Is 2011 the Year to Establish a Qualified Personal Residence Trust?

In December 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("TRA 2010"). TRA 2010 creates a two-year window of opportunity for clients who want to take advantage of increased gift limits to make certain sophisticated, intra-family transfers of wealth. A Qualified Personal Residence Trust (QPRT) is an irrevocable trust that holds an interest in the residence of the trust grantor, and otherwise complies with certain tax requirements applicable to QPRTs.

This summary discusses the QPRT opportunity.

The QPRT Opportunity

Many clients with exposure to federal estate tax want to minimize those taxes. Although a typical "best solution" might be to cover the estate tax exposure with the death benefits of a life insurance policy, this does nothing to reduce the actual tax liability incurred. Approaches to decreasing the overall tax liability frequently involve depleting a client's taxable estate through transfers to trusts. As stated above, the extension of the "Bush tax cuts" creates a two-year window of opportunity for clients who want to take advantage of increased gift limits enacted as part of that extension to make intra-family transfers of wealth. A Qualified Personal Residence Trust ("QPRT"), defined above, is one way to transfer wealth to heirs.

When a trust grantor transfers his or her property to a QPRT, he or she makes a gift to the trust beneficiaries (typically, the grantor's children). This gift is valued and taxed at the time of the transfer to the QPRT. But the grantor also keeps an interest in the property—the right to occupy and use the property for a period of time ("the QPRT term"). The value of the interest kept by the grantor reduces the taxable gift made to the beneficiaries. When the QPRT term expires, full ownership of the property transfers to the trust beneficiaries without any additional gift tax implications.

If the grantor wants to remain in the property following the QPRT term, rent should be paid to the new owners (i.e., the QPRT beneficiaries) of the property.

TRA 2010 also eliminated the modified carryover basis rules for 2010 and replaced them with the stepped-up basis rules that had applied before 2010. Property with a stepped-up basis generally receives a basis equal to the property's fair market value on the date of the decedent's death. Under the modified carryover basis rules that applied during 2010 before TRA 2010, executors generally could increase the basis of estate property only by a total of $1.3 million (plus an additional $3 million for assets passing to a surviving spouse, for a total increase of $4.3 million), with other estate property taking a carryover basis equal to the lesser of the decedent's basis or the property's fair market value on the decedent's death.

A QPRT can be created using a principal residence or a vacation home. If a principal residence is used, and the property is sold during the QPRT term, the gain exclusion of $250,000/$500,000 is available as long as the other requirements are met (i.e., length of use, etc.). The gain exclusion does not apply to the sale of a vacation home. Since a QPRT can only hold real estate, the sale of the home would terminate the QPRT which could then either distribute the sale proceeds to the grantor or convert the QPRT to a GRAT ("Grantor Retained Annuity Trust").

If the grantor dies during the QPRT term, the full value of the property at the grantor's date of death is included in the grantor's taxable estate. The estate will receive full credit for any gift tax consequences arising on the creation of the QPRT and is no worse off than if no QPRT had been created.

One technique employed to use QPRTs in estate plans focuses on hedging against the early death of the grantor by creating multiple QPRTs with different terms. For example, if the grantor might create three QPRTs with terms of 5, 10 and 15 years respectively. Then, if the grantor dies in year 13, only 33 1/3% of the property will be pulled back into the grantor's taxable estate.

Another peculiarity of QPRT design is that the QPRT may have to provide (because of GST considerations) that if the beneficiaries are all children of the grantor and one of them dies during the QPRT term, that child's share does not pass to his or her own children, but rather it passes to the other living QPRT beneficiaries. The risk of such premature deaths can be mitigated by term life insurance in many cases and/or the drafting attorney may be able to adopt provisions that are tailored to address the deceased child problem in the way that makes the most sense for the client. The reasons for these seemingly awkward or undesirable provisions are buried in the complicated estate tax rules, but are sure to strike clients (and advisors) as odd.

Establishing a QPRT: An Example

The timing for creating a QPRT appears to be improving each month. The factors that make a QPRT economically attractive include lowered real estate values and increased interest rates. Although property values appear to be stabilizing according to many reports, there does not yet appear to be a strong rebound in values. The interest rate required to be applied for discounting the value of the remainder interest in the QPRT property is commonly referred to as "the 7520 rate" which is published monthly by the IRS. The 7520 rates for 2011 that have been issued to date are:

IRC Section 7520 Rates for 2011	
January	2.4%
February	2.8%
March	3.0%
April	3.0%

The following example illustrates the advantage of a QPRT in an estate plan.

Assumptions:

1. A home worth $1,000,000 is transferred into a QPRT with a 15 year term in March 2011. At the time of transfer, the grantor was single and age 60. The IRS interest rate used for discounting that month is 3.0% making the gift tax value of this transfer $473,078. The grantor made no other lifetime gifts.

2. The grantor lived 25 years following this transfer. For the 10 years which followed the QPRT term, she paid annual rent of $100,000 to her children. Her children recognized this taxable income paying tax at their marginal brackets and depreciated the property during that time. For the purpose of this illustration, the children's income tax effect has been ignored; however, the rental expense of the parent depleted her estate prior to her death.

3. The property appreciated 4% annually from the time of the transfer until the death of the grantor.

4. The grantor had a gross estate (net of the property) of $8,000,000. At the time of her death, the combined gift and estate tax exclusion was $2,000,000 and the estate tax rate was 40%.

By establishing a QPRT, this individual would save over $1.2 million in estate taxes—savings which would be passed directly on to his or her heirs.

QPRT Example

Line	Item	With QPRT	Without QPRT
1.	Gross Estate	$7,000,000	$8,000,000
2.	Property Valued at Death		$2,665,836
3.	Taxable Gifts	$473,078	
4.	Gross Estate Subject to Tax	$7,473,078	$10,665,836
5.	Less: Exemption	($2,000,000)	($2,000,000)
6.	Net Taxable Estate	$5,473,078	$8,665,836
7.	Tax @ 40%	$2,189,231	$3,466,334
8.	Tax Using a QPRT		($2,189,231)
9.	Savings to Heirs		**$1,277,103**

Summary

A QPRT can be an effective way to transfer wealth to heirs. However, it is important to remember that you are giving away your home through this trust vehicle. The choice to establish a QPRT can mimimize federal taxes—but should be made carefully and with consideration.

Your Janney Financial Advisor can work with you and your other professional advisors—along with the Wealth Planning Department at Janney—to determine if a QPRT may be a beneficial strategy for you to apply in 2011 or future years.

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