

# ESTATE PLANNING NEWS



## Qualified Personal Residence Trust: Estate Tax Reduction Strategy for Homeowners

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If you own a home and expect to have a large taxable estate, you may want to consider this popular estate planning tool.

#### **What is a Qualified Personal Residence Trust?**

A qualified personal residence trust (“QPRT”) is an irrevocable trust into which the homeowner (“settlor”) transfers a primary residence or vacation home. The settlor retains the right to live in the home rent free (“retained interest”) for a specified number of years (“term”). At the end of the term, the trust property (“remainder interest”) passes to the settlor’s children or other selected beneficiaries (“remainder beneficiaries”).

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# Estate Planning News

## Announcements

A special thank you to those clients who have recently contacted me with personal and financial news. It is always good to hear from you and ensure that your estate plan remains up to date.



## Tip of the Month

### Dealing with Substantial Age Differences

Couples in second marriages may face a dilemma when they have a substantial age difference. Depending on the clients' wishes, most attorneys recommend a QTIP arrangement whereby the deceased spouse's estate is held in trust for the lifetime benefit of the surviving spouse. The remainder doesn't pass to the decedent's children until the second spouse dies.

For example, Harry and Sally are married. Harry is a 60-year-old with a 30-year-old son, Jim. Sally is 35-years-old with no children. Knowing that Sally is likely to outlive Harry by many years -- and perhaps she'll also outlive Jim -- how can Harry leave an inheritance to his son?

- (1) Harry could make one or more lifetime gifts to Jim.
- (2) Harry could instruct that a gift be made to Jim before the QTIP trust is created for Sally.
- (3) Harry could name Jim as beneficiary of life insurance policies or retirement accounts (subject to some restrictions).



## Entertainment

### The Heart of the Game (2005)

Attending predominantly white Roosevelt High because her mother thinks she will have better opportunities under the school's successful coach, gifted black hoopster Darnellia Russell puts herself -- and her coach -- through the wringer. Shot in a suburban Seattle high school over a 7-year-period, this stirring documentary explores the complicated relationship between gender, race, and organized sports.



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Behold the turtle. He only makes progress when he sticks his neck out.

-- JAMES BRYANT CONANT  
*U.S. Chemist & University President*

## Qualified Personal Residence Trusts

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### **Hypothetical**

Diane owns a \$1.5 million Lafayette home, a \$1 million Monterey beach home, and a \$2 million stock portfolio. She wants to reduce her estate tax liability (currently \$1,125,000). However, she is reluctant to give up control of her assets.

### **Creating the QPRT**

Diane considers transferring her beach home to a QPRT. Diane would retain the right to live in the home for 10 years. During this term, Diane would not pay rent. However, she would continue to pay for the home's expenses, including real property taxes, utilities, maintenance fees, and ordinary repairs.

At the end of the term, if Diane were still living, the beach home would pass to her children, Eleanor and Richard. Diane may then stay in the beach home, subject to her children's agreement.

### **Tax Advantages**

#### **1) Reduced gift tax value**

The transfer of the beach home to a QPRT would be a taxable gift, but the amount of the gift would not be \$1 million. Rather, the gift would be discounted by Diane's retained interest. The gift value would be an "actuarial value" based on IRS tables

that factor in Diane's age, the length of the term, and the monthly interest rate.

Assuming Diane is 60-years-old, and the interest rate is 6.5% when she transfers the beach home into the QPRT, the gift value would be only \$527,750. Diane could apply this gift against her \$1 million lifetime gift tax exemption.

#### **2) Avoid estate tax**

If Diane survived the 10-year-term, the entire value of the beach home would pass to Eleanor and Richard without estate tax. If the property appreciated to \$2 million, Diane would have transferred a \$2 million asset for a gift tax value of only \$527,750. This benefit is called an "estate tax freeze."

#### **3) No reassessment for property tax**

Under Prop 13, Diane may give her primary residence and up to \$1 million of other real property to her children without that property being reassessed.

### **Income Tax Considerations**

The remainder beneficiaries receive the settlor's carry-over basis, not a stepped-up basis. In other words, if Eleanor and Richard decided to sell the beach home, capital gains tax would be due on the sale.

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Assuming that Diane's basis is \$800,000, the projected income tax would be \$288,000 (*i.e.*, \$2 million sale price minus \$800,000 basis equals \$1.2 million gain taxed at 15% federal and 9% state).

Still, the income tax consequences are better than paying an estate tax of \$900,000 (\$2 million asset taxed at 45%). Even after factoring in the reduction of Diane's estate tax exemption (*i.e.*, for the lifetime gift of \$527,750), she would be giving nearly \$375,000 more to her children if she created the QPRT.

Better yet, if Eleanor and Richard keep the beach home until they die, a stepped-up basis would then be available.

### **Other Potential Drawbacks**

#### **1) Irrevocable**

Once the home is placed in the trust, there is no turning back.

#### **2) Administrative Burden and Expense**

Since the QPRT is irrevocable, it must keep its own records and file annual federal and state income tax returns.

#### **3) Death During Term**

If the settlor dies during the term, the property will be included in her taxable estate as though the QPRT never existed. Deciding upon the term becomes a trade-off. The longer the term, the smaller the gift's actuarial value, but the greater the likelihood that the settlor will not outlive

the term, defeating the QPRT's purpose. The best result can be achieved when the settlor is young and the term is long.

#### **4) No Annual Gift Tax Exclusion**

The remainder is a future interest, thus it does not qualify for the settlor's annual gift tax exclusion.

#### **5) Settlor Must Move Out or Pay Rent**

When the term expires, the settlor must forfeit all rights to occupy and control the home. However, if the remainder beneficiaries agree, the settlor may then rent the home. In fact, this provides the settlor another opportunity to pass money to intended beneficiaries free of gift and estate tax. Although rent constitutes income, there are offsetting deductions.

#### **6) One Home Per QPRT; Two QPRTs**

Generally, a QPRT is limited to owning one home and may not hold any property other than the home. The settlor may create a second QPRT, but not a third.

### **Conclusion**

All factors considered, the QPRT is one of the best techniques currently available for transferring a significant asset at a deep discount. It is especially desirable when a parent wishes to gift a home to an adult child after a certain number of years.

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