

QPRT

A Qualified Personal Residence Trust is a trust which holds your home or vacation home for a period of years. At the end of that period of years, your home or vacation home passes to your children or a trust for your children. Giving away one's home is not something most people consider doing. For this reason, this trust is one which is rarely used unless some tax benefit is attached to doing so - and even then, it feels unnatural.

The Qualified Personal Residence Trust is a trust which you create to own your home for a period of years. At the end of the period of years the home passes to your children (or other beneficiary) or a trust for your children.

At the time you create the trust and transfer your home to the trust, you are deemed to have made a gift to your children. The value of the gift is reduced to reflect that your children do not have the use of the home for the period of the trust. The reduction in value is based on the current interest rate. For example, let's assume you are 50 years old, you create a trust for 10 years transferring

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your \$500,000 home to the trust. Using the a federal rate of 7.2%, the amount of the gift to your children would be \$228,000.

If you die during the term of the trust, the home is included in your estate and your estate is credited with the amount of the gift tax on the transfer of the home to the QPRT. If you survive the term of the trust,

the home passes to your children with no additional tax.

Tax Benefits

You are able to transfer property, your home, to your children at a reduced tax cost. In the above example you give an asset valued at \$500,000 paying a gift tax on \$228,000 value. In the discussion below we will discuss ways to maximize the value transferred and minimize the size of the gift, to leverage the transfer so to speak.

Unnatural? Why?

It feels unnatural to most people from both a psychological perspective and from a financial perspective. Your home is your security, your place to come back to. Your place that is always there for you - your home base, your touchstone. If you have conflict with your children, want to feel independent of them, you come home. If you want to nurture your children, you have them come home for an evening, for a week, for a summer. The longer you have lived in your home, the stronger the feeling. If you give your home to your children, you change this

dynamic. They own your home. You go back to the home they own. The shift may be subtle but it is present nevertheless. This feeling seems to be stronger in women since I have found that more men are willing to use the QPRT

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than women.

Financially, purchasing a home and paying off the mortgage provides you with a place to live. If all other sources of income wither away, you have a home you can live in. If the home is valuable and all other investments go awry, the home can be sold and the proceeds invested for your security. Sometimes this concern is real. However, the “feeling” that one is giving up ones security, even though the perception is not accurate, creates a psychological impediment to using a QPRT. In addition, the idea that at the end of the term of the QPRT you will be living in a home your children own may be awkward. The idea of paying rent to your children may also be distasteful - even though paying rent is a good “wealth transfer” idea.

You can take a mid-ground position to minimize those feelings and transfer only part of your home to the QPRT. Transferring only a portion of your home is actually more advantageous, but I will discuss that benefit later.

Let’s look at the “irreversibility” of the QPRT. What if you *do* need the money.

Let’s say you had a business, oil and gas interests and real estate (highly leveraged

but also highly appreciating) valued at \$3 million and a home valued at \$500,000. You are 55 years old and create a 15 year QPRT. Over the next 10 years, the business goes under, the oil and gas dries up and the real estate declines slightly and is ultimately foreclosed on. However, the residential area where your home is located has boomed and your home is now worth \$1.5 million, and you need the funds the sale of your house would bring. Can you get them? Yes, *if you planned for that option in advance*. If you sell the home during the term of the QPRT and do not buy another house, you must either convert the trust into a Grantor Retained Annuity Trust (discussed below) or distribute the funds to the Grantor, i.e. you. If the Trustee does distribute the proceeds from the sale

...paying rent is a good “wealth transfer” idea.

of your home to you, you will have lost the portion of your exemption used on the initial gift, but your estate tax is not your concern, your retirement is. If you want to leave this option open to you, you cannot be the Trustee of your QPRT. Unless you want to retain this option, this option is not included and the grantor serves as the Trustee of the trust. With the increasing exemption amount, individuals with limited resources do not transfer any assets which they feel they might need in the future.

Now let’s assume that the QPRT remains beneficial, but you want to sell your home and move to another home. What are your options?

You can sell your home and reinvest the proceeds in another home or you can convert the QPRT to a GRAT. Oh no, another acronym. the GRAT is a Grantor Retained Annuity Trust. The GRAT was created in the same law which eliminated GRITs except for House GRITs. The GRAT is a trust for a term of years which pays a fixed amount to the Grantor (the person who created the trust). At the end of the term, the trust is distributed to your children or other beneficiary (or a trust for your children/beneficiary). If a QPRT is

If you sell the home during the term of the QPRT and do not buy another house, you must either convert the trust into a Grantor Retained Annuity Trust or, if you specifically provided for this option, distribute the funds to the Grantor, i.e. you.

converted to a GRAT, the proceeds from the sale of the house are invested and an annuity paid to the Grantor for the remaining term of the QPRT. For a more detailed discussion of a GRAT see the discussion below entitled "Grantor Retained Annuity Trust".

So when you create a QPRT one of four scenarios may occur:

< Your home is transferred to the QPRT and you live in the home for the full term of the trust. At the end of the term your home is transferred to your children/beneficiaries or a trust for your children or other beneficiaries. At that time you will pay rent to them if you continue to live in the house.

< Your home is transferred to the QPRT. Later you sell your home and reinvest the proceeds in another home. You live in the new home for the term of the trust. If the cost of the replacement home is more than the home you sold, the QPRT will own part of the home. E.g. if the proceeds were \$500,000 and the cost of the new home is \$750,000, the QPRT will own 2/3 of the new home and you will own 1/3 outside of the QPRT.

< Your home is transferred to the QPRT. Later you sell your home and do not purchase a new home. The QPRT is converted to a GRAT and you receive an annuity from the trust for the remainder of the term after you sell the home.

< Your home is transferred to the QPRT. Later you sell your home. You are not the Trustee. You need the funds for your support and specifically provided that the funds may be returned to you. The Trustee distributes all of the proceeds from the sale of the home to you.

What about the property tax exemption? Your taxes may have been frozen at age 65. You also have the benefit of the homestead exemption. You continue to have the property tax exemption for your homestead and to have your property taxes frozen at the age 65 level during the term of the QPRT. After the QPRT terminates you lose this benefit. However, if you only transfer a portion of your home to the QPRT, then the property tax exemptions are retained even after the term of the QPRT.

What about the exemption from capital gains tax for the sale of a home? Again, the exemption is retained for the term of the QPRT. The exemption is also retained for any portion of the home which you do not transfer to the QPRT.

Increasing the Benefit of a QPRT

You can increase the benefit of the QPRT in a couple of different ways.

First, transfer only a fraction of your house to the QPRT. If the QPRT is beneficial, it seems that transferring only part of your

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house would be less beneficial, not more beneficial. The reason transferring part of your house is more beneficial is that an undivided interest in real estate is not valued at a proportionate amount of the entire value. The IRS admits that the value is reduced a small amount. However, they generally take the position that the reduction in value is in the 5% to 15% range. However, the cases which have been decided by the courts on the reduction in value due to an undivided interest generally hold that the reduction in value is from 20% to 25%. Some cases have held that the reduction is between 30% to 44%.

Let's look at how this works in our \$500,000 home example. If you keep the house and do not transfer it to a QPRT,

you will have a \$500,000 asset in your estate. If you transfer your home to a 10 year QPRT, you are taxed on \$228,000. Now let's assume that you transfer 1/2 of your

You can increase the benefit of the QPRT...transfer only part of your house to the QPRT....have the QPRT continue as a "grantor trust" after the initial term of the QPRT.

home to the QPRT. Using a 20% discount, a one-half interest in your home will be valued at \$200,000. The remainder interest in property valued at \$200,000, is \$91,200. You still own a one-half interest which is also valued at \$200,000. You have reduced your estate to \$291,200 while still retaining one-half of the house. What if you transfer the remaining one-half of your house to another QPRT in a couple of years, you will further reduce the value of your estate.

Second, have the QPRT continue as a "grantor trust" after the initial term of the

If the psychological hurdles can be mounted, the tax benefits are worth it. Evidently a little too beneficial for the IRS.

QPRT. A grantor trust is a trust on which you are taxed on all of the income. The trust still provides that your children are the beneficiaries. The benefit of the trust being a "grantor trust" for income tax purposes is that the payment of rent to the trust will not be taxable. You cannot be taxed on income paid to yourself. The result is that the income is not taxed to

you nor is it taxed to your children. No income tax, no transfer tax. Not bad.

If the gift is covered by your \$1 million exemption, there is no loss of the use of the money which would have been used to pay the gift tax. For persons with larger

The exemption from capital gains tax for the sale of a home? Retained for the term of the QPRT.

estates who have used their \$1 million exemption for other gifts, the QPRT is most beneficial with a short term trust which continues as a grantor trust after the term to which rent can be paid.

If the psychological hurdles can be mounted, the tax benefits are worth it. Evidently a little too beneficial for the IRS. The IRS has requested in Clinton's 1998 budget proposal that the use of QPRTs be eliminated.