When a QPRT Is Not a "Qualified" Place to Park Your Residence

By Amiel Z. Weinstock

General Overview of a QPRT

A qualified personal residence trust (QPRT) is an irrevocable trust to which a donor (the "grantor") makes a gift of a personal residence (usually) for the ultimate benefit of the grantor's immediate family, typically the grantor's children. The Treasury Regulations under IRC § 2702 explain that the personal residence transferred to the QPRT must be the "principal residence" of the grantor or one "other residence" of the grantor and that the residence may not be used for something other than a personal residence when it is not occupied by the grantor. With minor exceptions, including working capital to maintain the residence and pay trust expenses, no other property can be contributed to a QPRT. See Treas. Reg. § 25.2702-5(c)(5)(ii).

The definition of "principal residence" is self-explanatory—the grantor can have only one principal residence. For a property to qualify as an "other" residence, the grantor must either use the property as a residence for 14 days during the calendar year, or, if the property is rented out for a portion of the year exceeding 140 days, the grantor must use the property as a residence for a number of days at least equal to 10% of the number of days it is rented out. See Treas. Reg. § 25.2702-5(c)(2)(i)(B) and the reference therein to IRC § 280A(d)(1) for the definition of an "other" residence.

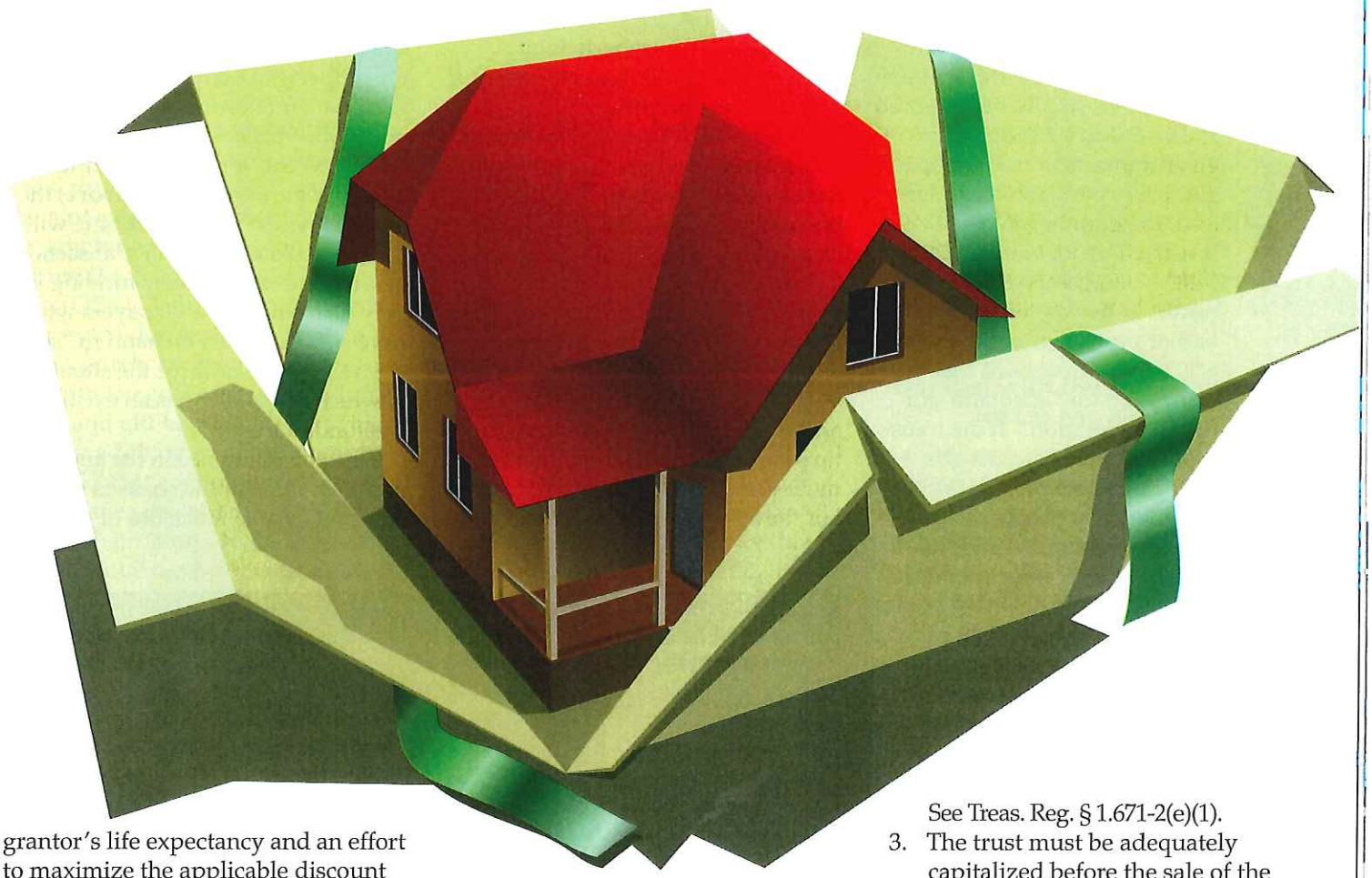
Amiel Z. Weinstock is general counsel in the Boston, Massachusetts, office of Thomas Brady & Associates.

The terms of a QPRT provide generally that, for a specified term of years (selected by the grantor), the QPRT will hold the property for the sole benefit of the grantor. During that term of years (referred to herein as the "QPRT Term") the grantor will have full use of the property as if it still were owned by the grantor individually. The grantor will be responsible for all expenses associated with the property and will be treated as the owner of the property for income tax purposes (because the QPRT is, by definition, a "grantor trust"—that is, a trust that is taxable to the grantor for income tax purposes).

If the grantor survives the QPRT Term, the remainder interest in the trust (that is, the full value of whatever the trust holds at the time) will be held or distributed for the benefit of the designated trust beneficiaries. In cases in which the grantor wants to be able to use the property after the QPRT Term, the trust often provides that the property will remain in trust, although sometimes the property is distributed outright to the beneficiaries. In either scenario, the grantor will be obligated to pay fair market rent to the QPRT, or directly to the beneficiaries if they received the property, for the right to continue to occupy the property. Rental payments that are below fair market value may be deemed to be gifts by the grantor to the owners of the property to the extent the payments are below fair market value.

If the grantor dies during the QPRT Term, the full value of the trust property will be included in the grantor's taxable estate for estate tax purposes under IRC § 2036. As such, many QPRTs provide that, if the grantor dies during the QPRT Term, the property will either be returned to the grantor's estate or be subject to the grantor's power of appointment. Note that if the grantor dies during the QPRT Term, the estate planning strategy has failed, and the grantor's estate will be taxed as if the strategy had never been implemented.

As a leveraged gift and estate planning tool for the transfer of real estate, the QPRT offers a straightforward strategy to minimize gift tax during the client's lifetime and reduce a client's taxable estate at death. The initial gift to the QPRT is determined by discounting the fair market value of the transferred residence by the value of the grantor's retained interest in the property. The value of that retained interest (and thus the value of the discount) depends on the applicable IRC § 7520 Rate as set by the IRS and as determined as of the date of the gift to the QPRT and the length of the grantor's retained term interest in the property, that is, the QPRT Term—the longer the QPRT Term, the greater the discount and the smaller the value of the gift. The value of the gift is reported on the grantor's gift tax return for that calendar year. Of course, as noted above, the one catch is that the grantor has to survive the QPRT Term to exclude the value of the residence from his or her estate. This uncertainty creates a tug of war between a practical, or conservative, estimate of the



grantor's life expectancy and an effort to maximize the applicable discount on the value of the gift. A secondary discount also may be available if the grantor makes a gift of a fractional interest in the property; for example, a husband and wife might each contribute a 50% interest in a vacation home to separate QPRTs. This discount applies directly to the value of the property and is not affected by the applicable interest rate or retained term use of the property.

QPRTs Are Inefficient in a Low-Interest Rate Environment and the Strict Statutory Requirements and Prohibitions Make QPRTs Administratively Burdensome

Notwithstanding the statutory framework and clear tax treatment of gifts to QPRTs, in this historically low interest rate environment, a QPRT may not be the most efficient gift and estate tax planning strategy for transfers of real estate. In addition, because of the strict parameters for a trust to qualify as a QPRT, a taxpayer might find that a traditional irrevocable trust is more appealing.

iStockphoto

Basic Requirements for a Sale to a Defective Grantor Trust

One alternative to a gift to a QPRT is a sale of the property to an intentionally defective grantor trust (IDGT) in exchange for a promissory note. A typical promissory note will be interest only at the lowest available Applicable Federal Rate (AFR), with a balloon payment at the end of the note term. The AFRs are published by the IRS on a monthly basis in accordance with the requirements of IRC § 1274(d).

Four key requirements to the sale technique are as follows:

1. The purchasing trust must be a grantor trust. This is essential because a grantor trust will be disregarded for income tax purposes, and there will be no sale treatment, that is, no gain will be triggered, when the grantor is on both sides of the transaction. See Rev. Rul. 85-13.
2. The transferor of the property also must be the grantor of the trust. See Treas. Reg. § 1.671-2(e)(1).
3. The trust must be adequately capitalized before the sale of the property to the trust. The goal is to ensure that the promissory note associated with the sale to the trust will be respected as bona fide debt. By capitalizing the trust with an appropriate amount of "seed money," debt-service payments can be made from assets in the trust other than the purchased property. Although there is no hard and fast rule for how much seed money is required, most practitioners are comfortable with 10%. See Steve R. Akers & Philip J. Hayes, *Estate Planning Issues with Intra-Family Loans and Notes*, Texas Tax Law. (Winter 2013); and Jonathan G. Blattmachr & Diana S.C. Zeydel, *Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth*, 47 Tax Mgm't Memo. 2 (Jan. 2006). In addition, in an ideal situation, there should be a period of time between the funding of the trust with the seed money and the sale of the property to

the trust. This will help refute an argument by the IRS that the transactions should be collapsed and re-characterized as a singular transaction that is a "part gift, part sale." If so characterized, the grantor can be exposed to estate includability under IRC § 2036, because a part gift results in the loss of the safe-harbor protection under IRC § 2036 for transactions that are completed for "adequate and full consideration." If the transaction is treated as part gift, the consideration paid is not automatically deemed to be "adequate and full," and IRC § 2036 could become implicated at the grantor's death. Note that if the trust is not already funded, a gift tax return will be required for any gifts to the trust.

4. The transaction should be properly documented, and the terms and form of the transaction must be respected by the parties. Proper documentation will help support the taxpayer's claim that the promissory note is in fact debt and not equity, which is another safeguard against IRC § 2036.

Comparison of a Gift to a QPRT and a Sale to an IDGT

To illustrate why a sale transaction may be preferable to a QPRT, a comparison can be made between the net result of (1) a gift to a QPRT and (2) a cash gift to an IDGT with a corresponding sale of the property to the IDGT. For simplicity, assume the following set of facts: John and Jane Doe, who are both 60 years old, own a vacation home with a fair market value of $3 million, which they wish to give to their children. Similar homes in the area rent for $16,000 per month. The applicable IRC § 7520 Rate for the month of the transfer is 2.00% and the mid-term AFR is 1.66%. John and Jane will each transfer, either by gift or sale, a 50% interest in the property. The proposed term of the QPRT is nine years, and the conservative estimate for the fractional interest discount for the 50% interest is 15%. The annual operating expenses for the property total $100,000 (or $50,000 for each one-half interest in the property).

Because each taxpayer transfers a 50% interest, the base value of each transfer is $1.5 million. The 15% fractional interest discount reduces that base value to $1.275 million. Based on the assumptions set forth above, the value of the taxable gift to the QPRT of a 50% interest in the property would be $931,464.

For the sake of a fair comparison, an assumption will be made that each taxpayer makes a cash gift of seed money of $931,464 to a separate IDGT. For the sale transaction, each IDGT will purchase the 50% interest in the property in exchange for a nine-year term, interest-only promissory note with a balloon payment obligation at the end of the nine-year term. Based on the assumptions above, the annual interest rate on this note will be 1.66%. Note that a sale transaction that requires seed money funding is only viable for those taxpayers who have sufficient cash on hand to "seed" the trust. (See below for the situation in which a taxpayer has an existing pre-funded trust.)

One key difference in the annual administration of the trusts is that, for Jane and John to make use of their

9-Year QPRT Calculation	
Undiscounted value of property	$1,500,000.00
Discounted value of property	$1,275,000.00
Taxable gift	$931,464.00
Value of property in 9 years at 4%	$2,134,967.72

Sale to Defective Grantor Trust—Two Scenarios		
	Rent of $96,000	Rent of $120,000
Undiscounted value of property	$1,500,000.00	$1,500,000.00
Discounted sale price	$1,275,000.00	$1,275,000.00
Applicable interest rate—Sept. 2013	1.66%	1.66%
Annual rental income	$96,000.00	$120,000.00
First year interest payment	$(21,165.00)	$(21,165.00)
Annual maintenance costs	$(50,000.00)	$(50,000.00)
Net income	$24,835.00	$48,835.00
Note balance after 9 years	$(1,036,054.19)	$(805,142.20)
Trust assets after 9 years:		
Appreciated value of cash at 4%	$1,325,763.71	$1,325,763.71
Appreciated value of real estate at 4%	$2,134,967.72	$2,134,967.72
(note balance)	$(1,036,054.19)	$(805,142.20)
	$2,424,677.24	$2,655,589.23

respective interests in the property held in the IDGT but avoid a IRC § 2036 retained interest problem, each will have to pay rent to the IDGT. No rent is required for the use of the property held in the QPRT during the nine-year QPRT Term because the grantor has retained the right to occupy the property as part of the gift to the QPRT. Although some clients may see paying rent as a negative, from a purely mathematical perspective with the goal of maximizing the estate and gift tax benefit, the ability to make additional contributions to the IDGT that are not treated as taxable gifts is a major advantage for the IDGT structure. To the extent the annual rental payment exceeds the $50,000 operating expense for the property, such excess cash becomes an asset of the IDGT. In the model payout plan described, that excess will be used to pay down the principal of the promissory note over the nine-year term.

Assuming an annual rate of appreciation of 4% on the real estate, if the taxpayers both survive the nine-year terms of their respective QPRTs, the undiscounted value of the 50% interest in the residence in each QPRT will be $2,134,968 (or $4,269,936 combined), which will no longer be included in the taxpayers' taxable estates.

On the other hand, and regardless of whether the taxpayers survive the nine years, the value of the assets in each IDGT at the end of nine years will be even higher. For example, if the fair market rent for the property is $96,000 per year for each 50% interest in the property (which is paid by each of the grantors), then the net value of each IDGT at the end of the nine years will be $2,424,677 (or $4,849,354 combined). These figures are calculated by adding the appreciated value of the undiscounted 50% interest in the residence to the appreciated value of the initial cash gift to each trust (also assuming a 4% rate of return) and subtracting the remaining balance due on the promissory note. If the rental payments can be legitimately higher, the IDGTs will do even better. Note that when a taxpayer dies, whether during the nine-year term of the note or thereafter, the value of the remaining balance due on the note will be included in his or her taxable estate.

At the most basic level, a QPRT is permitted to hold only one residence at a time, and that residence must be either the taxpayer's primary residence or one "other" residence.

The $580,000 differential between these two alternative planning strategies is a function of two things. First, a lower rate of interest applies to the promissory note (1.66% vs. 2.00% in the QPRT) because it is less expensive for the IDGT to borrow the money. Second, the extra rental payments that are made to the IDGT enable the IDGT to pay down the principal balance of the promissory note, which increases the net asset value of the IDGT. Importantly, the taxpayer's cash position does not change over the nine-year term of the promissory note despite the significant rental payments because the same amount is returned to the taxpayer in the form of interest and principal repayment on the promissory note. Thus, the sale structure is one that is best suited for those clients who have the available liquidity to make it work.

Using Previously Funded Trusts Is Even Better!

Use of the sale strategy can be even more desirable in the estate planning landscape post-ATRA (American Taxpayer Relief Act of 2012) because of all the trust funding activity that took place in 2012 before ATRA's promulgation. If a taxpayer already has a funded trust, the comparative options are (1) making a taxable gift in the form of a QPRT, which may be very unappealing if the taxpayer used all of his or her lifetime gift tax exemption, or (2) selling the property to the funded trust in exchange for a promissory note, which involves no gift but which captures all of the appreciation on the property inside the trust. For the same reasons why the sale technique is more appealing than the QPRT in the original scenario, the use of the sale technique with a previously funded trust is even better.

Dealing with the Real Estate Inside the Trust

In addition to the tax advantages outlined above, one of the more appealing aspects of using a standard irrevocable trust, such as an IDGT, instead of a QPRT is the enhanced flexibility that the trustees of the irrevocable trust have in dealing with the trust property.

At the most basic level, a QPRT is permitted to hold only one residence at a time, and that residence must be either the taxpayer's primary residence or one "other" residence. A taxpayer therefore can create only two QPRTs, and married couples can create only three. Those taxpayers who own more than two residences will need to look to other alternatives for wealth transfer strategies involving their residences.

Taxpayers also should take note that using a QPRT for a residence with a mortgage creates a host of tax reporting and administrative problems. Mortgaged property can be contributed to a QPRT, but each time a mortgage payment is made, presumably monthly, a new gift is made to the QPRT based on the equity portion of the payment. To calculate the value of such gift, the taxpayer must make the QPRT calculation each month based on the then applicable monthly IRC § 7520 Rate and the remaining time of the QPRT Term. There are solutions to this problem, such as paying off the mortgage before making the gift, converting the mortgage loan to an interest-only note with a balloon payment at the end, or treating all mortgage payments as loans to the QPRT, but they can be burdensome and are typically unappealing to the grantors.

Another drawback to the QPRT is the inability of the grantor to buy back the property from the trust at any time that the QPRT is a grantor trust. To be qualified, the QPRT provisions must include this prohibition. By definition, the QPRT is a grantor trust during the QPRT Term because of the grantor's retained use of the property. For income tax planning purposes, especially when the grantor expects to rent the property from the QPRT after the QPRT Term, many QPRTs are drafted so that they continue to be grantor trusts even after the QPRT Term ends. Because the payment from a grantor to a grantor trust is not a taxable event for income tax purposes, maintaining grantor trust status after the QPRT Term ends is appealing to eliminate any income tax on the rent payments.

The QPRT also must restrict the use of any funds resulting from the sale or other involuntary conversion of the residence during the QPRT Term. Because a QPRT must always hold a residence to qualify, sale or other conversion proceeds must be used within two years to acquire a replacement residence. If a replacement residence is not desired, or if one cannot be acquired within two years, the trust must be converted into a grantor retained annuity trust (GRAT), which must make annual annuity payments to the grantor for the remainder of the QPRT Term.

In contrast, property held by a traditional irrevocable trust can be sold at any time to any person, including the grantor. The proceeds can be reinvested in a new residence, held and invested in other assets, or distributed to the trust beneficiaries. The property can be subject to a mortgage or free of all such liabilities.

Trust Beneficiaries and Multi-Generational Transfer Tax Planning

What often gets overlooked with the QPRT strategy is the fact that it is not designed for multi-generational tax planning. Because the grantor of a QPRT has a retained interest in the trust property for a term of years, the grantor cannot allocate any GST tax exemption to the gift at the time that the residence is transferred to the QPRT. IRC § 2642(f)(1) provides that during that period of time in which the transferred property would still be included in the grantor's estate were the grantor to die (known as the "estate tax inclusion period" or "ETIP"), no GST exemption may be allocated to such property until the end of the ETIP. The explanation of the ETIP rule is beyond the scope of this article, but it is critical that planners be aware of this limitation.

What often gets overlooked with the QPRT strategy is the fact that it is not designed for multi-generational tax planning.

Integral to understanding this GST tax limitation is recognizing its consequence in the context of designating the QPRT beneficiaries. In short, the QPRT beneficiaries typically must be limited to the grantor's children or other beneficiaries who are in the same generation as those children. Naming grandchildren as trust beneficiaries may result in unintended GST tax liabilities. At first blush, one might not be troubled by this limitation because children are often the desired beneficiaries. The issue surfaces, however, in a situation in which a child predeceases the grantor during the QPRT Term. In such a situation, to avoid the unintended GST tax, the QPRT must be drafted so that the issue of that deceased child does not participate as a beneficiary. The QPRT most often will be drafted such that only those children who are living at the end of the QPRT term will inherit the remainder interest, which unfortunately disinherits the issue of a deceased child.

In contrast, when a gift is made to a traditional irrevocable trust, the grantor can allocate a portion of the grantor's GST tax exemption (which currently parallels the estate tax exemption of $5 million, indexed for inflation) to the value of the gift. The trust can have any number of beneficiaries from multiple generational levels, and the issue of a deceased child easily can inherit the share that was designated for that deceased child without the imposition of GST tax. This exemption continues to apply to all assets acquired by the trust through purchase.

Wasted Opportunities—Estate Tax Concerns

As mentioned above, if the grantor dies during the QPRT Term, the full value of the residence inside the QPRT will be included in the grantor's estate for estate tax purposes. Depending on the length of the QPRT Term, some level of risk may be acceptable to the taxpayer. The taxpayer can mitigate that risk by shortening the QPRT Term when drafting the trust, but such mitigation comes with a cost. A shorter QPRT Term will result in a larger taxable gift at the time of funding.

This mortality risk does not exist with a gift to a traditional irrevocable trust, nor with the sale of an asset to such trust. And, while the taxpayer may not gain the full benefit of the tax strategy if the taxpayer dies within a few years of the sale, at least some of the (expected) appreciation will have been captured outside of the taxpayer's estate.

Conclusion

As long as the AFR rates remain low, the sale technique will outpace the QPRT strategy on a mathematical basis. When this advantage is coupled with the fact that the sale technique has no mortality risk, in contrast to the QPRT strategy, the sale technique becomes even more appealing. Finally, in light of the administrative concerns outlined above, even when the interest rates increase and even if mortality risk is deemed to be only a modest concern, the use of a QPRT should be compared against available alternatives to assess its benefits against its costs. ■