The settlor trades off the step-up in basis at death for the estate tax savings of removing it from his or her estate at a discounted value. Taking our 40-year old settlor illustrated above as an extreme example, she removed $850,000 from her estate tax base by successfully employing the QPRT strategy. If the entire value of the residence were subject to an average estate tax rate of 45%, she will save $382,000 by using the QPRT. If, by contrast, she opted not to use the QPRT in favor of the date of death basis increase, her heirs would save $120,000 in income tax ($1,000,000 fair market value minus $200,000 basis times 15% capital gain rate). The estate tax savings are greater because the *minimum* estate tax rate (37%) exceeds the *maximum* capital gains tax rate (15%) by a full 22%.

- The residence will be removed from the settlor's balance sheet and may effect his or her credit-worthiness. This may be particularly important for young homeowners considering this strategy. The settlor cannot offer the residence as collateral to secure personal debt should he or she later need funds. This, however, is not often a concern for older people, who are particularly good candidates for this strategy. They are far enough along in their financial life cycles to own their homes free of debt and often have no foreseeable need to tap their equity.

[5] To avoid this result, planners often arranged for the settlor to purchase the residence (for its fair market value) from the QPRT one day before the rent- free term expired. That way, the residence would be included in the settlor's gross estate and receive a step up in basis upon his or her death, and the settlor would have successfully removed the fair market value of the residence from his or her estate at a reduced transfer tax cost. Effective May 16, 1996, however, the governing instrument of a QPRT must prohibit the sale of a residence held in a QPRT to the settlor or his or her spouse.

[6] The settlor can even avoid or minimize this problem by arranging a sale of the residence during your rent-free term. The trust can then use the proceeds to purchase a replacement residence or an annuity for the remainder of the trust term as described above. Either way, the settlor's children will not "inherit" any federal income tax problem from the settlor.