

Qualified Personal Residence Trusts

Under the present tax rules, there is an express provision which allows for substantial gift and estate tax savings by "leveraging" the gift tax/estate tax exclusion through the value of a personal residence. Under this arrangement, one is allowed:

- (i) to transfer an interest in a personal residence (a principal residence and/or a second home) to a trust for a specific number of years,
- (ii) retain the exclusive use and control of the property for that number of years, and then
- (iii) at the end of that number of years, have the value of that property removed from the taxable estate and pass to designated beneficiaries (or trusts for them) without any estate tax.

If the taxpayer dies before the end of the stated number of years, the trust simply terminates and the property is returned to the taxpayer's estate.

Martha Doe is a widow and is considering the creation of a qualified personal residence trust ("QPRT") to own the family vacation home. For gift tax purposes under this arrangement, Martha would make a taxable gift equal to (i) the present value of the home, less (ii) the value of her retained right to use the property for the given number of years, less (iii) the actuarial value of the possibility that she might die during the term and the property will be returned to her estate. Martha's \$1,000,000 gift tax "exclusion" would generally be used to cover the net value of the gift, so no actual gift tax would be payable. [Remember, under present law the exclusion is increasing for estate tax purposes, but is fixed at \$1 million for gift tax purposes.]

After creating the QPRT, one of two things must happen. Either Martha will live to survive the stated term of the trust and see the property removed from her taxable estate, or Martha will die before the end of the term. If she dies before the end of the trust term, the property is returned to her estate, her "exclusion" is restored (since she didn't make a gift after all,) and her estate is in no worse condition for her having tried. On the other hand, if Martha lives for the full term of the trust, she will have used a relatively small amount of her "exclusion" to remove the full value of the home plus all of the appreciation on the home from the estate. Consider the following example:

Example: Martha is age 57, the taxable estate valued at about \$4,500,000 including the vacation home valued at \$950,000, and Martha's objective is to ultimately leave the estate to the children. If Martha was to die in 25 years, and if the estate appreciates at a rate of 4% per year, it will grow to about \$11,996,263, and the estate tax bill would be about \$5,992,758!

Suppose Martha were to give the vacation home to a QPRT, retaining the exclusive right to its use and control for 10 years. For gift tax purposes, Martha would have made a gift of the value of the home (\$950,000) less (i) the value of the retained 10 year ownership interest and (ii) the actuarial value of the home's returning to Martha's estate if she dies within 10 years. Under the IRS valuation rules, the net value of the taxable gift would be only \$535,819. Martha would file a gift tax return and use \$535,819 of her \$1,000,000 "exclusion" to avoid paying any tax on this transfer.

Now, if Martha lives for the 10 year period, she will have removed the entire home from the taxable estate, plus all the appreciation thereon for the remainder of her lifetime. Assuming the same 4% growth rate used above, the value of the taxable estate at the assumed life expectancy would be reduced by about \$2,532,545, and the estate tax would be reduced by \$1,198,012.

That is, Martha would have currently used \$535,819 of her exclusion in order to have removed \$2,532,545 from the taxable estate at life expectancy. The effect is to have leveraged the value of the used exclusion amount by over 400%. Even if Martha were to die within the 10 year trust period, the trust would simply return the home to her estate and the exclusion would be restored, so nothing is lost for having tried.

Consider the following illustration of the anticipated results of such a trust, using IRS factors for January 2006 and assuming alternative terms for the trust of 5 and 10 years. As shown, the potential net tax savings after taking account of a 4% estimate of appreciation in the value of the property, is between \$1,085,181 and \$1,198,012, depending on the length of the trust term for which Martha must survive.

QUALIFIED PERSONAL RESIDENCE TRUST ILLUSTRATION

	OPTION #1 Do Nothing	OPTION #2 QPRT- 5 yrs	OPTION #3 QPRT- 10 yrs
Taxable Estate (beginning)	\$4,500,000	\$4,500,000	\$4,500,000
Present Value of Home Removed from Estate	\$0	\$950,000	\$950,000
Amount of Taxable Gift	\$0	\$723,910	\$535,819
Gift Tax payable	\$0	\$0	\$0
Taxable Estate - year 25 [Note #1]	\$11,996,263	\$9,463,719	\$9,463,719
Estate Tax due - year 25	\$5,992,758	\$4,907,577	\$4,794,746
Appreciated value of Home Removed From Estate [Note #2]		\$2,532,545	\$2,532,545
Net Reduction in Taxable Estate [Note #2]		\$2,532,545	\$2,532,545
Net Preserved for Family [Note #2]	\$6,003,505	\$7,088,686	\$7,201,518
Amount Saved by Trust [Note #2]	\$0	\$1,085,181	\$1,198,012
Actuarial Probability of Surviving Trust Term		94.5%	86.8%

[Note #1] - including appreciation but not adjusted taxable gifts [Note #2] - at assumed life expectancy with appreciation

During the term of the residence trust, Martha will still treat the property as her home for all tax purposes. She will still be able to claim a homestead exemption for Georgia property tax purposes (if it is her primary residence), and qualify any mortgage interest for deductibility on her income tax return. She is free to sell the home inside the trust at any time, and the sale will qualify for the \$250,000 income tax exclusion on capital gain if the home has been her principal residence. If the home is sold, she may either invest the proceeds in another home inside the trust or invest in other assets. If Martha chooses to invest in assets other than another home, Martha will be required to pay herself an income from the trust for the balance of the trust term.

Many people find the gift of a residence in this manner to be quite attractive, because (1) it doesn't require them to give up anything now, and (2) it's virtually a "no lose" situation from a tax planning viewpoint.

However, especially where the residence given to the trust is the taxpayer's principal home, he or she may be concerned about having to give up the home at the end of the trust term. In fact, Martha Doe is allowed to do any of several things which probably reduce that problem to a manageable level.

First, Martha can give less than the entire ownership in the vacation home to the trust, and retain a small interest for herself. For example, Martha can give a 95% interest in the property to the QPRT, and retain ownership of a 5% interest in the property. Under Georgia law (and the law of many other states,) every joint owner of property has an equal right to occupy the property along with every other joint owner, without being required to pay rent. Martha's retained 5% interest, then, would entitle her to continue to use the home as long as she likes.

Second, Martha can retain the right to lease the home from the children (or the trustee of a trust for them) and pay them rent based on the value of the home at that time. That would allow Martha to retain possession of the home for as long as she likes, and the rental payments would allow Martha to transfer additional funds to the children without incurring any gift tax. It is even possible to structure this alternative so that the rental payments will not be taxable income to the children.