

QPRT: An Attractive Tax Break for Gift of Residence

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Practice Area: Tax & Estate Planning

Persons whose estates will be subject to federal estate tax can often save significant gift and estate taxes through use of a qualified personal residence trust.

Generally, the estate of an unmarried person with a value in excess of \$600,000 is subject to estate tax.

The estates of married persons are normally not subject to estate tax until the death of the surviving spouse. At that time, \$1.2 million or more can escape estate tax if there has been tax planning while both spouses are living. Without proper planning, only \$600,000 of the spouses' property escapes taxation at the second death.

A QPRT can improve the estate tax shelter available to both unmarried and married persons.

How does a QPRT work? An owner transfers a principal residence or a vacation home, or both, to a trust for a specified term, for instance, five, seven or ten years, reserving the right to occupy the home during the term. At the end of the term, title passes to the beneficiaries, known as "remaindermen."

The transfer to the trust is a gift from the donor-owner to the remaindermen. Because the donor has reserved a right to occupy the residence for a term, the value of the gift is less than the market value of the residence. The tax saving potential is the product of three factors: the length of the term of reserved occupancy, the age of the donor, and an assumed rate of interest that reflects the value of the right of occupancy.

For instance, a 60-year old person transfers a \$400,000 home to a ten year QPRT. The donor can be the trustee. If the residence is owned jointly, each spouse transfers a half interest to separate QPRTs.

Based on IRS interest and mortality tables, the value of the gift (the remainder interest) is about 40 percent of the market value, or \$160,000. This is reported on the donor's federal gift tax return, and absorbs approximately \$160,000 of the donor's \$600,000 exemption from federal gift and estate taxes. No gift tax is payable. (There is no Wisconsin gift tax.)

This transfer removes the \$400,000 residence from the taxable estate of the donor at a gift tax cost of approximately \$160,000. If the residence appreciates in value, the appreciation is also removed.

During the term, the donor must pay real estate taxes and the cost of repairs and maintenance. Capital improvements, such as a new roof, may be paid for by the donor and remaindermen pro rata. If the donor pays the entire cost, the remaindermen's share of the payment is an additional gift to them, absorbing some of the donor's gift/estate tax exemption. Payments of mortgage principal are also gifts, therefore a QPRT works best with a mortgage-free residence.

If the donor continues to occupy the residence after the end of the term, a fair market rental must be paid to the remaindermen. This removes additional asset value from the estate of the donor; for the remaindermen, it is reportable income. Despite the attractive gift and estate tax benefits, some parents find it unpalatable to pay rent to their children. As a result, they use a vacation home to create a QPRT, which results in fewer rental payments.

There are several other factors that must be taken into account when considering a QPRT. The remaindermen receive the donor's cost basis for determining gain or loss on a later sale. If the remaindermen inherit the residence, the basis is "stepped up" to its fair market value at the donor's death, which reduces capital gain upon a sale by the remaindermen.

If the donor dies before the end of the term, ownership of the residence reverts to the estate. Since this would have occurred had there been no QPRT, it represents an aborted opportunity rather than a disadvantage. A QPRT would also be disadvantageous if the value of the real estate is expected to decline rather than appreciate.

Consider a QPRT as an attractive estate planning opportunity if:

- There will be a federal estate tax payable at the death of the owner;
- The owned residential real estate is likely to appreciate in value;
- The owner's children or other potential remaindermen are likely to retain the real estate after becoming the owners;
- The owner enjoys normal good health for his or her age; and
- The owner expects to occupy the premises after the end of the term and is willing to lease the residence from the remaindermen, and the remaindermen are willing to lease it.

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