

CHAPIN, BALLERANO & CHESLACK

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QUALIFIED PERSONAL RESIDENCE TRUSTS: TAKING ADVANTAGE OF HISTORICALLY LOW REAL ESTATE VALUES

The currently depressed real estate values create an interesting opportunity to engage in a simple and highly effective estate tax reduction technique that has little downside. The vehicle is known as the Qualified Personal Residence Trust (“QPRT”). As you will see in the example below, although the current low interest rate implies that a QPRT is a questionable technique, the historically low real estate values can outweigh the interest rate impact.

A QPRT is an irrevocable trust designed to own your residence in a tax preferred manner. The Trust has a fixed duration, or term of years, during which you retain the right to live in the residence rent-free. If you survive the term of years, the ownership of the residence passes to your selected heirs. This results in the value of the property, including appreciation during the term of years, escaping estate taxes.

There are two considerations to maximize the benefits of the QPRT. First, you must survive the term of the QPRT for the technique to work. This means the term of years should be less than your life expectancy. However, if you do not survive the term, the QPRT transaction is unwound for federal estate and gift tax purposes leaving your heirs in the same tax situation as if the QPRT was not created. Second, a QPRT is most effective in an appreciating real estate market. A successful QPRT results in the property value, with appreciation, escaping estate taxes. Therefore if you believe real estate values will go up, this is a good technique for you.

From a tax standpoint, upon establishment of a QPRT, you are treated as making a gift equal to the value of the residence placed in Trust, less the

value of your retained right to live rent-free in the residence for the term of years. For example, assume: (1) you are 70 years old; (2) your residence has a current value of \$1,000,000; (3) the applicable discount rate is 2%; and (4) the QPRT term is 10 years. The result is you are treated as making a taxable gift of \$541,300 on the transfer of the \$1,000,000 residence to the Trust. Each individual has a lifetime exemption from gift tax on \$1,000,000 of gifts. If you have sufficient unused Gift Tax Exemption, no gift tax is owed on the QPRT creation. Furthermore, if the value of the residence appreciates at an average annual rate of 5%, the projected value of the residence at the end of the QPRT term would be approximately \$1,629,000. Between the discount for the retained interest and the appreciation in the property, there is a potential estate tax savings of approximately \$490,000.

Although QPRT's normally are not advantageous in a low interest rate environment, the benefit of the current depressed real estate values can outweigh the interest rate affect. In the above example if we assume four years ago the same house was worth \$1,300,000 and the applicable discount rate was 4.6%, the taxable gift would have been approximately \$547,000. Although the higher interest rate creates a higher value for the retained life interest, the depressed value of the residence still produces a lower taxable gift. Additionally, with the depressed real estate values, the potential for appreciation outside of your estate is greater. The point is: implementing a QPRT with a depressed property value offers more bang for the buck, even when rates are historically low because it can result in a smaller gift and greater potential for growth outside your estate.

There are, of course, other nuances and more aggressive techniques to consider in the establishment of a QPRT. You should therefore seek experienced estate planning counsel to assist you this planning technique.

Click on the link below for more information about our firm

<http://www.estateplanning.com/chapin-law/>

Telephone: 561-272-1225

Facsimile: 561-272-4442

Delray Beach Office
1201 George Bush Blvd.
Delray Beach, FL 33483

Boca Raton Office
399 W. Palmetto Rd., Ste. 202
Boca Raton, FL 33432

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