




Presented for:

Presented by:



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. However, if the grantor (the original homeowner) dies during the term of the trust, the entire value of the residence is includible in the grantor's taxable estate. There are several other tax issues involved in setting up a QPRT.

MECHANICS OF CREATING AND *Operating* A QPRT

◆ *Structure of a QPRT*

To create a QPRT, a grantor transfers a residence to a 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. At the end of the term, the property can remain in trust or pass to the trust beneficiaries. Upon creation of the QPRT, the taxable gift is the remainder interest passing to the beneficiaries. The gift tax value of the remainder interest is calculated utilizing the actuarial tables issued by the IRS ("7520 Rate"). The amount of the gift depends on the length of the term, the existence of a contingent reversion (discussed below), and the 7520 Rate (issued monthly).



◆ ***Choosing the Residence***


The residence can be the grantor's principal residence, another personal residence of the grantor, 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 another residence. The principal use of the building must be as a personal residence of the grantor. If the residence's primary use shifts to some other 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 "personal residence" for QPRT purposes may include appurtenant structures used by the grantor for residential purposes (such as a guest house) and adjacent land to the extent reasonable. A "personal residence" does not include household furnishings or other personal property.

Generally, a grantor may not wish to transfer encumbered real estate to a QPRT. If the grantor pays the mortgage, each principal payment could be an additional gift to the trust. Also, the transfer of the property could cause the lender to accelerate the note.

◆ ***Effect of Sale of or Failure to Use Residence***

If the trust sells the residence, the trust has two years to acquire a substitute residence. If the trust does not acquire a new residence, the trust must return the trust assets to the grantor or convert into a grantor retained annuity trust (GRAT). If the grantor ceases to use the residence as a personal residence, the trust must return



the trust assets to the grantor or convert to a GRAT. Under the GRAT, the grantor would receive an annuity amount for the remainder of the original QPRT term.

◆ ***Contingent Reversion***

A drafter of a QPRT may wish to include a “contingent reversion” clause. This clause requires the trustee to return the house to the grantor’s estate if the grantor dies during the QPRT term. The clause reduces the value of the gift 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. There are, however, several ways the grantor can remain in the home. First, the grantor can lease the home from the trust for 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 could also 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*

There are strict limits on the type of assets a QPRT can hold. A QPRT can only hold 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 within three months (but only if the trustee has already entered a contract to purchase the residence). The trustee must distribute any excess cash to the grantor at least quarterly. The trust can also hold improvements to the residence, proceeds from the sale of the residence, and insurance policies on the residence.

INCOME TAX *Treatment...*

The QPRT must distribute any income to the grantor at least annually and cannot make distributions of principal or income to anyone but the grantor during the initial term. This makes the QPRT a grantor trust for income tax purposes. In a grantor trust, the grantor is the owner of the trust for income tax purposes. After the expiration of the initial term, the trust can 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 *Treatment...*

Normally, if a grantor retains an interest in a trust established for the benefit of a member or members of the grantor's family, the value of the retained interest will be zero for gift tax purposes. This means that the transferred interest will be worth the entire value of the property. Section 2702 contains an exception where the only property transferred is a personal residence for use by the grantor for a specific term. A QPRT falls under this exception. In a QPRT, 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.

A married couple can elect to split their gifts for a particular year, so that all gifts will be treated as being made one-half by each spouse. One potential drawback of splitting a gift to a QPRT is that if the grantor dies during the term of the QPRT (causing inclusion of the residence in the grantor's estate, as discussed below), the spouse cannot undo the effects of his or her share of the gift. The spouse cannot recover any unified credit he or she used to offset the gift and the gift still counts in calculating the tax rate on the spouse's future gifts and transfers at death. 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 below, transferring a fractional interest may create the additional advantage of a valuation discount for the interest transferred to each QPRT.



ESTATE TAX *Treatment...*

If a grantor dies during the initial term, the value of the trust assets will be includible in the grantor's taxable estate because of the grantor's retained interest in the property. This means the grantor must take care to select a term that the grantor can outlive.

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.

◆ ***Fractional Interest QPRTs***

As mentioned above, a grantor can transfer a fractional interest in a residence to a QPRT. This may allow a grantor to transfer fractional interests in the same residence to multiple QPRTs. The IRS has approved this technique in a private letter ruling. A private letter ruling is not binding on the IRS, but can give some insight into IRS thinking on an issue. The transfer of a fractional interest may qualify for a valuation discount because of the difficulties of joint ownership of real estate.




◆ ***Split-Purchase QPRT***

A relatively recent variant of the QPRT is the split-purchase QPRT. Under this type of scenario, two or more persons jointly purchase a home through a QPRT. The grantor executes a QPRT agreement and contributes cash equal to the actuarial value of the term interest. The remainder beneficiaries contribute cash equal to the actuarial value of the remainder interest. The trustee uses the cash to purchase the residence within three months of the creation of the trust as required by the IRS regulations. The IRS has issued a private letter ruling holding that such a transaction would not result in a taxable gift because the remainder beneficiaries have paid fair market value for their remainder interest.

◆ ***Sale of Residence to Grantor Trust with Leaseback to Grantor***

Another possible way to transfer a residence might be for the grantor of a grantor trust to sell the residence to the trust in exchange for a promissory note. The sale price would be the fair market value of the residence. Under this scenario, 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 the grantor died while the note was outstanding, only the value of the note would apparently be includible in the grantor's estate. Any appreciation in the value of the residence might 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



payments and the lease payments completely wash each other out. A complete discussion of these issues is beyond the scope of this discussion.

THE TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION *Act of 2010...*

The *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act* (“the Act”) was enacted on December 17, 2010. For 2011 and 2012, the Act provides for a \$5 million Federal gift, estate and generation skipping transfer tax exemption amount (indexed for inflation starting in 2012) and a top gift, estate and GST tax rate of 35%. On January 1, 2013, a \$1 million Federal gift, estate and GST exemption amount and a maximum gift, estate and GST tax rate of 55% is scheduled to go into effect. These considerations apply only to the Federal transfer taxes. Any state-level estate or inheritance tax should be evaluated separately.



Conclusion...

A QPRT can be an effective way to transfer a residence at a reduced gift tax cost. There are, however, several requirements and tax issues involved in setting up a QPRT. Anyone considering a QPRT should consult his or her legal and tax advisors regarding the issues and requirements involved.



Grantor

Grantor gifts personal residence or vacation home to a trust at a discounted value.

Grantor retains the right to use the home for a fixed period of time.

The taxable gift is the value of the remainder interest passing to the beneficiaries.

Note: If the grantor dies during the term, the trust assets will be includable in the taxable estate.

Grantor transfers asset



Grantor retains an interest in the property for a term of years



Qualified Personal Residence Trust (QPRT)

Trust receives assets from grantor.

At the expiration of the fixed term, the property may remain in trust or may be distributed to the beneficiaries.


Distribution to beneficiaries



Beneficiaries

The beneficiaries receive the property from the trust, either outright, or according to the terms of the trust document.

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.



This writing is provided for informational purposes only. Neither New York Life Insurance Company, its agents, or its employees are in the business of providing tax, legal or accounting advice, and none is intended nor should be inferred from the foregoing comments and observations. Clients should be advised to seek the counsel of their own tax, accounting and legal advisors who must form their own independent opinions on these matters based upon their independent knowledge and research.

This material includes a discussion of one or more tax-related topics. This tax-related discussion was prepared to assist in the promotion or marketing of the transactions or matters addressed in this material. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (“the Act”) was enacted on December 17, 2010. For 2011 and 2012, the Act provides for a \$5 million Federal gift, estate and generation skipping transfer tax exemption amount (indexed for inflation starting in 2012) and a top gift, estate and GST tax rate of 35%. On January 1, 2013, a \$1 million Federal gift, estate and GST exemption amount and a maximum gift, estate and GST tax rate of 55% is scheduled to go into effect. These considerations apply only to the Federal transfer taxes. Any state-level estate or inheritance tax should be evaluated separately. 436354 12/31/2011