THE QUALIFIED PERSONAL RESIDENCE TRUST

1. What is a Qualified Personal Residence Trust?

Simply stated a Qualified Personal Residence Trust is a transfer of a house by the Grantor, better known as the owner of the house, into a trust under which he or she will be allowed to remain in the house for a term of years, and after that term of years has expired, the house will pass to children or other intended beneficiaries. The result of this is that at the end of the trust term, the children receive the house, and the value of the house is removed from the Grantor's estate for estate tax purposes. At the death of the Grantor no estate tax is payable on the house, which is often a substantial savings.

A personal residence is taxable to the owner's estate, that is, it is taxable to the owner of the residence whose name appears on the deed. This can result in a substantial estate tax. For example, if a residence was acquired a number of years ago and the value has greatly appreciated, then a needless, substantial estate tax will be paid. A common example is as follows: A home was purchased for Sixty Thousand Dollars ($60,000) some time ago and the home is now worth Two Hundred Fifty Thousand Dollars ($250,000). If the property is held until death, it will pass to children or other beneficiaries, who will have what is known as a "step up" in basis in the property; in other words, the children will take the date-of-death value property as their basis for computing gain on the property when the property is sold by them. Put simply: it cost Sixty Thousand Dollars ($60,000), and (even assuming no further appreciation) is now worth Two Hundred Fifty Thousand Dollars ($250,000). The capital gain of One Hundred Ninety Thousand Dollars ($190,000) will be avoided; however, there will be an estate tax on Two Hundred Fifty Thousand Dollars ($250,000), which can be as much as 55%. A Qualified Personal Residence Trust will remove the house as an asset from the owner's taxable estate, and will save estate tax on the value of the house.

2. How much of a tax savings will I have by using a Qualified Personal Residence Trust?

The best way to discuss the tax savings gained by using a Qualified Personal Residence Trust is to illustrate it with two simple examples.

#1

Current Value of Home	=$600,000
Term of QPRT	=5 years
Value of Home at End of Term	=$729,992

Assume at 50% federal and state death tax bracket.

<u>Result:</u>

Death Tax Savings of $177,925, which is equal to the value of the property after five years ($729,992) reduced by the amount of the taxable gift given to the children ($374,142) multiplied by the 50% federal and state death tax bracket.

<u>Tax Savings of $177,925</u>

#2

Value of Home	=$600,000
Term of QPRT	=10 years
Value of Home at End of Term	=$888,147

Assume a 50% federal and state death tax bracket.

Result:

Death Tax Savings of $332,753, which is equal to the value of the property after ten years ($888,147) reduced by the amount of the taxable gift given to the children ($222, 542) multiplied by the 50% federal and state death tax bracket.

Tax Savings of $332,753

As you can see, the tax savings illustrated by the above examples are substantial, and clearly, the longer the term of the Trust, the more beneficial the tax savings; however, a Qualified Personal Residence Trust, even for a short term of three (3) years, will still result in a significant tax savings.

3. For what term of years should the Trust be created?

In deciding upon what term of years to use in a Qualified Personal Residence Trust, the most commonly considered factors are the Grantor's health and age. The Grantor must survive the term of years for the house to be removed from the Grantor's taxable estate.

4. Can I still live in the house during the term of the Trust?

The Grantor has the right to live in the house and use the property fully for the term of years of the Trust. During the term of the Trust, the Grantor pays all expenses relating to the residence, which includes real estate taxes and the like.

5. Once the term of the Trust is over, can I still remain in the house?

Once the term of the Trust is over, the Grantor may rent the house from the Trustees or beneficiaries for a then-current fair market rental. The lease can be for one year, or five years, etc., and it can be renewed as long as it is agreeable to the Trustees or beneficiaries. The reason that a lease is necessary is to make sure the Grantor has no "incidents of ownership" with regard to the house. If the Grantor continued to live in the house rent free after the term of years, it would appear that the Grantor never really transferred ownership to his or her children, and therefore the value of the house would be includible in the Grantor's taxable estate. To avoid creating this problem, there should be a formal lease agreement between the Grantor and the Trustees or beneficiaries. It should be an arm's length transaction and a true landlord/tenant relationship should be established. A fair market rent should be charged and paid by the Grantor and collected every month. The Grantor should provide a security deposit to the Trustees or beneficiaries as would be done in any other landlord/tenant relationship.

6. Can I purchase the house back at the end of the term of the Trust?

No. The provisions of Treasury Regulation Section 25.2702-5(c)(9) prohibit either the Grantor or any related party from repurchasing the house at the end of the term of the Trust.

7. What if I would like to leave the house to charity?

If the Grantor doesn't wish to leave the residence to children or a relative, but also doesn't wish to see it sold to a third party, the Grantor might consider leaving it to a charity. A simple way to do this would be to enter into a Qualified Personal Residence Trust naming a charity of the Grantor's choice as the end-of-term transferee. (Another option with regard to leaving the house to a charity would simply to be to a charity outright without using a Trust, and have the charity sign a lease with the Donor under which the Donor could live in the house for fair market rental value for as long he or she wished; the house would be removed from the Donor's estate for estate tax purposes.)

8. Can I fix or add improvements to the residence?

The Grantor, during the term of years of the Trust, may make any repairs or improvements that he or she wishes.

9. Can I sell the residence during the term of the Trust?

The Trustee can be authorized to sell the residence at any time during the term of the Trust. If the Trustee does so, the sale will be subject to the exclusion rules under section 1034 of the Internal Revenue Code, as amended by TRA '97. The Act repealed the former provisions allowing taxpayers to roll over the proceeds of a sale of a personal residence into a new residence of equal or greater value and the one-time exclusion of up to $125,000 for taxpayers age 55 or older. Under the rules enacted by TRA '97, effective May 7, 1997, there is no roll over, but married taxpayers filing a joint return may exclude up to $500,000, and single taxpayers may exclude up to $250,000, of the gain on the sale of a personal residence. The exclusion may be taken once every two years provided the taxpayer owned and used the premises as a principal residence for at least two of the five years preceding the sale of the residence. Any gain on the sale in excess of the $500,00 (or $250,000 for single taxpayers) would be taxed to the grantor. A partial exclusion may be taken if the residence must be sold prior to the expiration of two years if the second sale is due to change of employment, health or other unforeseen circumstances, as determined pursuant to rules to be issued by the Internal Revenue Service.

10. What if I retire to another state?

If the Grantor retires to another state and desires to sell the residence during the term of the Trust, the Trustee may sell it. The sale of the personal residence would be subject to the same exclusion rules discussed in Question 9, above.

11. What if Grantor dies during the term of the Trust?

If the Grantor dies before the term of the Trust is over, the value of the house is includible in the Grantor's taxable estate for estate tax purposes. However, any unified credit that was used when transferring the house as a gift to the Qualified Personal Residence Trust will be recouped, and used to offset estate taxes.

Conclusion

The Qualified Personal Residence Trust is a useful tool in reducing estate taxes. In many cases a second residence, whether it be a vacation residence or a house that is a meeting place for friends or family, is a place that you don't wish to sell to an outsider. The Qualified Personal Residence Trust is a way to ensure that the Grantor can enjoy the use of the house throughout the term of Trust, and even continue to do so thereafter by entering into a lease for fair market rental value. The Grantor can also ensure the transfer of the house to loved ones or to a charitable organization. This serves the purpose of removing the house from the Grantor's estate for estate tax purposes and "keeping it all in the family."

During the term of the Trust, the Grantor retains the right to full use of the residence, and also retains any and all tax advantages of ownership. The Grantor may repair the house and make alterations or additions during the term of the Trust. Once the term of the Trust is over, the Grantor may lease the house from the Trustees or beneficiaries at a fair market rent, for however long the Grantor wishes. However, any such lease should be a bona fide agreement under which a security deposit is given, and payments of rent are made every month to the Trustees or beneficiaries. There is always a risk that the Grantor will die during the term of the Trust, and in considering what the term of the Trust should be, the Grantor's health and life expectancy should be considered because if the Grantor does not survive the term of the Trust the house is includible in the Grantor's estate for estate tax purposes. The Trust is a bit of a gamble for this reason; however, the benefits in tax savings far outweigh the risk. In a sense, there is really no risk at all, because without the Trust the house would be included in the Grantor's taxable estate anyway. It is therefore beneficial to decide on a realistic term of years and attempt to garner all possible tax savings by using a Qualified Personal Residence Trust.