

**USING A “QUALIFIED PERSONAL RESIDENCE TRUST” MAY
PROVIDE TAX BENEFITS AND
PROTECT YOUR RESIDENCE FROM CREDITORS**

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1. *Do I have a problem that this may help me solve?*

Maybe. The federal estate and gift taxes are excise taxes imposed on the privilege of transferring wealth. Many families are first made aware of the existence of these taxes when receiving inheritances from a deceased parent. Much to their unpleasant surprise, they find they must pay a substantial -- sometimes confiscatory -- estate tax effectively resulting in a split of the inheritance between the heirs and their Uncle Sam. The same tax (but this time a federal gift tax) applies to lifetime gifts -- from a parent to a child, for example. Congress does provide a liberal gift and estate tax exemption.¹ However, each dollar in transferred wealth over this exempt amount is taxed at steeply graduated rates beginning at 37% increasing incrementally to a maximum rate of 55% once your “gross estate” reaches \$3 million in value.² The greater the value of the property transferred, the higher the tax. Consider the following examples based on the \$1,000,000 exemption available in 2002:

<u>Amount received by gift or inheritance</u>	<u>Estate or gift tax</u>	<u>Average rate of tax</u>	<u>Net remaining for donees/heir</u>
1,000,000	\$ 0	0%	\$1,000,000
2,000,000	\$435,500	21.75%	\$1,565,000
5,000,000	\$1,930,000	38.60%	\$3,070,000
10,000,000	\$4,430,000	44.30%	\$5,570,000

¹ In 2001, the gift and estate tax exemption amounts are \$675,000 per person. In 2002 and later years, the gift tax exemption will be \$1 million. The estate tax exemption will increase to \$1 million in 2002 and will continue to rise intermittently until it reaches \$3.5 million 2009. In 2010, the estate tax is scheduled to be repealed. In 2001, the estate tax is scheduled to return, along with a \$1 million exemption amount.

² Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the top estate tax rate is scheduled to decrease to 50% in 2002 and continue to decrease intermittently over time until it reaches 45% in 2009. In 2010, the estate tax is scheduled to be repealed. In 2001, the estate tax is scheduled to return, with a top marginal rate of 55%.

Families facing this problem include married couples with combined assets having a value over \$2 million (both spouses' \$1 million exemption amounts in 2002, combined), or single parents with more than \$1 million, who do not wish to see their children's inheritance unnecessarily eroded. They want to avoid forcing their heirs to conduct a "fire sale" of illiquid assets (such as a residence) to pay the tax.

For such families, estate tax reduction and management is an important object of "estate planning". A surprisingly large segment of our population must confront this problem: with the deathtime fair market value of residential real estate, retirement assets, life insurance death benefits (not pre-death cash values), and savings and investments added together as the base amount against which the estate tax is assessed, an increasing number of families may unwittingly be at risk. Many are seeking painless solutions to this problem which will not require substantial economic or lifestyle sacrifices on the part of the parents. Planners are increasingly frustrated as Congress continues to eliminate strategies formerly applied to help these families. The qualified personal residence trust ("QPRT"), a special form of a grantor retained income trust (or "GRIT"), is one of the few such strategies which remain.

2. What is a QPRT?

It is an irrevocable³ trust into which you can transfer a personal residence (primary or secondary⁴). You may transfer up to two residences, or fractional interests in those residences, to a maximum number of two QPRTs regardless of the value of the residences. You retain the right to the rent-free use and occupancy of the personal residence for period of years you designate in the trust document. Upon the expiration of your rent-free term, your interest terminates and trust property can be distributed to your children (or held in a "further trust" and remain available for you and your spouse -- if you are married -- to continue to occupy as discussed in paragraph 6 below).

3. What are the potential gift and estate tax savings?

The IRS allows you to discount the value of the future gift you make to your children when you create the trust. Two factors combine to allow this discount: (1) your children must wait until the expiration of your rent-free term before they receive any benefit from the arrangement; and (2) they will receive that benefit only if you survive beyond the expiration of your rent-free term. The latter factor creates a "mortality risk" that you will not survive the chosen QPRT term and the children will receive nothing

³ Irrevocability is a serious thing, but a QPRT arrangement can be prepared to be quite flexible. It can be terminated if future circumstances warrant it (see paragraph 7 below).

⁴ You may rent your second home for a portion of the year. This will not disqualify it as a personal residence which can benefit from this strategy, provided that you occupy it as your personal residence at least fourteen (14) days during the year and satisfy other requirements of the tax law relating to the deductibility of expenses such as upkeep and maintenance.

under the QPRT document which will require its assets to “revert” to your estate or revocable trust upon your premature death. The IRS has established mathematical formulas for determining the exact amount of the discount. Generally, as your rent-free term increases in length, the value of the future gift to the children decreases. The older the parent is on the day he or she creates the trust, the shorter the parent’s actuarial life expectancy, the greater the risk of the parent’s death during the rent-free term (and the children getting nothing from the QPRT), and the lesser the value of the gift to the children.

The following examples illustrate the gift tax calculations under various circumstances for QPRTs created in November, 2001 assuming a contribution of a \$200,000 personal residence.

<u>Age of Parent</u>	<u>Length of Parent’s Rent-Free Term</u>	<u>Discount Factor In Determining Gift to Children</u>	<u>Gift To Children</u>
40	25	75.38%	\$49,242
50	15	58.59%	\$82,820
60	10	48.79%	\$102,428
70	5	33.63%	\$132,750
80	3	30.29%	\$139,414

The potential estate and gift tax advantages are obvious. Take the 40 year old parent illustrated in the above table as an example. If he survives beyond the expiration of the 25 year rent-free term, and the personal residence held in the QPRT having an initial value of \$200,000, has appreciated during that period to \$533,167 (assuming annual appreciation at a rate of 4%), he will have had his cake and eaten it too: he retained the full use and enjoyment of the residence for a substantial period of time, while ultimately transferring it to his children at a gift tax value of approximately 9.2% of the estate tax value of the residence had he retained it and allowed it to pass to his children upon his death. This can save the family as much as \$240,000 in estate taxes. If you are considering a QPRT, we will “run the numbers” to determine the optimal rent-free term under your circumstances, particularly your age and current health status. While a longer term will maximize the gift tax discount, you should choose a term which you reasonably expect to outlive.

4. *Can I create a QPRT and still retain all the income tax benefits of owning a residence?*

Generally, yes. During your rent-free term, you (and not the trust) are treated as owner of the residence for federal income tax purposes. If the residence is mortgaged, you can deduct the interest you pay on your federal income tax return.⁵ You should also be able to deduct any real estate taxes you pay. You can arrange for the sale of the residence. If the residence is your principal residence, and the QPRT trustee sells it to a third party⁶ during the QPRT term, you may be able to use your \$250,000 (maximum \$500,000 if you are married) capital gain exclusion now available for sales of a principal residence to shelter the gain from capital gains taxation, provided that your use and occupancy of the residence satisfies the technical requirements defining eligibility for the exclusion.

5. Does the QPRT require costly and burdensome “care and feeding”?

No, at least not during your rent-free term. You can be the sole trustee of the trust. As indicated above, the trust is a transparency for income tax purposes; no separate income tax return is required. You need not provide any accounts to any beneficiaries. You can pay all carrying charges (mortgage payments, real estate taxes, etc.) directly and not through the trust. The trust is not required to obtain a separate taxpayer identification number, or establish a separate checking account. This will change, however, after the expiration of your rent-free term if a “further trust” is created for your children and/or your spouse (see paragraph 6, below). In this case an “independent” trustee (generally, someone other than you) may be appointed to administer the trust in a more formal manner.

6. Can I and my spouse be guaranteed continued occupancy of the personal residence after my rent-free term expires?

While technically this cannot be guaranteed, as a practical matter it is almost certain to occur if you wish. You can provide for the creation of a new trust -- call it a “further trust” -- after your rent-free term expires. While it is probably not absolutely necessary, it may be necessary that this further trust be administered by an independent trustee. This trustee must be an institution or individual who is not you, your spouse, or your children. It need not be a bank. The trustee can continue to hold the personal residence and rent it back to you for the payment of fair rental value. The trustee may be given the discretion to distribute trust income (your rental payments net of costs associated with the residence) among your spouse, if you are married, and children.⁷ If your spouse is living, the rent payments can be recycled back out to your

⁵ Beware, however, that certain adverse gift tax consequences can result from contributing a mortgaged residence to a QPRT. We can explain this in more detail to you if your residence is now mortgaged.

⁶ The text assumes a sale to a third party because the current QPRT rules require that the QPRT document must prohibit a sale of the personal residence to the QPRT grantor or certain family members, including a spouse, children or trusts created for their benefit.

⁷ In fact, after the expiration of the QPRT term, paying annual rent for continued occupancy can provide additional

spouse if needed. If not, they can be a form of gift tax-free transfer which will be available for distribution (immediately or in the future) to your children. If you die after the expiration of your rent-free term and are survived by your spouse, he or she can have the rent-free occupancy of the residence for his or her remaining lifetime.⁸ The children will wait to receive the residence until the deaths of the survivor of you and your spouse.

7. Can I “bail out” of the arrangement if I later decide it was a bad idea, or need to sell the residence to provide for my support and welfare or that of my spouse?

Yes. While the trust is technically irrevocable, you can retain an indirect power of revocation during your rent-free term by arranging the sale of the property. If there is a sale, and you do not wish to “roll over” the proceeds into the purchase of a replacement residence inside the trust (see paragraph 4, above), the trust document must direct that the sales proceeds be handled in one of two alternative ways: (i) either be distributed outright to you, or (ii) converted into an “annuity” which would make annual payments of income to you for the remainder of your rent-free term.⁹ The law does not require you prospectively to make the choice when you create the trust. This flexibility to “collapse” the trust later if appropriate takes some of the sting out of the trust’s irrevocability. After the expiration of your rent-free term, assuming an independent trustee agrees, the residence can be sold, with the sale proceeds distributed to your spouse (if you are married and your spouse is then living) or children in the independent trustee’s discretion.

8. Does the QPRT protect the residence from creditors?

Generally yes, assuming your initial transfer of the residence to the QPRT are

federal wealth transfer tax savings for those QPRT creators who have sufficient cash to pay rent, and are looking for creative ways to defund their estates. For example, the QPRT created for a wealthy client of mine has recently expired. The further trust created on the expiration of the QPRT term now holds a large beachfront property in an exclusive community. An appraiser has determined that its fair rental value during the “high season” from Memorial Day to Labor Day is \$1,500 per week. If there are 14 weeks during this period, and the client occupies the property during that period under a fair rental value lease, he can make \$21,000 of rent payments per year to the trust without any gift tax consequences. This will be sufficient to satisfy all carrying charges associated with the property and any excess can be invested for future growth for the benefit of the children. The further family trust is designed as a “grantor trust”. This means that it is my client’s “alter ego” for federal income tax purposes. This will allow the trustee to receive and reinvest the rental payments without erosion by the 39.6% income tax rate that otherwise applies to rental income.

⁸ If both you and your spouse are living, there is an alternative to paying full fair rental value to the trustee after the expiration of your rent-free term. Your spouse can be given the right to rent-free occupancy for her lifetime - you can continue to live in the residence as your spouse’s guest. Your obligation to pay rent would only commence upon your spouse’s death.

⁹ However, if you wish to allow for a distribution of the sale proceeds to yourself, you should not be the QPRT trustee when the sale occurs. Also, a distribution of the sale proceeds to you may forfeit the benefit of any gift and estate tax credit you consumed when you funded the QPRT. For this reason, you should not bail the sale proceeds out of the QPRT without first discussing it with us or another qualified tax professional.

not considered “fraudulent” as to your existing creditors.¹⁰ Many states have liberal “homestead exemptions” which protect the full value of a primary residence from creditors even if the owner goes into bankruptcy. New Hampshire is not so generous; as of January 1, 2002, our homestead exemption is limited to the first \$50,000 in equity.

Placing the residence in a bona fide QPRT can, practically speaking, make up in part for the lack of homestead protection. A creditor or trustee in bankruptcy can stand in your shoes and attempt to reach your right of rent-free occupancy during the rent-free term. But they cannot force a sale of the residence, or “break” the trust and eliminate your children’s future interest in the residence.

9. What are the down-side risks or drawbacks?

None, if the QPRT is considered purely from a gift and estate tax point of view. Sure, you may create a QPRT and not survive your rent-free term. But the worst that can happen upon your premature death is for the residence to be includible in your taxable estate. Any of your gift and estate tax exemption you consumed in funding the trust will be restored. You will be placed back to “square one”: you are no better or worse off (gift and estate tax-wise) for having used this strategy. There are, however, two other factors you should consider before acting:

a. If you survive your rent-free term and successfully escape estate taxation of the residence, your children will not receive the fair market value increase in the income tax cost “basis” of the residence they would have received had the property been subject to estate taxation. For example, if you successfully employ the QPRT, and your federal income tax cost basis in the appreciated \$500,000 residence is \$10,000, your children (or the trust) will use that low basis in calculating its capital gain should they later sell the property.¹¹ You are trading off the income tax benefit of the increased date of death basis against the estate tax savings of removing it from your estate at a discounted value. Taking our 40-year old parent illustrated above as an extreme example, he removed \$484,000 from his estate tax base by successfully employing the QPRT strategy. If the entire value of the residence were subject to an average estate tax rate of 45%, he will save \$218,000 by using the QPRT. If, by contrast, he opted not to use the QPRT in favor of the date of death basis increase, his heirs would save \$98,000 in income tax (\$500,000 fair market value minus \$10,000

¹⁰ Your creditors can “break” the QPRT and attach the full value of the residence if they can demonstrate you were insolvent when you initially transferred the residence to the QPRT, the transfer rendered you insolvent, or you made the transfer with the actual intent to hinder or delay your creditors.

¹¹ You can even avoid or minimize this problem by arranging a sale of the residence during your rent-free term. (Remember, however, that the QPRT trust document must prohibit you, your spouse, or any other “grantor trust” you or your spouse may have created, from purchasing the residence). You can then use the proceeds to purchase a replacement residence or an annuity for the remainder of the trust term as described in paragraph 7 above. Either way, your children will not “inherit” any federal income tax problem from you. Note, however, that under the terms of the 2001 Tax Act, both the estate tax and the step-up in basis rules disappear in 2010. Absent additional legislation, however, both the estate tax and step-up in basis rules will reappear in 2001.

basis times 20% capital gain rate). The estate tax savings are greater because the *minimum* estate tax rate (37%) exceeds the *maximum* capital gains tax rate (20%) by a full 17%.

b. The residence will be removed from your balance sheet and may affect your credit-worthiness. This may be particularly important for young homeowners considering this strategy. You cannot offer the residence as collateral to secure personal debt should you later need funds. This, however, is not often a concern for older people, who are particularly good candidates for this strategy. They are far enough along in their financial life cycles to own their homes free of debt and often have no foreseeable need to tap their equity.