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Planning with Qualified Personal Residence Trusts

A qualified personal residence trust (QPRT) is a form of “split-interest” estate planning. Split interest planning refers to dividing an item of property, a personal residence in the case of a QPRT, into a current use period and a remainder use period.

With a QPRT, the residence owner transfers a personal residence to a properly drafted irrevocable trust. The owner retains the right to use the property held in the trust as a personal residence for a set term of years, which is called the “current use period.” At the end of the current use period, the owner’s right to use the residence terminates unless otherwise provided, and the residence goes to the beneficiaries of the trust, or is held in trust for their benefit. The owner is referred to as the “current period owner,” and the children are referred to as the “remainder owners.”

What is the estate tax benefit of the QPRT? It is easier to understand the benefit if an example is used. Assume a 55 year old parent owns a residence, valued at \$500,000 with a basis of \$150,000. (This technique is available for use for a second residence as well, provided a separate QPRT is created) The parent anticipates that the residence will significantly increase in value in the future and sets up a 7-year QPRT. The anticipated value of residence will be \$2,000,000 after seven years.

What are the mathematics of this QPRT? The first calculation is to determine the values of the current use period and the remainder use period. This calculation is based upon certain interest rate assumptions provided by the IRS. Our calculations assume the interest rate is 7%. With the 7% assumption, the following are the valuations of the current use period and the remainder use period:

Property Value	\$500,000
Current Use Period Value	<214,000>
Remainder Use Period Value	\$286,000

The owner is treated as making a taxable gift of \$286,000. The gift of the remainder use period is not a gift of a present interest, but of future interest, and therefore does not qualify for the \$12,000 annual gift tax exclusion, so the owner uses \$286,000 of the owner’s

Planning with Qualified Personal Residence Trust

\$1,000,000 gift tax credit and of the owner’s \$2,000,000 estate tax credit. A comparison of the estate taxes due with the QPRT and without the QPRT reveals the estate tax benefit.

Estate Taxes w/o QPRT	
Value of Residence (yr. 2000)	\$2,000,000
Estate Taxes (48%)	<960,000>
Net Inheritance	\$1,040,000

Estate Taxes with QPRT	
Value of Residence (yr. 2000)	\$2,000,000
Estate Taxes (48%)	N/A
Net Inheritance	\$2,000,000

The QPRT saved \$960,000 in estate taxes at the cost of using \$286,000 of the parent’s tax and estate tax exclusions. If the parent dies prior to year seven, the transaction is unwound and treated as though the gift had never been made.

What about the capital gains tax consequences of the QPRT?

The residence is received by the heirs with a carryover basis of \$150,000, while an inherited residence would have an increased basis of \$2,000,000. The \$1,850,000 basis difference would generate a capital gains tax liability of \$277,500 on a sale. Even without the use of a charitable remainder trust to defer the tax on sale, the \$960,000 in estate tax savings offset by the \$277,500 capital gains tax amounts to an overall tax savings of \$682,000 (\$960,000 - \$277,500=\$682,500) which is still an enormous benefit.

What about the deductions for real estate taxes and the \$250,000 exclusion of gain on sale rules?

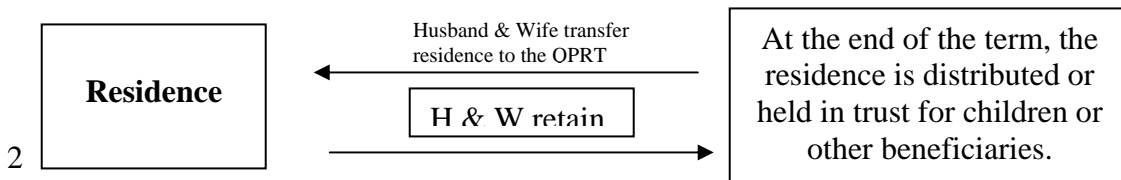
Because the QPRT is a grantor trust, the residence is treated like any other residence owned by the parent and no deductions or exclusions are lost.

What about using the residence at the end of the seven-year term?

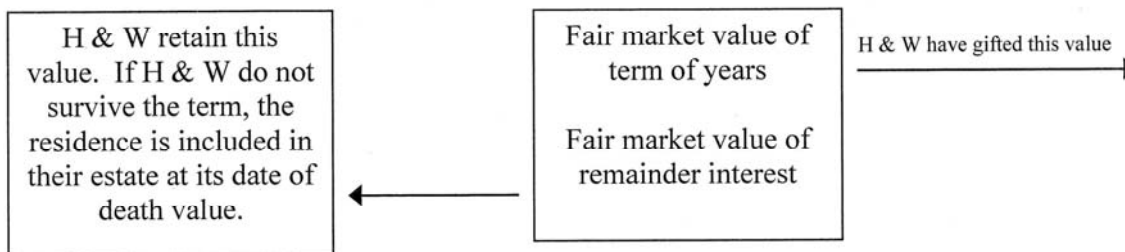
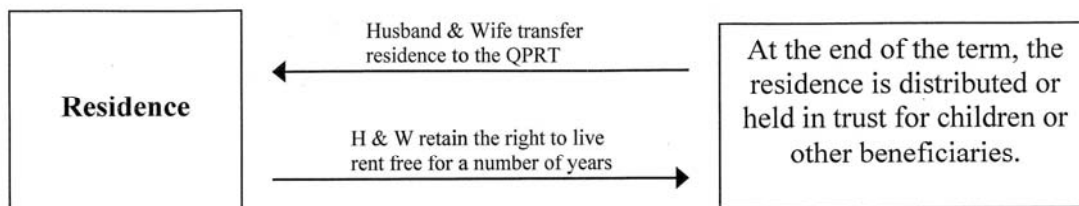
The QPRT agreement may be drafted so that at the end of the QPRT term the parent may retain a contractual right to reside in the residence by renting the residence at market rent. The market rent payable to the trust is not subject to income tax because the trust is a grantor trust even after the seven-year period. Therefore, the rent further reduces the parent’s estate without any gift, estate or income taxes being imposed.

QUALIFIED PERSONAL RESIDENCE TRUST

imposed.



QUALIFIED PERSONAL RESIDENCE TRUST



- * H & W may rent the residence for fair market value at the end of the term.
- * They continue to deduct interest and taxes.
- * They continue ability to exclude \$500,000 gain.

COMPARISON OF A QPRT AND A GRAT

To illustrate why a QPRT always works, contrast its operation with that of a GRAT. Both QPRTs and GRATs represent a transfer of property to a trust with a retained term interest. The gift for gift tax purposes is the value of the remainder interest. The difference between the QPRT and the GRAT is that the benefit being retained in the QPRT, the rent free use of the residence, does not increase the estate of the client. However, the retained interest in the GRAT, a series of payments, does increase the value of the client's estate. The term of a QPRT affects the value of the gift.

CHOICE OF QPRT TERM

In choosing the term of the QPRT, the planner has two competing considerations:

- The potential for the client's death before the end of the term.
- The ultimate value of the gift

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Because a trustor must survive the term of the QPRT, a shorter term may be preferable. However, a shorter term increases the value of the remainder interest and thereby, the value of the gift.

Residence value \$1,000,000
AFR 7.5%

	3 year	5 year	10 year	15 year
Value of a Gift	\$802,000	\$690,000	\$474,000	\$318,000
Value Reductions From 3 Year Term		<112,000>	<328,000>	<484,000>

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About Morris, Hall & Kinghorn, P.L.L.C.

Attorneys Dan Morris, Tim Hall, Kevin Kinghorn, Lora Johnson, T.S. Rusty Rollins, E. Eugene Neil, and Daniel R. Klein are noted speakers on living trusts and estate planning. Their law practice is devoted exclusively to preserving wealth, and they are members of the American Academy of Estate Planning Attorneys. Their seminars on estate planning are said to be “informative, entertaining & easy to understand.”

If you would like a current schedule of seminars in your area or would like a consultation with an attorney, please call Morris, Hall & Kinghorn, P.L.L.C., toll free at 1-888-222-1328



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