

CLIENT ALERT

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Qualified Personal Residence Trusts Attract IRS and NYS Estate Tax Audits

To Our Clients and Friends:

May 1, 2017

This Client Alert is for the particular attention of persons who have created, or are thinking of creating, Qualified Personal Residence Trusts (aka “QPRTs”) to own their primary residence or vacation home. Some background – a QPRT is created by a person, (the “Grantor”), establishing an irrevocable trust to which he or she makes a gift of his or her personal residence or vacation home, whether it be real property, a cooperative apartment or a condominium. The QPRT holds the home for a stated period of years (known as the retained interest period), during which time the Grantor uses the home and pays all the expenses. At the end of the retained interest period, if the Grantor wishes to continue to use and occupy the home, he or she must lease it from the QPRT and pay the QPRT fair market rent. The tax objective in using this estate planning tool is to remove the home from the Grantor’s estate for estate tax purposes at little or no gift tax cost when creating the QPRT.

Until recently, it was rare for the IRS or state tax departments to audit the operation of QPRTs as part of the exam-

ination of an estate tax return filed by the estate of the Grantor. However, we are now seeing more frequent audits and sometimes a rather extensive examination into the operation of a QPRT following the expiration of the retained interest period. If the QPRT is not properly administered there is a risk that the QPRT will be disregarded, in which case the value of the real property, at the Grantor’s date of death, will be included and taxed as part of his or her estate.

Below are examples of the inquiries being made by IRS estate tax agents during the audit of returns which report that a QPRT had been created by the Grantor prior to his/her death. Although the home in a QPRT is not an asset included in the Grantor’s taxable estate, the IRS requires that the existence of a QPRT be reported on the Grantor’s estate tax return, for informational purposes only. The questions asked and the information requested by the IRS agent relate to the period of time after the expiration of the retained interest period and up to the date of death of the Grantor are general, as follows:

1. Who paid the real property expenses and taxes? (the trust or the grantor)
2. Provide a copy of each invoice and bill for real estate taxes, maintenance, utilities and repairs; and bank statements supporting such payments.
3. Provide a detailed spreadsheet showing all such payments and the corresponding bank transaction dates for all such payments.
4. Provide a description of who took income tax deductions for real estate taxes and other expenses.
5. Provide description, invoices, bank statements and other supporting documents relating to any capital improvements made to the property.
6. Furnish a copy of any lease between the QPRT and the Grantor in effect after the expiration of the retained interest period.
7. Furnish the name and address of the real estate broker or other professional who advised in determining the fair market rental value of the home that was used to determine the rent stated in the lease between the QPRT and the Grantor.
8. Furnish bank statements supporting payment of the rent by the Grantor to the QPRT.
9. Provide a detailed spreadsheet showing all such payments of rent and the corresponding bank transaction dates for all such payments.
10. Provide documents showing the annual adjustments, if any, in the fair market rents paid by Grantor.
11. If no rent payments were made, explain the steps taken by the QPRT to enforce collection of the delinquent rent payments.

12. Provide copies of homeowner's insurance policies; and proof of payment of premiums.

It appears that the IRS is taking the administration of QPRTs quite seriously. It behooves all Grantors to review their record keeping and to comply with the best practices as indicated by the IRS questions above. Failure to do so might result in the value of the home being included and taxes in the estate of the Grantor. If you have any questions concerning any of this, please do not hesitate to contact us.

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