Qualified Personal Residence Trusts

Just the FAQs

HELSELL FETTERMAN

What is a Qualified Personal Residence Trust?

A Qualified Personal Residence Trust ("QPRT") is Trust which allows you to transfer your home to your named beneficiaries (usually your children) at a future date, at a substantially reduced gift tax rate. Individuals with a valuable home or second home can take advantage of this technique to save hundreds of thousands of dollars in estate taxes.

How does it work?

You work with your attorney to create an irrevocable trust that will terminate in a specified number of years. You agree to transfer your house to the trust but you retain all control over your house, including the right to live in the residence, and the right to sell the property and purchase a new primary residence. At the end of the specified term, the trust terminates and the residence is transferred to your named beneficiaries (usually your children).

Who runs this trust?

In the trust agreement, you appoint a Trustee to manage your residence during the trust term. You may serve as your own Trustee, or you may select a friend, relative, or corporate Trustee to serve in this role.

What are the tax benefits of a QPRT?

If you give your house to your children, the IRS deems the entire transfer a gift and assesses gift tax on the entire value of the house. However, when you transfer your house to a QPRT, the IRS apportions the value of the house into two parts - (1) the right to use the residence for a term of years (the "retained interest"), and (2) the right to receive the residence after the trust term (the "gift"). The IRS assigns values to each of these parts, depending on the term of years you choose. The longer the term, the larger the retained interest and hence, the smaller the gift. Only the gift portion is subject to gift tax.

Do I actually have to pay tax on the gift portion of the QPRT?

The gift portion of the transfer is a "future interest gift" and does not qualify for the annual exclusion from gift tax. Therefore, you must file a gift tax return in the year the residence is transferred to the trust. However, each taxpayer has the ability to shelter over $11 million (indexed for inflation) of taxable gifts during his or her lifetime ("lifetime exemption"). Therefore, if you haven't used all of your lifetime exemption, you will be able to apply it to this transfer and no gift tax will be due. If you are already making annual exclusion gifts to your children whether outright, in educational accounts, or in trust, the QPRT will not impact your gifting plan.

Can you illustrate the benefits of a QPRT for me?

Yes. Assume that Jack and Jill, ages 62 and 58 respectively, transfer a residence worth $800,000 to a house trust with a 20-year term. Based on the length of the trust (and a 1.8% applicable federal rate), the IRS treats this couple as having made a taxable gift of approximately $461,824 in the year the trust is established.

If the house appreciates at 4% annually, it will be worth $1,752,899 at the end of the 20-year trust term when ownership passes to Jack and Jill's children without further tax. If Jack and Jill each live to their actuarial life expectancy, the house will appreciate for another 6 years before they both die following termination of the trust and will be worth approximately $2,217,976 when the survivor dies. Depending what estate tax bracket the couple is in at that time, the potential estate tax saving could be roughly $645,538. Obviously, if a trust term longer than twenty years is used, or if the house appreciates at more than 4% annually, the potential estate tax savings would be even greater.

How do I choose a term?

The longer the trust term, the smaller the taxable gift, and the greater the potential tax savings. Therefore, you want to choose as long of a term as possible. However, if you die prior to end of the trust term, the residence will be included in your taxable estate. Therefore, the trust term should be as long as possible but shorter than your life expectancy.

What happens if I die during the trust term?

If you die prior to the end of the trust term, you are treated as if no trust had been formed. The residence will be included in your taxable estate and any credit used when you made the initial transfer will be recaptured. If two spouses are transferring the residence, and one dies within the term while the other outlives the term, they still save a substantial amount of estate taxes. However, the estate tax savings increases if they both outlive the term.

If I outlive the trust term, will I be kicked out of my house?

At the end of the trust term, the beneficiaries become the owners of the house. You may remain living in the residence, but you are required to pay fair market rent to your beneficiaries. While it may appear odd, the payment of rent to children is an additional method of shifting assets from wealthy parents to the next generation.

What property can be transferred to the trust?

You may only transfer your primary or secondary residence to the trust. You cannot transfer investment or rental property. If you are considering using this technique for your vacation home, and you currently rent out the home for part of the year, you will need to discontinue all rental activity prior to transferring the residence to the trust. Additionally, if your primary home or vacation home has substantial acreage, there may be an issue as to whether the entire property can be transferred into the trust.

What are the disadvantages to a QPRT?

One of the main disadvantages of a QPRT is the loss of stepped-up basis. When you own real estate and you pass it to a beneficiary through your Will, your beneficiary receives it with an income tax basis equal to the fair market value of the house at the time of death. All appreciation from the date of your acquisition through the date of your death disappears. This is called a “stepped-up basis”. When the beneficiary sells the property, he or she only pays capital gain on the appreciation (adjusted for capital improvements) from the date of your death through the date of sale. However, if the property is distributed to your beneficiary through a QPRT, he or she retains your low basis and receives the residence subject to the accumulated appreciation. When he or she later sells the property, he or she must pay capital gain on the appreciation (adjusted for capital improvements) from the date of your acquisition through the date of sale. The current federal estate tax rate is 40%, and the state estate tax rate is 10% - 20%. Compared with the current capital gains rate of 15%-20%, the estate tax savings of a QPRT will generally outweigh the capital gains savings of holding the property until death to obtain a stepped-up basis.

If I put my residence in trust, can I sell it later?

Yes, you may sell the residence in the trust at any time. To the extent sale proceeds are not reinvested in a new residence within two years, the funds are held as a Grantor Retained Annuity Trust (GRAT). For instance, you may decide to downsize your residence. The sale proceeds from the residence can be used to purchase a smaller home and the remainder will be deemed a GRAT. The GRAT pays you a fixed annuity based on a percentage rate under the IRS tables for prevailing interest rates in effect when the QPRT was originally established, until the end of the trust term. At the end of the trust term, the annuity is distributed to your beneficiaries. If you die prior to the end of the term, the annuity is included in your taxable estate.

Would I still qualify for the capital gain exclusion on the sale?

Yes, because the trust is a "grantor trust," you will be considered the owner for income tax purposes. Because of this, you can still qualify for the $250,000 (or $500,000 for a married couple) exclusion of gain on the sale of a primary residence.

What if my house has a mortgage?

If your house has a mortgage, you should retain the obligation when you transfer your residence to the trust. This way, you will be able to deduct the interest against your income.

What if I need to borrow against my house?

After you transfer the residence to the trust, you cannot use the residence as collateral for additional personal borrowing. Therefore, if you anticipate the need to borrow in the future, we encourage you secure the loan before the transfer and retain liability for repayment.

To learn more, contact our

Estate Planning & Probate Group

WWW.HELSELL.COM **Helsell Fetterman LLP**

Seattle 1001 Fourth Avenue, Suite 4200 Seattle, WA 98154

Bellevue 10900 NE Fourth Street, Suite 2300 Bellevue, WA 98004