

Committee Report: Estate Planning & Taxation

By Bruce J. Bettigole

QPRT Exit Strategy

Don't leave home without it

Okay—you've sold your clients on the potential estate tax benefit to be achieved with a qualified personal residence trust (QPRT).¹ And you've explained that, with a married couple, the benefits can be even greater if each deeds only a 50 percent interest in the residence to a separate QPRT. Then, in addition to the valuation discount available for the QPRT, an additional fractional interest discount will be applied, thereby further reducing the taxable gift.

So, now the client wants to know: "What happens when the QPRT term is over and I still want to use the property?"

And you reassure him: "You'll just enter into a lease providing for fair market rent—no problem."

But, will there really be no problem?

It's clear that, after expiration of the QPRT term, the grantor must pay rent if he's going to continue to use the property. If he doesn't, whatever the fair market value (FMV) of the property is when the grantor dies will be included in his estate for federal (and, in all likelihood, state) estate tax purposes.²

But, a lease arrangement raises some serious administrative questions:

- (1) Who is the lessor?
- (2) How is rent to be determined?
- (3) How are rental payments to be administered?
- (4) How are rental payments treated for income tax purposes?



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Let's examine those questions and potential answers one at a time.

(1) WHO IS THE LESSOR?

In most cases, it will probably be desirable, after the QPRT term expires, to have the QPRT provide for retention of the property in a continuing trust (for example, for the benefit of the grantor's children). If the property were distributed outright to the children, it would lose the asset protection benefit of a trust and might become subject to a partition action by a creditor of any one child.

Moreover, absent a buy-sell agreement among the children, upon the death of a child, his or her ownership interest could become fractionalized among the child's heirs. Accordingly, outright distribution of the property could result in a multiplicity of lessors. This result should probably be avoided.³

But even if the property remains in trust, there may be multiple lessors. For example, if when the QPRT term expires, the trust was divided among the children in separate trust shares, then arguably each separate trust would be a lessor with respect to its proportionate interest in the property. The problems posed by a multiplicity of lessors can be mitigated if the continuing trust can be treated as a grantor trust for income tax purposes.

(2) HOW ARE RENTAL PAYMENTS TO BE FUNDED?

Because during the QPRT term the grantor will have been paying all expenses related to the property, simply converting these payments to rent under a lease normally would not increase his financial burden. To avoid application of Internal Revenue Code Section 2036(a), the rent must be set at fair rental value. To minimize the estate tax inclusion risk, rent should be determined by an experienced appraiser—or at least by a realtor. That rent also should be adjusted periodically to reflect the current market. If the property is waterfront or other

desirable real estate, the grantor may be shocked to learn that fair rental value far exceeds the expenses he has been paying during the QPRT term, and may impose a financial burden that the grantor is unable to assume. Under such circumstances, the grantor's options are limited. Arguably, if the grantor were to perform maintenance and other services to the property, the rent could be reduced by the value of his efforts. But valuing such services may be difficult and, if overvalued, IRC Section 2036(a) may be an issue. One option would be for the grantor, in lieu of paying rent, to issue a promissory note (at the applicable federal rate for interest), with principal and accrued interest payable at the grantor's death. Care should be taken in drafting the lease to make sure that the QPRT will be taxed only when the note is paid.⁴

(3) HOW ARE RENTAL PAYMENTS TO BE ADMINISTERED?

Administration of rental payments when there is a single lessor is relatively simple: a checking account can be opened in the name of the lessor QPRT and rent checks deposited in that account. But administration becomes more complicated when there is more than one lessor. If at the end of the QPRT term the trust instrument requires division into separate trust shares among children, there is now a multiplicity of lessors. The problem is compounded with a married couple with identical QPRTs. If the couple has three children, then arguably there are six lessors. Must six separate accounts be established and six rent checks be issued each month? QPRT administration can be simplified if the QPRTs can continue as grantor trusts.

(4) HOW ARE RENTAL PAYMENTS TREATED FOR INCOME TAX PURPOSES?

Depending upon whether the QPRT is treated as a grantor trust for income tax purposes, QPRT administration can be relatively simple and inexpensive or annoyingly complex and quite expensive. Clients tend to have a short memory when you try to explain to them that the cost and complexity of QPRT administration are far outweighed by the estate tax savings realized by establishing the QPRT in the first place.

Let's examine the two options: non-grantor trust treatment versus grantor trust treatment. First, with the non-grantor trust, expect these consequences:

- The QPRT will be a tax-paying entity and require its own tax ID number. If there are separate trusts created under the "umbrella" QPRT, each trust will be a separate taxpayer and require its own tax ID number. A separate Form 1041 fiduciary income tax return will be required for each trust.

- Rental payments will be taxable income to the trust(s), which may be offset, in whole or in part, by expenses related to the property. To minimize taxable income, the trust(s) would take a depreciation deduction, which means that in all likelihood there will be recapture when the property is ultimately sold.⁵

- Each lessor trust may need to have a separate account into which the rental payments are deposited.

- If the property is the grantor's principal residence, no capital gains tax exclusion would be available when the property was sold and the capital gains tax was payable by the trust(s).⁶

The benefits of grantor trust treatment for income tax purposes are palpable:⁷

- The QPRT, and the multiple trusts created under it, won't be taxable entities and will not require separate tax ID numbers. No fiduciary income tax returns will be required.

- Rental payments will not constitute taxable income (the grantor is not taxed on income which for tax purposes is treated as being paid to himself)⁸, and the property won't be depreciated.

- While, technically, the property may be owned by several subtrusts, because they're not taxable entities, the QPRT may open a single account (owned by all the subtrusts but using the grantor's social security number) into which rent checks may be deposited.

- If the property is the grantor's principal residence, the capital gains exclusion will be available, and because the grantor will pay any capital gains tax, this payment further reduces the grantor's estate and is the functional equivalent of a tax free gift to the children.⁹

How To

So, how may the QPRT achieve grantor trust status?

When we parse the sections of the IRC that provide for grantor trust treatment (Sections 671 through 679), very few provisions can be invoked without also resulting in the property being included in the grantor's estate for estate tax purposes. Retaining any of these would be fatal to estate tax avoidance:

- (1) a reversionary interest (IRC Section 673);
- (2) the power to control beneficial enjoyment (IRC Section 674(a));
- (3) the power to revoke the QPRT (IRC Section 676);
or
- (4) a right to receive trust income (IRC Section 677).

While IRC Section 675(4)(C), the power to reacquire trust property by substituting other property of an equivalent value, often is relied upon to achieve grantor trust status, retaining this power in a QPRT is prohibited.¹⁰

Still, there are three provisions that may be used to achieve grantor trust status:

- (1) If the grantor is married, the grantor's spouse could be given powers that, if retained by the grantor, would result in the property being subject to estate tax in the grantor's estate. IRC Section 672(e) dictates that grantors are treated as holding any power or interest of their spouses. Therefore, a power in the spouse to control beneficial enjoyment, to exercise any of the powers enumerated under Section 675, or to receive income (Section 677) would result in grantor trust treatment.
- (2) If the grantor has more than one child, each child could be a trustee of each other child's trust (but not of his own trust). This arrangement would flunk Section 674(c) because more than half the trustees of each trust would be non-adverse parties who are related or subordinate parties to the grantor (Section 672(b) and (c)).
- (3) If neither of these first two options apply, grantor trust treatment still may be available if trust income

(and principal) may, in the discretion of a non-adverse party, be used to pay premiums on insurance policies on the life of the grantor or the grantor's spouse (Section 677(a)(3)).¹¹ There is some question, however, as to whether Section 677(a)(3) confers grantor trust status generally or only causes the grantor to be taxed on trust income actually applied to the payment of premiums.¹²

Of course, even if grantor trust treatment is achieved, the status will be lost upon the grantor's death or, if reliance is placed solely upon the first method, the death of the grantor's spouse. From that point on, non-grantor trust income tax consequences apply. But these consequences would have little practical adverse impact on rental payments under the lease if the event that triggered non-grantor trust status also resulted in termination of the lease.

Drafting Suggestions

To facilitate administration of the QPRT after its term expires, consider adding certain provisions to it.

If grantor trust treatment is not available:

- (1) Instead of creating separate share trusts, consider using a single "pot" trust until the property is no longer held in the QPRT. This will enable the QPRT to be the sole lessor, and will require only one tax ID number and a single fiduciary income tax return. The downside to this arrangement is that conflicts could arise among the beneficiaries as to their respective entitlement to the QPRT's net income.
- (2) If separate share trusts are desirable, include a provision authorizing the trust to enter into partnerships. This provision would enable the various subtrusts to form a single entity to be the lessor. But the partnership would require yet another tax ID number and tax return.
- (3) If both spouses create QPRTs, the number of lessors can be cut in half by including in each QPRT a provision authorizing the trustees to merge into one of the QPRTs the identical trusts established under the other QPRT.

If grantor trust treatment is potentially available:

- (1) Make sure the trustee provisions are flexible enough to allow the appointment of family member (and removal of non-family member) trustees to enable grantor trust treatment under Section 674(c).
- (2) Enable rent checks to be deposited into a single account (particularly when there are spousal QPRTs) and include a provision authorizing the appointment of an agent. Applying this provision, separate subtrusts could execute a document designating one person to open a checking account (using the grantor's social security number) in the name of an umbrella QPRT, with the understanding that the rent paid into that account will be shared pro-rata by the various subtrusts.¹³
- (3) A QPRT term often runs for many years, and the tax and other laws at its inception may be very different than at the end of the term. So it's essential that an independent trustee be given the power, without changing beneficial interests, to amend the QPRT, including an amendment to better conform to changing laws (tax or otherwise). For example, if the property were sold and then the grantor no longer wanted to be taxed on trust income and capital gains, the QPRT could be amended to eliminate the grantor trust feature. **EB**

It's Worth It

Advisors know that the effectiveness of a QPRT in reducing estate taxes outweighs the many administration issues that arise when the QPRT term expires. With careful advance planning and drafting by the practitioner, the client is likely to share that conclusion.

Endnotes

1. A qualified personal residence trust (QPRT) is an irrevocable trust, funded by a personal residence of the grantor, wherein the grantor retains rent-free use of the residence for a period of years, after which outright or beneficial ownership shifts to other beneficiaries (usually the grantor's children). The taxable gift the grantor is making to these beneficiaries is discounted by the value of the grantor's retained interest (which includes a reversion if the grantor does not survive the term of years). If the grantor does survive the term, the value of the residence (including all appreciation in the value of the residence from the time the QPRT is created) escapes taxation in the grantor's estate.
2. Internal Revenue Code Section 2036(a); Revenue Ruling 70-155.
3. In Massachusetts the children could convey their respective interests to a nominee trust which would be the sole lessor, but this vehicle is not generally available in other jurisdictions. Alternatively, if all of the children are competent, they could convey the property to a Limited Liability Company (LLC) which may provide both asset protection and avoid fractionalization of ownership interests. However, the income tax benefits available with a grantor trust (discussed below) could not be achieved with the LLC.
4. The lease should provide that the note is unsecured and not assignable in order to distinguish it from the facts in *Cowden v. Commr.*, 289 F.2d 20 (1961).
5. IRC Section 1016(a)(2).
6. IRC Section 121(a).
7. During the term the QPRT will generally be treated as a grantor trust for income tax purposes (IRC Section 673(a)).
8. Private Letter Ruling 200102037.
9. PLR 200104005.
10. Treasury Regulations Section 2702-5(c)(9).
11. While IRC Section 677(a) specifically applies only to the trust income, under IRC Section 671 and applicable regulations this would confer grantor trust status with respect to income only. This may be sufficient for purposes of rental payments, but it wouldn't make available the capital gains tax exclusion if the QPRT property were the grantor's principal residence and were sold. Even if the QPRT property were not the grantor's principal residence, a grantor trust only for income purposes would require the trust, not the grantor, to pay the capital gains tax, thereby eliminating the possibility of further reducing the grantor's estate and making the functional equivalent of a tax-free gift to the grantor's children. Accordingly, including the discretion to use principal as well as income to pay premiums is intended to, and hopefully will make the QPRT a grantor trust for all purposes.
12. See cases decided under a predecessor statute: *Iversen v. Commissioner*, 3 T.C. 756 (1944); *Weil v. Comm'r*, 3 T.C. 579 (1944), *acq.*, 1944 C.B. 29; *Rand v. Comm'r*, 40 B.T.A. 233 (1939), *aff'd*, 116 F.2d. 929 (8th Cir. 1941), *cert. denied*, 313 U.S. 594 (1941), *acq.*, 1939-2 C.B. 30. *Contra* PLR 8852003.
13. If, with spousal QPRTs, the spouses file joint income tax returns, it won't matter which QPRT or which grantor's social security number will be used.