

GIFT OF A PERSONAL RESIDENCE TO A QUALIFIED PERSONAL RESIDENCE TRUST (QPRT) FOR THE BENEFIT OF THE OWNER'S CHILDREN, FOR A TERM OF YEARS: ESTATE TAX STRATEGY, RULES AND RECOMMENDATIONS

The Qualified Personal Residence Trust ("QPRT") is a valuable estate tax planning strategy, briefly summarized below. This method enables the Grantor to gift the owner's personal residence ("Home"), to an Irrevocable Nongrantor Trust ("Trust"), established by the Grantor for the benefit of the Grantor's children, and thereby lawfully avoid paying the applicable estate tax upon the Grantor's subsequent death. The gift is made to the Trust at a substantially discounted value, retaining a "term interest" in the Home ("Term") for the Grantor to live in the Home for a specified number of years (IRC § 2702). The Grantor gifts the Home to their Trust at a fraction of the cost, reserving the right to live in the Home, rent-free, for a specified Term. There are substantial technical requirements to make the QPRT fully compliant with the Internal Revenue Code and a detailed analysis is beyond the scope of this discussion (see Treasury Regulation 25.2702.5(c).)

The value of the gift by the Grantor to the children's Trust is equal to the "value" of the remainder interest in the Home, based on the equity in the Home at the time of the initial transfer. In addition, the value of the gift is further reduced if the Grantor retains a contingent reversionary interest in the Home after the Term expires. For instance, the Home reverts to the Grantor's Estate if the Grantor does not survive the Term. Also, there is no additional estate tax for the contingent reversionary interest. If the Grantor survives the Term, all subsequent appreciation is removed from the Grantor's estate. The rationale for the QPRT is that the children must wait until the term for the QPRT to expire. Thus the value of the Home is less in current dollars (for example, "time value use of money").

At the end of the Term, the formal right of the Grantor to use the Home ceases and the Grantor's beneficial ownership is gone. The longer the term for the QPRT, the lower the value of the gift will be. The principal risk is that if the Grantor dies during the term of the QPRT, the entire value of the Home will be included in the Grantor's Estate for estate tax purposes (IRC §2036(a)(1)). This risk can be reduced by reducing the term of the QPRT. Of course, this reduces the value and the amount of discount allowed. A strategy to hedge against this risk is to purchase short-term life insurance for the term of the QPRT, thereby avoiding any downside problem. Most of the reduction in value occurs in the first few years of the Term. Thus, the higher the Applicable Federal Interest Rates, the greater the discount (IRC §7520). When the Grantor decides when to make the gift to the QPRT, the Grantor is choosing the Applicable Federal Interest Rate, since it may fluctuate quarterly. Thus, waiting to gift the Home to the QPRT may cause the value of the Home to increase and thereby reduce the value of the discount. Another concern is that the Home is no longer owned by the Grantor at the end of the term, making the Grantor technically homeless. The normal plan is for the Grantor to rent the home from the Grantor's Beneficiary provided the Grantor and the children's Trust can agree as to the rental terms. Another concern is that there is no step up in basis in the Home. This estate tax strategy will also provide substantial judgment creditor protection for the Grantor's Home should the Grantor be willing to allow someone else to be the Trustee, otherwise the Grantor can be the Trustee (IRC §2036(c)).

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