Qualified Personal Residence Trust

Overview of Personal Residence Trusts

In general, IRC § 2702 allows a grantor to transfer title to a personal residence to the trustee of an irrevocable trust, retaining the right to live in the residence rent-free for the term of years specified in the trust agreement. The grantor continues to pay all ordinary expenses relating to the residence, such as utilities, maintenance, taxes and repairs.

If the grantor is living at the end of the retained term, the residence passes to the remainder beneficiaries (typically the grantor's children or trusts for their benefit) designated in the trust agreement. Thereafter, the grantor may wish to lease the residence from its new owners (e.g., his or her children or trusts for their benefit). If the grantor dies prior to the end of the term, the residence is included in his or her gross estate for federal estate tax purposes. This is, however, essentially the same result that would occur if the grantor had not established the trust.

The value of the gift of the residence for gift tax purposes is based on the present value of the right of the beneficiaries of the personal residence trust to receive the residence at the end of the term of years. Because the beneficiaries must wait until the end of the term to receive the residence, the value of the gift of the residence is essentially "discounted." In other words, the value of the gift is substantially lower than the actual value of the residence at the time of transfer.

Qualified Personal Residence Trusts ("QPRT")

In order for a trust to qualify as a QPRT, it must meet the requirements for a QPRT set forth in the regulations, and the governing instrument must contain several provisions, which are discussed below in part. For a sample governing instrument for a QPRT, along with annotations and optional provisions, see Rev. Proc. 2003-42, 2003-1 C.B. 993.

Permissible Distributions. All of the income must be distributed to the term holder at least annually, and no distributions of principal may be made to anyone other than the term holder prior to the end of the retained term. Treas. Reg. §§ 25.2702-5(c)(3), (c)(4).

Permissible Trust Property. The governing instrument must prohibit the trust from holding any asset other than one residence to be used as a personal residence by the term holder. Treas. Reg. § 25.2702-5(c)(5)(i). That said, the governing instrument also may permit the trust to hold cash in a separate account for expenses.

> **Planning Point:** Additions of cash to a QPRT may be additional gifts to the QPRT. Items that the grantor, as the life tenant, is required to pay under applicable law, such as mortgage interest payments, taxes and utilities, however, should not be treated as additional gifts to the trust.

Cessation of Use as a Personal Residence. The governing instrument must provide that the trust ceases to be a QPRT if the residence held by the QPRT ceases to be the personal residence of the term holder. Treas. Reg. § 25.2702-5(c)(7). A trust may cease to be a QPRT if the personal residence is sold, damaged or destroyed. Treas. Reg. §§ 25.2702- 5(c)(7)(ii), (c)(7)(iii). The sale of the personal residence is not a cessation of use if the sale proceeds are used to acquire a new

residence within two years of the sale. Treas. Reg. § 25.2702-5(c)(7)(ii).

Gift, Estate and Income Tax Consequences

Gift Tax. A QPRT allows the grantor potentially to transfer his or her personal residence to others (*e.g.*, his or her children) at a reduced gift tax cost. For federal gift tax purposes, the original transfer of the residence to the QPRT will be treated as a taxable gift of the remainder interest to the remainder beneficiaries determined by subtracting from the value of the property transferred to the QPRT an amount equal to the value of the retained interest, determined under IRC § 7520.

The value of the gift to the QPRT for gift tax purposes is based on the present value of the right of the QPRT beneficiaries to receive the residence at the end of the term of years. In determining the value of the residence, a number of factors are considered, such as the grantor's age, the initial term of the QPRT, and the IRC § 7520 rate in effect for the month of the transfer. Because the QPRT beneficiaries must wait until the end of the term to receive the residence, the value of the gift is substantially lower than the actual value of the residence at the time of transfer. Therefore, the younger the donor or the longer the term of years, the lower the value of the gift.

Not only is the initial transfer of the residence a gift to the QPRT, but also later contributions of cash to the trust and the direct payment by the grantor of certain expenses and improvements are gifts to the QPRT.

Estate Tax. If the grantor survives the QPRT term, the full fair market value of the residence, including any appreciation in the value of the residence during the term of the trust, will not be included in the grantor's estate for federal estate tax purposes. If the grantor dies during the term of the QPRT, the full value of the residence is included in his or her gross estate for federal estate tax purposes under IRC § 2036(a)(1). Prop. Reg. § 20.2036-1(c)(2). If the property is included in the grantor's gross estate, any of the grantor's applicable exclusion amount used to shelter the gift to the trust is restored. Consequently, the result for federal gift and estate tax purposes is the same as if the QPRT had never been established. The only "cost" if the grantor dies during the term of the QPRT is the expense of creating and operating the QPRT and the loss of the use of the funds used to pay any gift tax upon creating the GRAT. If the grantor paid gift tax, the grantor's estate will be entitled to an adjustment for the gift tax paid.

Use of Residence After Retained Term. The QPRT instrument can include a "lease-back" provision. Pursuant to such a provision, if the grantor survives until the end of the term of the QPRT and the trust holds the residence at that time, the residence will continue to be held in trust for the benefit of the beneficiaries, subject to the grantor's right to lease the property for fair market value from the remainder beneficiaries. The grantor also could rent the residence from the children if the residence is distributed outright to them. If the trustee at any time decides to sell the residence, any sale would be subject to the grantor's continuing right to lease the property.

If the grantor or his or her spouse leases the residence from the remainder beneficiaries after the end of the QPRT term, the residence will not be subject to estate tax upon either spouse's death as long as the lease is at fair market value. See PLRs 199931028; 9723021. Although the rental payments will be taxable income to the beneficiaries, the income tax rate is less than the

estate tax rate.

Income Tax.

A QPRT is designed to be a grantor trust, which, as discussed above, means that the trust will be ignored for federal income tax purposes. Therefore, the grantor can deduct all real property tax payments on the residence in the QPRT and mortgage interest payments on his or her personal income tax return as long as the QPRT owns the residence. Further, if the home is the grantor's principal residence and is sold during the QPRT term, the grantor can take advantage of the capital gain exclusion for the sale of a principal residence that is available to an individual under IRC § 121 ($250,000 for an individual, $500,000 for a married individual filing jointly).

If the property is sold after the term of the QPRT has expired, even though the grantor may be leasing the property, the capital gain will not be taxed to the grantor, but rather to the persons who received the property when the QPRT ended (*e.g.*, the grantor's children) unless the residence is held in a continuing trust that is treated as a grantor trust for federal income tax purposes.

It should be noted that a residence held in a QPRT that ends before the grantor dies does not get a step-up in basis at the grantor's death. Instead, the grantor's cost basis in the residence will carry over to the beneficiaries. Therefore, if the residence is eventually sold, the capital gains tax could be higher than if the grantor had owned the residence at his or her death. The beneficiary may still be able to use his or her own exclusion under IRC § 121, but only if the property is the beneficiary's principal residence for the required length of time.