

CHAPTER FOURTEEN

EXISTING QPRTs – COMMON SITUATIONS AND OPTIONS

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By

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I. INTRODUCTION

Qualified personal residence trusts (as defined in II.A.) have been a commonly employed estate planning tool for over twenty years. During those two decades, qualified personal residence trusts have evolved from a “cutting edge” strategy to a fairly ordinary strategy. The use of qualified personal residence trusts has been informed over time and the purpose of this presentation is to provide a framework for working through common issues that arise during the administration of qualified personal residence trusts.

II. QUALIFIED PERSONAL RESIDENCE TRUSTS – GENERAL OVERVIEW

- A. Definition of Qualified Personal Residence Trust.** A qualified personal residence trust (“QPRT”) is an irrevocable trust that complies with the requirements of Reg. § 25.2702-5(c). A QPRT must hold no other assets other than an interest in one personal residence and certain related assets (such as proceeds from a sale). A QPRT is created for a specific period of time (the “initial QPRT term”) during which the interest in the personal residence used to fund the QPRT must be used by the donor as his or her personal residence or held for his or her use. Reg. § 25.2702-5(c)(7)(i). There may be a secondary term following the expiration of the initial QPRT term.
- B. Strategy.** When a QPRT is funded, the individual donor makes a gift (typically to children or to a follow on trust for the benefit of children) at a discounted value for federal gift tax purposes. Because Washington has no state gift tax, there is no state gift tax consideration for Washington practitioners and Washington clients, however, if the donor survives the initial QPRT term, the interest in the personal residence used to fund the QPRT will be removed from the donor’s estate for federal and state estate tax purposes.

The discount in the value of the gift upon QPRT funding is driven by two factors: first, the donor’s retained income interest in the residence – the right to occupy the residence for a certain period of time and second, the retained possibility of reversion in the case of the death of the donor during the QPRT term. QPRTs are a form of grantor retained income trust, but in 1990 when Chapter 14 was added to the Code, the use of grantor retained income trusts was limited and replaced by Grantor Retained Annuity Trusts and Grantor Retained Unitrusts. §2702. But §2702 contained a specific exception for trusts that held interests in personal residences. One significant advantage of the QPRT strategy is the statutory basis of this entity. Unlike other strategies without a specific statutory basis

(installment sales to grantor trusts, etc.), here the Code and Regulations specifically identify this entity and provide instructions for its creation and use, including requisite provisions for trust agreements. The Service even issued a model QPRT. (See Rev. Proc. 2003-42 attached as Exhibit A). A second important advantage of the QPRT strategy is that there is little downside risk to it. Either the donor survives the initial QPRT term and the trust property is excluded from the donor's estate or the donor does not survive the initial QPRT term and the trust property is included in the donor's estate and the gift tax exemption allocated to the initial gift is returned to the donor's estate.

C. Efficiency. The efficiency of a QPRT strategy is typically optimized in a high interest rate climate, because that will result in a larger discount of the initial gift and a smaller resulting value of the gift upon creation. QPRTs are also more efficient if funded when real property values are low or depressed. The current low interest rate climate (September 2011 §7520 rate = 2.0%) is not optimal for QPRT efficiency as it is historically low, but that may be offset somewhat by the current state of real estate markets. Other factors, such as the age of the donor and applicable discounts for any fractional interest in the interest in the personal residence used to fund the QPRT, will also impact the efficiency of the QPRT strategy. Remember that §7520 rates for each month are issued prior to the end of the prior month.

D. Most Common Format. A typical QPRT is an irrevocable trust created by an individual donor and funded by a transfer of such donor's interest in a personal residence to the trust. In Washington, when a married couple desires to employ a QPRT strategy as to a specific community property residence, the couple usually executes a deed transferring ownership of the real property from the marital community to the spouses as their respective separate property. Each spouse then funds his or her own QPRT with his or her separate interest in the real property. This strategy hedges against the mortality risk of the death of either spouse during the initial QPRT term. If either spouse dies during the initial QPRT term, only the portion of the personal residence used to fund the deceased spouse's QPRT will be included in the decedent's estate. This portion of the QPRT strategy will have failed, but the QPRT created by the surviving spouse will continue and may succeed. The survivor may also create a second QPRT for the portion of the personal residence that was included the decedent's estate, now with a stepped up income tax basis. Since a fractional interest in the property is used to fund each QPRT, a discount for the fractional interest of the personal residence used to fund each QPRT is typically applied when calculating the gift upon funding.

1. **Example:** H and W are a married couple and are Washington residents. They own a residence with a fair market value of \$1,000,000 as their community property. There is no mortgage on the residence. In order to implement a QPRT strategy: they first execute a deed transferring ownership of the property from the marital community to each of them as his/her separate property. Next, they each execute a QPRT. Then each executes a deed transferring his or her separate property interest in the

residence to his or her QPRT. They file federal gift tax returns reporting the gifts to the QPRTs. For purposes of the calculation of the gift reported on those returns, the value of the interest in the residence that each contributed to his or her QPRT would typically be reduced by a discount based upon the fractional nature of the interest in the property. (See *Ludwick v. Commissioner*, T.C. Memo 2010-104)

- E. Generation Skipping Transfer Tax Issue.** One trap for the unwary is that the estate tax inclusion period (“ETIP”) rule applies to gifts to QPRTs. This rule provides that the ETIP is the period during which, if the donor died, the transferred property would still be included in his estate or the estate of his spouse. § 2642(f)(3). The Code provides that any allocation of GST exemption to such property may not be made before the close of the estate tax inclusion period. § 2642(f)(1). Since, if the donor of a QPRT dies during the initial QPRT term, the QPRT property will be included in the donor’s gross estate under § 2036(a)(1), it is not possible to allocate GST exemption to a QPRT until the end of the initial QPRT term. This removes the ability to leverage the GST exemption with a QPRT in the same way the gift tax exemption can be leveraged. Since the GST exemption may not be allocated until the end of the initial QPRT term, the retained interest of the donor is not taken into consideration when valuing the gift and at the time of the GST allocation and the interest in the personal residence may have appreciated.

In addition, because of the way that the predeceased parent rules work for generational assignment, there is a tax risk associated with the potential death of a child of the donor during the initial QPRT term. If a child of the donor is deceased upon the creation of the QPRT, the descendants of that deceased child move up a generation for GST purposes. §2651(e)(1). However, if a child of the donor dies during the initial QPRT term, his or her descendants do not move up a generation for GST purposes since the generation assignment for the deceased parent exemption takes place at the time of the completion of the transfer for gift tax purposes. In most cases QPRTs name either the donor’s then living children who survive the initial QPRT term or a follow on trust for such children as remainder beneficiaries. It is very rare for a QPRT agreement to name the donor’s then living issue, per stirpes, as remainder beneficiaries, since the death of a child of the donor after the QPRT funding could lead to a termination for GST purposes upon the expiration of the initial QPRT term. Since the descendants of a child who dies during the initial QPRT term would not benefit from the typical QPRT format, donors often provide a make up provision under their other dispositive documents to address this possibility.

- F. Technical Corrections.** Reg. § 25.2702-(5)(c)(9) provides that after May 16, 1996, QPRTs must prohibit the sale of the personal residence to the grantor, the grantor’s spouse or an entity controlled by the grantor or the grantor’s spouse during the initial QPRT term or during any period after that term when the trust is a grantor trust. Until 1996, it was possible and simple to transfer an appreciated residence that had been used to fund a QPRT back to the estate of the donor to

obtain a stepped up income tax basis on the donor's death. This is no longer the case and the basis issue is discussed at III.E.

III. COMMON SITUATIONS THAT ARISE DURING THE ADMINISTRATION OF QPRTs

A. Sale of Residence.

1. Under the Regulations, a QPRT may allow for the sale of the residence during the initial QPRT term and the reinvestment of all or a portion of the proceeds in a new personal residence. Unfortunately, the sale transaction is rarely as simple as it could be.
 - a. If the purchase price of new residence is less than the sale proceeds of the old residence, the overage must be converted to a GRAT (see III.B. below), spent on capital improvements (See Reg. §25.2702(5)(c)(5)) or distributed to the donor if permitted by the QPRT agreement. (See III.E.2 below). Distribution back to the donor is typically not tax efficient, but may be desirable in certain circumstances.
 - (1) **Example:** In the case of the QPRTs funded by H and W in II.D.1. above, the trustees sell the residence held in the QPRTs for \$1,000,000 and the two QPRTs purchase a replacement residence for \$900,000. Leaving aside closing costs, taxes, etc., this leaves \$50,000 of cash proceeds in each QPRT.
 - b. If the purchase price of new residence is greater than the sale proceeds of the old residence, the donor has several options, the most commonly elected are: donor contributes the difference to the existing QPRT or donor purchases a portion of the new residence with existing QPRT as tenants in common. If the donor will purchase a portion of the residence in the donor's name, the donor may retain title in donor's name or contribute such interest to the existing QPRT or to a new QPRT. If cash or an interest in the new residence is contributed to the existing QPRT, the gift calculation will be based upon the age of the donor at the time of contribution, the term remaining of the initial QPRT term and the §7520 rate in effect upon the date of contribution. There should be a valuation discount applicable to the value of the fractional interest of the residence held in the donor's name if it is contributed to a new or existing QPRT. (See *Ludwick* case) Contribution of cash to the existing QPRT in this case may not be efficient, unless the purchase price differential is quite small.

- (1) **Example:** In the case of the QPRTs funded by H and W in II.D.1. above, the trustees sell the residence held in the QPRTs for \$1,000,000 and the two QPRTs plan to purchase a replacement residence for \$1,200,000. Leaving aside closing costs, taxes, etc., there is a shortfall of \$200,000 for the purchase of the replacement residence.
- c. There can be a timing issue present in connection with the sale of a residence. Clients often purchase a new residence before selling the old residence held in the QPRT. This creates several problems. First, a QPRT may only hold an interest in one residence. Second, if the donor takes title to the new residence in the donor's name and then sells the old residence from the QPRT, the proceeds from such sale will be in the QPRT and the QPRT will need to purchase the new residence from the donor, thus generating an additional level of real estate excise tax. In an optimal situation, the closing of the sale of the old residence occurs just before the closing of the sale on the new residence. It is usually prudent to schedule the closings at least a week apart.
- (1) The timing issues are more workable when the sale of the old residence is to one or more children/descendants of the donor. Under Reg. §25.2702-(5)(c)(9), a QPRT must prohibit the sale of the residence to the grantor, the grantor's spouse or an entity controlled by either of them while the QPRT is a grantor trust, but there is no prohibition against a sale to a child or descendant of the grantor.
 - (2) Do not forget that each spouse may maintain two QPRTs at one time. It is sometimes possible to have a non-donor spouse create a QPRT for a new residence to avoid timing issues if the couple has sufficient assets.

B. Conversion of QPRT to a GRAT.

1. If the interest in a residence used to fund a QPRT is sold and the proceeds are retained by the QPRT, but not reinvested in a replacement residence within two years, or if such residence ceases to be used or held for use as the donor's residence, the QPRT must pay an annuity to the donor for the remaining initial QPRT term. Reg. § 25.2702-5(c)(8). If the QPRT is converted to a Grantor Retained Annuity Trust ("GRAT"), the calculation of the annuity payments due to the donor is made by using the § 7520 rate and mortality rates in effect upon the creation of the QPRT not at the time of the conversion. Note that it is possible for there to be multiple GRAT conversions from a single QPRT (for example if the initial residence is sold and only a portion of the proceeds reinvested in a replacement

residence and then at some point in the future such replacement residence is sold and those proceeds are not reinvested). In order to comply with Rev. Proc. 2003-42, in the case of multiple GRAT conversions from a single QPRT, it is probably necessary to create separate shares for each GRAT conversion.

2. Conversion of a QPRT to a GRAT can be a useful method of providing money back to a donor who needs it, but note that it typically requires the sale of the residence. Thus, it may be useful where the donor needs money for health expenses or otherwise or where the increase in estate tax exemption renders the initial planning underpinnings of the QPRT less meaningful (as long as the donor desires to sell the residence). Conversion to a GRAT can be useful where the donor must move to an assisted living situation and requires assets for monthly payments, but does not need access to the entire principal of the QPRT.

C. **Funding a QPRT with Mortgaged Property or Refinancing Property Held in QPRT.**

1. It is possible to fund a QPRT with a personal residence that is the subject of a mortgage loan. Typically, the initial gift to the QPRT will be calculated only on the value of the donor's equity in the residence. In this situation, the donor may give the QPRT cash to make mortgage payments, provided that such payments must be reasonably expected to be made within six months from the transfer of such cash to the QPRT and any mortgage principal payments made by the donor will be considered to be additional gifts to the QPRT. It may be possible, if the donor remains legally obligated to personally pay off the mortgage, for the fair market value of the mortgaged residence to be used to calculate the initial gift. (See PLR 9340009). Some commentators question the viability of this approach. If at all possible, the best practice is for the donor to pay off the mortgage prior to funding the QPRT.
2. It can be difficult to refinance a mortgage on property held in a QPRT. Banks typically do not like to loan to irrevocable trusts. At times, in order to refinance a loan, lenders propose that the trustee of the QPRT distribute the real property out of the QPRT "for one day," refinance the loan and then transfer the property back to the QPRT. **DO NOT DO THIS.** This type of proposal represents the lender's fundamental lack of understanding regarding the QPRT. The lender may do this with revocable trusts, but it is not possible or prudent in the case of QPRTs.
3. What to do when a client contacts you to let you know that as part of a refinance that has already occurred, the residence was distributed back to the client/donor? Practical advice - contact the lender/individual who prepared the quit claim deed and have the lender prepare another deed to transfer the residence back to the QPRT. In a sense, this is the correction

of a unilateral or mutual mistake. The trustee and remainder beneficiaries could likely compel this result since the trustee had no authority to distribute the residence to the donor during the initial QPRT term.

D. Expiration of Initial QPRT Term; Holdover Donor. If the donor continues to occupy the subject residence after the expiration of the initial QPRT term, it is imperative that the donor pays to the remainder beneficiary of the QPRT (typically either children or a follow on trust) fair market value rent for the use of the residence. Failure to pay such rent will usually result in inclusion of the residence in the donor's estate as a result of a retained interest by the donor under §2036. It is typically prudent for the donor and the remainder beneficiary to execute a lease/rental agreement in connection with the residence in this situation. The fair market value rent for property should be determined by an independent, qualified party. Realtors familiar with the local rental market are often able to provide a letter opinion regarding fair market value rent.

1. In a situation where the QPRT expires, but the parties (donor and remainder beneficiary) failed to execute a lease agreement and the donor has not paid fair market value rent to the beneficiary, the prudent course would be to have the donor pay the rent due and to put a lease in place.
2. Some practitioners use the §2036 retained interest to attempt to obtain a stepped up basis in the residence where the donor has adequate estate tax exemption available. Thus, if the donor remains in the residence without paying fair market value rent, the residence should be included in the donor's estate and be eligible to receive a stepped up basis. The appearance of an agreement in this situation is problematic.
3. It should be possible to use a nonjudicial agreement (in Washington, under RCW 11.96A, the Trust and Estate Dispute Resolution Act ("TEDRA")) to address certain issues that may arise at the end of the initial QPRT term. For example, the initial QPRT term of a QPRT created in the early 1990's may be set to expire and distribute to a trust for the benefit of the donor's children, but the QPRT may have been drafted so that the follow on trust would not be a grantor trust for income tax purposes. If this resulted from a scrivener's error or other mistake, the interested parties (under 11.96A.220) may be able to correct the mistake.

E. Early Termination of QPRT.

1. There are a number of situations that may develop for a client who has created a QPRT which lead the client to conclude that he or she no longer desires to be subject to the QPRT. Our clients may have a vastly different appreciation of the adjective "irrevocable" as it is used in the phrase "irrevocable trust." Some of these situations include/may be caused by: terminally ill donor, desire for stepped up basis of residence, increased

federal estate tax exemption, desire to control residence after the death of the initial grantor when no follow on trust was initially included.

2. Options to consider in these situations:
 - a. Review the terms of the QPRT. Is there any way for a distribution to be made from the QPRT to the donor? Some QPRT agreements include a grant of authority to the trustee (or, if the donor is serving as trustee, to a special trustee) to distribute trust assets to the donor within thirty (30) days of the QPRT ceasing to be a qualified trust. Reg. §25.2702-5(c)(7) and (8). In some circumstances it may be acceptable to intentionally cause the QPRT to cease to be a qualified trust. In this manner, the trust assets could be distributed back to the donor. This will likely waste the gift tax exemption already allocated upon creation of the QPRT, but depending on the value of the donor's estate and the estate tax exemption, this may be a realistic option.
 - b. Consider donor purchase of remainder interest from children if possible under the spendthrift clause. Donor would become sole owner of residence and the trust would terminate. The value of the remainder interest would be calculated under the IRS tables. Children may have income tax liability on the sale proceeds. The typical spendthrift provision may need to be altered to allow for such sale by the donor. For example, some trust agreements grant to the remainder beneficiaries, other than the donor, a limited ability to assign or transfer any interest in the QPRT. It should be possible to include such provision without damaging the important protections of the typical spendthrift provision (affording protection against the creditors of the remainder beneficiaries).
 - c. Consider purchase by remainder beneficiaries/children of donor's retained interest if possible under the spendthrift clause. Children become sole owner of residence and trust terminates. This requires the children to have adequate assets to make purchase. It will also require donor to vacate the residence or begin to pay rent to children. The residence will be out of the donor's estate, even if the donor dies during the initial QPRT term. If this option appeals to the donor, consider granting in the QPRT the power to the donor to assign or transfer donor's interest in the trust. Also consider language prohibiting such sale by donor in the model QPRT issued under Rev. Proc. 2003-42 (attached as Exhibit A), but such sale by donor is not prohibited under the Regulations.
 - d. Convert to a GRAT. See III.B above. This has the advantage of providing a stream of payments to the donor, but requires that the residence be sold and the proceeds not invested in a replacement

residence or that the residence cease to be used or held for the use of the donor's residence. Thus, this option may not be helpful when the donor does not wish to sell the residence and plans to reside in it.

- e. Terminate the QPRT. Does the nuclear option exist here?
 - (1) Clients may seek legal and practical advice. Under the Regulations, it is not possible to commute a QPRT. Reg. § 25.2702-5(c)(6).
 - (2) Considerations.
 - (a) Under RCW 11.96.070(4), as introduced as part of the 1984 Trust Act, the court could confer on the personal representatives or trustees any necessary or desirable powers that the court determines "are not inconsistent with the provisions or purposes of the will or trust." RCW 11.96.070(4). RCW 11.96.070 also allowed interested parties to enter into a written agreement resolving any matter under RCW 11.96.170. Thus, the interested parties could enter into an agreement to terminate an irrevocable trust if it was determined that such termination was not inconsistent with the purposes of the trust.
 - (b) In 1999, RCW 11.96.070 was integrated into RCW 11.96A.030(1), which defined a "matter" to include any question or dispute involving the grant to a personal representative or trustee of any "necessary or desirable power not otherwise granted in the governing instrument or given by law." RCW 11.96.030(1)(d). The official comments of the drafting committee which were adopted by the House and Senate Judiciary Committee staffs noted that the definition of "matter" was changed to remove the requirement of a determination that the requested action "not be inconsistent with the purpose of the will or trust." Comments to SB 5196 (1/28/1999) §104(1) RCW 11.96A.030.
 - (c) Thus, it is clear from the legislative history of TEDRA that a nonjudicial agreement by the interested parties may be used to terminate a trust.
 - (d) Issues to consider if considering terminating a QPRT:

- (i) Who are the “interested parties” that are required to join in the agreement under RCW 11.96A.220?
- (ii) Will a Special Representative be required to represent unborn, unascertained or minor parties?
- (iii) If the residence will be distributed back to the donor, will there be a reportable gift by the remainder beneficiaries (often children) to the grantor?
- (iv) Will any gift tax exemption allocated to the initial QPRT funding be returned to the donor’s estate in the calculation of adjusted taxable gifts? Note that this is a different situation than a death of the donor during the initial QPRT term. (See III.G. below)

F. Amendment of QPRT. As described above, state law may grant the parties interested in a QPRT some ability to amend a QPRT when all such parties agree.

G. Death of Donor During Initial QPRT Term. A typical QPRT provides that if the donor dies before the end of the initial QPRT term, the trust terminates and the interest in the residence held in the QPRT reverts to the donor’s estate. The interest in the residence will receive a stepped up basis for income tax purposes and the gift tax exemption applied to the initial gift to the QPRT will be recovered by the estate of the donor. The mechanics of such recovery take place in the calculation of Adjusted Taxable Gifts for the deceased donor’s federal estate tax return. On the federal estate tax worksheet for taxable gifts (Worksheet TG - Taxable Gifts Reconciliation attached as Exhibit B) there is a separate column for gifts that are included in the estate (column C). The value of gifts reported in column C is subtracted from the value of taxable gifts reported on line 2, Column B so the value of the initial QPRT gift is not included in Adjusted Taxable Gifts. Since the amount of the gift upon funding is not counted as a taxable gift, it does not reduce the federal estate tax exemption as it would if the donor had survived the term.

IV. CONCLUSION

The QPRT is a powerful estate planning tool. It is important to understand the circumstances under which its leverage is maximized. It is also important to make sure that clients understand the features and limitations of a QPRT strategy before entering into the strategy. However, practical options for addressing administration issues that arise after the QPRT strategy has been implemented do exist.

