



**OWNER'S MANUAL FOR THE GRANTOR AND TRUSTEE OF A
SINGLE GRANTOR SPLIT PURCHASE QPRT ("SPQT")**

*Prepared for: Jane Adams, "Trustee"
and
John Adams, "Grantor"*

Q. How should we pay "carrying charges" (utilities, property taxes, home owner's insurance premiums, expenses for maintenance and repairs, etc.) during John's lifetime as the SPQT's Grantor?

A. The SPQT document imposes this obligation on John as the Grantor. Arrangements should be made with the insurance agent to send property and casualty insurance notices directly to John. Statements for utilities, etc., will also be sent directly to John. As legal owner of the property, Jane as Trustee will receive property tax and insurance premium bills and should give them to John as soon as Jane receives them. John will pay each invoice directly to the creditor/provider of services without first running the funds used to pay the bills through a SPQT account. Jane need not receive copies of bills or any proof of payment from John.

Q. What about the costs of capital improvements?

A. The carrying charges for which John as the SPQT Grantor is responsible include ordinary repairs and maintenance. These include costs incurred to maintain the property in a reasonable state of repair. Capital improvements are those which enhance (versus maintain) the property's value. Capital improvements must be financed by contributions made by John and the GST Exempt Separate Family Trust (the "SFT") as holder of the remainder interest in percentages determined by reference to IRS actuarial tables based on John's age when the improvements are to be paid for. We can run these numbers for you when the need for funding a capital improvement arises.

For example, if an addition is to be constructed on the residence in the year 2008 at an estimated cost of \$500,000, John and Joe McDonald as SFT Trustee will contribute percentages of the \$500,000 estimate based on the application of the actuarial tables on the date the estimate is given. If further contributions are to be made to complete the project, each party will contribute additional amounts based on the percentages applicable when the additional contribution is made.

Be careful: if contributions are made in the same year but at different times, the actuarial tables require the percentages to be adjusted if John's age has changed because the calculations require as an input John's age as of his birthday nearest to the date the contribution is to be made. We have software which will enable us to perform these calculations if they are needed. If the project comes in under budget, and as the Trustee Jane is holding excess cash, Jane will refund that to John and the SFT in the percentages in which the funds were contributed.

An addition or the construction of a pool are obvious capital improvements. The line sometimes blurs between maintenance and repairs and capital improvements for items such as replacing a roof or a furnace or another "fixture". We and your accountant can help determine the nature of each expenditure as a capital improvement or an expenditure for maintenance. Generally, repairs to or replacements of "fixtures" such as the furnace or roof constitute capital improvements. Replacement or repairs of non-fixtures such as a refrigerator or a stove fall within the category or expenses for which John will be solely responsible.

Q. How is the SPQT treated for federal income tax purposes? Who reports deductions for things like the property taxes John pays?

A. The SPQT is treated as a "grantor trust" as to John as the SPQT's Grantor during his lifetime. This means that the SPQT is transparent for income tax purposes. Any deductions which would be available to John as the Grantor if he owned the property directly will be available to him even though the SPQT owns the property. The SPQT need not file a federal income tax return, Form 1041. John will simply report deductible items on his and Jane's joint 1040 as if the SPQT did not exist.

Q. What happens if as Trustee Jane sells the property?

- ***Will the \$250,000 capital gain exclusion be available?***

- Yes, as long as John satisfies the requirements for the exemption (i.e., John the home as a **principal** residence (not a second home) for at least two of the five years before the sale, etc.). (We understand that the plan is for John and Jane to use the property initially as a second home, but this would be important if later they sell their primary residence and make the SPQT-owned residence their primary home).

- ***What must Jane as Trustee do with the sale proceeds?***

- She must be careful. As Trustee Jane has a period of two years after the date of the sale to reinvest all or a portion of the sale proceeds in the purchase of a replacement residence within the SPQT. If as Trustee Jane reinvests the entire proceeds in the SPQT's purchase for a replacement residence, as Trustee she has no further obligation, and the SPQT can continue as a valid split purchase QPRT as it has prior to the sale. To the extent that as Trustee Jane does not reinvest the sale proceeds

within the two-year replacement period, however, ARTICLE IX of the SPQT document requires that Jane manage the unreinvested proceeds as if they were contributed to a “grantor retained annuity trust”, or “GRAT”. Generally, this means that as Trustee Jane must distribute a portion of the amount subject to the GRAT requirements each year to John as the Grantor as an “Annuity Amount” for the remainder of John’s life. The Annuity Amount will be determined based on actuarial assumptions and IRS tables which are applied as if the GRAT were created as of the date of the SPQT’s creation, not as of the GRAT conversion date. Upon John death, any remaining assets subject to the GRAT requirements will be distributed to the SFT as the “remainder” beneficiary of the SPQT.

Here again, we have available actuarial software which will enable Jane as Trustee to determine the amount subject to the GRAT rules and the Annuity Amount to be distributed to John in each year should the property be sold and the entire net proceeds are not reinvested.

The foregoing discussion assumes that as Trustee Jane reinvests all of the net proceeds or trades down -- purchases a replacement residence with less than all of the net sale proceeds.

- ***What if as Trustee Jane “trades up”?***

- If additional funds are required to purchase the replacement residence, each of John as the SPQT’s Grantor, and Joe as SFT Trustee, must make their contributions based on actuarial factors applied on the date cash is required to fund the purchase of the replacement residence. Essentially, the same types of calculations done when the initial residence was purchased must be duplicated at the time of the purchase of the more expensive replacement residence, based on John’s age and the applicable discount rate at the time the additional contribution is made.

Q. Can Jane as Trustee borrow against the SPQT’s residence to finance capital improvements, etc.?

A. Yes, but the rules concerning repayment are somewhat complex. The “principal” portion of each payment made on a loan secured by the residence and used to finance capital improvements must be made by John and Joe as the SFT’s Trustee based on actuarial calculations performed as of the date the payment is made. Each party will contribute his percentage share, and as Trustee Jane will run those contributions through the SPQT’s checking account. As Grantor John will alone be responsible to fund the interest portion of each payment. Because of the SPQT’s character as a complete “grantor trust” as to John, he will also be entitled to benefit from any tax deduction the SPQT’s payment of interest might produce for John or his 1040 as if he were the owner of the residence which secures the mortgage.

Note that the percentage of each principal payment from John and the SFT will be different if John is actuarially a year older than he was when the prior mortgage payment was made.

Q. What happens upon John's death?

A. The SPQT will terminate, and the residence and any assets remaining in a GRAT created to hold the excess proceeds of the SPQT's sale of the residence will be distributed to the SFT.

Q. Can Jane rent the property to third parties?

A. Generally no. Anything other than incidental rentals could destroy the SPQT's status as a "qualified" personal residence trust. Let us know about any plans you may have to rent the property and we can advise you whether they could create such qualification problems.