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The Qualified Personal Residence Trust: Passing Wealth to the Next Generation at a Reduced Transfer Tax Cost

The qualified personal residence trust can be an effective means of transferring substantial wealth to the next generation at a significantly reduced transfer tax cost. But transfer of a personal residence to family members can raise complex family issues. This article examines both the non-tax and tax issues relating to the qualified personal residence trust, including qualification requirements under Section 2702 of the Internal Revenue Code.

By Barbara Freedman Wand

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A major challenge for the estate planner is to assist clients in making optimal use of the applicable exclusion amount. That is, the maximum amount that the client can transfer to the next generation with no estate tax. To the extent that either a lifetime gift or a testamentary disposition can qualify for a discount with respect to the value of the asset transferred, the applicable exclusion amount can be leveraged. The effect of the discount is to decrease the amount of the applicable exclusion amount that must be allocated to the transfer. The qualified personal residence trust (QPRT) is one mechanism for transferring a valuable asset, namely a personal residence, to a client's beneficiaries in a way that decreases the gift tax value of the transfer.

Unlike estate planning devices that are created by the minds of enterprising estate planners and must await the blessing or curse of the Internal Revenue Service (IRS) after the fact, the QPRT is an estate planning vehicle that is specifically sanctioned by the IRS. In an effort to discourage the use of the grantor retained income trust (GRIT), the IRS enacted Section 2702 of Chapter 14 of the Internal Revenue Code (Code). This section drastically curtailed a donor's ability to obtain a discount with respect to

the value of a gift to a trust in which the donor has retained an income (or use and occupancy) interest. The QPRT is an express exception to the restrictive valuation rules of Section 2702.[1] The rules prescribed for the valuation of remainder interests in QPRTs permit a significant discount for the value of the retained interest of the donor for a stated term of years. Hence, a QPRT should be considered for clients who own significant interests in residential real estate that they would like to transfer to family members at a reduced transfer tax cost.

Overview of the Structure of a QPRT

With a QPRT, the owner of a personal residence transfers that property to an irrevocable trust. Under the terms of the trust, the donor retains the exclusive use of the residence for a term of years (the QPRT term). At the end of the QPRT term, the donor's rights to use and occupy the residence terminate. At that time, the residence can remain in trust for beneficiaries named by the donor (the follow-on trust), or it can pass outright to them, thus terminating the trust.

Because the real property involved is, by definition, a personal residence of the donor, a threshold question for those contemplating a QPRT is whether the donor is willing to part with ownership of his or her residence. While the donor's rent-free retained use of the property must terminate upon the expiration of the QPRT term, it is possible for the donor to retain the option to rent the residence from the follow-on trust after the end of the QPRT term for fair market rental. While the psychological and financial impact of renting the residence from the follow-on trust (essentially from the donor's children) is something with which the donor must be comfortable, that arrangement can actually be an additional benefit of the QPRT from an estate planning perspective. The payment of rent provides an additional method of transferring wealth to one's beneficiaries, without the limitation of the $10,000 annual exclusion. The donor may not retain the right, however, to repurchase the residence from the trust at the expiration of the QPRT term. In fact, the final QPRT regulations issued by the U.S. Treasury Department require that the QPRT specifically prohibit repurchase.[2]

When structuring the QPRT and deciding upon the beneficiaries who will take the property at the expiration of the QPRT term, consider the fact that naming grandchildren or more remote issue as beneficiaries may result in the imposition of a generation-skipping transfer (GST) tax. The donor will not be able to allocate the GST exemption to the QPRT, to shield the property from the GST tax, until the expiration of the QPRT term. This is less than optimal because (a) the donor must remember to file a gift tax return to allocate the GST exemption at the end of the QPRT term, which may be a significant number of years after the creation of the trust, and (b) the GST exemption will need to be allocated to the value of the property at the end of the QPRT term, which may be significantly higher than the value of the property at the date of the funding of the trust.

One alternative for avoiding the generation-skipping issue is to have the property pass only to children and not to more remote issue. The effect of this choice is that the issue of a deceased child would not take a share of a valuable asset. This result must be acceptable to the donor from a dispositive perspective. The donor may decide to equalize the shares of the grandchildren via other aspects of the estate plan.

If the donor dies before the end of the QPRT term, the QPRT will not accomplish its purpose. The property will be included in the taxable estate of the donor because of the retained right to use the property. The QPRT generally provides that if the donor dies before the expiration of the QPRT term, the trust will end and the trust property will be distributed to the donor's estate. This reversionary interest further reduces the value of the gift for transfer tax purposes. An alternative to the termination of the trust upon the donor's death during the QPRT term is the inclusion of a testamentary general power of appointment in the trust, giving the donor the right to direct the disposition of the trust property by will if he or she dies before the expiration of the QPRT term. If a power of appointment is included in the trust, the terms of the QPRT will set forth the disposition of the property in default of the donor's exercise of the power.

The donor can generally be a trustee of the QPRT during the

QPRT term, but should not be a trustee after the expiration of the QPRT term. This avoids any argument that the donor has retained powers that might render the trust includable in his or her estate under Sections 2036 or 2038 of the Code.

Gift Tax Treatment of Transfers to the QPRT

Upon the transfer of the residence to the QPRT, the donor has made a gift to the beneficiaries who will succeed to the donor's interest in the property when the QPRT term ends. That gift is not valued at 100 percent of the value of the residence at the time of the gift, but it is discounted to reflect (1) the donor's retained use of the residence for the QPRT term, and (2) the possibility that the remainder beneficiaries will not receive the residence at all if the donor dies during the QPRT term. The gift of the remainder interest is reported on the gift tax return of the donor for the year in which the gift is made. The value of the gift is calculated actuarially using IRS life expectancy tables and the applicable federal rate under Section 7520 of the Code. The amount of the gift will depend upon the age of the donor, the length of the QPRT term, and the discount rate in effect during the month in which the gift is made.

The gift and estate tax savings (or the leverage of the applicable exclusion amount, if the donor has not yet fully used it) can be considerable. For example, if a 65-year-old donor transfers a personal residence worth $500,000 to a QPRT on October 1, 1999, with a QPRT term of 12 years, then based on the applicable discount rate of 7.2 percent for October 1999, the value of the gift for gift tax purposes would be $151,170. If during the 12 years in which the donor retained the right to use the residence, the property appreciated at the rate of 4 percent per year, then at the end of the QPRT term, when the donor is age 77 and the beneficiaries receive the residence, its fair market value would be $800,516. In addition to the gift tax savings achieved by the reduction in value of the property for gift tax purposes to take account of the retained interest by the donor, all appreciation in the value of the residence during the QPRT term passes to the beneficiaries free of any transfer tax. If the donor's marginal estate tax rate was 55 percent, the estate tax savings achieved by the QPRT would be approximately $354,140.

Income Tax Considerations

A major factor in deciding whether to make a lifetime gift of a personal residence to a QPRT is the capital gains tax effect of a lifetime gift, as contrasted with a transfer at death. When property is transferred by gift during lifetime, the recipient of the property takes the donor's basis in the property (a carryover basis) for purposes of calculating capital gains taxes due upon the sale of the property. The unrealized capital gains with respect to the property during the donor's ownership become the responsibility of the recipient upon its sale. By contrast, when property is transferred at death, the recipient receives a "step-up" in the basis of the property to its fair market value at the date of death of the decedent. The capital gains tax due upon sale of the property will not include the unrealized capital gain on the property during the decedent's lifetime. Therefore, if residential property has a very low basis and significant unrealized capital gains, the loss of the step-up in basis at death must be compared to the transfer tax savings provided by the QPRT. With the maximum capital gains rate at 20 percent and the highest marginal estate tax rate at 55 percent, it often will be the case that the benefit of the discounted transfer tax value and the removal of the post-gift appreciation on the property from the estate of the donor will outweigh the loss of the carryover basis. Where the property in question is a vacation home that has been in the family for generations and will likely be retained and not sold, the capital gains issue is less significant than when the property is a primary residence of the donor that will likely be sold by the children at the donor's death. An individual analysis should be performed taking all circumstances into account in making a decision as how to proceed.

Increased Tax Savings Using Fractional Interest Gifts

Further transfer tax savings are achievable where the interest in the residence conveyed to the QPRT is a fractional interest in real property rather than an entire parcel. The burdens inherent in the shared ownership of property support a discount in

value from the full value of the fractional interest. To illustrate, a one-third interest in a $300,000 residence would likely be valued at less than $100,000 because of the burdens of owning a fractional interest in the property.

Obtaining a fractional interest discount for an interest in a residence conveyed to a QPRT can be achieved in several ways. If a husband and wife own a residence jointly, they could each convey his or her respective interests (converted to tenancy in common) to separate QPRTs for the same beneficiaries. Since each QPRT would hold only a fractional interest in the residence, the value of the property conveyed to the QPRT would reflect the burdens of ownership of the partial interest. Alternatively, if a donor has several children, conveying partial interests in the property to separate QPRTs for each child may also support the fractional interest discount.

To demonstrate the value of the fractional interest discount in the calculation of QPRT transfer tax savings illustrated above, if the donor conveys a one-third interest in a $500,000 residence to each of three QPRTs, one for each of her children, then an additional discount to the value of the interests transferred would be justified. Using a conservative 15 percent discount, the value of the cumulative gifts would be reduced to $128,495 for a transfer of a $500,000 residence that would be worth $800,516 at the end of the QPRT term.

Conveying fractional interests in real property to QPRTs can serve a function other than justifying an additional discount to the value of the real estate. Since the benefits of the QPRT are not achieved unless the donor survives until the expiration of the QPRT term, one strategy to increase the chances of achieving some transfer tax savings is for a donor to convey fractional interests in a residence to several QPRTs, each with a different term. Those QPRTs with a shorter term will have a larger gift tax valuation than those with a longer term, but the likelihood that the donor will survive the shorter-term QPRTs is greater. As each QPRT term expires, the donor will have accomplished some of her goal of removing significant value from her estate. If she does not survive until the expiration of the longest term, she will nevertheless have removed some of the value of the residence from her estate.

A similar strategy can be employed by having a husband and wife each create a QPRT, with a QPRT term optimal for their respective ages (assuming they are not the same age), and having them each convey their partial interest in the residence to each of the QPRTs. Even if only one of the spouses lives to the end of his or her designated QPRT term, some transfer tax savings will be achieved.

QPRT Requirements and Considerations

Personal Residence

The only property that can be conveyed to a QPRT is an interest in a personal residence of the donor. The donor can have an interest in QPRTs with respect to two personal residences at the same time: one with respect to his or her principal residence and another with respect to another personal residence, for example, a vacation home. Only real property can be transferred to a QPRT. Therefore, if the donor wishes to transfer personal property that is located in the residence to be conveyed to the QPRT, such as furnishings, to the beneficiaries of the QPRT, the transfer must be accomplished through a separate gift outside the QPRT.

When a residence includes extensive adjacent land, the question may arise as to whether the entire lot can be considered part of the "personal residence" for purposes of the QPRT. If the size of the lot is "reasonably appropriate" for residential purposes, taking into account the size of the residence and other lots in the same or similar locations, the adjacent land will likely be held to be part of the personal residence.[3] Factors such as whether the acreage has always been used as part of the residence and whether the acreage could be subdivided are also relevant considerations in determining whether the acreage is part of the personal residence.

Whether a vacation home that is sometimes rented to third parties is a personal residence depends upon the period of personal use, as opposed to nonpersonal use. If the residence is occupied by the owner for the greater of 14 days or 10 percent of the number of days during the tax year the property is rented for a fair market rental, the property will be held to be a per-

sonal residence for purposes of the QPRT.

Issues may arise as to whether uses of the real property other than as a residence of the donor, such as rental of a room within a residence or rental of acreage for farming purposes, will preclude the parcel from being considered a personal residence for QPRT purposes. Whether a particular use will preclude the characterization of a property as a personal residence depends on whether the use is incidental to the primary use of the property as a personal residence.

Clients are often concerned about the effect on the QPRT of the donor's move to a nursing home. So long as the residence remains available at all times during the remainder of the QPRT term for the donor's use as a residence, the QPRT will continue to be valid.[4]

Property Subject to a Mortgage

While there is no prohibition against transferring property subject to a mortgage to a QPRT, mortgaged property in a QPRT adds complexity.

A gift of mortgaged property to a QPRT would likely be valued at only the equity in the property. If the donor makes principal payments on the mortgage after the property has been contributed to the QPRT, the principal component of each mortgage payment made by the donor during the QPRT term would be an additional gift. If the property continues to be held in trust following the expiration of the QPRT term, and the donor continues to make the mortgage payments, both income and principal components of the payment would likely be considered gifts. If the donor no longer makes the payments, and the trust continues for the benefit of the remainder beneficiaries, arrangements must be made for the continued mortgage payments.

The mortgage institution also may require permission before title to a mortgaged property is conveyed to a QPRT. A transfer without the permission of the mortgage institution might be an event of default triggering acceleration of the mortgage balances. For these reasons, it is preferable to convey only mortgage-free property to a QPRT.

Selection of the QPRT Term

The selection of the appropriate QPRT term is an important component of QPRT planning and involves a balancing of competing considerations. Since Section 2035 of the Code would require the inclusion of the trust property in the donor's estate if the donor died within three years of the gift, the QPRT term should not be shorter than three years. Beyond that constraint, the tension from a planning perspective is between selecting a term long enough to obtain a significant discount to the value of the residence and yet short enough that the donor will likely survive until its expiration (since, as noted above, the property is includable in the donor's estate if he or she dies before the expiration of the term). A probability analysis can help to identify the optimal term.

Of course, as with all estate planning devices, there are nontax considerations in deciding upon the length of the QPRT term as well. Especially where a primary residence is concerned, the donor may wish to select a term that coincides with an expected change in living arrangements—a move to an assisted living community or to a warmer climate. The nontax aspects of the decision must be fully explored.

Expenses and Improvements During the QPRT Term

During the QPRT term, the donor can pay those expenses of the property that are the responsibility of a life tenant under local law, and the payment of those expenses will not be considered as an additional gift to the trust. The donor may pay those expenses directly or may make payments of cash to the QPRT to meet those expenses. There are restrictions, however, on the amount of cash that may be held in a QPRT, and "excess" cash must be distributed to the donor at specified intervals.[5] The donor will be able to deduct real estate taxes paid with respect to the residence during the QPRT term.[6]

Changes in Character of Trust Property During the QPRT Term

Not only is a personal residence the only property that may be conveyed to a QPRT (other than the limited amount of cash mentioned above), but the QPRT must continue to hold a person-

al residence of the donor during the QPRT term in order to achieve the maximum planned tax objectives. This requirement is designed to ensure that the donor receives the benefit of the retained use of the property that justified the discount to the value of the property for gift tax purposes.

Treasury Regulations provide that if the original residence conveyed to the QPRT is sold, damaged, or destroyed, the proceeds of the sale or insurance must be applied to replacement or repair of the personal residence. Any proceeds not used must either be retained in the trust as a separate "qualified annuity interest" for the benefit of the donor for the remainder of the QPRT term or distributed outright to the donor. Either of these alternatives will decrease the planned benefit of the QPRT by returning assets to the donor that, it was hoped, would pass to the remainder beneficiaries of the QPRT.

Capital Gains Taxes Upon Sale of Residence

Significant capital gains tax benefits inure to the owner of a primary residence. Recently revised income tax laws now give an individual the right to exclude $250,000 (and a married couple the right to exclude $500,000) in capital gains taxes from the sale of a primary residence once every two years.[7] These benefits need not be lost for clients who choose to convey their interest in a primary residence to a QPRT.

The QPRT is clearly a "grantor trust"[8] with respect to the income of the trust because of the retained right to exclusive use of the property. This carries with it the right to any rental income if the residence is rented during the QPRT term. (As noted above, the rental must be incidental to the primary residential use of the property by the donor.)

Upon sale of the residence, however, for the capital gains to pass through to the donor, however, the trust must be a grantor trust with respect to principal as well. This can be accomplished through the inclusion in the QPRT of one of the powers that render a trust a grantor trust as to principal.[9] If the QPRT is a grantor trust as to principal, then if the residence is sold, the gain would be taxed to the donor, thus permitting the use of the exclusions from gain available upon the sale.

There is some uncertainty about the wisdom of structuring the QPRT to remain a grantor trust after the expiration of the QPRT term. If permissible, continuing the grantor trust status after the QPRT term ends can yield significant tax benefits. The capital gains tax upon sale of the property would be the liability of the donor, thus reducing his or her estate and preserving the value of the trust assets to pass to the donor's beneficiaries. In addition, if the donor rents the property from the trust, no income tax on the rental income received by the trust would be payable. The preamble to the QPRT regulations, however, intimates that QPRTs that remain grantor trusts after the expiration of the QPRT term may receive special scrutiny. A balancing of the risks and benefits of continued grantor trust status should be undertaken in each case when drafting the QPRT.

Loss of Benefits of Owner-Occupied Real Estate

Owner-occupied real property may be eligible for special insurance rates, property tax exemptions, and other benefits that may not be available if the real property is conveyed to a QPRT. Clients should be made aware of the potential loss of these benefits when considering a QPRT.

Conclusion

The qualified personal residence trust can provide significant transfer tax savings in connection with the transfer of a personal residence to family members. Because of the complex emotions that surround the personal residence, nontax as well as tax considerations should be explored with clients when a QPRT is being considered. An individualized analysis of the transfer tax savings, the loss of step-up in basis, and the potential loss of benefits of owner-occupied real estate should all be considered. In the right case, however, the QPRT can be an important part of the estate plan and a major vehicle for transfer of a valuable asset at a reduced transfer tax cost.

Endnotes

1. *See* I.R.C. § 2702(a)(3)(A)(ii). The Treasury Regulations under Section 2702 provide that two forms of residence trusts are exempted from the valuation rules of Section 2702: the personal residence trust and the qualified personal residence trust. Because the latter is a more flexible vehicle, it is used with more frequency

and hence is the subject of this column.

2. *See* Treas. Reg. § 25.2702-5(c)(9) (1997).

3. *See* Treas. Reg. § 25.2702-5(c)(2)(ii) (1992).

4. *See* Treas. Reg. § 25.2702-5(d), Ex. 5 (1992).

5. *See* Treas. Reg. § 25.2702-5(c)(5)(ii)(A)(2) (1992).

6. *See* Treas. Reg. § 1.671-3(a).

7. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 313, 330 Stat. 386.

8. As used in this column, the term "grantor trust" is a trust that is treated as owned by the donor for income tax purposes pursuant to the provisions of Sections 671 through 679 of the Code.

9. For a description of the powers that could be used to render the trust a grantor trust for income tax purposes, see Code Sections 671 through 679.