Column: QPRTs can be ticking tax bombs

BY JESSICA GALLIGAN GOLDSMITH AND DAVID Y. CHOI

The home is often a family's largest asset. Since many parents wish to pass property to the next generation, families have sought ways to protect the family home from taxes and creditors. In the past, many financial planners recommended parents use qualified personal residence trusts, or QPRTs, to transfer the home from the parents to the children. However, due to recent changes in tax law, the vast majority of estates are now, or will soon be, fully exempt from federal and state estate taxes. Unfortunately, for families with QPRTs, the tax burden may have risen.

Two significant changes have occurred over the past decade that may have turned many QPRTs into ticking tax bombs. First, the individual federal estate tax exemption has increased by more than 250 percent, reaching $5,430,000 effective Jan. 1. Second, the top marginal capital gains tax rate has increased by nearly 60 percent over this same period. The effect of these changes means that a primary benefit of the QPRT (paying capital gains tax in exchange for avoiding estate tax) has disappeared.

For these reasons, many children whose parents established QPRTs are discovering they will owe significant income taxes on the sale of the family home with little or no estate tax savings. Had the parents kept the family home, the children would not have paid any federal or state estate taxes, and the income tax basis in the home would have been adjusted ("stepped up") to fair market value when the parents died. In this scenario, the sale of the home would have been free of income taxes for the children. Unfortunately, because the QPRT removed the home from the parents' estates, the children will not receive a stepped-up basis. Therefore, the children will likely have to pay significant capital gains taxes when the home is sold.

Ironically, the solution to this problem may be found in Tax Court cases previously favoring the IRS. In the past, when federal estate tax rates were high and the estate tax exemption was low, the IRS worked diligently to limit the effectiveness of QPRTs. The IRS routinely argued that the taxpayer's QPRT was not bona fide, pointing to the parents treating the home as their own even though the children had technically taken title through the QPRT. The argument made by the IRS was simple – the QPRT was not valid for federal estate tax purposes because the family members behaved as if the QPRT did not exist. Therefore, the IRS argued that the home should be included for estate tax purposes in the estates of the parents.

The truth is that the IRS is correct. Parents routinely fail to follow the strict formalities that are required to make a QPRT effective. For example, parents often continue to occupy and use the home, but fail to sign a lease or to pay market rent at the end of the QPRT. In addition, parents often continue to pay for the expenses of the home themselves, rather than paying through the QPRT. Finally, parents and children

often agree that the home will not be sold while the parents are living there. Under these circumstances, it appears that notwithstanding the QPRT, when the parents die, the value of the home should be included in the parents' estates, and therefore the children should receive the stepped-up basis in the home for capital gains tax purposes when the home is sold. In a holiday season filled with goodwill toward others, isn't it nice to agree with the IRS?

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