

CLIENT MEMORANDUM QUALIFIED PERSONAL RESIDENCE TRUST

This memorandum explores the benefits of incorporating a Qualified Personal Residence Trust (“QPRT”) into a sophisticated estate plan.

WHAT IS A QPRT?

A QPRT can be described very simply: the owner of a personal residence (the “grantor”) transfers the residence to an irrevocable trust while retaining the right to live there for a certain number of years (the “QPRT term”). At the end of the QPRT term, ownership of the residence passes to the ultimate beneficiaries of the trust, such as the grantor’s children. The residence does not have to be the grantor’s principal residence. However, a grantor can have no more than two QPRTs, and if two are established, one must be the grantor’s principal residence.

TERMS OF THE QPRT

The QPRT will contain a number of important provisions affecting its operation, both from tax and practical perspectives. The QPRT will provide the grantor with the right to live in the home for a specified number of years, which cannot be changed once the QPRT has been created.

1. During the QPRT term, the grantor will retain all of the rights and responsibilities of occupancy, including liability for maintenance costs.
2. If the Trustee sells the residence during the trust term, a replacement residence can be purchased. However, the grantor could lose some of the desired tax benefits if all of the sales proceeds are not used to purchase a new home. If the new home is less expensive than the old residence, the unused cash proceeds must be distributed back to the grantor or be reinvested in an annuity payable to the grantor for the remaining QPRT term.
3. The QPRT will also contain special provisions relating to the grantor’s abandonment of the residence.
4. Due to Treasury Regulations, a QPRT must prohibit a sale of the residence to the grantor, the grantor’s spouse or a trust established by the grantor or the grantor’s spouse.

Often, the most important provisions of a QPRT concern the disposition of the residence after the QPRT term. Most grantors wish to ensure that they will not be forced to leave their homes. Although moving out of the residence after the QPRT term is the safest course from a tax perspective, estate planners have developed several techniques which will permit the grantor to live

in the residence after the QPRT term. For example, the ultimate beneficiaries of the QPRT may simply let the grantor continue to live in the residence or the QPRT may provide for a continuing trust after the trust term for the benefit of the grantor's spouse.

Alternatively (since the foregoing techniques suggest a proscribed prearrangement for the grantor's continued use of the residence that may cause negative federal estate tax consequences) the grantor may lease the residence from the Trustee or from the children. So long as the grantor pays fair market value rent, the grantor can live in the residence for the rest of his or her life and the residence still will not be subject to estate tax upon the death of the grantor.¹

TRANSFER TAX IMPLICATIONS

The creation of the QPRT results in a taxable gift. However, unlike the recipients of an outright gift of property, the ultimate beneficiaries of a QPRT must await the end of the QPRT term before enjoying the property held in the trust. Because the ultimate beneficiaries' enjoyment is postponed, the grantor is able to take advantage of a "discount" for the QPRT term when valuing the transfer for gift tax purposes. This discount is calculated using actuarial tables developed by the federal government. Technically, the only portion of the transfer to the QPRT subject to gift tax is the value of the "remainder interest," that is, the total value of the residence less the value of the grantor's use during the QPRT term. Because only the value of the remainder interest is subject to federal gift tax, the amount of the gift is substantially lower than the value of the house itself. The table below shows the amount of the taxable gift for a transfer of a residence worth \$1,000,000 to a QPRT by a 65-year old individual in January 2012:

<u>QPRT Term</u>	<u>Taxable Gift</u>
5 years	\$ 848,550
10 years	683,270
15 years	501,720
20 years	317,470
25 years	158,700

The objective of the QPRT is to reduce estate taxes by removing the value of the residence from the grantor's gross estate. If the grantor dies after the QPRT term; the gift to the QPRT will have removed all appreciation in the residence after the date of the gift from the grantor's gross estate. As you will note from the above table, a longer QPRT term will decrease the size of the taxable gift and increase the tax savings. However, a longer QPRT term will also increase the risk that the grantor will die before the end of the term. If the grantor dies before the QPRT term ends, the tax benefits of the arrangement will be lost. If the property is included in the grantor's gross estate for

¹ The rental payments will also permit the grantor to shift wealth to younger family members free of gift tax.

federal estate tax purposes, then the prior gift is ignored in computing the grantor's federal estate tax, but any gift tax paid is allowed as a credit against the estate tax. Thus, where a grantor actually pays federal gift tax in connection with the creation of the QPRT but dies prior to the end of the QPRT term, the grantor is placed in the same position he or she would have been had the QPRT not been created, except that some estate tax will have been prepaid (without any benefit for having paid early).

INCOME TAX IMPLICATIONS

Because of the grantor's interest in the QPRT, the trust will be a grantor trust for income tax purposes, which means that any income or capital gains earned by the QPRT will be taxed to the grantor. This principle is important, because if a QPRT holds the grantor's principal residence and the Trustee of the QPRT sells the residence during the QPRT term, and does not reinvest the proceeds in another residence, the grantor may be entitled to exclude from gross income up to \$250,000 (\$500,000 with respect to a joint return) of gain on the sale.

Another significant income tax issue concerns the residence's cost basis. If the grantor survives the QPRT term, the ultimate beneficiaries will receive the residence with the grantor's existing income tax cost basis. This means that if the grantor transfers a residence to the QPRT and the residence appreciates in value, the ultimate beneficiaries may be liable for the capital gains tax if they sell the property after the end of the QPRT term. In contrast, if the property were included in the grantor's gross estate at death, the beneficiaries would receive a "step-up" in the property's income tax cost basis to the fair market value of the property at the grantor's death, which would eliminate any capital gain on the sale. However, paying the lower capital gains tax (at a marginal rate of 15%) will normally be preferable to paying the estate tax (at a marginal rate of as high as 55%) which would have otherwise been payable if the grantor had not created the QPRT.

OTHER ISSUES

A Florida residence that is the homestead of the owner is subject to certain favorable protections under Florida law. For example, the increase in the annual property taxes payable with respect to the residence cannot exceed 3% of the prior year's tax (the "Save Our Homes" exemption). During the term of the QPRT, the grantor will continue to enjoy this cap on the property taxes and creditor protections applicable to homestead property. In addition, if, as discussed above, the grantor enters into a long-term lease prior to the end of the term of the QPRT, the homestead protections can still be available to the grantor because the long-term lease can be treated as the equivalent of ownership of the property. When the grantor passes away, the ultimate beneficiaries will receive the property and the lease will terminate.

ILLUSTRATIONS

The attached Exhibit shows the potential tax savings available to grantors. The table assumes: (1) a 65-year old grantor creates the QPRT in January 2012; (2) the grantor survives the 15-year QPRT term; (3) the value of the residence increases at a 4% rate annually; and (3) the grantor is in a 35% marginal gift and estate tax bracket. The Exhibit shows the amount of the initial taxable gift, the amount that will eventually pass to the remainder beneficiaries and the transfer tax savings under varying assumptions regarding the QPRT term and appreciation in the property value.

NOTE TO OUR READERS

This Client Memorandum is intended to convey to you the principal characteristics of a Qualified Personal Residence Trust as they apply to common situations. For that reason we have deliberately simplified technical aspects of the tax law in the interest of clear communication. Under no circumstances should you rely solely on the contents of this Memorandum for technical advice nor should you reach any decisions with respect to such a trust without further discussion and consultation with your legal counsel and tax advisor.

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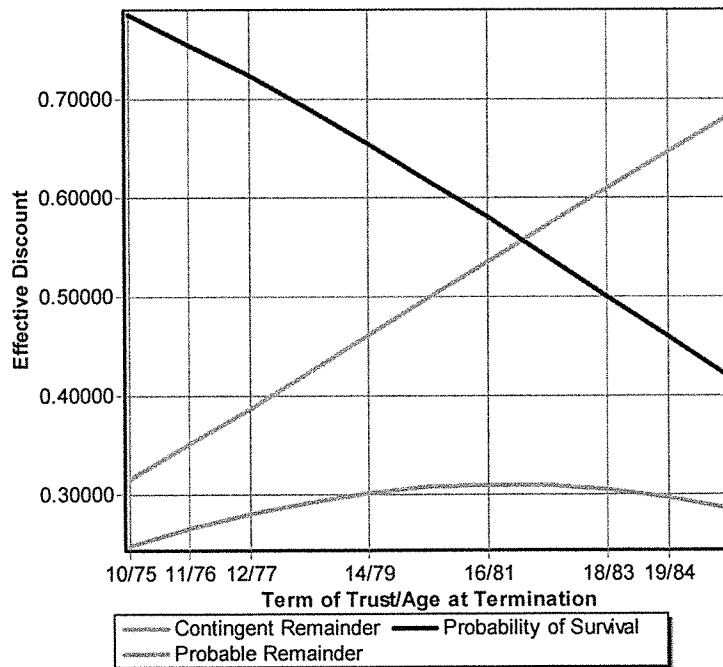
GRIT and Qualified Personal Residence Trust

Transfer Date: 1/2012
 \$7520 Rate: 1.40%
 Principal: \$1,000,000
 Grantor's Current Age: 65
 Term of Trust: 15
 After-Tax Growth: 4.00%
 Comb. Death Tax Bracket: 35.00%
 With Reversion? Yes

Grantor's Age When Trust Term Ends: 80
 Value of Nontaxable Interest Retained by Grantor: \$498,280
 Taxable Gift (Present Value of Remainder Interest): \$501,720
 Property Value After 15 Years: \$1,800,944

Potential Death Tax Savings: \$454,728
 (Combined Bracket times [Value of Property minus Taxable Gift])
 Qualified Annuity that Must be Paid Annually
 if Entire Trust Ceases to be a QPRT: \$43,906

	<u>Reversion</u>	<u>Total Income Interest</u>	<u>Income Interest With Reversion</u>	<u>Remainder</u>
Factor:	0.33940	0.15888	0.49828	0.50172
Value:	\$339,400	\$158,880	\$498,280	\$501,720



GRIT and Qualified Personal Residence Trust

<u>Term of Trust</u>	<u>Grantor's Age at Termination</u>	<u>Taxable Gift</u>
10	75	\$683,270
11	76	\$648,060
12	77	\$612,190
13	78	\$575,770
14	79	\$538,910
15	80	\$501,720
16	81	\$464,360
17	82	\$427,040
18	83	\$389,960
19	84	\$353,340
20	85	\$317,470