The Fractional Interest Short-Term Qualified Personal Residence Trust For Older People In Good Health With Expensive Residences Who Have Substantial Estate Tax Exposure

Background

The Qualified Personal Residence Trust ("QPRT") is a gift technique which was created by Congress as an exception to the general rules regarding gifts with retained interests. Generally, if you give away an asset but continue to retain an interest in it (such as the right to the income or use of the property), the IRS will include the full value of the property in your estate at your death. Presumably Congress was convinced to provide some transfer tax relief to people desirous of passing their personal residences to the next generation, some of which have been held by families for many years. This strategy is also appealing to a lot of people who like the idea of reducing their estate tax exposure by only giving away a future interest in a residence in which they can continue to live (at least for a certain term) without going out-of-pocket and reducing their spendable liquid assets.

This exception granted by Congress, however, is not a guarantee and is not without its down sides. The creator of the Trust ("the Grantor") has to select a term for the trust and outlive the term selected in order for the technique to succeed. If the Grantor fails to survive the term selected, the tax benefit of the QPRT is lost as the residence will revert back to the estate and be included in the estate at full fair market value at such time. Selecting a longer term will increase the tax benefits of the QPRT because it increases the actuarial value of the life interest retained and consequently decreases the taxable gift of the remainder interest. Thus, one must essentially tempt fate in choosing a term. Also, failing to select a term that the Grantor survives may also mean that other gift strategies utilizing the Grantor's gift tax exemption are not utilized..

Unfortunately, Congress did not bless such trusts so that they could last for the lifetimes of the Grantors. Interestingly though, if structured properly, a parent or parents can purchase a life interest and their children can purchase the remainder interest if they enter into a joint purchase of a new personal residence as opposed to the gifting of an interest in an existing personal residence as is contemplated with a standard QPRT. A discussion of such joint purchases was the subject of a previous article I've published and is beyond the scope of this article.

Other Possible Down Sides- Generally, if a residence is held until the death, the property will obtain a new cost basis known as a "stepped-up basis" equal to the value of such property on the date of death. Recipients of gifted property, however, generally assume the gifting party's basis. Thus, if the property is highly appreciated, utilizing this technique would result in a loss of the ability to obtain a stepped-up basis at death and there will be tax due on the capital gains if and when the property is sold.

One must also be aware that it may become necessary to rent back the property (at fair market value) at the end of the QPRT's term if the Grantor wishes to continue occupying the residence.

Some clients, at least at first, do not like this aspect. However, this can result in an opportunity to make additional tax-free gifts equal to the amount of rent paid if the remainder interest of the QPRT is designed as a grantor trust. In some cases, where a husband and wife are both living, this can be avoided, if desired.

Also, due to historically low interest rates, this strategy looks less attractive than when interest rates are higher. The current Section 7520 rate (the monthly rate equal to 120% of the Federal mid-term rate), required to be used in the calculations of the taxable gift, is one of the components used in calculating the size of the taxable gift. The lower the rate, the higher the taxable gift becomes because a lower rate reduces the value of the retained term interest. Even so, see the example herein and I think you will still see the potential benefits.

Finally, if you believe that the value of your residence may significantly drop further in the future, this might not be a tax effective transfer if the value of the property in fact does decline after the establishment of the QPRT.

Who Should Consider a Fractional Interest Short-Term QPRT Now ?
Generally, the typical candidates are older people with expensive residences who have substantial estate tax exposure, are in relatively good health, and do not believe that the value of their residence will substantially decline before their death. I have developed an acronym for the fractional interest short-term qualified personal residence trust which, to my knowledge, no else uses. I call it " the FIST QPRT".

Hypothetical Example:

Facts- Tillie and Jack (the names of my grandparents) ages 82 and 84, are in relatively good health, own a jointly held residence currently valued at $2,000,000. The residence has been in the family for many years and they desire to pass the residence to their children in the most tax efficient manner. They have other substantial assets that, unless the estate tax is repealed, will likely subject the survivor's estate to estate tax. For purposes of this example, let's ignore cost basis with the understanding that capital gains tax would be recognized whenever the residence is ultimately sold.

Strategy Implemented-

Tillie and Jack divide their property by deed so that each owns an undivided one-half interest as tenants in common. Tillie transfers her one-half interest into a FIST QPRT for a four year term in July of 2011 utilizing the July Section 7520 rate of 2.4 %. Jack transfers his one-half interest into a FIST QPRT for a four year term in August 2011 utilizing the August Section 7520 rate of 2.2 %.

Results - First, because we are only transferring partial interests of the residence, a fractional interest discount on the transfer to each FIST QPRT may be taken. A discussion of the extent of

such discounts is beyond the scope of this article but I think a 20% -25% discount would be attainable in most cases.. A good appraiser should be selected for both valuing the property and ascertaining the discount. If the IRS chose to audit these transactions, it may come to a showdown between the appraiser for the taxpayer and the appraiser for the IRS. IRS representatives have admitted that they have do not have a substantial budget to hire quality appraisers and often these matters are reasonably settled. Typically, I like to leave room in the client's gift tax exemption so that even if the entire discount is disallowed, gift tax will not be payable upon the transfer to the QPRT. Utilizing this approach may take away the incentive for the IRS to audit since an audit will not result in an immediate collection of tax.

Second, assuming that a 25% fractional interest discount is reasonable, Tillie's transfer would result in a taxable gift of only $476,212 and Jack's transfer would result in a taxable gift of $516, 495 -see calculations attached. A significant reason for the reduction of the taxable gift is attributed to the fact that the IRS allows the Grantor to reduce the taxable gift by the actuarial value of the "reversion". The reversion is an actuarial calculation of the value of the chance that the Grantor does not survive the term selected in which case the property would revert back to the Grantor's estate. This is a significant reason why this technique looks attractive even when the term of the QPRT is short. The reversion is calculated by taking into consideration the Grantor's age using the IRS mortality tables . If Jack and Tillie, however, are in relatively good health, this may be a reasonable gamble to take, albeit it is a gamble. If Jack and Tillie survive their selected terms, they transferred their $2,000,000 residence for a total gift tax value of only $992,707 ($476,212 + $516, 495). This is a significant reduction considering that they haven't really done anything different than they would have had they not entered into this transaction-at least not yet. .

Third, if the property appreciates between the date of the gift and the date of the death, such appreciation would not be included in the estate for estate tax purposes.

Fourth, let's now suppose now that Jack and Tillie have survived their selected terms and still wish to remain in the property. Ignoring the timing differences of when the two QPRTs expired, let's also assume that the fair market rental value of the property is $10,000 per month and that one of them lives for an additional 6 years. If, the remainder of the QPRT was designed to be held in a Grantor Trust (as defined under Sections 671- 679 of the Internal Revenue Code), the lease payments to the trust would not be considered taxable transfers for income tax purposes (therefore no recognition of rental income) and such transfers would essentially result in tax-free gifts to the trust thus shielding an additional $720,000 ($10,000 x 72 months) from inclusion in their estates for estate tax purposes.

Finally, some may be wondering whether this strategy can be implemented for a single person. The answer is yes. If Jack had predeceased Tillie, Tillie could have entered into the same FIST QPRT. Then, when Tillie dies and is left owning the remaining half interest in the residence, the representatives of Tillie's estate may then be in a position to claim a fractional interest discount on Tillie estate tax return as discussed above. While the drafters of the QPRT legislation may

not have contemplated contributions of partial interests in residences by single persons, the statute and regulations make reference to undivided fractional interests in residences. There also exists a Private Letter Ruling which blessed a transfer of a partial interest in a personal residence by a single person. Unfortunately, a Private Letter Ruling, while perhaps providing guidance on the IRS' position can only be relied upon by the taxpayer that requested the ruling.

Conclusion.

When the circumstances are right, the FIST QPRT can be a great technique.

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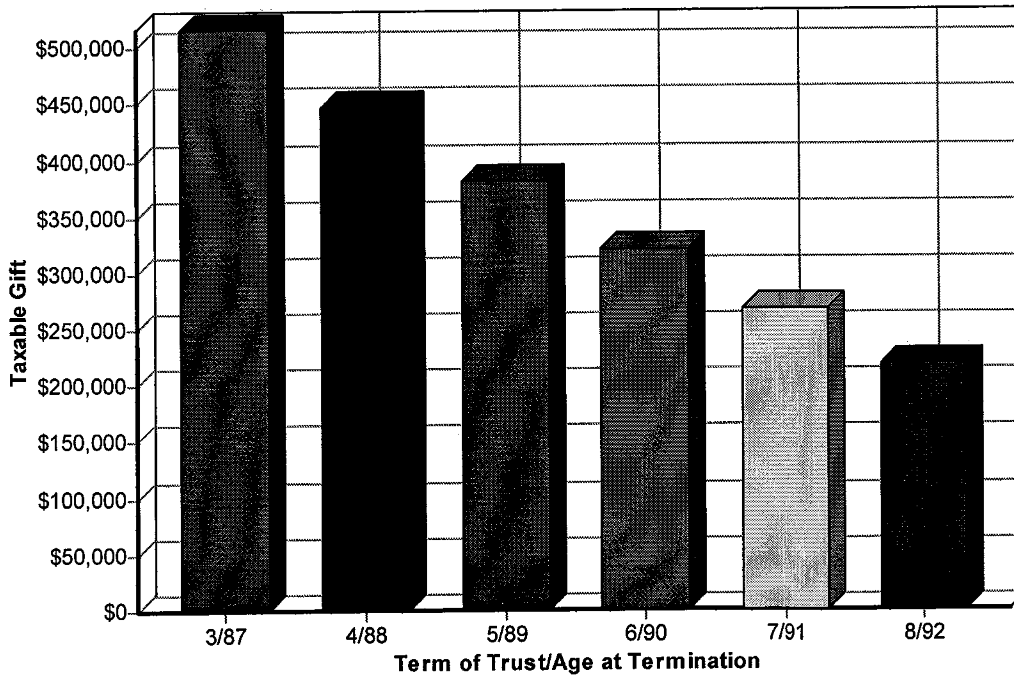
Transfer Date:	8/2011
§7520 Rate:	2.20%
Principal:	$750,000
Grantor's Current Age:	84
Term of Trust:	3
After-Tax Growth:	4.00%
Comb. Death Tax Bracket:	35.00%
With Reversion?	Yes

Grantor's Age When Trust Term Ends:	87
Value of Nontaxable Interest Retained by Grantor:	$233,505
Taxable Gift (Present Value of Remainder Interest):	$516,495
Property Value After 3 Years:	$843,648

Potential Death Tax Savings: $114,504
(Combined Bracket times [Value of Property minus Taxable Gift])

Qualified Annuity that Must be Paid Annually
if Entire Trust Ceases to be a QPRT: $93,615

	Reversion	Total Income Interest	Income Interest With Reversion	Remainder
Factor:	0.25646	0.05488	0.31134	0.68866
Value:	$192,345	$41,160	$233,505	$516,495



Transfer Date:	7/2011
§7520 Rate:	2.40%
Principal:	$750,000
Grantor's Current Age:	82
Term of Trust:	4
After-Tax Growth:	4.00%
Comb. Death Tax Bracket:	50.00%
With Reversion?	Yes

Grantor's Age When Trust Term Ends:	86
Value of Nontaxable Interest Retained by Grantor:	$273,788
Taxable Gift (Present Value of Remainder Interest):	$476,212
Property Value After 4 Years:	$877,394

Potential Death Tax Savings: $200,591
(Combined Bracket times [Value of Property minus Taxable Gift])

Qualified Annuity that Must be Paid Annually
if Entire Trust Ceases to be a QPRT: $85,300

	Reversion	Total Income Interest	Income Interest With Reversion	Remainder
Factor:	0.28802	0.07703	0.36505	0.63495
Value:	$216,015	$57,773	$273,788	$476,213