Home Repair : A Handy Lawyer's Guide to Fixing a Damaged QPRT

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It is a truth universally acknowledged that a wealthy client in possession of a good beach house must be in want of a Qualified Personal Residence Trust (QPRT). But QPRTs are not right for everyone—and even when they do make sense at the outset, family, financial, tax, and other circumstances can change, lessening the effectiveness of the QPRT as a wealth transfer tool making it a detriment to the family. This article will outline briefly the nuts and bolts of QPRT construction and the substantial estate planning benefits that can be reaped from a healthy QPRT. We will then describe common (and uncommon) scenarios when a QPRT can lose effectiveness and illustrate methods to repair any damage and shore up a positive outcome.

QPRT Operations and Fundamental Requirements

QPRTs can be effective estate planning tools because they take advantage of reduced valuations resulting from retained interests. In a QPRT transaction, a grantor transfers a personal residence to a qualifying trust in which the grantor retains an interest for a term of years. At the end of the term, the personal residence passes to one or more designated individuals (or a trust for their benefit). Because the grantor retains an interest for a term of years, for gift tax purposes the value of the gift is reduced by the value of her retained interest. Thus, if the grantor survives the term, a grantor can transfer a valuable personal residence (such as a beach house or family cottage) for pennies on the dollar.

The seven requirements for a trust to qualify as a QPRT are set forth in Treas. Reg. 25.2702-5(c). Generally, to satisfy these seven requirements the governing instrument must provide:

1. The trust owns only a personal residence of the grantor, to be used only by the grantor, grantor's spouse, and the grantor's dependents as a residence (but with an allowance for the trust to own cash to pay certain expenses of the property);
2. Distribution of trust income to the grantor at least annually;

3. No distributions of principal can be made from the trust to anyone other than the grantor during the term (“retained term interest”) of the trust;
4. The grantor’s interest cannot be commuted through prepayment;
5. The trust ceases to qualify as a QPRT if the residence owned by the trust is no longer used as a personal residence of the grantor (with further specific rules for when the property is sold, damaged, or destroyed);
6. Within 30 days of the trust ceasing to qualify as a QPRT, the assets of the trust must be distributed to the grantor or the assets convert to a grantor retained annuity trust (GRAT) for the benefit of the grantor for the remaining term of the trust; and
7. The personal residence cannot be sold to the grantor, the grantor’s spouse, or an entity controlled by the grantor or the grantor’s spouse.

Issues During Administration

QPRTs can be a very valuable estate planning tool, but, as with most techniques, the devil is in the details. The best planned QPRT will fail if not administered correctly. The most common issues that arise during administration relate to improvements to the property, mortgaging the property during the QPRT term, and sale of the property during the QPRT term.

As noted above, a QPRT may hold only a personal residence and cash for expenses incurred or reasonably expected to be paid within six months of the addition of the cash. An example of proper expenses incurred would be construction costs for an improvement to the residence that has already been completed at the time of the additional gift of cash. An example of expenses reasonably expected to be paid within six months would be estimated mortgage payments for the six months following the additional gift of cash. At the end of the six month period, any excess cash must be distributed back to the donor. This ability to contribute additional funds can be problematic in the QPRT administration because it creates a trap for those not focused on the details of trust administration.

One of the first issues that can cause problems is when the donor wants to make improvements to the property during the QPRT term. The donor, as the term tenant, is responsible for regular maintenance and repairs to the property, but any capital improvements (such as additions or substantial renovations) are chargeable to principal and therefore constitute additional gifts to the QPRT. For example, if Mrs. Swimmer determines that her beach house, which has previously been transferred to a QPRT, would be better with a pool, then, if she builds the pool, she would be making an additional gift to the QPRT in the amount of the cost of construction. Such a gift will need to be valued and reported for gift tax purposes. If there are several phases of construction and Mrs. Swimmer makes multiple payments to the contractor, then gift tax reporting can become increasingly difficult because each additional payment must be calculated and reported. Perhaps an easier way to handle capital improvements is for the donor to make a loan to the QPRT to cover the costs of construction. The loan can be payable at the end of the QPRT term. This way, if there are additional expenses that were not anticipated at the beginning of the project, the loan balance can simply be increased without the necessity of valuing and reporting an additional gift to the trust. If the donor decides to forgive the loan sometime later, the gift tax reporting is fairly simple because it would constitute forgiveness of a readily identifiable lump sum.

A second issue that can arise during the QPRT term is if the donor or remainder beneficiaries decide to mortgage the property. Any loan proceeds must be used to further the purposes of the QPRT. An example of proper use of the mortgage funds would be to make improvements to the residence. Remember, however, that any excess cash held by the QPRT must be distributed to the donor at least quarterly. It is critical for drafters to provide that the terms of the QPRT keep the loan proceeds from being considered excess cash that must be distributed to the donor and instead provide that any excess funds should be used to pay down the principal balance of the loan. Because the QPRT is treated as a grantor trust as to the donor for federal income tax purposes during the donor's retained term, the grantor of the QPRT may have income tax deductions available for the payment of mortgage interest regardless of whether the grantor or the QPRT makes the mortgage payment. Additionally, a contribution to the QPRT to pay mortgage interest may not be a gift to the QPRT, because it is an expense chargeable to the grantor. But if any part of the contribution by the grantor is used to pay principal on the mortgage, this would result in an additional gift to the trust, which would need to be valued and reported appropriately for gift tax purposes.

Additionally, QPRT trustees must exercise caution concerning any sale of property during the QPRT term. The applicable Treasury regulations provide that a QPRT trustee may sell the residence the QPRT holds without ceasing to qualify as a QPRT if (a) the proceeds are held in a separate account and are used within two years to purchase a new residence, or (b) the QPRT converts to a GRAT. As noted above, the residence cannot be sold to the grantor, the grantor's spouse, or an entity controlled by either of them during the QPRT term. Further, if the property passes to a remainder trust at the end of the retained term, and the remainder trust is a grantor trust as to the donor, the trustee of the remainder trust is also prohibited from selling the property to the grantor. If a replacement residence is not purchased within two years of the sale of the original residence, then the trust ceases to be a QPRT. Within 30 days of such event, the assets of the trust must be distributed back to the grantor (thereby losing all wealth transfer benefits) or the trust must convert to a GRAT.

Although it may sound easy to replace the original residence with a new residence, seldom is it quite so simple. The replacement residence is almost always more expensive or less expensive than the original residence. If the replacement residence is less expensive, then the QPRT must partially convert to a GRAT with respect to the proceeds from the sale of the original residence that are not reinvested in the replacement residence. On the other hand, if the replacement residence costs more than the original residence, additional capital must be raised. The simplest way to pay for a more expensive replacement residence is for the grantor to make an additional contribution of cash to the QPRT or to make a loan to the QPRT for the additional money needed to purchase the replacement residence. But if the donor does not want to (or cannot afford to) make an additional gift to the QPRT, a joint purchase is also an option where the grantor and the QPRT jointly purchase the replacement property and own proportionate shares as tenants in common. If the donor later decides she wants to make a gift of her proportionate share of the property to the QPRT, she can do so and likely take advantage of applicable fractional interest discounts for gift tax purposes. One important point to keep in mind is that the QPRT can hold only one residence at a time, so the original residence needs to be sold before the purchase of the replacement residence. For example, Mrs. Ocean could not sell the beach house owned by her QPRT and instead purchase two oceanfront condominiums in the QPRT. The QPRT could hold only one condominium, and any excess proceeds would either be paid to Mrs. Ocean or converted into a GRAT.

Typically, because QPRT planning is done with a property that is intended to remain in the family long-term, the conversion to a GRAT occurs only if something unexpected happens, and the residence is sold without purchasing a replacement residence. Usually this occurs because the family has determined that holding the residence is no longer an appropriate goal of the family or if the donor needs to move into an assisted living facility and cannot afford the expenses related to the QPRT in addition to health care expenses.

Although these issues arise during the administration of QPRT, often they are not recognized until the QPRT term has ended. When reviewing an existing QPRT for a client, particularly one drafted by another, planners should ask their clients questions about these administration issues and, if necessary, take the steps identified above to address any outstanding issues, including filing amended gift tax returns as needed to report any additional gifts. In the next section, we will discuss issues that arise once the QPRT retained term has ended.

Issues After Administration

The most common challenges after a QPRT term has ended are generation-skipping transfer (GST) tax issues and the grantor's continued use of the property.

Although QPRTs may be an effective way to transfer property for gift and estate tax purposes, QPRTs typically should not be used for GST tax planning. Similar to GRATs (or any other irrevocable trust where the grantor retains an interest), the grantor is not able to allocate the GST exemption to the QPRT when the QPRT is created. Rather, the grantor must wait until the end of the QPRT term—also known as the end of the estate tax inclusion period (ETIP)—to allocate the GST exemption.

For two reasons, at the end of the ETIP, the value of the property in the QPRT is unlikely to be the same as the value reported on the grantor's gift tax return (which is based on the value of the property when the QPRT was initially funded). First, because of deterioration, appreciation, or other factors, the value of the underlying personal residence is likely to have changed. Second, and more important, the grantor no longer receives the benefit of the discounted gift tax valuation resulting from her retained interest because the grantor's retained interest has ceased. Instead, the value of the property at the end of the ETIP is the property's fair market value. Depending upon the location of the property and length of the QPRT term, by the end of the QPRT term, the property may have appreciated greatly from its fair market value at the time of funding, thus "costing" the grantor more in use of GST allocation.

By way of illustration, when Mrs. Gifter contributed her beach house to the QPRT, its fair market value was $1 million. After calculating Mrs. Gifter's retained interest in the property, the value of the gift reported on the gift tax return was $500,000. At the end of the QPRT term, the beach house is valued at $2.1 million. If Mrs. Gifter decides to allocate GST tax exemption to the property, she will be using $2.1 million of GST tax exemption even though for gift tax purposes the gift of the property was valued at

$500,000 (a difference of $1.6 million). At that time, Mrs. Gifter may not have $2.1 million of GST tax exemption available to allocate to the property. Even if Mrs. Gifter does have the requisite GST tax exemption, this example illustrates that the allocation of GST tax exemption to the property at the end of the ETIP can be highly inefficient GST tax planning.

In a perfect world, the QPRT should be designed to ensure that the remainder interest passes only to non-skip persons at the end of the term. GST tax is imposed at the end of the QPRT term if the property passes to a beneficiary who is more than one generation below the grantor (e.g., a grandchild), also known as a skip person. As long as the property does not pass to a skip person, GST tax will not be imposed, and the allocation of GST tax exemption is not an issue. Unfortunately, there are occasions where the QPRT remainder does pass to a skip person.

For example, if Mrs. Granny's QPRT designates her "then living descendants, per stirpes" as the remainder beneficiaries, and one of her children dies during the QPRT term (and is survived by descendants), GST tax will be imposed at the end of the QPRT term when property passes to grandchildren. (It is important to note that the predeceased ancestor rule does not apply to beneficiaries who die during the QPRT term.) If Mrs. Granny decides to allocate GST tax exemption at the end of the term to avoid GST tax, GST tax exemption must be allocated to the entire value of the property—not just the value of the property passing to the skip person. Thus, if the skip person has a one-fourth interest in a property valued at $2.1 million, Mrs. Granny needs to allocate $2.1 million of her GST tax exemption as opposed to only $525,000 (which represents the skip person's interest at the end of the term).

Like most problems, it is critical to address a potential QPRT GST tax inefficiency sooner rather than later (i.e., before the end of the QPRT term). If the remainder beneficiaries include both skip persons and non-skip persons, the grantor can make a qualified severance of the QPRT before the end of the term. The qualified severance of the QPRT will allow the grantor to allocate only the GST tax exemption necessary for the skip person's share instead of allocating GST tax exemption to the entire property. Thus, the grantor can avoid "wasting" GST tax exemption on property that ultimately passes to a non-skip person.

If the beneficiary designation issue is caught before a child of the grantor dies, the terms of the QPRT may be modified—by court order, a nonjudicial settlement agreement, or through decanting—to grant each non-skip beneficiary a testamentary general power of appointment with respect to his or her interest in the QPRT. By including a general power of appointment, a drafter can ensure the QPRT interest will be includable in the estate of each non-skip beneficiary, thus avoiding the imposition of GST tax. (Discussions regarding the feasibility and tax consequences of a beneficiary's sale of his or her remainder interest in the QPRT to a GST trust for GST planning purposes are beyond the scope of this article.)

The other issue at the end of the QPRT term is not as technically challenging as GST allocation—rather, it is more emotional: the grantor's retained interest in what may be a beloved family property has ended. Despite a planner's explanation of QPRT operations to the grantor at the outset, not to mention the grantor's having time to prepare for the end of the QPRT term (in some cases, for decades), it can be very difficult for the grantor to accept that the grantor no longer has a legal right or title to the property.

If the grantor is using the QPRT property as a primary residence, then, long before the end of the QPRT term, the grantor should be making arrangements to locate new housing to ensure a smooth transition. Many times, however, the grantor does not want to move from the property (or, for health reasons, cannot relocate). There are options for the grantor who does not want to (or cannot) leave the QPRT property at the end of the term.

The most popular solution is for the grantor to rent back the property from the remainder beneficiaries for fair market rent. If the grantor continues to reside in or otherwise use or occupy the property after the QPRT term has ended and does not pay rent to the new owner, the property may be includible in the grantor's gross estate for estate tax purposes (thus destroying any wealth transfer benefits) because the grantor retains incidents of ownership in the property. Even though the new owners may be family members, it is critical that all parties treat the rental as an arms-length transaction. That means the parties should enter into a written rental agreement (preferably drafted by an attorney), and a real estate professional should be retained to determine the fair market rent. Once executed, the parties should closely follow the terms of the rental agreement, including the timely payment and collection of rent. Additionally, if the parties decide to renew the lease in future years, a real estate professional should confirm that the rental rate accurately reflects the fair market rent at that time.

Although the grantor may be emotionally opposed to renting the property from the remainder beneficiaries (likely, the grantor's children), there is an estate and gift tax benefit to the arrangement. If the grantor has a taxable estate for estate tax purposes, the payment of rent by the grantor to the beneficiaries transfers assets out of the grantor's estate to the grantor's beneficiaries without any gift tax implications. Paying rent to one's children may be a hard pill for some to swallow, but there is a silver lining from a tax perspective.

Another option is for the grantor to purchase the property from the remainder beneficiaries after the QPRT term has ended. As indicated in the beginning of this article, the QPRT must prohibit the property from being sold to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse. It is important to note that this prohibition applies only after the end of the QPRT term if the property is owned by a trust that is treated as a grantor trust for income tax purposes. Accordingly, the grantor could repurchase the property after the end of the QPRT term if the property is distributed outright to individual beneficiaries or is held in a non-grantor trust. Even if the grantor is interested in purchasing the property after the QPRT term has ended, the grantor should consider the capital gains tax implications to the remainder beneficiaries and whether it is the best use of the grantor's funds to purchase an asset the grantor has so tax efficiently removed from the grantor's taxable estate.

Conclusion

As interest rates and housing prices steadily rise across the country, we expect an increasing market for QPRTs. Advisors should be cautious before recommending that clients engage in this long-term (if not life-long) transaction, but clients and planners alike can take comfort and encouragement that there are myriad ways to repair (or unwind) a QPRT if the roof caves in. n