

The Qualified Personal Residence Trust

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For many individuals, their residence is the single most valuable asset they own. By putting his residence into a qualified personal residence trust ("QPRT") during his life, an individual can transfer the residence to his children at a significantly lower transfer tax cost than he would incur if he left the residence to them in his will.

A QPRT (sometimes called a "residence GRIT") is specifically authorized by the Internal Revenue Service Section 2702 of the Code. Close attention to the requirements of the IRS regs for that section of the Code is essential in planning to use a QPRT.

Let me describe how a QPRT can reduce the gift and estate tax costs of transferring a personal residence to family members. I will discuss the non-tax considerations which should be addressed in deciding whether to create a QPRT.

How a QPRT can reduce transfer tax costs:

An individual (grantor) creates a QPRT by transferring his personal residence to a trust and retaining the right to use the residence without the payment of rent for a specified period of time.

At the end of that period, the residence either passes outright to beneficiaries designated by the grantor (usually members of his family) or continues in trust for their benefit. The grantor may continue to occupy the residence after his retained interest terminates, but if he does so he must pay fair market value rent.

When the grantor transfers his residence to the trust, he is treated as having made a gift to the family members who will receive the residence when his retained interest terminates. The value of the gift is the fair market value of the residence, reduced by the present value of the grantor's retained interest (the right to live in the residence rent free for the specified period of time). The present value of the retained interest is determined by using the IRS valuation tables and the Code Sec. 7520 interest rate for the month of the transfer.

This method of valuation is advantageous to the grantor because the value of his retained interest, determined under Code Secs. 7520, will usually be greater than the rental value of the residence based on market conditions. The result is an unrealistically high discount for gift tax purposes--but one that IRS can't challenge, because use of the IRS valuation tables is mandated by Code Secs. 7520.

When the grantor's retained interest terminates, the residence passes to the family members free of additional gift tax, even if it has appreciated in value

since the trust was created. Thus, use of a QPRT "freezes" the value of the residence at its market value when the trust is created. This means that the transfer tax savings that can be achieved with a QPRT are especially high if the trust is created at a time when real estate market values are low.

If the grantor is still living when his retained interest terminates, the residence won't be includible in his gross estate for estate tax purposes (unless he continues to live in the residence without paying fair market value rent). If the grantor dies during the term of his retained interest, the residence will be includible in his gross estate under the retained life estate rule. But he won't be any worse off than he would have been if he hadn't created the trust in the first place.

As previously stated, for a QPRT to work, the grantor has to survive the term of his retained interest. But if he does, that means that ownership of his residence will pass to the remaindermen of the trust (usually the grantor's children) while he's still alive, and he will have to pay rent to them if he wants to continue to occupy the residence. If he continues to occupy the residence without paying fair market value rent, the residence will be includible in his gross estate and the transfer tax savings potential of the QPRT will be lost.

Many people feel uncomfortable about the prospect of living in a residence owned by--and paying rent to--their children. For some people, the potential tax savings offered by a QPRT will outweigh the anxiety they feel about giving up ownership of their residence to their children. But others will be willing to forego the tax savings for the sake of continuing to own their own home until they die.

The decision is such a personal one that it should be made by you alone, with no pressure in either direction from the planner. The planner's job is to provide you with all the information you need to make a fully informed decision. To that end, make sure you are aware of the following points:

1. A vacation home can qualify as a personal residence for purposes of the QPRT rules. If you aren't willing to put your primary residence into a QPRT, you may be willing to do so with your vacation home, because anxieties about children owning the residence may not be as strong where a vacation home is concerned.
2. If you plan to move out of your residence at some foreseeable time in the future, a QPRT can be set up so that your retained interest terminates at the time you intend to move. For example, if a 55-year-old client who lives in Colorado and plan to retire at age 65 and move to Arizona, you could put your Colorado residence in a QPRT and retain the right to live in the residence rent free for ten years. When your retained right terminates, the Colorado residence will pass to the children, but since you will be living in Arizona by that time, you need not be concerned about living in a residence owned by your children.