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QUALIFIED PERSONAL RESIDENCE TRUST

CAUTION:

The purposes of this memorandum are to assist you and the trustee of your qualified personal residence trust ("QPRT") in:

1. Creating your QPRT and transferring assets to the trust;
2. Maintaining records for the trust; and
3. Filing any required tax returns.

This memorandum can only provide *general* information. If you or your trustee have any questions, please contact us.

INTRODUCTION

This memorandum discusses the documents that are required to create your QPRT. The most important of those documents is the trust agreement, but there are other documents that must be signed and filed. The purpose of the trust is to transfer your primary residence or a vacation home to the remainder beneficiaries (usually your descendants) at a gift tax cost less than the full fair market value of the property. This is done by your retaining the right to use the residence for a term of years. To obtain this gift tax advantage, there are a number of formalities that must be observed, both in the creation of the trust and in the continuing administration of the trust.

Trust Agreement

A separate summary is usually prepared outlining the terms of your QPRT trust agreement. In general, the agreement tells the trustee how to administer the trust property. You cannot change the trust or any of its terms after it is executed and funded. It must be *irrevocable* in order to give you the advantage of not having the property transferred to the trust taxed in your estate at your death, assuming that you live beyond the trust term. To receive the tax advantage of transferring the property during your lifetime at less than the full fair market value for gift tax purposes, the trust must meet the requirements of a “qualified personal residence trust” under the Treasury Regulations.

You retain the right to use the residence free of rent during the trust term. You may pay expenses associated with the residence. Alternatively, you may transfer cash to the trust so that the trustee may pay expenses, but the trustee may only retain limited amounts of cash. Any excess cash must be distributed to you at least quarterly. The trustee will also distribute any net income of the trust to you, at least annually. While you may pay ordinary expenses associated with the residence, any *additions or other improvements* made to the residence will constitute additional gifts. Before you make any improvements to the residence owned by the QPRT, be sure to discuss them with us or your accountant.

If the trustee sells the residence, any sales proceeds not used to purchase a new residence within the next two years must either be distributed to you or converted into a Grantor Retained Annuity Trust (“GRAT”), at the trustee’s election. If the trustee has the power to make this election, you cannot be trustee, or this decision should be made by a Special Trustee. Current Treasury Regulations generally prohibit the trust from selling or transferring the residence to you, your spouse, or an entity controlled by you or your spouse. If a sale or transfer is contemplated, please discuss it with us or your accountant.

If the residence is damaged or subject to condemnation proceedings, proceeds from insurance or any other source that are not used to repair or replace the residence within the next two years must also either be distributed to you or converted into a GRAT, at the trustee’s election. If the residence ceases to be used as a personal residence, as defined in the Internal Revenue Code, the property must also either be distributed to you or converted to a GRAT, at the trustee’s election.

The trust will terminate a specified number of years after the trust is created, or at your earlier death. If the trust terminates on your death, the trust property will be distributed to your estate, and will then

be administered under your Will. The value of the property will be included in your estate for estate tax purposes if you die before the end of the initial trust term.

If the trust terminates at the end of the specified term, the trust property will be distributed to the remainder beneficiaries or, if you are married, it may be administered for the benefit of your spouse first, depending upon the terms of the trust agreement. You may be able to lease the residence at fair rental value, but you cannot retain the right to purchase the residence at the end of the term.

State Law Matters

Because the trust is irrevocable, certain state law requirements apply under Colorado’s version of the Uniform Trust Code “UTC”. The trustee may decide to register the trust with the district court of the county in which the “principal place of administration” is located. The principal place of administration is where the trustee usually keeps the records pertaining to the trust, such as the trustee’s usual place of business or the trustee’s residence. The purposes of the trust registration statement are to give the current beneficiaries notice of the creation of the trust, and to establish the court that has jurisdiction to hear any dispute concerning the trust. This filing used to be mandatory if the trust is administered in Colorado, but is now optional. The Colorado UTC instead requires a Notice to be sent to the “qualified beneficiaries” of the trust written 60 days after acceptance of the trustee, including information about the trust. We usually prepare that Notice as part of the documentation for the trust.

Taxpayer Identification Number

Because the trust should be considered a “grantor trust” under the IRS rules, your social security number can be used as the taxpayer identification number for the trust during your lifetime. You should sign an IRS form W-9 to give your social security number to your trustee. Your social security number should be used for any separate bank account opened in the name of the trust. All income received by the trust and deductible expenses (such as mortgage interest or real estate taxes) paid by the trust will be reported by you on your individual form 1040. The trustee is required to give you a statement of income and expenses each year so that you can prepare your return.

Transfer of Property to the Trust, and Acquisition of Property by the Trust

In general, you should use this format for titling assets in the name of your irrevocable trust:

The _____ [name of your trust], dated _____.

Identification of Trustees

When the trustee acquires or sells property in the name of the trust, he may be asked to provide evidence of who the trustees are, and who can sign for the trust. You or the trustee may, of course,

provide a copy of the trust agreement to show that information. However, you may not want the trustee to disclose the entire trust agreement.

Colorado's version of the Uniform Trust Code authorizes the use of a Certification of Trust form that discloses pertinent information about the trust instead of providing the entire trust agreement. We usually prepare that form as part of our estate plans.

Real Estate

Real estate, such as the interest in your residence, can generally be transferred to the trust by signing and recording a deed. Colorado law allows real property to be titled in the name of the trust itself (without naming the trustee in the deed), as long as a Statement of Authority is also recorded in the real estate records to show the identity of the trustee(s). If there is a change of trustees, a new Statement of Authority should be recorded to reflect the change before the property is conveyed by the trustee. Sometimes the Certification of Trust and Statement of Authority forms are combined.

Before you transfer any real estate to your trust, there are several special issues that you should consider:

- ◆ If the real estate is subject to any debt (that is, if there is a deed of trust or mortgage against the property), the note and deed of trust or mortgage documents should be checked to see whether there are any restrictions on transferring the property. Those documents may contain a "due on transfer" clause, allowing the lender to accelerate the balance due on the loan if you transfer the property. In such a case, you should ask the lender if it will waive its right to accelerate the loan with respect to the transfer to your trust. If you do obtain a waiver, be sure it is in writing. *Principal payments on the mortgage will be additional gifts to the trust.*
- ◆ If you transfer real estate located in a state other than Colorado to the trust, you will have to comply with the real estate laws of the state where the property is located. Therefore, if you have real estate in another state that you want to transfer to the trust, please contact us.

There are a number of technical issues relating to real estate titles. As a result, we generally recommend that you not try to handle transfers of real estate to your trust by yourself, but let us help you make those transfers. You should be sure to name the trust as an "additional insured" on casualty insurance and title insurance policies.

Gift (and Generation-Skipping) Tax Considerations

Before transferring property to the trust, you must obtain a written valuation of the property. Because the trust is irrevocable, the present value of the remainder interest in any property you transfer to the trust is a completed gift for gift tax purposes. This present value will have to be computed for purposes of filing the gift tax return.

A gift tax return must be filed for each calendar year in which a gift is made. In addition, if you and your spouse want to elect “gift-splitting,” so that each gift made by either of you to a third party during a particular calendar year will be treated as made one-half by each of you, you must file gift tax returns in order to make the gift-splitting election. The gift tax return is made on IRS Form 709, is filed with the Internal Revenue Service, and is due by April 15 of the year following the calendar year in which the gift is made. Therefore, you need to file a gift tax return for the year in which the trust is funded.

Generation-skipping tax exemption can only be allocated to a QPRT upon the termination of the initial trust term, and not on the gift tax return filed when the gift of property to the trust is reported. Generally, generation-skipping involves providing benefits to persons who are two or more generations younger than you, such as your grandchildren. If the remainder beneficiaries include grandchildren, then you should consider whether the GST exemption should be allocated at that time on a gift tax return filed for the year of termination of the trust term.