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ADVISORY

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QUALIFIED PERSONAL RESIDENCE TRUSTS

A special kind of irrevocable trust, known as a qualified personal residence trust (or QPRT), may enable you to transfer your residence to your children (or others) at a significantly reduced value for tax purposes, yet allow you to continue to live in the residence for as long as you wish.

SETTING UP A QPRT

To create a QPRT, you must transfer your residence to a trust. You may continue to use the residence rent-free for a fixed number of years specified in the trust instrument (the "fixed term"), which should be a period you are likely to survive. During the fixed term, you will continue to pay mortgage expenses, real estate taxes, insurance, and expenses for maintenance and repairs, and will continue to deduct mortgage interest and real estate taxes on your individual income tax return. When the fixed term ends, the residence is distributed to the named beneficiaries, or remains in further trust for them.

Even after the fixed term ends, you may continue to use the residence in one of two ways:

1. Rather than immediately distributing the residence to the beneficiaries, the residence can be retained in trust for your spouse's lifetime.
2. You can enter into a lease with the beneficiaries that allows you to live in the residence for as long as you wish. If you lease the property, however, you must pay fair market value rent after the fixed term ends in order to keep the residence from being subject to estate tax at your death.

TAX CONSEQUENCES

Although the transfer of the residence to the trust is a taxable gift, you are allowed to subtract from the value of the gift the value of your right to live rent-free in the residence for the fixed term. Thus, the amount of the taxable gift will usually be substantially less than the fair market value of the residence. The actual amount of discount available through the use of a QPRT depends on your age, the IRS interest rate in effect at the time of the gift, and the term of the trust. If the amount of the gift is less than your available exclusion from the federal estate and gift taxes ($12,920,000 minus prior gifts, as of 2023), no federal gift tax will be due as a result of your gift to the trust. (If the residence is in Connecticut, no state gift tax will be due now that the Connecticut gift tax exclusion matches the federal amount.)

CONTINUED

QUALIFIED PERSONAL RESIDENCE TRUSTS

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If you survive the fixed term of the QPRT, the value of the residence will not be included in your estate for estate tax purposes. If you don't survive the fixed term, the residence remains a part of your taxable estate, but the estate tax consequences will be no worse than they would have been if you hadn't created the QPRT. In other words, from an estate tax perspective, there's no downside to a QPRT.

The tax savings of a QPRT can be seen by the following example:

Assume Mr. Jones, age 60, decides to transfer his residence worth $1,000,000 to a 15-year QPRT. (According to IRS actuarial tables, Mr. Jones' life expectancy is 24 years.) Based on the September 2023 IRS interest rate of 5% (this rate changes every month), the value of Mr. Jones' gift is only $375,280. Assuming that the residence would have been taxed in Mr. Jones' estate at the 40% estate tax rate, and that he outlives the 15-year term of the trust, Mr. Jones and his family will realize a tax saving of $249,888. If the residence appreciates in value, the estate tax savings can be significantly higher. (However, the beneficiaries, who take a carry-over basis in the property, may have to pay capital gains taxes on the appreciation if they sell the residence). Notably, if property appreciates at 5% a year over a 15-year trust term, it will have more than doubled in value, all of which may pass to a QPRT beneficiary with no further gift or estate tax liability.

OTHER CONSIDERATIONS

To obtain the estate tax benefits described above, you must give the property away. Even if you can continue to use the property, you would not own the property. Also, you would need to survive the fixed term to achieve the estate tax savings. This is especially crucial for a Connecticut resident who transfers Connecticut real property to a QPRT, because if the donor does not survive the QPRT term, Connecticut may assess a gift tax at the time the QPRT is established and an estate tax on the property at the donor's death. (Federal law allows a credit for the gift tax in this situation, so only the estate tax would apply.) However, as stated above, you would be no worse off than if you had not created the QPRT in the first place. Assuming you survive the QPRT term, because the transfer to the ultimate beneficiaries is by gift, their tax basis in the property will be the same as yours – a "carry-over" basis; the beneficiaries will not get a "step up" in basis upon your death.

CONCLUSION

A QPRT can be an extremely effective way to remove a residence's value from your estate at a greatly reduced gift tax cost. This is especially true in a high interest rate environment (like in September 2023) because this means a lower present value, a lower gift value, and lower gift and estate taxes. Because a QPRT can be established for either a primary or a secondary residence, it may be a particularly attractive option for individuals with a vacation home.

If you have questions about creating a QPRT, please contact your Wiggin and Dana attorney.