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TRUSTS & ESTATES ALERT
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QPRTs Funded with Fractional Interest Realize Significant Tax Savings

The estate planning technique known as the QPRT (qualified personal residence trust) is an important estate planning technique to save taxes under the federal gift and estate tax system. Under that system, the value of any asset given away during life or transferred at death is subject to tax at a rate of up to 46% if the value of the asset exceeds the donor's "applicable exclusion amount" (i.e., the amount an individual can transfer without incurring gift or estate tax--$1 million for lifetime gifts and $2 million for estates in 2006). Because the rates for gift and estate taxes are so high, every effective estate plan should include a range of techniques aimed at both the reduction of the asset values subject to tax and the strategic use of the applicable exclusion amount. The QPRT is a technique that accomplishes both of these goals for individuals owning residential property.

To create a QPRT, a homeowner places residential property into an irrevocable trust. The homeowner specifies the duration of the trust and selects the beneficiaries and a trustee--usually a family member. During the term of the trust, the former homeowner must, to some extent, use the property as a residence. If the homeowner outlives the duration of the trust, the residence will pass to the beneficiaries when the trust terminates. If the homeowner does not outlive the duration of the trust, the residence will become part of his or her estate as if the QPRT had never existed.

When creating the QPRT, the homeowner may give his or her spouse a life interest in the residence immediately after the trust term. Such a life interest will allow the homeowner and the spouse to continue to live in the residence. Another possibility after the trust ends is for the homeowner to lease the residence from the beneficiaries--resulting in the tax-free transfer of additional funds from the homeowner's estate to the beneficiaries in the form of rent. The rental income for the beneficiaries may be offset for income tax purposes by deductions of expenses relating to the property.

The homeowner will use a portion of the homeowner's applicable exclusion amount (or, if that amount has been used entirely, he or she may owe gift tax) on the transfer of the residential property to a QPRT. However, the amount of the gift that is subject to tax will be significantly less than the market value of the property. For gift tax purposes, the value is reduced--often dramatically--by the actuarial value of the homeowner's right to use the residence until the end of the trust term.

Moreover, the homeowner may divide the residence into fractional interests for each of the intended beneficiaries and thereby realize an even greater savings in gift tax. If a homeowner intends to give the property to two or more beneficiaries, the homeowner should consider creating a separate QPRT for each beneficiary with each QPRT holding a fractional interest in the property. Because each QPRT will hold only a fractional interest, a fractional interest discount will further reduce the total value of the transfer. The homeowner will thus "shelter" from transfer tax both the value of the homeowner's right to use the residence and the amount discounted due to the QPRT's fractional interest holding.

There are other savings available with a QPRT. For instance, because the value of the residence for transfer tax purposes is the value at the time of transfer to the QPRT, any appreciation in value between that time and the time of the homeowner's death will never be subject to gift tax or estate tax. Instead, all of the appreciation will pass to the QPRT beneficiaries free of tax. Because the taxable value of the gift is significantly reduced and the appreciation on the property will not be subject to gift or estate tax at all, a QPRT is an extremely effective technique for leveraging the benefit of the homeowner's applicable exclusion amount.

An example of the potential tax savings is a 65 year old homeowner who has two children. In May 2006, the homeowner transfers a 50 percent interest in a $300,000 residence to separate QPRTs for each child. The term of each QPRT is 10 years. Each 50 percent interest will be discounted by a real estate appraiser for lack of marketability. If each 50 percent interest is discounted by 25 percent such that the actuarial value of each interest is approximately $112,500, then the total value of the taxable gifts will be about $107,000 after taking into account the interest retained by the homeowner. The homeowner will not pay tax on the remaining value of the home--$193,000--nor will the homeowner pay tax on any appreciation of the property. Furthermore, if the homeowner has at least $107,000 of the applicable exclusion amount available, the creation of the QPRTs will not require payment of any gift tax.

The QPRT technique has other advantages. A QPRT allows the homeowner to remain financially flexible because the trust can sell the residence to a third party--but not to the former homeowner--and invest the proceeds in a new residence. An individual can transfer up to two residences to QPRTs, and a married couple can transfer up to three.

In sum, the basic benefit of any QPRT is that it allows an individual to remove significant assets from his or her estate and materially reduce the taxes imposed on the transfer of assets between generations.

To learn more about QPRTs and whether a QPRT is appropriate for a particular estate plan, call Bruce A. Rosenfield at 215-751-2080 or send an e-mail to brosenfield@schnader.com.