

Taxes: Private Letter Ruling on Reverse Qualified Personal Residence Trust (QPRT)

With residential real estate values depressed, the time is right for Qualified Personal Residence Trusts (QPRTs). QPRTs are typically used to facilitate the transfer of the grantor's personal residence to his or her children. The grantor establishes the trust and retains an interest for a term of years, during which time he or she continues to live in the home. After expiration of the term, the residence is distributed to the grantor's children, either outright or in trust.

What makes QPRTs attractive is that the gift tax value of the residence is discounted by the value of the retained interest while future appreciation is shifted to the children. With home prices depressed, current valuations are low and the potential for future appreciation high.

A QPRT with a Twist

Although QPRTs are typically used to gift the remainder interest in a residence, the IRS has recently ruled that a trust can qualify as a QPRT when the grantor gifts the use of the property for a term of years and retains the reversionary interest. See 200816025 (April 18, 2008); PLR 200848003 (November 28, 2008); PLR 200848007 (November 28, 2008); PLR 200848008 (November 28, 2008); PLR 200901019 (January 2, 2009); PLR 200904022 (January 23, 2009); PLR 200904023 (January 23, 2009); and PLR 200920033 (May 15, 2009). The favorable rulings were conditioned on the trust instrument being substantially similar to the sample in Section 4 of Revenue Procedure 2003-42 and the residence qualifying as a personal residence under Section 25.2702-5(c)(2) of the Gift Tax Regulations.

Such trusts, providing an older generation family member with use of a residence for a term of years and younger generation family members with a reversionary interest, are referred to as "reverse" or "backward" QPRTs.

The Reverse QPRT Rescue

Every tax planning vehicle has its place, and the most likely place for a vehicle as unusual as a reverse QPRT is to rescue the "plain vanilla" or regular QPRT.

An issue planners face with QPRTs is what to do at the end of the trust term assuming the grantor survives. Typically, title to the residence passes to the grantor's children; however, the grantor may have reached an advanced age and may be reluctant to leave. If the grantor continues to occupy the residence without paying rent, he or she may be deemed to have made

gifts to the children of the foregone rent. If the grantor has already used up his or her gift tax exemption, gift tax could be payable on the constructive gifts.

To avoid constructive gifts of foregone rent and the potential for taxable gifts, the children should charge the grantor rent based on the appraised fair rental value of the property. However, if the residence has appreciated significantly in value during the trust term, the fair rental value of the property and the resultant monthly rent payment could be larger than the grantor can afford. In fact, the monthly rent could exceed the grantor's fixed income from annuities and pensions.

One solution to this dilemma could be a reverse QPRT. Consider the following example:

Example 1

Joan created a QPRT a few years ago when she was 65 years old. She retained the right to live in the residence for a ten-year period that is about to expire. At age 75, Joan is in good health and wishes to remain in her home. Her sole child, John, is the remainderman under the QPRT and will take title to the residence when the trust terminates. When the residence was transferred to the QPRT, it was valued at \$3 million. At the time, the Section 7520 rate was 6 percent and taking into account Joan's contingent reversionary interest, the value of the remainder interest gifted to John was only \$1,315,329.

The QPRT has worked out well, because the residence (an ocean view in Santa Barbara) has increased in value to \$7 million. An appraiser has estimated the fair rental value to be \$28,000 per month. Unfortunately, Joan has converted most of her holdings to fixed annuities and her fixed monthly income is not nearly enough to pay the rent and maintain the lifestyle to which she has become accustomed.

Joan and John's advisor suggests a reverse QPRT. John will transfer the house to a trust, which gives Joan the right to continue living in there for another five years. If Joan dies during the five-year term, the trust terminates and John receives the residence. If Joan survives the trust, the trust terminates, title to the house reverts to John and additional planning will be necessary.

Relying on the recent private letter rulings cited above, the value of the gift from John to Joan is calculated to be \$1,077,636. Although the gift should qualify for the annual gift tax exclusion (\$13,000 in 2009), the balance of the gift is taxable. Assuming John has exhausted his gift tax exemption, the tax on the \$1,064,636 taxable gift at a 45 percent marginal rate is \$479,086.

However, if the property appreciates to \$10 million in the next five years (the term of the reverse QPRT), both Joan and John will have made a pretty good deal. She continues to live in her home rent free and John receives a \$10 million residence for a gift tax cost of less than \$500,000.

Cautions

First, it should be remembered that private letter rulings bind the IRS only with respect to the taxpayer to whom they are issued. However, given the fact that all rulings have been authored by the same individual at the IRS and that the reasoning is consistent across all of the rulings, it is reasonable to believe that situations with facts substantially similar to those in the rulings would also be viewed favorably.

Advisors can take steps to minimize the Section 2036 hazard. First, there should be no written agreement to create a reverse QPRT in the event the grantor of the regular QPRT survives the initial term. Second, it may make sense to have the grantor of the initial QPRT pay rent for a few months following termination of the regular QPRT while options including the reverse QPRT are explored..

Second, each ruling contains the following caution:

“...no opinion is expressed or implied concerning whether the transfer of Residence to Trust would result in Residence being included in the gross estate of (Parent) under §2036.”

Apparently, this somewhat cryptic statement means the IRS could take the view that creation of the reverse QPRT was agreed to at the time the regular QPRT was formed and that the grantor of the regular QPRT always intended to retain a beneficial interest in the reverse QPRT. Under IRC Section 2036, retention of the right to live in the residence for a term of years under the reverse QPRT would cause inclusion of the trust property (the residence) in the original grantor's estate.

Of course, if the grantor dies during the term of the regular QPRT, the value of the residence is clearly included in his or her gross estate. But this is a gamble most planners are willing to take.

On the other hand, if the grantor survives the term of the initial QPRT, he or she is older and the mortality risk is greater. Furthermore, having won the bet with the regular QPRT, it might be considered unwise to chance inclusion of the residence in the original grantor's estate with the reverse QPRT.

However, advisors can take steps to minimize the Section 2036 hazard. First, there should be no written agreement to create a reverse QPRT in the event the grantor of the regular QPRT survives the initial term. Second, it may make sense to have the grantor of the initial QPRT pay rent for a few months following termination of the regular QPRT while options including the reverse QPRT are explored. Documentation evidencing exploration of various options should be maintained.

Bottom Line

QPRTs can be an effective planning tool for discounting transfer tax values, shifting appreciation, and transferring a client's wealth to heirs.

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