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Tax Bulletin:
Effectively Using a QPRT Strategy in Your Estate Plan

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Estate planning is an area of wealth management that focuses on the accumulation, management, preservation, and eventual transfer of an individual's assets in a manner that minimizes transfer taxes and transaction costs while simultaneously adhering to the individual's personal wishes. It can be a complex minefield replete with confusing subjects and difficult conversations. Many individuals avoid planning for their inevitable death because they find the subject matter of their own mortality too morbid. However, if they can overcome the emotional and practical challenges of estate planning, there are various tools that can be employed to facilitate an effective and efficient transfer of wealth to future generations. One such tool, the Qualified Personal Residence Trust ("QPRT"), allows an individual to remove a large portion of his assets, a personal home, from his gross estate prior to his death. This article discusses the fundamentals of a QPRT: what it is, how it works, its benefits and limitations, and how it can be used to lower your estate and gift tax liability.

What is a QPRT?

A QPRT is an estate planning device used to transfer residential property to the next generation at a reduced gift tax cost. It is an irrevocable trust established by the donor to hold a principal residence or vacation home with the goal of transferring the home in the future to the trust's beneficiaries at a discount from the home's current fair market value. If executed properly, the QPRT could yield significant estate and gift tax savings.

How does a QPRT work?

The donor transfers ownership of a personal residence or vacation home (not rental property) to a QPRT for a term of years (the "QPRT term") as stipulated in the trust agreement. The donor retains the right to occupy the residence for the QPRT term rent-free. At the end of the QPRT term, assuming the donor survives it, the QPRT terminates and ownership of the home transfers to the beneficiaries of the trust, either outright or in continuing trust. If the donor wants to continue to live in the home, then the donor will need to pay fair market rent.

The transfer of the residence to a QPRT constitutes a taxable gift based on the home's fair market value at the date of transfer less the donor's retained interest, i.e., the present value of the donor's right to use the home rent-free for the QPRT term. Consequently, the taxable gift is the present value that transfers to the remainder beneficiaries (remainder interest) computed at the date the residence is transferred to the QPRT. The taxable gift is reported on a gift tax return (IRS Form 709).

During the QPRT term, the donor pays the ordinary and recurring expenses of owning a home, such as real estate taxes, insurance, and maintenance. These types of expenses would not be considered gifts to the QPRT because they are personal obligations of the donor. Additionally, a QPRT is a grantor trust for income tax purposes, meaning the donor reports all income and deductions of the QPRT on his individual income tax return. Thus, the donor can deduct the

real estate taxes paid on his income tax return. However, any capital improvements paid by the donor would be treated as additional taxable gifts to the trust. The value of the taxable gift is the cost of the improvement discounted by the amount of the donor's retained interest for the remainder of the QPRT term using the discount rate in effect at the time of the capital improvement.

What are the benefits of utilizing a QPRT in your estate plan?

- The QPRT is an estate freeze device in that it "freezes" the value of the residence for transfer tax purposes at the date the property is transferred to the QPRT, meaning the value of the residence is the amount of the taxable gift to the QPRT (home value less retained interest). Since this is an irrevocable gift, the property and any future appreciation from the date of the gift, will not be included in the donor's estate, assuming the donor survives the QPRT term.
- If the donor rents the home after the QPRT term expires, then a benefit to a lease arrangement is that each rental payment allows the donor to transfer additional wealth from his estate to the beneficiaries of the QPRT (usually the donor's children) on a gift-tax free basis, i.e., the monthly rental payments are not subject to gift tax as long as they are valued at fair market rent. Of course, this could also be viewed by the donor as a detriment since the donor will now have to pay fair market rent for use of the residence.
- From an income tax perspective, a QPRT is an irrevocable trust that is disregarded for income tax purposes and is generally considered a grantor trust. This type of trust requires all items of income, gain, loss, deduction, and credits to be reported on the donor's individual income tax return. Because the QPRT is a grantor trust that usually does not generate any income, it may not be required to file a separate trust income tax return (IRS Form 1041). This can reduce compliance costs and other administrative burdens. If the grantor is not also a trustee (or co-trustee), then the trustee would need to issue a tax information letter to the grantor, so that the grantor can report taxable items on his income tax return.
- If the donor's principal residence is transferred to a QPRT and the home is later sold during the trust's term at a gain, then such capital gain may qualify for exclusion up to $250,000 for single filers or $500,000 for joint filers, as long as other tax code requirements for gain exclusion are satisfied.
- One home can be transferred to multiple QPRTs thereby securing an additional discount related to the transfer of fractional interests. For example, husband and wife can create two QPRTs and transfer their undivided 50% fractional interests into each of their respective trusts. Another example, an individual could create multiple QPRTs with varying terms of years and transfer a fractional interest into each trust. This strategy could be used to minimize the risk of the donor not surviving the duration of one long-term QPRT.

What are some limitations of a QPRT strategy?

- QPRTs are only successful if the donor survives the trust term. If the donor dies during the trust term, the QPRT is terminated and the date of death value of the property is included in the donor's gross estate. Therefore, a donor should be in good health and should choose a realistic trust term for the QPRT to be an effective wealth transfer vehicle.
- QPRT beneficiaries are usually the donor's children. This strategy is not typically used to transfer a residence to grandchildren because of how the generation skipping transfer ("GST") tax exemption is allocated. Thus, QPRTs may not be an effective tool to leverage the GST exemption.
- If the donor survives the QPRT term, the trust terminates and the residence transfers to the beneficiaries. This

means that the donor relinquishes his right to occupy the home once the QPRT terminates. Thus, careful consideration should be given to the donor's use of the residence after the expiration of the QPRT. If the donor wants to continue to use the residence, the donor must lease it at a fair market rent from the beneficiaries who are now the owners of the residence. If the donor does not lease the home at a fair market rent, then the value of the home at the donor's date of death would be included in his gross estate under the principle that the donor retained an interest in the property subsequent to the expiration of the trust. This would defeat the purpose of the QPRT strategy.

- A QPRT residence can be subject to a mortgage. However, if the donor transfers a residence subject to a mortgage to a QPRT, the gift to the remainder beneficiaries only includes the equity of the home less the donor's retained interest. Consequently, any mortgage payments consisting of principal made on the property after the transfer would be deemed additional taxable gifts to the QPRT, which would severely curtail the estate planning benefits of the trust. The gifts would also be subject to gift tax, creating additional tax filing requirements (after the gift tax return reporting the initial transfer) that otherwise would not exist, and the calculation of the gift amount would be complex due, in part, to the number of principal payments made on a typical mortgage loan. Furthermore, the transfer of a home subject to a mortgage could activate a clause in the loan agreement that makes the mortgage due immediately, unless you receive the lender's consent prior to the transfer to the trust. Hence, for the QPRT to be most effective, the donor should consider paying off the mortgage or refinancing it to an interest only mortgage for the term of the QPRT, prior to transferring the residence into the trust.
- A QPRT can only be funded with a personal residence (principal residence or other residence). It cannot be funded with an interest in an entity like an LLC, partnership, or corporation, that holds a residence.

When should a QPRT device be implemented?

Although the perfect time to implement a QPRT technique is difficult to determine, careful consideration should be placed on the following factors:

- The age, health, and wealth of the donor:

◊ *Age* - The older the donor is, the more appealing the QPRT technique becomes because of how the taxable gift is computed. This is because the probability of survival decreases the older the donor becomes, which translates into a greater retained reversionary interest and a lower gift tax value.

◊ *Health* - If the donor is in good health, the odds of his surviving the QPRT term increases. Remember, the donor needs to survive the QPRT term in order for the technique to be successful. If the donor does not, then the value of the property is brought back into the donor's gross estate.

◊ *Wealth* - Will the donor's estate exceed the estate tax exclusion? A QPRT is meaningless if the donor's estate is not large enough to be subject to federal estate tax. Indeed, in the case where a donor would not be subject to federal estate tax, a QPRT could be tax detrimental from an income tax perspective, since the residence would not pass through the estate and receive a step up in basis for capital gain purposes. The beneficiaries of a QPRT receive a carryover basis (donor's basis), which could result in higher capital gains when the residence is later sold.

- What is the value of the residence in proportion to the donor's total assets? If the donor's personal residence is a large portion of his estate, then he may need to sell the property for his retirement. Always consider other sources of capital that may be needed during the donor's life before executing a QPRT.
- The objective of the QPRT is to reduce transfer taxes for

the donor's family. It is designed to transfer wealth efficiently to the donor's children, and thus, may not be an appropriate wealth transfer tool for clients with no progeny.

Other Considerations:

- A QPRT is limited to holding a personal residence and cash to pay for up to six months of property expenses.
- A QPRT is more propitious in a high interest rate environment, but can also work with low interest rates, especially when property values are temporarily depressed. This is because the 7520 rate (named after the Internal Revenue Code section that requires this rate for valuing partial interests in property for estate and gift tax purposes) is integral to the calculation of the taxable gift. The higher the 7520 rate, the higher the retained interest (donor's use of residence during the QPRT term), and the lower the gift value that is subject to gift tax. Conversely, the lower the 7520 rate, the lower the retained interest, and the higher the gift amount resulting in higher transfer taxes.
- Another concern arises when the home is intended to be sold by the beneficiaries following the trust term. By utilizing a QPRT, the donor is passing ownership of the residence to the beneficiaries at the donor's adjusted basis (i.e., the price the donor paid to acquire the home, plus the cost of any capital improvements made to the home prior to the transfer to the QPRT). If the fair market value of the residence increased significantly over its adjusted basis, the beneficiaries could have a considerable income tax liability if the property were eventually sold. Therefore, an analysis needs to be conducted with respect to the potential estate tax savings from utilizing a QPRT against the income tax savings received had the home passed through the donor's estate. If the residence transferred at death via the donor's estate to the beneficiaries, rather than transferred through a QPRT, the beneficiaries would receive the property with an adjusted basis equaled to the fair market value of the home at the donor's date of death (basis step-up). This could potentially reduce or eliminate a large capital gains tax liability on any subsequent sale by the beneficiaries.
- If the property ceases to be used or held for use as a personal residence, the QPRT terminates and the trustee must either distribute the assets to the donor (thereby losing the tax benefits of a QPRT) or convert them to a qualified annuity interest, such as a grantor retained annuity trust ("GRAT") that will pay an annuity to the donor for the remainder of the QPRT term. If the residence is sold during the QPRT term, the trustee can reinvest the sales proceeds within two years of the sale in a replacement residence that meets the same QPRT requirements, or as previously mentioned, can distribute the proceeds to the donor, or convert the QPRT to a GRAT.
- The transfer (gift) of the home to the QPRT does not qualify for the annual gift tax exclusion, currently $14,000, since it is not a transfer of a present interest. The beneficiaries have no rights to the property in the trust until the QPRT terminates.
- Consider the impact of multiple beneficiaries who may have different objectives with respect to the residence once the QPRT terminates and the residence transfers to the beneficiaries.
- A donor cannot have QPRTs operating concurrently on more than two residences (principal residence and other residence). Note that trusts holding fractional interests in the same residence are treated as one trust.
- The trust instrument must prohibit the trust from selling the residence to the donor, the donor's spouse, or an entity controlled by either of them.
- Consider purchasing term life insurance in an Irrevocable Life Insurance Trust ("ILIT") on the donor's life for the same term as the QPRT as a hedge against his premature death. If the donor dies during the QPRT

	Donor's Age - 60 Years Old	Donor's Age - 60 Years Old
Property Value	$5,000,000	$5,000,000
Section 7520 Rate	**2.40%**	**5.40%**
Term of Trust (with Reversion)	15	15
After-Tax Growth	4.00%	4.00%
Taxable Gift (Present Value of Remainder Interest)	**$2,582,050**	**$1,674,350**
Property Value After 15 Years	$9,004,718	$9,004,718
Potential Estate Tax Savings*	**$3,211,334**	**$3,665,184**

	Donor's Age - 70 Years Old	Donor's Age - 70 Years Old
Property Value	$5,000,000	$5,000,000
Section 7520 Rate	**2.40%**	**5.40%**
Term of Trust (with Reversion)	15	15
After-Tax Growth	4.00%	4.00%
Taxable Gift (Present Value of Remainder Interest)	**$1,614,550**	**$1,047,000**
Property Value After 15 Years	$9,004,718	$9,004,718
Potential Estate Tax Savings*	**$3,695,084**	**$3,978,859**

*Assumes a combined 50% tax rate

term, the value of the QPRT property is included in the donor's gross estate. The proceeds from the term insurance policy, however, can be used to offset the estate tax on the home's value that reverts to the donor's estate.

- If the residence continues in a trust after the QPRT term expires, then consider the type of trust and its tax consequences, i.e., grantor trust versus nongrantor trust.

Illustration:

The above illustrations depict the changes in the amount of the taxable gift based on different 7520 rates and the donor's age at the date of gift. As discussed above, the higher the 7520 rate and the older the donor is at the date of transfer, the lower the taxable gift, and the greater the potential estate and gift tax savings.

In conclusion, QPRTs can be a highly effective planning tool for passing a personal residence to the next generation at a discounted value that can result in significant transfer tax savings. As interest rates rise, the QPRT may become a more attractive estate planning vehicle for the well-heeled individual. Naturally, tax and non-tax implications should be evaluated when deciding on executing a QPRT. If you are interested in learning more about the QPRT strategy and whether it is suitable to your estate plan, please feel free to contact a member of the Chilton Trust tax team to discuss your wealth profile in more detail.

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