QUALIFIED PERSONAL RESIDENCE TRUST ("QPRT")

General Planning Memorandum

What is a QPRT? – A qualified personal residence trust ("QPRT") is a technique which allows the owner of a personal residence to give the residence in trust for the ultimate benefit of children or other beneficiaries in a way so that the gift tax value of the residence is significantly below its fair market value. Under the terms of the QPRT, the owner, as grantor of the trust, retains the right to use the residence for a specified period of years.

How to Create a QPRT - An irrevocable trust is created by the grantor, and the grantor then transfers a personal residence to it. In creating the trust, the grantor specifies the number of years during which the grantor may live in the residence. At the end of the specified period, if the grantor is living, title to the residence is transferred from the trust to the beneficiaries designated in the trust instrument – typically, children or trusts for their benefit. If the grantor dies before the end of the specified period, the residence is transferred back to the grantor's estate. In that event, there is no benefit from the QPRT, because the residence is included in the grantor’s estate at its value at death, and the result is the same as if the QPRT had not been created. ¹

What Makes a QPRT Attractive? – The grantor’s retained occupancy right lowers the value of a gift of the residence by the actuarial value of the grantor's retained interests. If the grantor lives beyond the specified number of years, then the property and its appreciation is excluded from the grantor’s estate. As a result, the difference between the gift tax value of the property and its fair market value, and all appreciation subsequent to the time of the gift, escapes both gift and estate tax.

The actuarial value of the retained use is based on a number of factors. The first is the assumed rate of return, which the federal government determines monthly. The second factor is the period of years for the grantor’s retained use. The final factor is the grantor's age. Accordingly, the longer the period specified for the retained right to use the residence, the higher the interest rate, and the older the grantor, then the more the value of the gift is reduced – and, the greater the potential tax benefit.

The potential for long term benefit from a QPRT is illustrated in the attached chart.

Gift and Estate Taxes Concerns -- The gift made when the QPRT is created does not qualify for the annual exclusion ($13,000 in 2012). Therefore, the gift uses a portion (or all) of the grantor's available lifetime gift tax exemption ($5,120,000 in 2012) which has not already been used. If the value of the gift combined with other

¹ Any applicable gift tax exemption ($5,120,000 in 2012) used would be restored, although it is important as a technical matter that so-called “split-gift” reporting for gift tax purposes is not used.
post-1976 gifts exceeds the available credit amount, then the gift tax will be due and payable on April 15 following the year in which the QPRT is created.

A longer trust term decreases the value of the gift on which gift tax potentially must be paid, but a longer trust term also increases the risk that the grantor will not survive the fixed QPRT term of years. The value of the gift is also affected by the IRS interest rate applicable at the time when the QPRT is created, which fluctuates based on monthly market interest rates. From July 2003 forward, the IRS rate has been as high as 6.2% and as low as 1.0%, with monthly changes based on fluctuations in market interest rates.

If the grantor dies before the end of the period selected, it is as if no gift had been made and there is no benefit from the QPRT, because the residence is included in the grantor's estate at its value at death. Any lifetime gift tax exemption used, however, would be restored (i.e. no double taxation).

Neither the grantor nor the grantor's spouse (or to an entity controlled by either of them) may purchase the residence at any time after the QPRT is created. The residence may be sold to other persons (including family members), in which event the proceeds may be invested in a new residence (and any proceeds not invested in a new residence converted into an annuity for the grantor until the end of the fixed QPRT term).

If the grantor survives the trust term, then the residence passes at the end of the trust term for the remainder beneficiaries without any additional gift or estate tax cost, even if the property has appreciated substantially from its value at the time of its transfer into the trust.

**Distribution Upon QPRT Termination** -- After the specified number of years has passed and the residence is distributed out of the trust, it will no longer be held for the grantor’s benefit. If the grantor wishes to continue to use the residence, the tax law makes provision for the grantor to rent it from the beneficiaries (if agreeable) at a rent that is not below fair market value. When the QPRT is created, there should be no agreement or understanding (oral or written) about the renting of the residence by the grantor once the fixed term is reached. Accordingly, it is important that the grantor understand he or she cannot be certain of continued use of the residence at the end of the period.

It is possible to direct that the residence remain in continuing trust at the end of the specified period. Children are typically designated as beneficiaries of the continuing trust, and one or more of the children may act as trustee. If the grantor is married, the grantor can provide for a continuing trust which gives his or her spouse a life use of the residence.\(^2\) An additional income tax planning advantage may be available

\(^2\) Where spouses owning undivided interests in a residence as tenants-in-common create separate QPRTs with
through provision for flexibility to subject the grantor (rather than children or the
trust) to income taxation on the trust under the grantor trust income taxation rules.³

More Than One Residence – If a person owns more than one residence, it is
important to consider whether to use the primary or vacation residence in
establishing a QPRT. Often it is preferable to use a vacation residence:

• A primary residence is eligible for a $250,000 exclusion of capital gain on
  sale ($500,000 for certain joint returns) for an owner who uses the residence as
  his or her principal residence for periods aggregating two years or more out of
  the five year period ending on the date of the sale.

• Assuming that the grantor will transfer one residence to a QPRT and continue
to own the other residence, the residence that the grantor owns will receive a
new basis for income tax purposes equal to its value at the grantor’s death.
Consequently, the residence retained by the grantor can be sold after death
without any capital gain (although it will be subject to estate tax) after death.
This step-up in basis is not available for a residence transferred to a successful
QPRT (where the grantor outlives the fixed QPRT term, so that the residence
is not included in the grantor’s estate), and often it is the vacation residence
(rather than the primary residence) that the grantor’s family may wish to retain
after the grantor’s death.

• It is usually more practical to rent a vacation residence after the specified
  period of the fixed QPRT term than in the case of a primary residence.

The one situation in which a vacation residence might not be a good choice is where
it is rented to others for some part of the year. This is because the grantor’s inability
to use the vacation home during the rental period may prevent the trust from
qualifying as a QPRT.

The IRS regulations specify that a grantor can establish only two active QPRTs
during his or her lifetime.

Other QPRT Issues - The fact that a residence is subject to a mortgage does not
affect its status as a personal residence. During the trust term, the grantor will be
treated as the owner of the income and corpus of the trust for federal income tax

³ This provision may be used to avoid income taxation on rent which is payable by the grantor after the end of
the specified QPRT period of years.
purposes and therefore will be entitled to deductions for mortgage interest, taxes and other deductions applicable to property during the trust term without regard to whether grantor makes the payments directly or the trust makes the payments. For purposes of determining the value of the gift of the remainder interest, the mortgage must generally be taken into consideration. Each time a mortgage payment is made and a portion of the principal loan balance is reduced, the grantor would be treated as having made an additional gift to the QPRT.\textsuperscript{4} This could create additional accounting, tax, and administrative burdens. It is typically advisable not to use a mortgaged property for a QPRT – or, if a mortgage exists, to enter into an agreement at the creation of the QPRT whereby the grantor is to be personally liable for the mortgage debt.

The tax law strictly limits the assets, other than a residence, that a QPRT can hold, as well as the uses that may be made of the QRPT property (including insurance proceeds due to damage to the residence). Also, where a grantor no longer makes use of the residence (due to placement in a nursing home, or for some other reason), the trust may cease to qualify as a QPRT if the property is rented to others.

In some situations, it may be advantageous for a QPRT to be created for a partial interest (say, an undivided one-half) in a residence. This may be helpful in planning for a married couple to use each spouse’s available gift tax exemption amount ($5,120,000 in 2012). Use of a partial interest may also permit a valuation discount to reduce the amount of the taxable gift.\textsuperscript{5}

Finally, the current $5,120,000 gift tax exemption amount is scheduled to decrease as of January 1, 2013 to $1,000,000 and remain at that level, unless Congress may enact legislation to put it at a different level (e.g., $3,500,000). Accordingly, it is important for taxpayers considering a QPRT to determine whether to move forward and put it in place before calendar year end 2012.

\* \* \*

This outline discusses general considerations in estate planning for a QPRT. For

\textsuperscript{4} A related issue is how to calculate the additional gift triggered by each payment of the mortgage, and there is little IRS guidance; however, it would appear, absent agreement at the creation of the QPRT for the grantor to be primarily liable on the mortgage, that principal payments by the grantor are recurring a gift (undiscounted) in the full amount of the mortgage principal payment.

\textsuperscript{5} There is a separate issue involving risk of full estate tax inclusion for a partial interest in QPRT property at the grantor’s death where, after the end of the fixed QPRT term of years, the grantor occupies the residence – without paying rent – by virtue of a right to occupy the residence due to a separate partial interest held by the grantor or his or her spouse. Even though aggressive, this position (as to which there is little IRS or case law guidance) may not be advantageous from a pure tax planning perspective – particularly where there is a continuing grantor trust for income tax purposes after the end of the period of the fixed QPRT term. The time for decision regarding occupancy (and rent) is at the end of the fixed QPRT term (based on relevant legal authorities at that time).
more information, please contact Hollis F. Russell, Esq. or Lauren E. Touchard, Esq., at (516) 829-6900 or hrussell@alcllp.com, or any of our firm’s other attorneys.

August 2012

Ackerman, Levine, Cullen, Brickman & Limmer, LLP
1010 Northern Boulevard, Suite 400
Great Neck, New York 11021
Telephone: (516) 829-6900
Facsimile: (516) 829-6966
www.ackermanlevine.com
ILLUSTRATION – BENEFIT TO BENEFICIARIES AT END OF QPRT

Value of residence given is assumed to be $1,000,000 in each case, and a 2% IRS interest rate is assumed to apply. A 2% interest rate is higher than the 1.0% rate applicable for August 2012 but more in line with recent historic interest rates.

<table>
<thead>
<tr>
<th></th>
<th>3 Years</th>
<th>5 Years</th>
<th>8 Years</th>
<th>12 Years</th>
<th>15 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Grantor age 50</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actuarial factor of retained use</td>
<td>7.10%</td>
<td>11.73%</td>
<td>18.63%</td>
<td>27.81%</td>
<td>34.72%</td>
</tr>
<tr>
<td>Value of gift</td>
<td>929,021</td>
<td>882,698</td>
<td>813,675</td>
<td>721,936</td>
<td>652,773</td>
</tr>
<tr>
<td><strong>Grantor age 60</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actuarial factor of retained use</td>
<td>8.97%</td>
<td>14.98%</td>
<td>23.95%</td>
<td>36.01%</td>
<td>45.24%</td>
</tr>
<tr>
<td>Value of gift</td>
<td>910,318</td>
<td>850,195</td>
<td>760,526</td>
<td>639,940</td>
<td>547,632</td>
</tr>
<tr>
<td><strong>Grantor age 70</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actuarial factor of retained use</td>
<td>13%</td>
<td>21.82%</td>
<td>35.27%</td>
<td>53.11%</td>
<td>65.76%</td>
</tr>
<tr>
<td>Value of gift</td>
<td>870,030</td>
<td>781,813</td>
<td>647,255</td>
<td>468,864</td>
<td>342,440</td>
</tr>
<tr>
<td><strong>Grantor age 80</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actuarial factor of retained use</td>
<td>23.64%</td>
<td>38.56%</td>
<td>58.75%</td>
<td>79.66%</td>
<td>89.95%</td>
</tr>
<tr>
<td>Value of gift</td>
<td>763,608</td>
<td>614,365</td>
<td>412,545</td>
<td>203,426</td>
<td>100,459</td>
</tr>
</tbody>
</table>

For **Comparison**, the value of the residence at the end of each of the above terms of years, assuming a 2% growth rate, is:

$1,061,208 1,104,080 1,171,659 1,268,241 1,345,868