Folks:

Take-Away: If a qualified personal residence trust (QPRT) is to be a part of an estate plan, consider causing the QPRT's remainder interest to be a *grantor* trust for income tax purposes to add flexibility.

Background: A few weeks back I prepared a short missive on the benefits of a qualified personal residence trust (QPRT) in a period of high(er) interest rates. As the applicable federal rate (AFR) increases, the value of the settlor's retained 'exclusive use term' interest in the QPRT increases. Correspondingly, there will be a lower value assigned to the QPRT's remainder interest which is a taxable gift by the settlor. If the QPRT works as intended, the full value of the residence held in the QPRT, along with all future appreciation, will be permanently removed from the settlor's taxable estate at a significantly reduced gift tax-cost.

> **Example:** Bill and Mary own a waterfront home. Their home is worth $1.0 million. Bill and Mary are each age 72. They project that their home will grow in value at the rate of 4% a year, which is a reasonable assumption since their home is in a highly desirable location. Bill and Mary transfer title to their home to a QPRT in which they retain the exclusive right to use and occupy the home for 13 years. Bill and Mary name their children as the remainder beneficiaries of the QPRT after their 13-year exclusive use period ends. The AFR for the month that Bill and Mary transfer their home to the QPRT is 5.60%. Bill and Mary will report as a taxable gift to their children upon funding the QPRT a gift of **$361,780.** Had Bill and Mary created and funded the QPRT back in October, 2022, when the AFR was 4.0%, with the exact same facts, their taxable gift to their children of the QPRT's remainder interest would have been **$441,210.** The higher the AFR rate used to value the settlors'

retained exclusive use interest of the home, the lower the value of the taxable gift of the remainder interest. To finish the story, if Bill and/or Mary survive the 13-year exclusive use period, the value of the home that will pass to their children will be worth **$1,665,074,** which will be completely removed from Bill and/or Mary's taxable estate for estate tax purposes.

Transfer Taxes: The gift of the QPRT's remainder interest is not covered by the settlors' gift tax annual exclusions, because the gift of the remainder interest in the QPRT is a future interest. In addition, the settlors' GST exemption cannot be allocated to the gift of the QPRT's remainder interest due to the estate tax inclusion period (ETIP). What that means is that the settlors' GST exemption can be allocated to the QPRT's remainder interest but only after the settlors' retained exclusive period comes to an end. Thus, using the prior example, if Bill and Mary survive their retained exclusive use period of 13 years, it is only then, when the home is worth $1,665.074, that their GST exemptions will be applied to the gifted remainder interest (not the $1.0 million the home was worth when it was transferred to the QPRT by Bill and Mary.)

Reversionary Interest: It also needs to be stressed that if the settlor does not survive his/her retained exclusive use period in the QPRT, then the home's full value will be included in the settlor's taxable estate. Since this is a key QPRT 'rule,' most QPRTs are intentionally structured so that the settlor expressly reserves a reversionary interest in the QPRT should he/she not survive the QPRT's exclusive use period. The retention of that reversionary interest in the QPRT will cause more 'value' to be assigned to the settlor's retained interest in the home, and thus a lower value will be assigned to the taxable gift of the QPRT's remainder interest. This also then means that the home, if returned to the settlor's estate via the retained reversionary interest, will result in a larger gross estate, and potentially a larger federal estate tax due on the settlor's death; the home's value on the date of the settlor's death will be exposed to federal estate taxes. This risk of federal estate taxation on the reversionary interest is why most QPRTs select an exclusive use period that is shorter

than the settlor's estimated life expectancy- to avoid the reversionary interest being 'triggered.' The settlor's other estate planning instruments will also need to include provision in contemplation that the reversionary interest is actually 'triggered' by the settlor's 'premature' death, directing to whom the home is to be distributed, e.g., to the settlor's surviving spouse.

Income Tax Basis: The prior example demonstrates the effectiveness of a QPRT to remove a valuable asset and its appreciation from an individual's taxable estate, at a low gift tax-cost. A QPRT is particularly useful for a 'legacy' home or cottage which the family plans to keep for several generations. If it is a legacy home or cottage transferred to the QPRT, the loss of an income tax basis adjustment on the death of the settlor is not considered too large a negative when title to the home passes from the settlor via a lifetime gift (with carryover tax basis.)

Post-Exclusive Use Term Decisions: While most attention is given to the tax benefits associated with the use of a QPRT to shift wealth at a low transfer-tax cost out of the settlor's taxable estate, less attention is given to whether the QPRT should terminate at the end of the settlor's retained exclusive use term, or whether the QPRT should continue in some form with the settlor's children or more remote descendants as the 'continuing' trust beneficiaries.

QPRT Regulations: A couple of IRS Regulations address the settlor's use of the home after the exclusive use period ends.

1. **No Repurchase Right:** The QPRT Regulations make it clear that the settlor cannot reserve the right to re-purchase the residence at the end of the exclusive use period. The failure to include this limitation in the QPRT instrument will cause the home value to be included in the settlor's taxable estate.

2. **Right to Rent for Fair Rental Value:** The settlor can, however, reserve the right in the QPRT to rent the home either from the

‘continuing’ trust, or from the remainder beneficiaries if title is distributed to them outright, for the home’s fair rental value. It is best if the ‘continuing’ trust contains a provision that requires that the settlor pay fair rental value if the settlor continues to use the home after his/her exclusive use period comes to an end. Such a provision tends to rebut a presumption the IRS may try to assert that there was no intention to ever transfer the home to the remainder holders following the QPR’'s termination. [IRC 2036(a).]

Grantor **Trust:** If the QPRT’s exclusive use period ends and the title to the home is distributed outright to the settlor’s children, if the settlor exercises his/her right to continue to use the home by paying fair rental value for its use, the children will have taxable income to the extent of the rent paid, less the expenses associated with the home. In addition, the children will have to reduce their ‘carryover’ basis in the home by depreciation that may be allowable, which translates to a higher income tax on the children’s eventual sale of the home. If the continuing trust, i.e., the QPRT’s remainder beneficiary, is structured as a *grantor* trust, and the settlor continues to rent the home after the exclusive use period ends:

(i) The required rental payments by the settlor will not be taxable, and the basis of the home will not be further depreciated;

(ii) The later sale of the home by the *grantor* trust will likely be offset by the home sale exclusion so long as the ownership and occupancy requirements of IRC 121 are met;

(iii) The trust can be structured to allow a child-beneficiary to live in the property rent-free; and

(iv) Creditors of the children will not be able to access the home that is held in an irrevocable trust.

However, the *grantor* trust provisions must be carefully selected. The QPRT Regulations make it clear that the settlor may not retain

the power of substitution under IRC 675(4) to cause the ‘continuing’ trust to be classified as a *grantor* trust. [Regulation 25.2702-5(c)(9).] Instead, another ‘retained’ power must be used by the QPRT settlor to cause the trust to be classified as a *grantor* trust, such as naming the settlor’s spouse as a permitted beneficiary [IRC 677] or allowing the settlor to borrow from the ‘continuing’ trust with less than adequate security. [IRC 675(2).]

Conclusion: Any individual with a valuable home, particularly one that is greatly appreciating in value, should consider the use of a QPRT. Current IRC 7520 interest rates favor a QPRT since those higher rates lead to a lower value of the gifted QPRT remainder interest. Moreover, if the QPRT continues in trust after the end of the exclusive use period as a *grantor* trust, tax savings can be achieved and the home protected from the beneficiaries’ creditors, which may be extremely important if the subject property is a legacy-type home that is intended to remain in the family for generations.