

Qualified Personal Residence Trusts and Remainder Purchase Marital Trusts

An owner of valuable real estate in the form of a second home or vacation home may consider transferring it in order to utilize all or a portion of his/her lifetime exemption amount.

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A QPRT is an irrevocable trust created to transfer a personal residence in the future to family members in a transfer-tax efficient manner.

In light of the increasing estate, gift and GST (generation-skipping transfer) tax exemptions, some affluent individuals are looking for various ways to utilize their exemption amounts during their lifetime to remove the value from their estates for estate tax purposes and transfer the future potential appreciation outside their taxable estates. However, some of these individuals, regardless of the extent of their wealth, are reluctant to divest themselves permanently of the use and benefit of assets that could potentially support their lifestyle into the future. The conundrum of wanting to take advantage of wealth transfer opportunities but not being comfortable enough to part with lifestyle-sustaining assets can leave them perplexed to the point of doing nothing.

One option for such people is to consider giving other assets that will likely not be needed to support the lifestyle they are accustomed to living. For example, if the family has valuable real estate in the form of a second home or vacation home (or several vacation homes), they may consider transferring one or more of the residences to utilize all or a portion of their lifetime exemption amounts.

How do you transfer real estate?

There are many ways to transfer real property, through gifts or sales to trusts for children, but this article will focus on the benefits, considerations and differences of two vehicles: the Qualified Personal Residence Trust ("QPRT") and the Remainder Purchase Marital Trust ("RPMT").

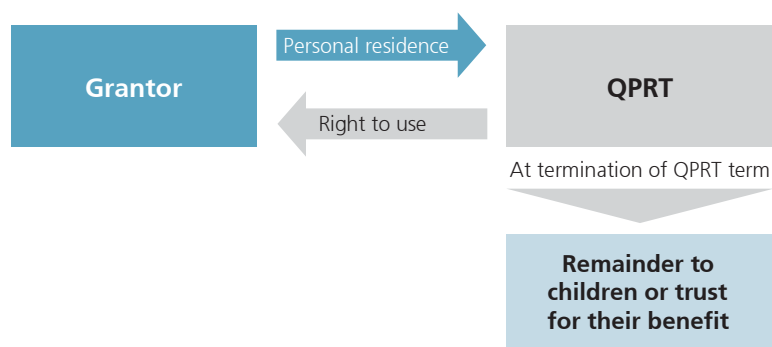
What is a QPRT?

You may be familiar with a QPRT and how it works. It is a strategy straight out of the regulations under the Internal Revenue Code whereby an irrevocable trust is created for the purpose of transferring a personal residence in the future to family members in a transfer tax-efficient manner.

Here's how it works

The grantor transfers his or her primary residence or vacation home to a QPRT. The grantor retains the right to live in the home for a set number of years. At the end of the QPRT term, the home passes outright to, or in trust for, the grantor's children. The grantor must outlive the term or else the value of the property will be included in the grantor's estate for estate tax purposes.

At the end of the trust term, the grantor may continue to reside in the home, but must pay fair market rent to the new owner of the home, i.e., the children or a trust for their benefit. For gift tax purposes, the grantor is only making a gift of the actuarially determined future value—computed using the IRS Section 7520 rate as the discount rate—of the residence at the end of the term.



If the grantor survives the QPRT term, the value of the home is not subject to estate tax at his/her death.

QPRTs generally are utilized more when the 7520 rate is relatively high. In a low interest rate environment, a QPRT may not provide the best use of lifetime gift tax exemption because the lower the 7520 rate, the larger the future value of the home and therefore the larger the taxable gift will be. However, even during periods of low 7520 rates, a QPRT may be appropriate due to depressed real estate values and the increased gift tax exemption which allows larger gifts to be made. In particular, if a personal residence is the only asset available to give without compromising lifestyle, then it may make sense to transfer it to a QPRT so as not to lose the opportunity to take advantage of current increased exemption amounts.

Advantages

- The gift to the trust may be relatively small compared with the value of the home, because the gift is based on the future value of the home, not the present value.
- The grantor may pass property of large value to family members without potentially changing his or her lifestyle.
- If rent payments are eventually made to the family members, the payments are additional asset transfers not subject to gift or estate tax.
- If the grantor survives the QPRT term, the value of the home at death is not subject to estate tax.

Considerations

- Creating a QPRT uses gift tax exemption or could result in a taxable gift if all exemption has been used.
- To receive intended benefits from a QPRT, the grantor must survive the term.
- The home is transferred with the grantor's income tax basis. The opportunity to "step up" the basis at death is lost.
- If the grantor dies during the QPRT term, the home is included in grantor's estate.
- The rules governing the allocation of the GST tax exemption to trusts render unattractive the use of a QPRT for transfers to grandchildren.
- An appraisal of the home is required.
- Compared to other techniques, the QPRT may provide less leverage of the gift tax exclusion amount or of taxable gifts.

What is a RPMT?

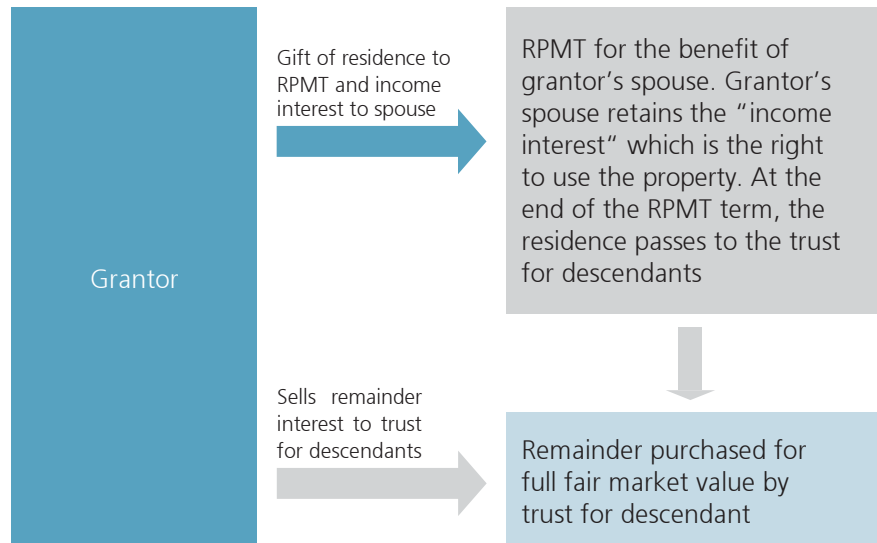
Some estate planning practitioners are looking to the RPMT as another option to transfer real property in a transfer tax-efficient manner. Although this strategy has not been fully vetted by the Internal Revenue Service, it is being discussed and considered by some attorneys. The premise behind a RPMT is that it is a vehicle by which married couples may transfer real property to descendants (or other remainder beneficiaries) without incurring gift and estate tax. The proponents of this strategy believe that a RPMT may be used as an alternative to a QPRT and that it provides greater flexibility without the restrictions of a QPRT.

Here is how it works

The grantor transfers property (a personal residence, vacation home or other real property) to the RPMT. The grantor gives his spouse an income interest in the trust for life or a term of years. The income interest given to the spouse is essentially the right to the use and benefit of the property. The gift of the income interest to the spouse should qualify for the marital deduction so there should be no gift tax consequence for the gift to the spouse. At the same time, the grantor sells the remainder interest in the

An RPMT may own more than one residence and it may even own property that is leased to a third party.

RPMT for full fair market value to a trust for his descendants. The result is that the RPMT owns the residence, the spouse is entitled to the income interest (or the right to use and occupy) and the remainder interest is owned by a trust for grantor's descendants. Upon the termination of the income interest at the spouse's death, the property passes to the trust that owns the remainder interest.



Potential advantages

- Unlike the QPRT, the RPMT does not have mortality risk because the grantor retains no interest in the trust: the spouse receives the income interest and the trust for descendants owns the remainder interest.
- Proponents of this strategy believe that the property is not included in the surviving spouse's estate because the remainder interest is sold for full and adequate consideration.
- Unlike a QPRT, a RPMT may own more than one residence and may even own property that is leased to a third party.
- The property held in a RPMT may be sold during the term without any requirement that a replacement property be purchased, as is generally the case with a QPRT.
- An RPMT can be used for transfer to grandchildren, though GST exemption should be allocated to the RPMT to avoid a taxable termination, when GST tax would be due.

Considerations

- Unlike a QPRT, the RPMT is not based on the Treasury Regulations, and we do not have the benefit of a long line of case law analyzing or blessing the strategy. In fact, in analogous situations, the IRS has historically taken the view that this sort of strategy does not work, though more recently the courts have treated the IRS less than favorably in this regard. Consequently, and as with any wealth transfer strategy, it should not be implemented without careful consideration of the potential risks as well as benefits. You should consult with your attorney and consider carefully the potential benefits and considerations of this less "tried and true" strategy. In particular, although there are sound arguments in support of the RPMT, if you are completely audit adverse and want to avoid even the possibility of IRS scrutiny, then this strategy may not be appropriate.

- Unless a trust already exists for the grantor's descendants which holds sufficient assets, then a gift is required because the trust purchasing the remainder interest must have the requisite funds to make the purchase.

Conclusion

The QPRT and the RPMT may be two options to discuss with tax advisors (though it is important to note again that the RPMT is not sanctioned by any statute or IRS regulations).

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