Dean, Mead, Minton & Zwemer
1903 South 25th Street, Suite 200
P.O. Box 2757 (ZIP 34954)
Fort Pierce, Florida 34947

772-464-7700
772-464-7877 Fax
www.deanmead.com

Orlando
Fort Pierce
Viera

BRADLEY R. GOULD
772-464-7700
bgould@deanmead.com

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Estate Tax Planning for Personal Residences and Vacation Homes

by
Bradley R. Gould, Esq.
Richard I. Withers, Esq.

I. Introduction

As property values across the state of Florida, and indeed the nation, experienced significant appreciation during most of this decade, personal residences and vacation homes ("Personal Residences") became a substantial component of the financial worth of many individuals. However, the downturn in the real estate market has materially depressed property values and thereby enhanced the transfer tax savings that can be achieved on a life time transfer of a Personal Residence. The Qualified Personal Residence Trust ("QPRT") is an estate planning technique designed specifically to address the Personal Residence and is one of the best transfer tax savings techniques available today (transfer taxes include the gift tax, estate tax, and generation-skipping transfer tax). A QPRT allows an individual to give away up to two Personal Residences, one principal residence and one additional residence (e.g., vacation home), at a substantially reduced transfer tax cost than would have been incurred on an ordinary transfer of the Personal Residence during life or at death. Additionally, the QPRT can be structured so that the original homeowner experiences almost no immediate change in the manner in which he or she enjoys the Personal Residence. However, the QPRT is not appropriate in every situation and experienced legal counsel should be consulted before placing a Personal Residence in a QPRT.

II. How it Works

A QPRT is an irrevocable trust established when the owner of a Personal Residence (the "Grantor") transfers the residence to the trust. The terms of the QPRT provide the Grantor with the right to use and occupy the Personal Residence for a fixed number of years (the "Term"). Upon the expiration of the Term, the Grantor ceases to have the right to reside in the Personal Residence and the property is distributed to the QPRT beneficiaries, either outright or in further trust.

III. Advantages

The principal advantage of a QPRT is that the Personal Residence may be transferred during the Grantor's life at substantially less than its fair market value for federal gift tax purposes. This result occurs because the Grantor is treated as retaining the value associated with

the right to use and occupy the Personal Residence during the Term and making a taxable gift only of the value of the remainder interest (the remainder interest is the right to own the Personal Residence after the Term expires). Thus, the value of the gift is only a fraction of the Personal Residence's fair market value. The fraction will ordinarily be determined by reference to the Treasury's actuarial tables, which are formulated based upon the age of the Grantor, the length of the trust Term, and the current interest rates at the date of the gift. Provided the donor survives the trust Term, the beneficiaries of the QPRT will receive the Personal Residence at no additional tax cost to the Grantor or the Grantor's estate, regardless of any appreciation in value subsequent to funding of the QPRT. If the Grantor wishes to reside in the Personal Residence after the Term, he or she may lease it from the beneficiaries. Such a lease has the added benefits of reducing the Grantor's estate and transferring additional assets to the QPRT beneficiaries.

Another reason a QPRT is such an effective estate planning technique is that it provides an opportunity to freeze the value of the Grantor's residence for transfer tax purposes. The value of the Personal Residence is established for transfer tax purposes on the date of the gift and any appreciation subsequent to the date of the transfer to the QPRT will pass to the beneficiaries free of transfer tax (provided of course that the Grantor survives the Term). The cost of this estate freeze is that the beneficiaries will not receive the Personal Residence with a basis adjusted to fair market value, as they would have had the Grantor retained ownership until death, but this cost is more than compensated by the disparity between the capital gains rate of 15% and the estate tax rate of 45%.

Finally, a QPRT is a "grantor trust" for federal income tax purposes, which allows the QPRT to utilize the Grantor's $250,000 ($500,000 for married persons filing jointly) gain exemption upon the sale of a principal residence if the residence is sold during the Term and entitles the Grantor to deductions for mortgage interest, taxes, and other eligible costs applicable during the Term.

IV. Disadvantages

While the above discussion of the advantages that can be obtained by using a QPRT may suggest that a QPRT is a universally advantageous estate planning vehicle, there are several potential disadvantages that should be carefully considered. First, if the Grantor dies during the Term, the Personal Residence will be included in the Grantor's gross estate for estate tax purposes at its fair market value on the Grantor's date of death. For this reason, a Term should be chosen that the Grantor is expected to outlive. However, if the Grantor dies during the term, the only real loss is the cost incurred to establish and fund the QPRT since the Personal Residence would have been included in the Grantor's gross estate if the QPRT was never undertaken.

Second, a QPRT is an irrevocable trust, essentially meaning it cannot be changed. While the terms of the QPRT may provide for limited flexibility, there is always the risk that a change in circumstances may make the trust undesirable or ineffective in the future.

Finally, some other potential disadvantages that should be considered include: (i) a gift to a QPRT does not qualify for the gift tax annual exclusion, (ii) transferring a Personal Residence subject to a mortgage, although permissible, creates added complications and transaction costs

that impact the overall effectiveness of a QPRT, and (iii) generation-skipping transfer tax exemption cannot be effectively allocated to the QPRT until the Term ends.

V. Other Considerations

During the Term, the Grantor is responsible for paying the expenses of the Personal Residence that are normally allocated to a life tenant (i.e., ordinary repairs, maintenance fees, property taxes and insurance). The remainder beneficiaries of the QPRT bear the costs of improvements and major repairs.

If the Grantor ceases to use the Personal Residence as a personal residence or the residence is sold, damaged or destroyed during the Term, then the Grantor can repair or replace the property within two years. Otherwise, the trust will cease to be a QPRT and the residence or proceeds from its disposition must be either distributed outright to the Grantor or converted into a qualified annuity trust benefiting the Grantor for the remainder of the Term.

VI. Example

Assume that Jane, a 50 year old single woman, establishes a QPRT in September 2009 by transferring her vacation home having a value of $1,000,000 to the trust. If the QPRT has a 20 year term, Jane would retain an interest worth $590,530 and make a taxable gift of only $409,470. Should Jane outlive the term, she will have used only $409,470 of her $1,000,000 lifetime gift tax exemption and any appreciation in the home that occurs subsequent to the gift will not be subject to estate or gift tax. If the home were to appreciate 6% per year, the home would be worth $3,207,135 when the QPRT ends. At current tax rates, this planning would save Jane $1,258,949 in estate and gift tax.

VII. Conclusion

A QPRT can be an extremely effective vehicle for reducing the size of a potentially taxable estate without significantly impairing the Grantor's right to use and occupy its Personal Residence. As with all estate planning vehicles, the QPRT has some potential disadvantages that may make it an inappropriate technique for some. Thus, it is important to carefully consider the impact of the various factors discussed above and make an informed choice that a QPRT is the appropriate vehicle for a particular individual prior to establishing or funding a QPRT.

About the Author:
Bradley R. Gould is an associate attorney with Dean, Mead, Minton & Zwemer. He represents businesses and business owners in all types of business and tax matters, including choice of entity, mergers and acquisitions, reorganizations, and other general business matters.

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