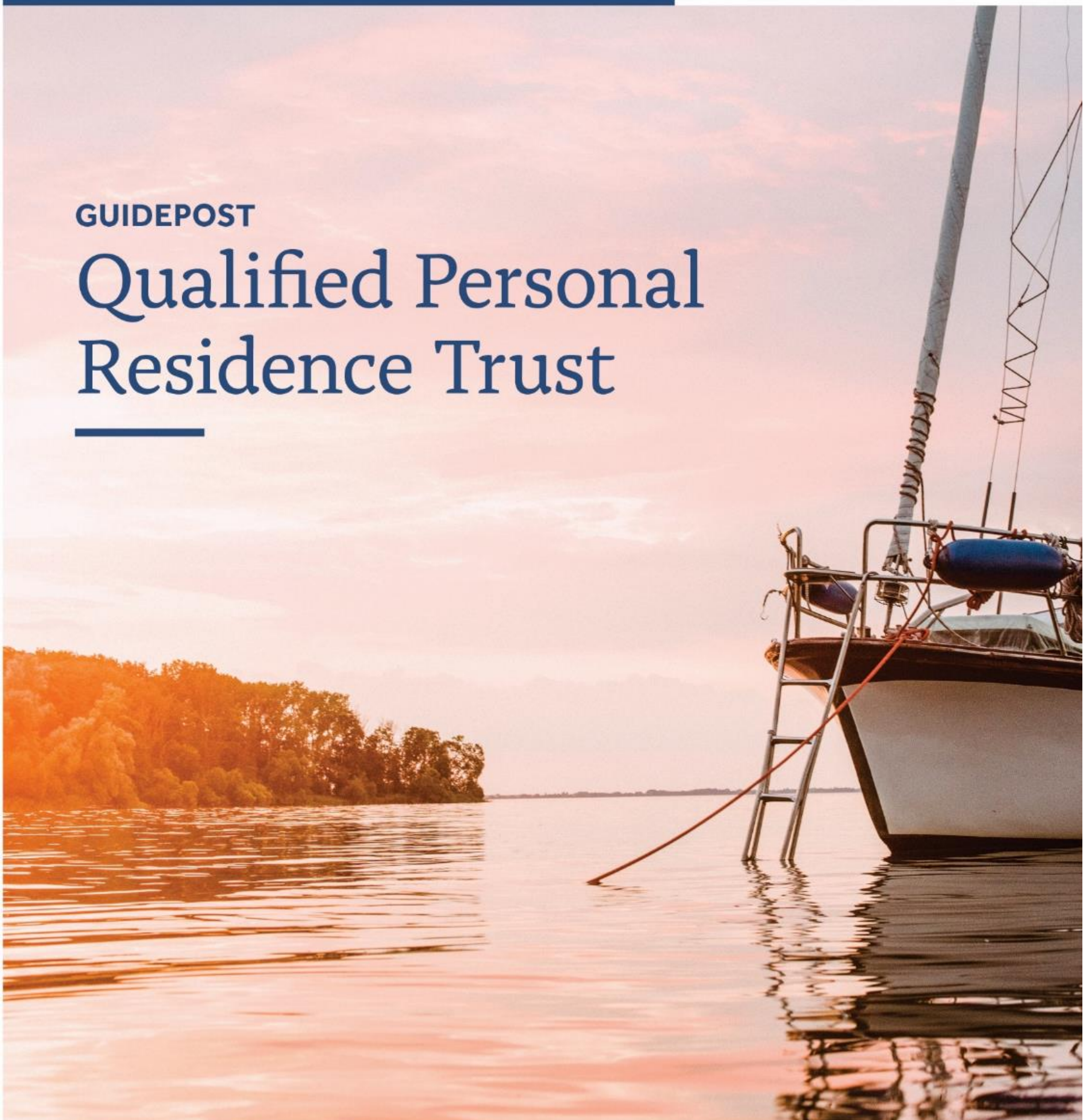
Wealth Coach of Kentucky
dba Larry E. Botts & Associates

GUIDEPOST

Qualified Personal Residence Trust

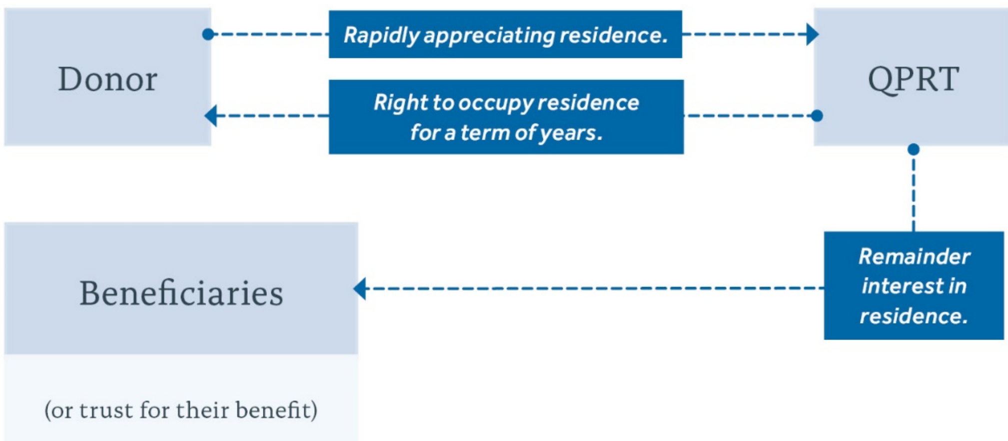


Qualified Personal Residence Trust

A qualified personal residence trust (QPRT) can allow a homeowner (the donor) to transfer a residence (or a vacation home) to his/her children or other beneficiaries at a reduced gift tax cost while retaining the right to occupy the residence for a term of years. At the end of that term, the residence is removed from the donor's estate. If used with a highly appreciating residence, a QPRT can provide significant estate tax savings.

Implementing a QPRT

To implement a QPRT, a donor transfers a qualifying residence to an irrevocable trust established for the benefit of his/her beneficiaries. The donor retains the right to occupy the residence for a specified number of years (the QPRT term). At the end of the QPRT term, the residence either remains in trust for the donor's beneficiaries or is distributed outright to the donor's beneficiaries.



The value of the beneficiaries' remainder interest in the residence is a taxable gift upon QPRT funding. In the event the donor dies during the QPRT term, the residence will be included in his/her taxable estate.

QPRT Requirements

To provide a benefit to the donor, a QPRT must be structured so that the value of the donor's right to occupy the residence for the QPRT term can be subtracted from the value of trust assets in calculating the value of the gift upon formation. To do so, the irrevocable trust must be designed to comply with the QPRT requirements as set out in Treasury Regulation §25.2702-5.

- The trust can hold only one "personal residence" (a residence that is not occupied by anyone other than the donor [and his/her spouse or dependents] and is available for use as a personal residence to the donor).
- In addition to one residence, the trust also can hold insurance on the residence as well as 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 into 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 trust should provide that cash in excess of needs for expenses will be distributed to the donor.
- Distributions of trust principal can only be made to the donor during the QPRT term.
- Income must be distributed to the donor annually.

- The term interest cannot be commuted.

Though a QPRT can only own one residence, one donor can have a QPRT term interest in two QPRTs. This allows a donor to utilize a QPRT as an asset shifting technique for one residence and a vacation property. Thus, a married couple may have up to three QPRTs: one for the personal residence and each spouse's separately owned vacation home. Also, a donor can transfer a fractional interest in a residence to a QPRT. The transfer of a fractional interest may (1) qualify for a valuation discount because of the difficulties of joint ownership of real estate, and (2) mitigate the potential for estate inclusion as a result of death during the QPRT term if fractional interests are transferred to multiple trusts, each with varying QPRT terms.

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. If monthly payments of principal and interest are made, the gift tax value for each payment must be calculated using the rate as established in Internal Revenue Code (IRC) §7520, the donor's age, and the remaining term of the QPRT.

To avoid this complex reporting, generally the best solution is to pay off any mortgage before transferring the residence to a 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, but any balloon payment made during the QPRT term would be considered an additional gift.

If the interest-only mortgage option 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 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.

Additionally, a mortgage may contain a "due-on-sale" clause, which could accelerate the note due in full upon transfer of the residence to the QPRT.

Termination

If the residence ceases to be the donor's personal residence, if the residence is sold and proceeds are not used to replace it within two years of the sale, or if damage or destruction causes the residence to cease to be used as a personal residence for more than two years, then the trust no longer will be considered a QPRT and the assets must then be distributed to the donor or the trust must be converted to a grantor retained annuity trust (GRAT). Under a GRAT, the donor would receive an annuity amount for the remainder of the original QPRT term.

Contingent Reversion

If the donor dies during the QPRT term, the date of death value of the residence will be included in his/her estate. Accordingly, a QPRT generally includes a "contingent reversion" clause which provides that upon the donor's death during the QPRT term the residence will be distributed to the donor's estate. This will allow him/her to transfer the residence to his/her spouse and utilize the unlimited marital deduction.

Donor's Ability to Use Residence after QPRT Term

At the end of the specified term, the donor's right to occupy the residence ends. However, there are several ways the donor can continue to occupy the residence. First, the donor can lease the residence from the trust for its fair market rent. A second option, for a married donor, is to make the remainder beneficiary a trust of which the donor's spouse is a beneficiary. The trustee can give the spouse the right to use the residence rent-free. As long as the spouse lives, and the couple remain married, the spouse also could allow the donor to occupy the home.

Tax Considerations

Homestead Exemption & Property Tax

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 donor at least annually and cannot make distributions of principal or income to anyone other than the donor during the trust term, making a QPRT a "grantor trust" for income tax purposes. This means the donor must include the trust income, gain, loss, deductions, and credits in his/her income tax return. If assets will remain in trust for beneficiaries after the QPRT term, the trust can be structured to continue its grantor trust status, if so desired.

After the QPRT term, the donor's beneficiaries (or the trust) receive a carried-over basis in the residence. This means that the beneficiary's/trust's basis will equal the donor's basis at the time he/she contributed the residence to the QPRT.

Gift Tax

The value of the taxable gift that results from implementing a QPRT is the value of the beneficiaries' remainder interest in the residence. The value of the remainder interest is the value of the residence reduced by the value of the donor's retained interest. The value of the donor's retained interest takes into account the donor's age, the length of the QPRT term and the Section 7520 rate. The longer the QPRT term, the lower the taxable gift. By adjusting the QPRT term, the remainder interest may be "zeroed out," resulting in little or no gift tax liability upon QPRT funding.

If gift tax liability results from QPRT funding, the donor may be able to utilize his/her lifetime exclusion amount (in 2019, $11.4 million) to offset the liability. Because a transfer to a QPRT is not a present interest gift, the annual gift tax exclusion amount (in 2019, $15,000 per donee) is not available to offset gift tax liability.

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 donor dies during the term of the QPRT (causing inclusion of the residence in the donor's estate), 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.

Planning Tip: An alternative might be to divide the ownership of the residence into two shares and have each spouse create a separate QPRT.

Estate Tax

At the end of the trust term, the residence would be removed from the donor's taxable estate. If the donor dies during the trust term, the value of the trust assets will be included in the donor's taxable estate. However, the donor'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.

Generation Skipping Transfer Tax

Generation skipping transfer (GST) tax exemption cannot be allocated to transfers during any estate tax inclusion period (ETIP). The QPRT terms is an ETIP, meaning the donor cannot allocate GST exemption to the trust until the end of the QPRT term. For this reason, QPRT planning is typically only used to benefit a child or other non-skip beneficiary.

Advantages of a QPRT

- To the extent the current basic exclusion amount "sunsets," as is scheduled to occur on December 31st, 2025, it may be prudent for high net worth individuals to utilize the temporarily increased lifetime exclusion through lifetime asset shifting techniques, such as a QPRT.
- A highly appreciating residence can be removed from the donor's taxable estate at a reduced transfer cost.

- Because the requirements are provided in IRS Treasury Regulations, a QPRT may have less audit risk than other asset shifting techniques.
- Even if a donor dies during the QPRT term, the donor's estate will be in no worse position than had the QPRT not been entered into.

Disadvantages of a QPRT

- Generally, when the Section 7520 rate is lower, the gift tax value of the remainder interest is higher.
- The donor must pay fair market value rent after the QPRT term if he/she wishes to remain in the residence. (This, however, could also be an advantage since rental payments allow the donor to further reduce his/her taxable estate.)
- GST tax exemption cannot be allocated to QPRT assets until the end of the QPRT term or upon the donor's death.
- A QPRT is not ideal if the residence is subject to one or more mortgages.

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