



PERSONAL RESIDENCE TRUSTS

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I. BACKGROUND.

Personal residence trusts are the outgrowth of the 1990 introduction of the provisions of Chapter 14 into the Internal Revenue Code.¹ Among other things, these special valuation provisions, §§2401-2404, obliterated the traditional rules of valuation of life estates, terms for years, and remainder interests under certain applicable situations.

Before the introduction of Chapter 14, assume Mother, age 45, irrevocably² transfers into trust unproductive property with a fair market value of \$100,000, and retains an income interest for 20 years³, with the remainder at the end of the trust term to Daughter. Mother has made a completed gift of a future interest⁴ to Daughter, the value of which is calculated by subtracting the value of her retained income interest from the fair market value of the property. Assuming a §7520⁵ rate of 6% (the “7520 rate” is an assumed rate of return determined by the Internal Revenue Service), the value of the retained interest is \$68,820 and the value of the taxable gift to Daughter is \$31,180⁶. At the end of the 20 year term, assuming a 8% annual growth, Daughter receives property then valued at

¹ All references to the Internal Revenue Code (“Code”) and all “§” references are to the Internal Revenue Code of 1986, as amended.

² In this outline, a transfer into trust will be assumed to be a transfer into an irrevocable trust.

³ Pursuant to current IRS life expectancy tables a 45 year old has a life expectancy of 33.4 years.

⁴ Because the remainder interest is a future interest, the gift into trust does not qualify for the §2503(b) annual exclusion for present interest gifts.

⁵ The “7520 rate” is 120 percent of the applicable federal midterm rate, rounded to the nearest 2/10ths of one percent. §7520

⁶ Based upon Regulation §20.2031-7(d)(6)(Table B)

\$466,096 with minimum gift tax exposure to Mother. A good deal, as the gift has been discounted by roughly 60%.

The perceived abuse with the above example is that Mother never intended the unproductive property to generate income, although the IRS valued her retained interest as if it earned income at the §7520 rate. In response to this perceived abuse with the of transfer of property into trust for the benefit of family members, Congress enacted §2702 which sets forth special valuation rules for the initial transfer into trust. Generally speaking, §2702 applies where an donor makes a completed “transfer of an interest in trust to (or for the benefit of) a member of the [donor’s] family” while retaining an interest in the property. In such a situation, §2702 states that the value of the retained interest shall be zero. Thus, in the above example, Mother’s retained income interest would be valued at zero, and the completed gift to Daughter would be valued at \$100,000.

Section 2702 provides several exceptions to the “zero valuation” rule, one of which concerns the transfer of a personal residence into trust where the donor reserves the income interest (the right to use and occupy the home) for a stated term of years (the “trust term”) with the remainder to one or more family members. It is these personal residence trusts which are the subject of this outline and which provide parents with a wonderful opportunity to transfer personal residences, including vacation property, to their children with minimal gift tax consequences.

II. THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001.

A. The Act: On May 26, 2001 Congress adopted The Economic Growth and Tax Relief Reconciliation Act of 2001, which was signed into law by President George W. Bush on June 7, 2001 as P.L. 106-15. Very briefly, the Act ravages the hard fought “unification” of the gift and estate tax achieved in 1976 wherein lifetime and testamentary transfers are included in a cumulative tax base and taxed under a single rate schedule with a unified credit. Under the Act, the gift tax credit increases to \$1 million in 2002 and there it remains. The gift tax is never repealed. The estate tax credit and generation-skipping transfer (“GST”) tax exemption increase to \$1 million in 2002, \$1.5 million in 2004, \$2 million in 2006, \$3.5 million in 2009, with repeal of the estate and GST tax in 2010. These taxes re-surface in 2011, unless Congress acts. In June of 2002 the House passed H.R. 2143, known as the “Permanent Death Tax Repeal Act of 2001”, which would have made the repeal permanent, but this Act was defeated in the Senate.

B. Impact on Personal Residence Trusts: The impact of the Act on estate planning in general, and personal residence trusts in particular, is still subject to discussion and debate within the estate planning community. However, the following may be noted:

1. *Sunrise, Sunset*: Gifting techniques which leverage the use of the \$1 million gift tax credit will continue to appeal to clients, especially in light of the possible re-surfacing of the estate tax in 2011.

2. *State Estate Tax Laws*: The 2002-2005 phase-out of the §2011 credit for state death taxes may cause states to begin to enact individual death taxes, thereby reversing the trend of the past decades where individual state laws were repealed in favor of a “sponge tax” which picked up the federal credit amount. The possibility of state death taxation is an inducement for a client to continue to reduce the size of her estate.

3. *Automatic Allocation of GST Exemption*: New §§2632(c) and 2632(d) – effective for QPRT’s with initial QPRT terms ending after December 31, 2000 – automatically allocates GST exemptions to certain trusts. The purpose of these sections was to assist taxpayers (and their advisors) who failed to allocate GST exemption to trusts that would otherwise be subject to the punitive 50% (in 2002) GST tax. Unfortunately, the result is that now taxpayers (and their advisors) are faced with the necessity to *opt out* of the automatic allocation system where the automatic allocation would result in a waste of the taxpayer’s GST exemption. Most continuing QPRTs by their terms will not be subject to the automatic allocation rules because they will fit into the exceptions provided in §2632(c)(3)(B)(i)-(vi). However, these code sections are extremely confusing at first glance, and many advisors believe it would be more cost effective for the client to simply file a gift tax return at the end of the initial QPRT term, opting out of the automatic allocation, rather than rely upon the application of the exemptions in §2632(c)(3)(B). Due to the effective date of the automatic allocation rules, advisors should review all QPRTs with QPRT terms that terminated after December 31, 2000.

4. *Grantor Trusts*: New §2511(c) provides that after 2009, transfers into trust will be a §2503 taxable gift unless the entire trust is treated as a grantor trust for income tax purposes as to the donor or the donor’s spouse (except as provided by regulations). What does that mean? One commentator has suggested that personal residence trusts should not be

executed with an initial trust term beyond 2011 in order to see whether the client can take advantage of nontaxable gifting into grantor trusts.⁷

5. *Qualified Severance*: If you make a mistake and draft your QPRT as a generation-skipping trust (see Part V-H, *infra*), the new “qualified severance” provisions of the Act, §2642(a), may permit the QPRT to be divided into separate shares at the end of the ETIP period, thus permitting a donor to allocate GST exemption to only that portion of the QPRT that may be subject to the GST tax.

6. *Basis*: Section 121(d)(9)(A) provides that the \$250,000 exclusion of gain from the sale of a principal residence applies to the sale of a principal residence in 2010 by “the estate of the decedent” (rather than the carry-over basis rule of §1022). If the donor dies in 2010 during the QPRT term, and the QPRT directs that the principal residence is to be distributed to the estate, assuming the other requirements of §121 are met the \$250,000 exclusion should apply to the sale of that residence in 2010 (the only year of repeal).

III. THE BASICS (OR WHY PUT THE “Q” IN QPRT?).

A. Personal Residence Trust v. Qualified Personal Residence Trust: Section 2702 exempts both a personal residence trust (PRT) and a qualified personal residence trust (QPRT) from the dire valuation consequences of Chapter 14. Rarely is a PRT utilized given the greater flexibility of the QPRT.⁸ Unlike a PRT, the QPRT trust instrument may:

1. Provide for the holding of cash and other assets that are related to the residence.⁹ For example, cash to pay expenses reasonably expected to be paid (or improvements reasonably expected to be made) within 6 months from the date the cash is added to the trust, or cash to initially

⁷ Harry Lee, Current Estate Planning Implications of EGTRRA (Presented on June 6, 2001 to the Trusts and Estates Section of the Boston Bar Association).

⁸ The IRS has also recently introduced the “QRT” or “qualified revocable trust” as part of its proposed regulations on §645, the revocable trust election which permits certain trusts to be treated as estates for a limited time following the death of the grantor. The ABA’s Postmortem Income Tax Planning Committee of the Real Property, Probate, and Trust Law Section has suggested that this acronym be deleted as too confusing in light of the already established QPRT and PRT acronyms.

⁹ Reg. §25.2702-5(c)(5)(A)

purchase the personal residence as long as the trustee has already entered into the P&S and the closing will occur within 3 months.¹⁰

2. Provide for the Trustee power to make improvements to the residence, as long as its character as a principal residence is preserved.¹¹

3. Permit the trustee to sell the residence and use the proceeds to purchase another residence.¹²

4. Permit the conversion into a qualified annuity trust (a "GRAT") where the sale (or insurance) proceeds are not used to purchase another residence.¹³ Note that if a excess proceeds remain after the purchase of a replacement property that such proceeds may be held in a separate share as an annuity. PLR 200220014.

B. Mandatory QPRT Requirements: In addition to the permissible requirements noted above, mandatory provisions within the trust instrument include:

1. The trust instrument must prohibit the trust from holding any asset other than an interest in a personal residence, and certain permitted cash and insurance policies.¹⁴

2. The trust instrument must provide for mandatory distributions of income to the donor during the trust term. These distributions must be made at least annually, or more frequently.¹⁵

¹⁰ Where the trustee is permitted to hold cash, the trust instrument must also provide that determination of cash needs be made at least quarterly, and provide that excess cash will be distributed back to the donor. Reg. §25.2702-5(c)(5)(A)

¹¹ Reg. §25.2702-5(c)(5)(B)

¹² Reg. §25.2702-5(c)(5)(C). Note that the sale proceeds must be held in a separate account.

¹³ Reg. §25.2702-5(c)(8)(ii)(B). The trust instrument must require that the GRAT annuity will commence on the so-called "cessation date" --- the date of the sale or destruction --- even though the first annuity payment may be paid 30 days after the cessation date (with adequate interest as defined in the Regulation).

¹⁴ Reg. §25.2702-5(c)(2)

¹⁵ Reg. §25.2702-5(c)(3)

3. The trust instrument must prohibit distributions of trust property to anyone other than the donor during the trust term.¹⁶
4. Commutation must be prohibited by the trust instrument. There may be no prepayment of the donor's retained interest.¹⁷
5. The trust instrument must state that QPRT status terminates if:¹⁸
 - a. The property ceases to be a personal residence.
 - b. The residence is sold, unless the trust instrument permits the trustee to use the proceeds to purchase a new personal residence and such residence is purchased within 2 years.
 - c. The residence is damaged or destroyed causing cessation of use as a personal residence, unless within 2 years the residence is repaired or replaced.
6. The trust instrument must state that within 30 days after the trust ceases to be a QPRT the trustee either distributes the trust property outright to the donor or converts the trust property to a GRAT. The trust instrument may give the trustee discretion to choose between these outcomes.¹⁹
7. The trust instrument must prohibit the sale or transfer of the residence (directly or indirectly) to the donor, the donor's spouse, or an entity controlled by the donor or the donor's spouse at any time during the trust term and after the trust term if the trust is a grantor trust.²⁰

C. Not Necessary But Nice to Have:

¹⁶ Reg. §25.2702-5(c)(4)

¹⁷ Reg. §25.2702-5(c)(6)

¹⁸ Reg. §25.2702-5(c)(7)(i)-(iii)

¹⁹ Reg. §25.2702-5(c)(8)(i)(A)-(C)

²⁰ Reg. §25.2702-5(c)(9)

1. *Post-Term Occupancy*: Many donors will wish to continue to reside in the residence after the trust term. Unless the remainderman is the donor's spouse²¹, such continued use of the residence would cause inclusion of the residence in the donor's estate under §2036.

a. Section 2036 is avoided if the donor's occupancy is buttressed by a valid lease. Therefore, the QPRT could include the following language:

“Notwithstanding the foregoing provisions of this Article, if upon the expiration of the Trust Term, the donor is living and the Trust holds legal or equitable title to the residence or interest originally transferred to the Trust or a replacement residence or interest which was used by the donor or the donor's spouse as a personal residence, then the donor or the donor's spouse, or both, shall have the right to lease said residence or interest from the Trust or from the succeeding owner of the residence. The lease agreement shall provide for a maximum term of five years with an option to renew for an additional five year period, in both cases at fair market rent, to be determined by an independent appraiser, and on standard terms and conditions for a residential lease, including a requirement that the lessee pay all real estate taxes as well as all costs for maintenance, utilities and repairs. If the donor or the donor's spouse do not exercise such right by notice in writing to the trustee or the succeeding owners of the residence within sixty (60) days of the end of the Trust Term, such right shall lapse.”

b. It is important that clients understand that these rental payments are taxable income (after depreciation and other related deductions) to the landlord/remaindermen.

2. *Intent of Donor*: Massachusetts courts are increasingly willing to examine the intent of a donor when interpreting the terms of a trust.²² To guide the court, the trust should clearly state that it is the donor's intent to create a QPRT and to comply with §2702 and applicable

²¹ Gutchess' Estate v. Commissioner, 46 T. C. 554 (1966)

²² Most recently in Walker v. Walker, 433 Mass 581, 744 N.E. 2d 60 (2001) the Supreme Judicial Court permitted a trustee to reform a trust to insert an ascertainable standard to govern trustee distributions in order to effectuate the tax intentions of the trust's donor.

regulations. Additionally, since §2702 permits a trust to be cured of defects via court reformation,²³ the donor might state in the trust instrument that the trustee is authorized to pursue such reformation if needed.

D. Don't Forget the Details. In addition to a proper trust instrument, the following details must be considered:

1. *Mortgages*: Personal residences often are encumbered with a mortgage, and while a mortgage does not change the status of the property as a “personal residence” under §2702²⁴, the debt brings with it so many complications that it is often best to simply have the client pay it off prior to transfer into the QPRT. Such payment serves to further reduce the size of the donor’s estate (although it also increases the size of the gift).

a. If mortgaged property is transferred to the QPRT, the payment of the mortgage principal by the donor will be a gift to the beneficiaries of the trust. Alternatively, the principal payment may be characterized as a loan if an agreement is reached between the donor and the trustee which renders the mortgage the responsibility of the QPRT.

b. While federal law prohibits the trigger of a mortgage acceleration clause where property is transferred to an inter vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property²⁵, transfers into a QPRT seem to fall outside this protection because the occupancy rights change at the end of the term. The donor who insists on transferring mortgaged property should contact the mortgage holder and attempt to avoid the acceleration of the debt.

2. *Deed into trust*: If the property is to be deeded directly into the QPRT, it will be necessary to record both the deed and the QPRT. If privacy is a client concern, the lawyer might consider deeding the property into an agency nominee trust, and listing the QPRT as the

²³ Reg. §25.2702-5(a)(2)

²⁴ Reg. §25.2702-5(b)(2)(ii)

²⁵ 12 U.S.C. 1701j-3(d)(8) (The Garn St. Germain Act of 1982)

100% beneficiary on the nominee trust's schedule of beneficial interests.²⁶

3. *Residential or Veteran's Property Tax Exemptions:* A few towns and cities (Brookline and Boston, for example) offer residential and/or veteran's property tax exemptions based upon ownership and residence. The prudent lawyer will check with the local tax assessor's office to see if the transfer of the residence into the QPRT will blow any exemption. A client may wish to forgo the exemption for the greater benefits of the QPRT, but this should be a conscious decision, not a surprise.

4. *Insurance Carrier:* Confirm in advance that the homeowner's insurance will continue after the transfer into the QPRT. Make sure you receive this confirmation in writing from the carrier.

5. *Gift Tax Return and Qualified Appraisal:* A timely filed gift tax return with adequate disclosure of the gift is essential to start the running of the applicable statute of limitations. Be sure your client obtains an appraisal of the residence by a qualified real estate appraiser (not the local real estate agent, unless he has the requisite credentials) and confirm in writing who will file the return: the lawyer or the accountant.

6. *Homestead Exemption:* The Massachusetts homestead exemption is a statutory protection whereby a homeowner may record a "Declaration of Homestead" which, very generally speaking, protects the equity in her home from creditors while she resides there or while a spouse and/or minor children continue to reside in the home. The equity protected by the Massachusetts homestead exemption increased to \$300,000 in 2000 (a husband and wife over the age of 62 may each claim an exemption for a total of \$600,000).²⁷ It is generally agreed (although open to some debate) that the Massachusetts homestead protection is lost where a residence is transferred into a trust. Clients should be informed of the loss of this exemption if a Declaration has been filed, or of its future unavailability.

²⁶ The author found only two PLRs concerning use of a nominee trust in connection with a QPRT. In PLR 9249014, the IRS approved a QPRT where the donor retained legal title to cooperative shares as nominee for the QPRT and the beneficial interest in the shares were transferred to the QPRT. Similar facts were presented in PLR 199925027.

²⁷ Mass. G. L. Chap. 188, §§ 1 and 1A

7. *Tenancy By the Entirety*: Holding the principal residence as tenants by the entirety also affords a wife and husband a degree of creditor protection. Severing the tenancy by deed into trust should be discussed with the clients.

8. *Spousal Rights*: Massachusetts's spousal elective share statute does not give a spouse any specific right to the residence, although it permits a surviving spouse to claim a percentage interest in real property. Query whether it is necessary to obtain a spousal waiver of such rights in order to provide the QPRT trustee with marketable title? The author does not require such a waiver, although if out-of-state property was involved, local counsel should be consulted as to that jurisdiction's laws regarding spousal property rights.

IV. THE RISKS.

A. Death During the Term: If the donor dies during the initial trust term, the residence is included in his estate pursuant to §2036(a) and is valued for estate tax purposes as of the date of death (or the applicable alternate valuation date).

1. *Reversion*: The donor might reserve a contingent reversionary interest in the QPRT that is triggered on death within the term. For example, the QPRT could provide that if death occurred within the term, the trustee will distribute the trust property to the donor's revocable estate planning trust. The reversion renders the property available as an asset with which to pay estate taxes.

Note: The reversion also reduces the size of the gift upon the trust's initial funding with the residence because the right to receive the trust property after 20 years is worth more than the right to receive the property after 20 years only if the donor is then living. Note that where a client is only concerned with reducing the size of the gift (and not with physically pulling the property back into the estate), the donor could retain a testamentary general power of appointment during the trust term. Because the general power of appointment is a retained power, and not a donated power, the estate inclusion rules of §2041(a)(2) and §2041(b)(2) are inapplicable when the term ends and the power of appointment lapses.

2. *Insurance*: If the personal residence is of great value, the donor, through an irrevocable life insurance trust (ILIT), might purchase term insurance measured by the trust term to cover the possibility of estate inclusion. After the donor's death, the ILIT could purchase an interest in the home or lend money to the estate.

3. *Split-Gift*: Any unified credit used by the donor will be returned to his estate. But, §2513 does not return unified credit that may have been used by the donor's spouse. Since under §2513 the splitting of any gift in a year requires the splitting of all gifts within that same year, a client should be advised to refrain from gift-splitting in the year the QPRT is created.

4. *Step-Up In Tax Basis*: At least until 2010, death within the term has an up-side. The inclusion of the residence within the donor's estate enables utilization of the §1014 "step-up" in tax basis equal to the date of death value of the property. The Act eliminates the step-up basis for deaths occurring in 2010, and substitutes a modified "carry-over" basis. (But see Part II-B-6 above)

B. Failure to Comply With QPRT Requirements: There are many gray areas within the QPRT universe which are discussed in detail in Part V. Many lawyers insist that a client obtain a private letter ruling ("PLR") if there is any doubt as to the resolution of a particular issue in a client's favor. Under the relatively new "reduced user fees", a PLR fee of \$500 is available for clients with gross income of less than \$250,000.²⁸

C. The Remaindermen's Creditors: After the trust term, the donor no longer owns the property. If the QPRT states that the residence is to be distributed outright to the remainder beneficiaries, the residence will be vulnerable to a beneficiary's creditor and/or ex-spouse. To minimize this risk, the QPRT could provide that the residence be distributed to another trust at the end of the trust term, with the "remainder trust" containing standard creditor protection provisions (such as a spendthrift clause) or even more sophisticated provisions involving special powers of appointment.

D. Client Involvement: Good practice management requires the lawyer to fully discuss these risks with the client, both at a conference and in writing.

²⁸ Rev. Proc. 2001-1, 2001-1 I.R.B. (January 2, 2001)

V. QPRT PLANNING

A. The QPRT Client.

1. *Member of Family*: Section 2702 only applies to transfers to or for the benefit of the “members of the family” of the donor. These include a donor’s spouse, any ancestor or lineal descendent of the donor or the donor’s spouse, the donor’s brothers or sisters, and the spouse of any of the foregoing individuals. Thus, if the client wishes to transfer the residence into trust for the benefit of nieces or nephews, this may be done outside of the QPRT rules. A “house GRIT” (grantor retained income trust) is the preferred choice: the old valuation rules apply without the cumbersome QPRT trust provisions.

2. *Desire to Keep the Property*: QPRTS are best for clients who wish to keep a particular piece of qualifying property within the family over an extended period of time.

a. If the client intends to sell the property during the trust term, the expense of a QPRT is generally unwarranted. Also, the status of the QPRT as a grantor trust during the trust term for income tax purposes²⁹ may render the capital gains attributable to the donor, with the proceeds remaining within the QPRT.³⁰

b. If the remaindermen intend to sell the residence, the effect of the §1015 carry-over basis for property acquired by gift must be considered as it impacts on the gain realized on the sale.

²⁹ Under §673, if the donor retains a reversionary interest in the trust property which exceeds 5% of the value of the property, the donor will be treated as the owner of the corpus of the trust for income tax purposes. Under §677, the retention of the income interest by the donor renders the donor the owner of the income portion of the trust for income tax purposes.

³⁰ If the QPRT is a grantor trust as to principal, the §121 exclusion for capital gains on the sale of a principal residence should apply, assuming all other §121 requirements are met.

3. *The 7520 Rate:* A QPRT works best when the §7520 rate is high. For example, a 60 year old donor transfers property valued at \$100,000 into a QPRT with a retained 10 year term interest and a reversion. A §7520 rate of 6% yields a taxable gift of \$46,483 while a rate of 8% yields a taxable gift of \$38,641. The §7520 rate for a month is typically released mid-way through the previous month. Thus, it is good practice to plan on signing a QPRT at the end of the month. For example, assume the §7520 rate for June is 6.5% and the client is to sign the QPRT on June 30th. On or about June 15th, the July §7520 rate is released and assume it is 7%. The client may be willing to postpone the signing by a day or two to take advantage of the more favorable July rate.

4. *Appreciating Property:* The maximum estate tax savings is achieved when the real property going into the QPRT is expected to appreciate, because the gift is valued at the time of the transfer into trust, thus removing all subsequent appreciation from the donor's estate (assuming survival of the trust term).

B. Selecting the Trust Term

1. *Healthy Spouse:* As stated earlier, the donor's death within the term causes the inclusion of the residence in the donor's estate. Therefore, care should be taken to select an initial trust term which the donor is likely to survive. Where the residence is currently owned jointly by husband and wife, it is often advisable to have the property initially deeded to the spouse which has the longer life expectancy (often the wife), and thereafter to have that spouse deed the property into the QPRT.

2. *Risk Averse Client:* There are times where a client is unable or unwilling to assume the risk of death within the term. That client might then consider a sale of the remainder interest or, if the property has not yet been acquired, a split purchase.³¹

C. The Trustee: During the trust term, the donor or the donor's spouse may serve as trustee and exercise significant powers, since the trust property will be

³¹ Estate of Magin v. Commissioner, 184 F.3d 1074 (9th Cir. 1999); Wheeler V. United States, 116 F.3d 749 (5th Cir. 1997); and D'Ambrosio v. Commissioner, 101 F.3d 309 (3rd Cir. 1996), cert. denied, 520 U.S. 1230 (1997)

included in the donor's estate in any event if death occurs within the term. After the term, the donor or the donor's spouse may continue to serve as trustee as long as they do not possess any prohibited powers which might cause estate tax inclusion under §§2036-2041. The risk adverse client will not serve as trustee after the trust term, but may retain the power to remove a trustee and appoint a trustee who is not a related or subordinate party as defined by §672(c).³²

D. Personal Residence. A QPRT may be established with the donor's personal residence, a vacation home, or a fractional interest in a personal residence or vacation home.

1. *Land*: A personal residence includes appurtenant structures used by the donor³³ and adjacent land reasonably appropriate to the residence, taking into consideration the residence's size and location³⁴.

a. There are numerous PLRs regarding these issues³⁵ and it is a hard area to articulate firm rules.

b. Since each ruling is fact dependent, and because private letter rulings may not be relied upon by other taxpayers³⁶ clients should be informed in writing of the risks inherent in tricky fact patterns, and the availability of a PLR to put any fears to rest.

³² Rev. Rul. 95-58

³³ Reg. §25.2702-5(b)(2)(C)(ii)

³⁴ Reg. §25.2702-5(c)(2)(C)(ii)

³⁵ For example PLR 9639064 (Approving personal residence with apartment for caretaker and housekeeper, 43 acres, swimming pool, greenhouse, pool house, barn and corral, and tool shed). PLR 200211036 permitted the taxpayer to subdivide land so that one parcel qualified for a QPRT (main house, garage, and cottage) while the other parcel (second home, barn, and farm land) was held for another use.

³⁶ Section 6110(k)(3) states that a PLR may not be used or cited as precedent. However, with respect to the accuracy-related penalty, Reg. §1.6662-4(d)(3)(iii) permits PLRs issued after October 31, 1976 to be counted in determining whether there is substantial authority for the tax treatment of an item. And, under Reg. §1.6694-2(b)(2), PLRs also are authority for determining if a position on a tax return satisfies the realistic possibility standard.

2. *Vacation Home*: A vacation home meets the definition of “personal residence” if it comes within the meaning of personal use articulated in §280A(d)(1), with regard to §280A(d)(2)³⁷. This straightforward test requires that the donor uses all or any part of the vacation home for the greater of 14 days or 10% of the number of days during the year for which it is rented at fair rent.

a. Although the regulations seem to require that the vacation home not be occupied by anyone other than the donor, the donor’s spouse, or a dependent, and to be available to the donor at all times³⁸, an example in the regulations³⁹ endorses a QPRT where the donor rents the property for 6 months, during which one presumes the property not available to the donor.

b. There are numerous private letter rulings which permit the rental of a portion of the property while still qualifying as a “personal residence.”⁴⁰

3. *Cooperatives*: Stock ownership in a cooperative housing corporation qualifies as a personal residence.⁴¹

E. Multiple QPRTs: A donor “term holder” may hold interests in two personal residence trusts. The regulations provide that trusts holding fractional interests in the same residence are treated as one trust.⁴²

1. *Rolling QPRTs*: If a client is hesitant about selecting a trust term, she could fractionalize her interest in a residence and transfer the fractional interests into substantially similar QPRTs, the only difference being the trust term. For example a 50% interest into a 10 year QPRT

³⁷ Reg. §25.2702-5(c)(2)(i)(B)

³⁸ Reg. §25.2702-(b)(1)

³⁹ Reg. §25-2702-5(d)(Example 2)

⁴⁰ For example, PLR 200117021 (rental of vacation property for two months every year permissible); PLR 200112018 (property consisting of vacation house and guest house qualify as personal residence); PLR 9718007 (property occupied on and off by a caretaker and the donor’s friends qualify as personal residence); PLR 971004 (long-term rental of a small portion of property permitted).

⁴¹ PLR 9151046

⁴² Reg. §25.2702-5(a)(1)(last sentence)

and a 50% interest into a 15 year QPRT. By this technique, death in year 12 only results in estate inclusion of 50% of her interest, and the value for estate tax purposes of that 50% interest will be discounted for lack of marketability. And the two QPRTs are treated as one under the regulations.

2. *Where there are Two QPRTs, One QPRT Must Hold Principal Residence*: A donor may have two QPRTs as long as one holds the principal residence. For example, client has vacation property in Maine and California and a principal residence in Massachusetts. The first QPRT may involve any of the 3 properties, but the second QPRT must involve the Massachusetts principal residence if not utilized in the first QPRT.

3. *Wife Plus Husband Equals 3 QPRTs (And Sometimes 4)*: A wife and husband can put their principal residence into a QPRT, and each may put one vacation property into a QPRT. Where the wife and husband maintain separate residences, four QPRTs are possible.

F. QPRT and ILIT. Where a post-term lease is contemplated, one commentator has suggested the residence be transferred to an irrevocable life insurance (grantor) trust at the end of the trust term.⁴³ The payments of rent to the ILIT could be used to pay the premiums on a life insurance policy, or to fund roll-out of a policy subject to a corporate split dollar agreement.

G. Cascading Beneficiaries. At the time of the irrevocable QPRT's creation, it is impossible to predict the family's situation at the end of the trust term, especially if donor is young and a long trust term is feasible. For increased flexibility, at the end of the term the QPRT could distribute the residence to a complex trust that provides for several scenarios such as whether a lease is executed, or whether an intended beneficiary has creditor or marriage problems, or whether one or more beneficiaries want their interest bought out by the remaining beneficiaries, with the trustee given discretion (within guidelines) as to how to ultimately distribute the trust property. While such complexities could be provided for in the QPRT itself, the QPRT must be disclosed to the IRS with the gift tax return, and might itself be recorded if a nominee trust is not used, and therefore for privacy reasons a separate trust is advisable.

H. GST Tax Trap

⁴³ Albert R. Kingan, *Using a QPRT With An ILIT* 27 Est. Plan 486 (December 2000)

1. *General Background.* The generation-skipping transfer (“GST”) tax is a transfer tax separate from the estate and gift tax. Transfers subject to the GST tax are taxed at the highest estate tax rate, presently 55% (but this rate gradually decreases under the Act until repealed for transfers in 2010). To avoid the GST tax, a donor may presently allocate up to roughly \$1 million in GST exemption to a transfer into trust that is subject to the tax (or may be subject to the tax in the future) in order to obtain a trust “inclusion ratio” of zero, which means distributions from the trust will never be subject to the GST tax. However, GST exemption may not be allocated during an “estate tax inclusion period” (“ETIP”). Generally speaking, an ETIP is the period time in which the value of previously transferred property could be included in the transferor’s estate for estate tax purposes.⁴⁴

2. *ETIP and QPRTs:* The retained QPRT trust term is an ETIP because the donor’s death within the trust term brings the residence back into the donor’s estate. Allocation of GST exemption is permitted during an ETIP but it is not effective until the end of the ETIP period. Therefore, a QPRT established for the ultimate benefit of grandchildren can have dire consequences. At the end of the trust term, a GST tax “a taxable termination” occurs because at that point all remaining interests in the QPRT are held by grandchildren (“skip persons”). Assume the residence was valued at \$600,000 going into the QPRT but valued at \$1.4 million at the end of the trust term, which is also the end of the ETIP period. The donor would not have sufficient GST exemption at that time to give the QPRT an inclusion ratio of zero. A very bad result.⁴⁵

3. *Don’t Get Cute:* A QPRT is not the vehicle to play with GST. The remainder beneficiaries should be limited to children and other non-skip persons. Look to client assets other than the personal residence for GST exemption allocation.

I. Durable Power of Attorney: In a technical advice memorandum⁴⁶, the IRS approved a QPRT that was established by a donor’s attorney-in-fact under a durable power of attorney. The TAM sets forth the terms of the durable power relied upon the IRS.

⁴⁴ §2642(f)(3) and Reg. §26.2632-1(c)(2).

⁴⁵ For a similar scenario and (again) the power of judicial reformation, see Simches v. Simches, 423 Mass 683, 671 N.E.2d 1226 (1996).

⁴⁶ TAM 199944005

J. Joint QPRT: Although the author is hard pressed to think of a situation where a joint QPRT is more desirable than transferring separate fractional interests to separate trusts, those looking for some guidance can look at PLR 9626041 where the IRS approved a joint QPRT⁴⁷.

WARNING: While the information contained in this Outline is intended to be accurate, it is, nonetheless, presented with the understanding that it does not constitute legal advice or professional assistance in any manner, but rather is offered to guide the presentation and stimulate discussion. An independent investigation of the current law must always be undertaken before recommending any action or inaction on the basis of these materials.

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⁴⁷ Joint trusts are authorized by Reg. §25.2702-5(c)(2)(iv)