The Law Office of
Brown & Brown, P.C.
Estate, Trust, Tax and
Long Term Care Planning

www.brownandbrownpc.com
1250 E. Sherwood Drive
Grand Junction, Colorado 81501
Phone: (970) 243-8250 ♦ Fax: (970) 241-1144

Baird B. Brown **Clara Brown Shaffer** **Shauna C. Clemmer** **Daniel F. Fitzgerald**

"Accumulating wealth is one thing. Preserving it is another.
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Special Report

The Qualified Personal Residence Trust

Case Study: Taxable estate containing a residence (or a vacation home)

The Situation and Goal of Sam

An individual, Sam, age 60, has what is likely to be a taxable estate. Sam has an estate of $12,000,000 which includes a residence valued at $1,000,000. The residence will likely increase significantly in value prior to his death. Recognizing the possibility Congress will not change the current estate tax law (which will impose an estate tax on estates in excess of $13,990,000 for those individuals dying in 2025, Sam wishes to be proactive and look at ways to reduce the estate tax which may be owed upon his death.

A Possible Solution

Sam has heard of a trust, a "Qualified Personal Residence Trust," which may meet his goals. He has heard he can transfer his residence to the trust, thereby capping the appreciation of the residence. By capping the increase in the value of the residence, he can also reduce the amount of estate tax his estate may have to pay.

The Analysis of the Qualified Personal Residence Trust

The current estate tax may have a substantial impact on the value of assets which can be passed to an individual's heirs. For decedents dying in 2025 the estate tax exclusion is $13,990,000. This amount is indexed for inflation and will increase annually.

There are a multitude of ways of planning to reduce the impact of the estate tax. The planning techniques generally fall into one of five categories: (1) giving away assets, thereby removing the future appreciation of the assets from the individual's estate; (2) making the assets worth less on paper through the use of family entities having a business purpose; (3) making charitable gifts; (4) using life insurance to pay the cost of the anticipated estate taxes; and (5) for some, who are owners of a closely held business or are farmers and ranchers, there are other special provisions.

Using a Qualified Personal Residence Trust (QPRT) is a planning technique involving a residence or vacation home which combines giving away assets and making them worth less on paper. This effective planning technique may be advantageous, depending upon the current value of the individual's estate, the anticipated growth of the value of his or her estate, the individual's anticipated life expectancy, and the desire to maximize the amount which can be passed free of estate tax (which varies from year to year and does not always go up).

In this Special Report, we will give you a broad-brush review (avoiding the nuances of any particular plan, which depends upon each individual's situation) of the use of the QPRT to help you analyze whether its use fits your needs and long-term goals.

To utilize a QPRT, a residence or vacation property is transferred into a trust. Each individual is allowed to establish only two QPRTs: one for his or her primary residence and one for his or her vacation home. The creator of the trust, the grantor, reserves the right to live in the residence (or the vacation home) for a set number of years, after which the residence would pass to the remainder (or future) trust beneficiaries, who are presumably the heirs.

For example, if an individual (the grantor) transfers his or her residence into a trust, but yet reserves the right to live in it for the next twenty years, at the end of the twenty-year term the value of the residence, together with any appreciation between now and the end of the twenty-year term, would pass to the remainder beneficiaries i.e., the heirs. The value of the residence would not be included in the grantor's estate upon his or her death and would not be subject to estate tax.

Upon the creation of the QPRT, the grantor would value the future interest to be transferred to the remainder beneficiaries. To avoid paying a current gift tax, the grantor will likely elect to utilize a portion of his or her "gift tax lifetime exclusion" which is currently $13,990,000 for 2025. To the extent a portion of an individual's gift tax lifetime exclusion is used during life, the amount so used will be deducted from his or her applicable exclusion amount available at death (currently also $13,990,000).

As an example, if an individual created a QPRT and the value of the gift to the remainder beneficiary was $350,000, his or her applicable exclusion amount would be reduced by the $350,000. If the applicable exclusion amount was $13,990,000 at the death of the individual, he or she would have $13,640,000 of his or her applicable exclusion amount remaining to be used on the date of death.

There is a catch! In the above example, if the grantor were to die before the expiration of the twenty-year period, the full value of the residence at the time of death would be included in the grantor's estate. Any portion of the individual's applicable exclusion amount which had been used by the prior gift, however, would be "restored." Additionally, the individual's estate would receive a credit for any gift taxes which had been paid.

The longer the time period an individual chooses to retain the right to live in the residence, subject to the QPRT, the less the current value of the gift to the heirs. One might say, "Pick a long time period to lessen the value of the current gift and the use of the gift tax lifetime exemption." There is some logic to this, but remember, if the grantor dies during the selected term, the full value of the residence (i.e., value at the time of the grantor's death) is included in the grantor's estate.

It is important to individuals creating QPRTs to pick realistic time periods they believe they can survive. The longer the time-period chosen, the smaller the value of the gift to the remainder beneficiaries. The smaller the value of the gift to the remainder beneficiaries, the smaller amount of the applicable exclusion amount which would be used. Using a QPRT can be a very effective way of shifting what would potentially be a high value asset in an estate into the names of the grantor's heirs at a lower than full market value valuation.

Let's look at some numbers to help understand the benefits of a QPRT. Sam's residence has a current value of $1,000,000 and is expected to increase in value at 5% per year. Using a twenty-year term for the QPRT, the residence will have increased to a value of $2,653,298 at the end of the twenty-year term. At the time the QPRT is created, the present value of the interest to the remainder beneficiaries is based on the age of the grantor (Sam's age is 60), the then-stated IRS "7520 rate" the value of the residence and the term of the trust. In Sam's case, the value of the gift to the remainder beneficiaries is $171,630. Yes, it is true! The current gift is only $171,630, although the value of the residence is $1,000,000! If Sam is able to outlive the chosen term, he has effectively removed $2,481,668 from his estate. At an estate tax rate of 45%, this would be a savings to his heirs of $1,116,750!

Using the QPRT allows individuals to transfer great wealth at a low transfer tax cost. The QPRT trust is not right for everyone, but is certainly right for many. The QPRT may be right for those who fit the following criteria:

- Individuals with a high net worth who believe they will have a taxable estate. If the value of an individual's estate, including a residence, is in excess of the applicable exclusion amount (allowing for an inflation adjustment), then a QPRT may be a viable option. For a married couple, who each have the estate tax exclusion to work with, this means they may exclude $27,980,000 if they both die in 2025. However, it is important to remember the power of inflation and how it may erode the effectiveness of the applicable exclusion amounts, even if they are supposedly adjusted for inflation.

- Those who anticipate keeping their residence or vacation home for the balance of their lives.

- Individuals with good health as it is important the grantor (or creator) of the trust outlive the selected term of the QPRT.

- Individuals who wish to benefit their heirs and leave the residence to them.

A QPRT may not be right for everyone. If you have bad health and cannot survive the selected retained term of years; anticipate selling your residence to fund other cash flow needs; believe your estate will escape estate taxes; don't want to pay rent to your remainder beneficiaries if you want to continue to reside in the residence at the expiration of the retained term of years; have a mortgage against the residence intended to be transferred to the QPRT; or fear loss of flexibility or control of the residence, the QPRT may not fit your needs.

There are additional considerations to the use of a QPRT. When the grantor makes a gift, a gift tax return will have to be prepared and filed with the IRS (between January 1 and April 15 of the year after the calendar year in which the gift is made). Appraisals will also have to be obtained (appraising the residence to be transferred to the QPRT). The costs associated with filing the gift tax return and securing the appraisal will need to be taken into account in deciding if using a QPRT is right for your estate plan.

It may also be possible for grantors to leverage their current gifts if the interest they own in the residence is co-owned with another individual such as a spouse. Obtaining a further appraisal, which would value each of the co-owner's fractional interest in the residence, would result in a lower value of the gifted interest. This additional appraisal would "discount" the value of the asset based on the lack of marketability and control of the owner of the fractional interest. Discounts can further reduce the pro rata or liquidation value of the grantor's interest by as much as 5% to 40%, or even higher depending upon the circumstances.

If a grantor wishes to discount the value by obtaining yet another "discount appraisal," this appraisal will need to be included with the gift tax return explaining the valuation and the discount taken. It is necessary to have an "expert" prepare this discount appraisal.

There are many nuances to a plan for any particular individual. Whether the QPRT is a "tool" which fits into your planning depends upon a variety of factors. It is best to analyze these in the context of the individual's overall estate plan, balancing the plan with his or her long-term goals to ensure there is a match.

Creating a QPRT does take time to accomplish and is not a simple form which can be created using modern-day technology. Each must be crafted in such a way as to meet the individual's goals.