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Qualified Personal Residence Trust

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Qualified Personal Residence Trust

What is it?

A qualified personal residence trust (QPRT, pronounced "Q-Pert") is a specialized form of grantor retained interest trust (GRIT). It is an irrevocable trust into which you transfer an interest in a personal residence, and in which you retain the "income" interest — the right to use or live in the home for a specified term of years. At the end of the term of years or upon your death, whichever is earlier, the home passes to the remainder beneficiaries named in the trust document (typically children) or is held in trust for their benefit. You may continue to live in the home after the term of years ends as long as you pay fair market rental to the remainder beneficiaries.

Potential tax advantages of a QPRT include:

- The grantor's retained interest is subtracted from the value of the home when determining the amount of the gift to the remainder beneficiaries for federal gift tax purposes (i.e., the gift is "discounted"). The amount of the discount is determined using a calculation based on the IRS' assumed rate of return in effect during the month the transfer is made (this is known as the Section 7520 rate, hurdle rate, or discount rate). Any gift tax due can be offset to the extent of the grantor's available federal gift and estate tax applicable exclusion amount ($12,060,000 in 2022).
- Property transferred to a QPRT will not be included in the grantor's gross estate as long as he or she outlives the term of the retained interest. If the grantor dies before the term of the retained interest ends, however, the full value of the property on date of death will be included in the grantor's gross estate for federal estate tax purposes.
- Appreciation in the property after being transferred to the QPRT will also not be included in the grantor's estate.

Example(s): *Jill, age 50, transfers her vacation home valued at $1 million into a QPRT with a 10-year term and a right of reversion. The Section 7520 rate at the time is 3.0% (i.e., the IRS anticipates that the property will grow at this rate). The QPRT specifically provides that Jill has the right to live in the home rent free for 10 years. According to IRS valuation tables, Jill's gift can be discounted by $303,580. The gift is valued at $696,420. Jill owes no federal gift tax, however, because it is totally offset by a portion of Jill's gift and estate tax applicable exclusion amount. After the 10-year period ends, the house plus all appreciation passes to Jill's remainder beneficiaries free of any additional federal gift or estate tax consequences.*

As explained above, a QPRT can minimize gift and estate tax, but only if it is successful. For a QPRT to be successful, the grantor must outlive the term of the QPRT. If the QPRT is not successful, though, the grantor is in some ways no worse off than he or she was before creating the QPRT. For example, if the grantor dies before the term of years expires, the property will be included in the grantor's gross estate for estate tax purposes, just as it would have been had the QPRT not been created. If the property does not appreciate greater than the Section 7520 rate, the result is merely that little or no additional value is transferred gift tax free. The only risk associated with an unsuccessful QPRT is any costs incurred to create and maintain the trust.

Tip: *Each person is permitted to create two QPRTs, one for a principal residence and one for an occasional or vacation residence.*

When can it be used?

A QPRT generally works best for people who are expected to outlive the specified term of years, and have multiple residences or enough income to pay fair market rental to continue living in the home after the term of years expires.

Strengths

Use of QPRT may allow transfer of residence to be discounted for federal gift tax purposes

Transferring a residence to a QPRT is considered a taxable gift to the remainder beneficiaries. However, since the grantor retains a valuable interest and the remainder beneficiaries of the QPRT will not receive the property until some time in the future, the IRS generally allows the grantor to discount the value of the gift for gift tax purposes. The size of the discount depends on the length of the term of years and the applicable Section 7520 rate. The longer the term of years and the higher the Section 7520 rate, the more the value of the gift may be discounted.

If there is a taxable gift, however, gift tax due may be offset by the grantor's gift and estate tax exemption, to the extent it has not already been used up.

Caution: *If the grantor lives in one of the handful of states that impose their own gift tax, state gift tax may also be due.*

Value of property in QPRT will not be included in grantor's gross estate as long as grantor outlives the term of years

As long as the grantor outlives the term of years set out in the trust document, the value of property in the QPRT will not be included in the gross estate of the grantor for estate tax purposes. The grantor need only outlive the term of years for one day.

Thus, a QPRT can be an excellent vehicle for transferring a home's future appreciation gift and estate tax free.

QPRT may avoid ancillary probate if you own a residence located in another state

If you own property in more than one state when you die, probate proceedings will have to be conducted in each state where the properties are located. This means that you will have to hire an attorney in each of those states and go through the time and expense to conduct separate probate proceedings. However, if the only property located in another state is a residence (a vacation home, for example) and you transfer that residence to a QPRT, then that property will avoid ancillary probate if you outlive the term of years.

Tradeoffs

Property in QPRT will not escape estate taxation if grantor does not outlive the term of years

Failing to outlive the term of years throws the QPRT property back into the grantor's gross estate, and the advantages of the QPRT are lost.

Tip: *To provide for this contingency, many estate planners recommend that the remainder beneficiaries purchase a life insurance policy on the grantor for the term of years. Then, if the grantor dies too early, the remainder beneficiaries will have the funds to pay the estate taxes.*

Transfer of property to QPRT is a taxable gift

Since a QPRT is an irrevocable trust (i.e., it cannot be changed or ended except by its terms), a transfer of property to the QPRT is considered a taxable gift to the remainder beneficiaries. Therefore, gift tax may have to be paid if the amount of the taxable gift is above the gift and estate tax exemption or if the grantor's exemption has already been used.

Transfer of property to QPRT does not qualify for annual gift tax exclusion

A transfer of property to a QPRT does not qualify for the annual gift tax exclusion. To qualify for the annual gift tax exclusion, the donees (i.e., recipients) must have a present interest in the gift (i.e., the donees must be able to currently possess, use, and enjoy the gift). However, with a QPRT, the remainder beneficiaries will not have a present interest in the property until the grantor's retained interest ends at some point in the future.

You must pay rent to if you wish to live in home after term of years expires

If you wish to occupy the home once the specified term of years expires, you must pay fair market rental to the remainder beneficiaries of the trust.

Tip: *If this situation occurs, you must enter into a written lease with the remainder beneficiaries, and should do so only at the end of the term of years. The lease should contain all the standard lease terms for that type of rental. The remainder beneficiaries should strictly enforce the terms of the lease.*

Cost of creating QPRT may be wasted if QPRT is unsuccessful

There may be costs incurred to create and maintain a QPRT. First, a competent and experienced estate planning attorney will be needed to draft the trust document. Second, the attorney will have to transfer and retitle the home in the name of the QPRT. Third, a qualified, experienced real estate appraiser should be hired to appraise the value of the residence that you transfer to the trust (you should have a written appraisal in case the IRS challenges the valuation that you use for the residence). Finally, the transfer is considered a taxable gift. Gift tax returns will need to be prepared and filed, and gift taxes may need to be paid. If the QPRT is unsuccessful, these costs may be incurred for nothing.

QPRT not generally appropriate for generation-skipping transfers

The federal generation-skipping transfer (GST) tax (and perhaps state GST tax as well) will apply to a transfer made to a QPRT if some or all of the remainder beneficiaries are two or more generations below the grantor (these are known as skip persons). However, the transfer does not occur until the grantor's retained interest ends. Thus, the grantor cannot allocate his or her GST tax exemption to the transfer until the end of his or her retained interest (or estate tax inclusion) period (this is known as the estate tax inclusion period or "ETIP" rule). Allocating the GST tax exemption when the trust property has already appreciated fails to leverage the exemption. Thus, a QPRT may not be an appropriate device for making transfers to skip persons.

Tip: *A grantor may be able to circumvent these generation-skipping transfer limitations if the remainder beneficiaries sell the remainder equivalent to a dynasty trust. This remainder sale strategy is a sophisticated estate planning technique and beyond the scope of this discussion. An experienced estate planning attorney should be consulted.*

Income tax consequences of QPRT

QPRT considered a grantor trust for income tax purposes

For income tax purposes, a QPRT should be a grantor trust. Being classified as a grantor trust means that all items of income and deductions flow through to the grantor. The grantor continues to pay for all repairs, insurance, and property taxes. This also preserves the grantor's ability to take the home sale capital gain exclusion in case the home is sold before the term of years expires.

Remainder beneficiaries do not receive a step-up in basis

Unlike property received because of the death of the transferor, property transferred to the remainder beneficiaries does not receive a step-up (or step-down) in basis.

Questions & Answers

Can you transfer more than one residence to a QPRT?

No, you cannot transfer more than one residence to a single QPRT. However, you are allowed to set up two QPRTs and then transfer one home into each trust. In theory, a married couple could transfer up to three homes to QPRTs — one home that is jointly owned and two homes owned separately by each of the spouses.

Can mortgaged property be placed in a QPRT?

Yes. You can transfer mortgaged property to a QPRT. However, any mortgage payments that you make will be considered gifts to the beneficiaries. For this reason, some estate planners recommend that you not transfer mortgaged property to a QPRT.

Must the grantor live in the home during the term of years?

To attain the tax benefits, you, your spouse, or your dependents must occupy the residence for the term of years. The home must be available for residential use at all times and cannot be used for any other purpose or sold (unless a replacement home is purchased). The home may be either your principal residence or a vacation house. Although the primary use must be as a residence, you are allowed to have a home office or some other secondary use in the home.

Can other property be transferred to a QPRT?

Property that is transferred to the QPRT may include not only the actual home but also other structures (e.g., a separate garage) that are appurtenant to the home. You may also include the surrounding land that is reasonably appropriate. You may not transfer personal property such as furniture.

A QPRT can also hold cash for the initial purchase of a residence, but the purchase must take place within three months of the transfer. Cash can be held by the trust for the replacement of an existing residence, but again the replacement must be purchased within three months. A QPRT can also hold cash for up to six months for the payment of certain trust expenses such as mortgage payments and improvements to the property. If the property is sold or a fire destroys the property, there is generally a two-year replacement period. The trust may hold the cash received either from the sale or from the insurance proceeds for up to two years before a replacement residence has to be bought and transferred to the QPRT.

Caution: *Any excess cash held by the trust must be distributed at least quarterly to the grantor. If the trust is terminated, all funds in the trust must be distributed to the grantor; distributions to persons other than the grantor are not allowed.*

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