QUALIFIED PERSONAL RESIDENCE TRUSTS (QPRTs)

DEFINITION

A Qualified Personal Residence Trust (QPRT) is an irrevocable trust for estate planning utilized by individuals and families to help reduce the size of an estate. It is designed to hold one's primary or secondary residence and remove its value from his or her taxable estate. Once a residence is transferred into a QPRT, the grantor retains an interest in the property, and then the difference in value between the two is subject to gift taxes. The value of the retained interest and the future growth in value of the property are subsequently removed from the grantor's estate.

HOW THEY WORK

SETUP

A Qualified Personal Residence Trust should be created with the help of an estate planning attorney. Once the appropriate documents have been drafted, either a primary or secondary residence is transferred into the name of the QPRT. This is done by recording a new deed with the county to the name of the trust and it is important to obtain a professional appraisal of the residence in order to avoid IRS scrutiny of the value. The grantor can name the trustee they would like to administer the trust, but once the residence is placed inside the QPRT, the grantor is not allowed to change the terms of the trust or remove the property. They can, however, select and change who the beneficiaries will be, and the terms under which they will receive the residence.

TRUSTEE

The grantor of a QPRT can act as trustee for their trust. However, they should only serve as trustee during the retained interest term. After this, a relative or other third party should be designated as trustee to managed and distribute trust assets as stipulated by the trust documents.

RETAINED INTEREST

When a grantor transfers a residence to a QPRT, it is considered a gift to the trust's beneficiaries. This gift does not qualify for the annual gift tax exclusion since the transfer is not a gift of a present interest. To reduce this gift tax exposure, the fair market value of the residence is discounted by the value of a "retained interest." With this interest, the grantor retains the exclusive use (rent-free), possession and enjoyment of the residence during the term of the QPRT. The grantor pays any ordinary and recurring expenses such as real estate taxes, insurance and minor repairs.

IRC SECTION 7520

The value of the retained interest described above is reliant upon the Internal Revenue Code Section 7520 as this values the retained interest using the term of the trust, the life expectancy of the grantor, and the federal interest rate in effect for the month of the transfer. The federal interest rate is one of the main factors in valuing the gift of a residence; the higher the federal interest rate, the higher the value of the retained interest and, subsequently, the lower the potential gift tax. The longer the term of the trust and life expectancy of the grantor is, the lower the value of the remainder interest passing to the beneficiaries and estate tax liability.

TAX SAVINGS

The main purpose of a QPRT is estate tax savings. Although the value of the residence will be subject to the unified gift and estate tax upon death, it will have been reduced by the value of the retained interest. In addition, any growth in value of the residence between the times of transfer and death will have escaped estate taxation. For example, if a residence valued at $1,000,000 is transferred to a QPRT, with a retained interest of $400,000 to the grantor, only $600,000 will be subject to the unified gift and estate tax. If the term of the trust is 10 years, and the value of the residence can be assumed to grow at 5% on average annually, the value of the residence will be over $1,600,000 at the end of the trust term. As a comparison, a residence that was not transferred to a QPRT would have contributed over $1,600,000 to a potential estate tax liability.

TRUST TERM

To be an effective estate planning tool, the grantor must outlive the term of the trust. If the grantor dies before the trust term expires, the QPRT's full date-of-death value will be included in the grantor's estate and will be subject to estate taxes. However, the grantor's estate will receive full credit for any tax consequences of the initial gift to the QPRT, resulting in the grantor being no worse off than if he or she had not created the QPRT. If the grantor outlives the term of the trust, the residence passes to the beneficiaries at the end of the term. The grantor can then lease the residence back from the beneficiaries at fair market rent, allowing the grantor to continue living in the house.