Benefits of Establishing a Qualified Personal Residence Trust (QPRT) For Your Personal Residence

What is a Qualified Personal Residence Trust?

Often a taxpayer desires to give away assets from his or her estate in order to reduce future estate taxes, but needs to retain income producing assets. In many situations the largest single other asset owned by a person is the personal residence or a vacation home. A Qualified Personal Residence Trust (QPRT) is a planning technique that allows the taxpayer to transfer a residence to a trust and continue to reside in the residence while potentially removing the residence entirely from his or her estate at a relatively small gift tax cost (or at the "cost" of using a portion of the unified credit amount) at the time of transfer. Other similar devices are Grantor Retained Annuity (Unitrust) Trusts (GRAT & GRUT). This Memorandum will provide information on QPRTs and comparisons with GRATs, but does not go into detail regarding GRATs.

Comparison with Certain Other Competing Techniques

1. What the QPRT Can Accomplish.

The QPRT offers a way of discounting the value of a gift of a personal residence or vacation home by an amount calculated to equal the retained value of a person's retained interest in the trust. The permitted discount is generally unrealistically high for two reasons. First, under current market conditions, the rental value of a residence will not always equal the value of the residence multiplied by the Code Sec. 7520 rate, particularly since you are responsible for paying all of the expenses of the residence. Secondly, the ability to reduce the value by the reversionary interest permits a valuation reduction without a transfer cost to you. You have nothing to lose, from the standpoint of the transfer tax, by retaining this remainder interest. Whether you retained it or not, if you die within the term of the QPRT, the property would be included in your gross estate at its full fair market value. If you lives beyond the trust term the full value of the residence is removed from your estate. Accordingly, where you have sufficient liquid assets to comfortably buy back the residence shortly before the end of the QPRT term, the QPRT can be a particularly attractive technique.

2. QPRTs vs. GRATs.

The QPRT, like the Grantor Retained Annuity Trust (GRAT), serves as an estate freezing device. The value of the residence in your estate (so long as you outlive the QPRT term) will be frozen at the discounted value at the time of the gift. The use of the residence during the term of the QPRT will not increase the size of the gross estate and all appreciation in value will accrue to the remainder beneficiaries.

The GRAT requires for its success that you have assets to transfer that are likely to outperform the Code Sec. 7520 rate. This is not necessary for a QPRT.

The GRAT, if it is established with a low gift value, presents almost no risk of creating a transfer tax disadvantage. If the property declines in value, the property is simply returned to you. No gift tax has been paid and no adjusted taxable gifts have been created to increase the amount of estate tax to be paid at your death.

In contrast, the QPRT can backfire. If the value of the property declines and if you outlive the QPRT term, the discounted initial value will remain an adjusted taxable gift. This could produce a higher combined estate and gift tax than would have been payable if the QPRT had not been created. *(Note, this only occurs if the value of the property depreciates in value.)*

3. QPRTs vs. Loans.

A loan produces a transfer tax advantage only if the borrower is able to invest the funds to achieve a return in excess of the interest rate required to be charged by Code Sec. 7872. A QPRT can produce a transfer tax advantage even if it remains at its initial value throughout the term of the QPRT and does not appreciate in value.

4. QPRTs vs. Sales.

The sale of a residence is unlikely to be as attractive as a QPRT as a means of shifting future increases in value. The sale crates no opportunity for the kind of discount that the QPRT presents. Additionally, if the property has appreciated enough in value, a sale might produce gain recognition. Also the sale if financed by the seller will result in interest income to the seller with no offsetting deductions for rent paid for the use of the residence.

General Tax Consequences of Establishing a QPRT

In 1990 Congress added Section 2702 to the Internal Revenue Code (the "Code"). This section was designed to curtail several "estate freeze" transactions utilizing trusts. This Code section provides, generally, that when a taxpayer transfers an interest in trust to (or for the benefit of) a member of the transferor's family, the value of the gift of the transferred interest will be determined by treating the value of any interest retained by the transferor as zero. Exceptions to this general rule include the retention of a "qualified interest", such as you retain in a Grantor-Retained Annuity Trust (GRAT) or a Grantor-Retained Unitrust (GRAT), as well as a "transfer of an interest in trust all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust (a QPRT)." This later exception allows a taxpayer to transfer a personal residence to a trust and retain the right to use the residence as a personal residence during the term of the trust and get a discounted value for the gift of the remainder interest.

The most significant advantage of a QPRT, as opposed to a GRAT or a GRAT, is that you retain a right to utilize the residence in the QPRT without any requirement that payments be made from the QPRT to you. Under a GRAT or a GRAT, payments must be made to you as grantor. This results in the your having assets revert back to you which, if not expended or given away, will be in included in your gross estate for federal estate tax purposes upon your death. Also such payments are subject to income taxes by you. Because of this feature, the QPRT, in the right circumstances, can be one of the most advantageous estate planning techniques available.

When establishing a QPRT, the transfer of the value of the remainder interest in the trust will be treated as a gift for federal gift tax purposes and is not eligible for the annual gift exclusion (currently $15,000 in 2018) provided under Sec. 2503(b) because it is a gift of a future interest in the QPRT property. This remainder interest will be valued using valuation tables prescribed by the IRS and applying the interest rate prescribed under Sec. 7520 (e.g., 1.2% for transfers in December 2012).

EXAMPLE: Mr. Jones, age 60, owns a home with a present fair market value of $1,000,000. It is free and clear. Since at age 60 his life expectancy is about 22-25 years based on current IRS tables, and Mr. Jones is in excellent health, he elected to retain the right to live in the residence for 15 years (the "term of the trust") when he established a QPRT by the transfer of the residence to the trust. If Mr. Jones dies before the term has expired, the residence will be returned to his estate (the "contingent reversionary interest"). If Mr. Jones survives the 15 year term, the residence will be distributed to his children (the "remainder beneficiaries").

Assuming the IRS interest rate table in the month of transfer is 7.2%, the value of Mr. Jones' retained rights are $802,640. He has two rights; namely (i) the right to live in the residence for the next 15 years and (ii) his retained right to have the residence restored to his estate if he dies within the 15 year term. The value of the gift to his children upon establishing the trust is $197,360 ($1,000,000 - $802,640). The IRS says that he has made a gift of a future interest valued at $197,360. *(Note, this gift* ***does not*** *qualify under the annual $14,000 (in 2017) gift tax exclusions, but is 100% taxable. He can, however, use what remains of his "exemption equivalent" to avoid having to pay a tax at the time of the gift.)*

If you survive the term of years specified in the trust instrument, your interest in the Qualified Personal Residence Trust will terminate and the residence will be distributed to those persons you selected when you created the QPRT, such as children or grandchildren.

There will be no additional gift tax when the residence is distributed to the beneficiaries at the end of the term. The only taxable event involved occurs when the residence is transferred to the trust; no additional taxable gift occurs when your interest in the QPRT terminates, *even though the residence may have appreciated since its transfer.*

The residence does not obtain a step up in income tax basis when it is distributed to the remainder beneficiaries. Instead, your income tax basis in the residence carries over, increased by a portion of the gift taxes paid, if any. If the remainder beneficiaries sell the residence, they will recognize gain to the extent that the sales price exceeds your income tax basis, as adjusted by the gift tax, if any.

Since you would no longer have any interest in the property transferred to the QPRT, the residence would not be subject to estate tax at your subsequent death.

After your interest in the QPRT terminates, you will no longer have the right to reside in the residence. If you wish to continue living in the residence when the trust terminates, you must lease the residence for fair rental value from the beneficiaries to whom the residence is distributed or "purchase" the residence for its then fair market value.

If you die before expiration of the selected term of years, the residence will be included in your estate for federal estate tax purposes, just as if you had never transferred it to the QPRT. Any gift tax credit that was applied against the gift tax when the property was transferred to the QPRT will be restored and any gift taxes actually paid will be credited dollar for dollar against your estate tax liability. For this reason, except for the cost of establishing the QPRT, there is no downside risk to you.

Consequences of Transfer of Mortgaged Property to a QPRT

If the personal residence transferred to the QPRT is mortgaged or otherwise has a lien (promissory note secured by a deed of trust, etc.), it is important that you remain personally liable on said indebtedness and mortgage and, furthermore, agrees to reimburse the trust if the lender should proceed against the mortgaged property. Thus, if there is a mortgage on the property, the trust document needs to contain additional provisions requiring you to remain liable. The reason for structuring the gift in this manner has to do with the Internal Revenue Service rules that apply to gifts of mortgaged property. A brief summary of these rules will explain why it is important that you remain personally liable and continue to make the mortgage payments.

As a general rule mortgage debt on a residence can be a "recourse liability." That is to say, the lender has the right to go after the individual who signs the mortgage or promissory note for payment of the indebtedness. The property then only acts as security for such indebtedness. When such property is gifted away, the value of the gift depends upon whether the donee has a right to be subrogated to the lender's rights against the you as the grantor-donor, should the lender proceed against the mortgaged property rather than against the donor directly.

If the donee has a right of subrogation, the value of the gift is the entire value of the property. If the donee does not have a right of subrogation, the amount of the gift is the value of the property less the debt. Under these circumstances, the problem is that every time the donor makes an additional mortgage payment, he would be treated as making an additional gift to the donee. You can readily see the complications this would create in a QPRT where every month you would be considered to make additional gifts to the remainder beneficiaries. Such gifts would not qualify for the annual gift exclusion but would have to go against your exemption equivalent, creating complexities in the accounting and in filing gift tax returns.

If you remain personally liable on the mortgage and, furthermore, agrees to reimburse the trust should the lender proceed against the property, you avoid being treated as making an additional gift to the remainder beneficiaries every time a mortgage payment is made. The net result of this will be a lower overall gift tax cost, even though it will increase the amount of the initial gift made by you upon the transfer of the residence to the trust. (This is because the value of the gift is the gross value of the property not reduced by the debt.)

Furthermore, this means that you will continue to make the mortgage payments and will be entitled to a deduction for the interest and real estate taxes paid on the property. It also means that should there still be a mortgage indebtedness on the property at the end of the term of the trust, this obligation belongs to you and does not "attach" to the residence. In effect, it's a loan by you secured by property owned by other parties (the remainder beneficiaries). As a general rule, we suggest that if at all possible the mortgage indebtedness be paid off prior to the end of the term of the QPRT.

* * * * *

IRS Circular 230 Disclosure

Pursuant to recently enacted U.S. Treasury Department Regulations and to ensure compliance with the requirements imposed upon us by the United States Internal Revenue Service, we are now required to advise you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including attachments and enclosures, is not intended or written to be used, and may not be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

Presented By:
James G. Knollmiller
KNOLLMILLER & ARENOFSKY, LLP
1745 S. Alma School Rd., Suite 130
Mesa, Arizona 85210
e-mail: info@aboutestateplanning.com

