Creative Uses of QPRTs

by Jon J. Gallo, J.D.

This month's column examines the qualified personal residence trust, or QPRT, and suggests some creative uses that should be kept in mind by the sophisticated estate planner.

Chapter 14 of the Internal Revenue Code (IRC sections 2701–2704) was enacted by Congress to limit the use of estate freeze transactions. Estate freezes are devices that permit a transferor to retain, substantially intact, management and control of a transferred asset and its current income stream, while passing future appreciation to his or her intended beneficiaries at a minimal gift tax cost.

Among the techniques specifically targeted by Section 2702 were the grantor retained income trust (GRIT) and the split-interest purchase. A GRIT is an irrevocable trust to which the grantor transfers property while retaining the income from, or the use of, the transferred property for a term of years specified in the trust instrument (the term interest).

Upon expiration of the term interest, the trust corpus usually would be distributed to one or more of the remainder beneficiaries. The transfer to the GRIT is a taxable gift trust by the grantor. Prior to enactment of Chapter 14, the amount of the gift was determined by subtracting the value of the grantor's retained term interest and contingent reversionary interest from the value of the property transferred to the GRIT. The retained term interest was valued based on the assumption that all property produced income at the discount rate prescribed in Section 7520. The contingent reversionary interest was valued using standard insurance mortality tables.

A split-interest purchase involved the purchase of a life estate by the older generation and the remainder interest by the younger generation. Assuming that the funds to purchase the remainder interest did not originate with the older generation, no portion of the property would be included in the older generation's taxable estate at death.

Although Section 2702 generally abolished the use of both GRITs and split-interest purchases, Section 2702(a)(3) (A)(ii) provides an exception for trusts entirely funded with "a residence to be used as a personal residence by persons holding term interests in such trust." The Internal Revenue Service (IRS) has provided guidance in the form of regulations authorizing the use of QPRTs.

A QPRT is essentially nothing more than a pre-Chapter 14 GRIT funded exclusively with an interest in the grantor's personal residence or vacation home. The grantor retains the exclusive use of the residence for a term of years specified in the trust instrument. The grantor may select any term of years; there is no minimum or maximum term required by the Internal Revenue Code. The retained "rental value" of the residence or vacation home is determined using the Section 7520 rate in effect for the month in which the transfer to the trust occurs. The trust also may provide for a contingent reversionary interest that causes the residence to revert to the grantor's estate if the grantor dies before expiration of the term of the trust. The reversionary interest is valued using insurance mortality tables. If the grantor survives the term of the trust, the QPRT terminates and the residence is either retained in further trust for, or distributed outright to, one or more remainder beneficiaries.

An Example

The transfer of the residence or vacation home to the QPRT is a taxable gift by the grantor to the remainder beneficiaries. The amount of the gift is a function of the grantor's age, the value of the residence or vacation home, and the term of the trust selected by the grantor. For example, Mr. Brown, age 60, owns a home worth $1 million. The home is owned free and clear. Mr. Brown transfers it to a QPRT and retains the right to live in the residence for the next 15 years, as well as a contingent reversion if he dies before the end of the 15-year term. If Mr. Brown survives for 15 years, the residence will be distributed to his children (the remainder beneficiaries).

The Section 7520 rate for November 2001 was five percent. Using a five percent discount rate and insurance industry mortality tables, Mr. Brown's retained right to live in the residence for the next 15 years, plus his retained

right to have the residence restored to his estate if he dies within the 15-year term of the trust, have an aggregate value of $792,540. Because the amount of the gift is the value of the residence at the time it is transferred to the trust, less the value of the grantor's retained interests, Mr. Brown would be deemed to have made a gift to his children of only $207,460.

If Mr. Brown dies before expiration of the selected term, the residence will be included in his gross estate for federal estate tax purposes. Any unified credit that had been applied against the gift tax liability arising on creation of the QPRT is restored, and any gift taxes paid are credited against the resulting estate tax liability. If he survives the term of years specified in the trust instrument, his interest in the QPRT terminates and the residence will either be retained in trust for the benefit of, or distributed outright to, the remainder beneficiaries. The only taxable event involved occurs when the residence is transferred to the QPRT; another taxable gift does not occur when Mr. Brown's interest in the QPRT terminates, even though the residence may have appreciated since its transfer.
The residence does not obtain a step-up in income tax basis when it is distributed to the remainder beneficiaries. Instead, Mr. Brown's income tax basis in the residence carries over, increased by a portion of the gift taxes paid, if any. If the remainder beneficiaries sell the residence, they will recognize gain to the extent that the sales price exceeds Mr. Brown's income tax basis, as adjusted by the gift tax, if any.

After his interest in the QPRT terminates, Mr. Brown will no longer have the legal right to stay in the residence. If he wishes to continue living in the residence when the trust terminates, he may lease the residence for fair rental value from the beneficiaries to whom the residence is distributed. In PLR 9249014, the IRS approved a QPRT that obligated the trustee to lease the property to the grantor for fair-market-value rent upon termination of the grantor's term interest. The favorable ruling was expressly conditioned upon the requirement that the grantor pay fair-market-value rent.

Contrary to common practice, there is no requirement that the residence be transferred outright to the remainder beneficiaries upon termination of the grantor's retained term. Instead, the residence could be retained in trust for the beneficiaries for several years and leased back to the grantor. If the QPRT is drafted so that it retains grantor trust status after termination of the grantor's retained term interest, transactions between the grantor and the trust will be disregarded for income tax purposes. (See Revenue Ruling 85-13, 1985-1 CB 184.) As a result, payment of rent to the former QPRT will not generate taxable income for the trust or the beneficiaries. In addition, such payments will not constitute gifts because the grantor receives valid consideration in the form of a fair market lease. Rental payments would effectively constitute nontaxable transfers to the beneficiaries of the grantor trust.

If the grantor's estate plan involves the creation of an irrevocable life insurance trust (ILIT) to which annual gifts will have to be made to provide funds for the payment of premiums, consider drafting the ILIT so that it will be a grantor trust, and naming it as the remainder beneficiary of the QPRT. Rental payments upon termination of the QPRT would constitute nontaxable transfers to the ILIT, which could reduce or replace the need for taxable gifts.

Alternatives to Traditional Planning

The sophisticated estate planner should consider several alternatives to traditional QPRT planning. For example, you can use a QPRT to accomplish a split-interest purchase of a residence or vacation home. In PLR 9841017, a married couple and their son contributed funds to an irrevocable trust, which satisfied the requirements for a QPRT. The trust subsequently acquired a residence. Although the ruling is silent as to the amounts involved, the couple acquired the life estate and the son acquired the remainder interest. Presumably, the term interests were valued and funds contributed by reference to Section 7520. The taxpayers represented that each had "independent sources of funds." After reviewing the terms of the trust, the IRS concluded that the residence qualified as a personal residence and that the trust satisfied the exception under Section 2702(a)(3)(A)(ii). As a result, no gift occurred on creation of the trust or on its subsequent purchase of the residence. The IRS expressly withheld giving an opinion on the effects of Section 2036.

The relevancy of the taxpayers' representation that they had "independent sources of funds" appears to have its

roots in TAM 9206006, in which technical advice was sought concerning a purported split-interest acquisition of a condominium by a parent and child occurring before enactment of Chapter 14. The decedent, age 84, purchased a life estate in the condominium and her daughter and son-in-law purchased the remainder interest.

The parties used the actuarial tables in Treasury Regulation Section 20.2031-7 to compute their respective contributions. All but $9,000 of the purchase price contributed by the daughter and son-in-law were borrowed from the decedent's revocable trust. The terms of the note required five years of interest-only payments, with a balloon payment at the end of the term. At the time of the purchase, the decedent's actuarial life expectancy was five years, but she died six months after the close of escrow, which led the IRS to conclude that her actual life expectancy was less than the tables indicated. The IRS concluded that the decedent should be viewed as having provided all of the consideration for the purchase in excess of the $9,000 contributed by the daughter and son-in-law from their own funds.
The IRS's ruling position in TAM 9206006 is open to criticism on the grounds that there is no statutory basis to require that the consideration provided by the remainder beneficiaries did not originate with the decedent. Prudence, however, suggests that independent assets should be used by the remainder beneficiary if litigation with the IRS is to be avoided.

Court Rulings

Interestingly, PLR 9841017 made no mention of *Gradow v. U.S.*, 11 Cl. Ct. 807 (1987) aff'd 897 F.2d 516 (Fed. Cir. 1990), which held that for purposes of determining full and adequate consideration for the purchase of a remainder interest, the seller must receive payment for the full value of the property and not the actuarial value of the remainder interest determined under Section 7520. The reasoning in *Gradow* has been rejected by three appellate courts to date, namely, *Magnin v. Comm'r*, 184 F.3d 1074 (9th Cir. 1999); *Wheeler v. U.S.*, 97-2 USTC ¶60,278 (5th Cir. 1997) and *D'Ambrosio v. Comm'r*, 101 F.3d 309 (3rd Cir. 1996). *Gradow* appears to have been wrongly decided, and *Magnin*, *Wheeler* and *D'Ambrosio* appear to be correct. Since a PLR has no official precedential value, the reader should be aware that the IRS might seek to apply *Gradow* to a split-interest purchase of a residence.

It appears preferable for a split-interest purchase of a residence to take the form sanctioned in PLR 9841017—funds should be contributed to a trust that meets the governing instrument requirements of a QPRT, and the trust should acquire the residence. Unlike a QPRT, however, such a trust could be structured so that the term interest being acquired by the senior generation beneficiaries will take the form of a life estate, rather than a term of years.

Another alternative to the traditional QPRT is a transaction structured as a part gift, part sale, to an intentionally defective grantor trust. The grantor would make a gift of an undivided 10 to 15 percent interest in the residence to a grantor trust, then sell the remaining 85 to 90 percent interest to the grantor trust for its fair market value, determined after taking into consideration applicable fractional interest discounts. The grantor will take back a promissory note from the trustee with interest at the applicable federal rate under Section 1274. Married couples can maximize discounts if they own the residence as tenants in common or as community property, and each gifts/sells his or her undivided 50 percent interest to a separate intentionally defective grantor trust created by that spouse; for example, each would make a gift of 5 to 7 1/2 percent of the residence, followed by a sale of the remaining 45 to 42 1/2 percent to his or her defective grantor trust.

Following the gift/sale, the grantor would enter into a lease of the residence with the grantor trust for fair market value. Since transactions between a grantor and his or her grantor trust are disregarded for income tax purposes (Revenue Ruling 85-13, 1985-1 CB 184), payment of rent to the grantor trust would be ignored for income tax purposes and could be used by the trust to amortize the grantor's promissory note. After the note is fully amortized, additional rental payments would effectively constitute non-taxable transfers to the beneficiaries of the grantor trust.

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