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Waterfront Legal Notes

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What is a QPRT?

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We have many clients with valuable lakefront homes or cottages. Often they desire to pass these properties on to the next generation, but are concerned about the estate or gift tax consequences of doing so. Basic gift tax law provides that a person can gift no more than Twelve Thousand dollars per year per person, without having to file a gift tax return. In addition a person may gift an asset worth One Million dollars during his or her lifetime without incurring gift tax liability. The challenge for lakefront homeowners is to accomplish the gift without exceeding their One Million dollar personal lifetime exemption. At the same time, many of these homeowners want to decrease the size of their estates, so that their estates will not be subject to estate taxes at a 45% tax rate upon their deaths. Currently estates greater than Two Million dollars would be subject to estate taxes on the excess amount.

It is possible to create an irrevocable trust, called a Qualified Personal Residence Trust (QPRT), in order to accomplish some of the goals mentioned above. Suppose a homeowner-Donor (age 70) has a home on Lake Michigan that is worth Two Million Dollars ($2,000,000). The homeowner wants to pass the home on to two of her children (or friends, since this technique does not depend on the Donees being relatives).

The Donor creates two irrevocable trusts and she transfers a one-half undivided interest in her residence into each trust. Each trust provides that she has the right to continue living in the residence for a period of twelve years, after which one of the Donees becomes the owner of the one-half interest. Because she has retained the right to live in the house, the value of the gift she has made to each Donee is reduced by the value of the Donor's retained right.

The initial value of the property transferred to the QPRT is $1,000,000. According to the calculations required by the IRS, the value of the Donor's retained rights is $713,820, leaving the value of the taxable gift to the Donee of $286,180. Since the Donor created two trusts, i.e. made two identical gifts, the total value of the gift was $572,360. So long as the Donor outlives the term of the trust (12 years), the property will no longer be a part of the Donor's estate. The Donor will have succeeded in transferring an asset worth $3,202,064. (assuming that the $2,000,000 house appreciated at 4% per year), at a gift tax value of $572,360, a potential tax savings of $1,314,852, as compared to the estate taxes that would have been owed if the house had been kept in the estate.

A QPRT can be designed in many different ways, but one must always be cautious to select a term which the Donor is expected to outlive; otherwise the assets of the QPRT will not be excluded from the Donor's estate. After the term of the QPRT has expired, the Donor will no longer be legally entitled to reside in the home. However, the trust can be written so that the trust continues for the benefit of the Donees, and the trustee may rent the house to the Donor, if the Donor wishes to continue living there. In fact, in a case where the Donor has a taxable estate, the rent that the Donor pays to the QPRT could be viewed as just another gift to the Donees, although because it's rent, the amount paid is not limited to the annual gift tax exclusion of $12,000. A Donor could even provide that at the end of the QPRT, the property is transferred to a Cottage LLC, (see my article in a previous issue of this newsletter).

A QPRT is a highly leveraged gifting strategy that allows Donors to transfer more of their wealth at a lower cost. If you are serious about reducing the size of your estate, and have a valuable residence, you should give consideration to using a QPRT.