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Qualified Personal Residence Trust (QPRT)

Overview

A Qualified Personal Residence Trust (QPRT) can allow a homeowner to transfer a residence to other family members at a reduced gift tax cost while retaining the right to use the residence for a term of years. At the end of the period, the residence is removed from the grantor's estate. However, if the grantor dies during the term of the trust, the entire value of the residence will be included in the grantor's taxable estate. QPRTs are valuable estate planning tools for homeowners, especially if a home has significantly appreciated in value, or if the personal residence or vacation home is of substantial value.

Description & Operation

To create a QPRT, a grantor transfers a residence to an irrevocable trust established for the benefit of family members or others. The grantor retains the right to use the residence for a specified number of years. Because the grantor has a retained interest, the taxable gift to the trust is reduced from its fair market value. The taxable gift is the value of the remainder interest passing to the beneficiaries, which is calculated utilizing the actuarial tables issued by the IRS ("Section 7520 Rate"). Generally, when the §7520 Rate is lower, the gift tax value is higher. The value of the gift depends on the length of the term, the existence of a contingent reversion (discussed below), and the §7520 Rate (issued monthly). At the end of the term, the property can remain in trust or can pass to the trust beneficiaries.

Choosing the Residence

A QPRT may only hold one personal residence. The residence can be the grantor's principal residence, another personal residence or vacation home, or a fractional interest in either one. A grantor can only have two active QPRTs at a time: one for the grantor's principal residence and one for a vacation home. The principal use of the building must be as a personal residence to the grantor. If the primary use shifts to another purpose (such as a business), the trust ceases to be a QPRT. If the residence is not the donor's principal residence, there are requirements as to the number of days a year the donor must personally use the home. A married couple may have up to three QPRTs: one for the personal residence and each spouse's separately owned vacation home.

A "personal residence" may include appurtenant structures used by the grantor for residential purposes (such as a guest house) and adjacent land to the extent reasonable. It does not include household furnishings or other personal property. Under certain circumstances, a houseboat or "trailer home" may qualify as a personal residence.

Mortgaged Residence

Although the IRS allows a QPRT to own a residence that is subject to a mortgage, any subsequent mortgage principal payments by the donor constitute additional gifts to the trust. The rationale is that such payments reduce the debt and increase the equity in the property held in trust.

If monthly payments of principal and interest are made, the gift tax value for each payment must be calculated using the applicable §7520 Rate, the grantor's age, and the remaining term of the QPRT. The gifts would reduce the grantor's lifetime gift tax exemption. Because transfers to QPRTs represent future interest gifts, the annual gift tax exclusion would not be available. A gift tax return must be filed each year.

To avoid this complex reporting, generally the best solution is to pay off the mortgage before making the gift to the QPRT. If this is not viable, the mortgage could be restructured as an interest-only mortgage during the QPRT term with a balloon payment of principal due at the end of the period. Interest payments are not considered additional gifts to the trust because they do not increase the equity in the property. Additionally, mortgage interest is considered a current expense, and the donor, as the trust's income beneficiary, is responsible for current expenses.

If the interest-only mortgage option also is not feasible, the trust instrument could provide that any mortgage principal payments made by the donor will be considered interest-free loans to the trust, repayable at the end of the QPRT term. However, the parties must determine how the trust or remainder beneficiaries will repay the donor. The donor could choose to forgive the loan at the expiration of the term, but this would be considered an additional taxable gift to the remainder beneficiaries. A concern with this approach is that if the donor agrees to forgive the debt in advance, the loan would not be bona fide and the payments would be considered additional gifts to the trust, as discussed above.

Additionally, the mortgage may contain a "due-on-sale" clause, which could accelerate the note due in full upon transfer of the residence to the QPRT. However, 12 U.S.C. §1701j-3(d) prohibits mortgage lenders from enforcing due-on-sale clauses for certain intra-family and trust transfers of residences.

Termination

If the trust sells the residence, the trust has two years to acquire a substitute residence. Likewise, if damage or destruction occurs which causes the property to cease to be used as a personal residence, repair or replacement must occur within two years. If the trust does not acquire a new residence or if the grantor ceases to use the home as a personal residence, the trust must return the assets to the grantor or convert into a Grantor Retained Annuity Trust (GRAT). Under a GRAT, the grantor would receive an annuity amount for the remainder of the original QPRT term.

Contingent Reversion

A QPRT normally includes a "contingent reversion" clause. This clause requires that the residence revert to the grantor's estate if the grantor dies during the term. The value of the gift is reduced because the beneficiaries' interest depends on the grantor surviving the term.

Grantor's Ability to Use Residence after QPRT Term

At the end of the specified term, the grantor's right to live in the residence ends. However, there are several ways the grantor can remain in the home. First, the grantor can lease the home from the trust for its fair market rent. A second option, for a married grantor, is to make the remainder beneficiary a trust of which the grantor's spouse is a beneficiary. The trustee can give the spouse the right to use the home rent free. As long as the spouse lives and the couple remain married, the spouse also could allow the grantor to live in the home. The IRS appears to have foreclosed a third potential option: the grantor's purchase of the home from the trust. IRS regulations require that the QPRT instrument forbid the trustee from directly or indirectly selling the residence to the grantor, the grantor's spouse, or any entity controlled by the grantor or the grantor's spouse.

Other Assets in a QPRT

A QPRT is strictly limited on the types of assets it can hold. A QPRT can only retain sufficient cash to cover: (1) trust expenses already incurred or expected within six months; (2) improvements to the residence the trust expects to make within six months; (3) the purchase of the initial residence within three months of the creation of the trust (but only if the trustee has already entered a contract to purchase the residence); and (4) the purchase of a replacement residence (where the previous residence is sold and the replacement will be acquired within two years).

The trustee must distribute any excess cash to the grantor at least quarterly. The trust also can hold improvements to the residence, proceeds from the sale of the residence, and insurance policies on the residence. A separate irrevocable life insurance trust may be established to provide liquidity to pay expenses of the property long term.

Advanced Planning With a Residence

There are several variations of the QPRT and other advanced techniques that a homeowner can use to transfer a residence at low or zero gift tax cost.

A grantor can transfer a fractional interest in a residence to a QPRT, which potentially may allow a grantor to transfer fractional interests in the same residence to multiple QPRTs. The transfer of a fractional interest may qualify for a valuation discount because of the difficulties of joint ownership of real estate.

Another variation of the QPRT is the split-purchase QPRT. A split-purchase QPRT allows two or more people to jointly purchase a home through a QPRT. If a homeowner owns an existing residence, the owner would transfer the residence to the QPRT and the remainder beneficiaries would pay the owner the actuarial value of the remainder interest. Capital gain would be recognized to the extent the amount contributed by the remainder beneficiaries exceeds the owner’s basis. Alternatively, the grantor and the remainder beneficiaries could jointly acquire a new residence. The grantor would contribute cash equal to the actuarial value of the term interest to the QPRT, and the remainder beneficiaries would contribute cash equal to the actuarial value of the remainder interest. Per IRS regulations, the trustee would use the cash to purchase the residence within three months of creation of the trust. The creation and funding of the split-purchase QPRT would not result in a taxable gift since the remainder beneficiaries pay fair market value for their remainder interest.

Instead of a QPRT, a homeowner also can transfer property by selling the residence for its fair market value to a trust in exchange for a promissory note. The trust's note would bear interest at the applicable federal rate (AFR) to avoid a deemed taxable gift. The grantor trust status of the trust would allow the grantor to avoid recognizing taxable gain on the sale. The trust could then lease the residence back to the grantor for fair market rent. Since the trust would pay fair market value, there would theoretically be no taxable gift. If

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the grantor dies while the note is outstanding, only the value of the note would be included in the grantor's estate. Any appreciation in the value of the residence may escape inclusion. In order to avoid an IRS attempt to re-characterize the transaction as a gift with a retained interest, the parties should be careful to avoid having the note and lease payments cancel each other out.

Tax Ramifications

Homestead Exemption & Property Tax Considerations

Professional advisors should be consulted to determine whether local homestead and property tax exemptions may be lost if the residence is transferred to a QPRT.

Income Tax Considerations

The QPRT must distribute any income to the grantor at least annually and cannot make distributions of principal or income to anyone other than the grantor during the trust term, making the QPRT a grantor trust for income tax purposes. After the expiration of the initial term, the trust may remain a grantor trust (if the grantor or a third person has certain powers over the trust) or become a separate entity for tax purposes.

Gift Tax Considerations

Because the residence transferred is not a present interest gift, the transfer is subject to gift taxes. The actuarial value of the grantor's retained interest reduces the gift tax value of the residence. The longer the term, the lower the gift tax value. However, the remainder interest may be "zeroed out" at the time the QPRT is established, resulting in little or no gift tax liability upon funding. This means the transferred interest will be worth the entire value of the property.

Even if the residence is owned by one spouse, a married couple may elect to split gifts for a particular year, so that all gifts will be treated as being made one-half by each spouse. However, if the grantor dies during the term of the QPRT (causing inclusion of the residence in the grantor's estate, as discussed below), the survivor cannot recover any unified credit used to offset the gift. For this reason, a couple may not want to split gifts in a year in which one of them creates a QPRT. An alternative might be to divide the ownership of the residence into two shares and have each spouse create a separate QPRT. As discussed above, transferring a fractional interest may create the additional advantage of a valuation discount for the interest transferred to each QPRT.

Estate Tax Considerations

At the end of the trust term, the residence would be removed from the grantor's taxable estate. If the grantor dies during the trust term, the value of the trust assets will be included in the grantor's taxable estate. However, the grantor's estate would recoup any lifetime gift tax exemption amount allocated to the trust. As such, transfer taxes would be no higher had the arrangement never been entered into.

GST Tax Considerations

A drawback of QPRTs is that effective generation skipping transfer (GST) tax planning is prevented under the Estate Tax Inclusion Period (ETIP) rules. ETIP rules prevent allocation of the GST exemption until the end of the trust term. At the end of the period, the GST exemption may be allocated to the transfer, but at its then-current value. However, by this time, property appreciation may have precluded the effective use of the exemption.

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