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Life Cycle of a QPRT: Don't Give Home Without One!

Natalie B. Choate, Esq.
Nutter McClennen & Fish LLP, Boston

Abbreviations Used in this Paper 2

I. INTRODUCTION 2
- A. What a QPRT is 2
- B. Why QPRTs exist 3
- C. Warning regarding transfer tax calculations 3

II. WHY QPRTS ARE THE BEST ESTATE TAX SHELTER 4
- A. Easy, safe, guaranteed 4
- B. How to save $864,000 of estate tax on a $1 million asset 4
- C. The QPRT valuation discounts 6
- D. Gift vs. split purchase of, or sale of remainder in, residence 6

III. THE BAD PART: GENERATION-SKIPPING PROBLEMS . . . . .
- A. The problem 9
- B. The solutions 11
- C. Who uses/should use which approach? 12

IV. DRAFTING FOR PROBLEMS YOU DIDN'T KNOW YOU HAD 13
- A. Multiple GRAT conversions 14
- B. QPRT sells residence; donor wants to buy TWO replacement residences 14
- C. What if spouse appoints to a skip person? 15
- D. What if donor stays in the residence after the end of the term? 15
- E. The Catch-22 of the donor's option to purchase 19
- F. What if all the donor's children die prior to expiration of the QPRT term? 21
- G. IRS sample QPRT form prohibits sales as well as commutations 21
- H. Limiting estate inclusion after GRAT conversion 22
- I. Income tax reimbursement language required—no, forbidden! 22
- J. Draft for amendability! 24
- K. Keeping grantor trust status after term ends 25

V. RESIDENCE; MORTGAGES; OTHER OPERATIONAL ISSUES 25
- A. Residence held in a single-member LLC 25
- B. Confusion between "used" and "held for use" as donor's residence 26
- C. Give adult children ownership interests, so they can occupy 27
- D. How do you buy a replacement residence that's more expensive? 27
- E. Why not use life insurance? 29
- F. Mortgaging the QPRT-owned residence 29

VI. PROBLEMS AT THE STARTING GATE 32
- A. QPRT deed never recorded 32
- B. Gift tax return never filed 32
- C. QPRT set up before residence exists 33

VII. 50 WAYS (WELL, 10 WAYS) TO LEAVE YOUR QPRT 34

Appendix A: Advice to Client re Unwinding QPRT Gift after the Term 39
Appendix B: QPRT–PRT Comparison 45
Appendix C: QPRT Private Letter Rulings 47

Abbreviations Used in this Paper

¶	Cross reference to a section of *The QPRT Manual*; see PART I below.
§	Reference to a section of the Code unless otherwise indicated.
Code	The Internal Revenue Code of 1986 as amended through September 2012.
ETIP	Estate tax inclusion period. See PART III(A).
GRAT	Grantor retained annuity trust. See PART I(B).
GST	Generation-skipping transfer. See § 2611 *et seq.*
IRS	Internal Revenue Service.
PLR	Private letter ruling issued by the IRS.
PRT	Personal residence trust. See PART I(B) and Appendix B.
QPRT	Qualified personal residence trust within the meaning of Reg. § 25.2702-5(c).
Reg.	Treasury Regulation.

I. INTRODUCTION

This paper includes updated excerpts from *The QPRT Manual* by Natalie B. Choate, Esq. (2004; Ataxplan Publications). The book may be purchased by on line at www.ataxplan.com. This paper contains cross references (indicated by the symbol "¶") to other parts of the book not reproduced here. The book contains 450 pages of text (6" X 9"), plus Table of Contents and Index, so could not be reproduced in its entirety for a seminar handout.

Cross references to "PART [number]" or "Appendix [letter]" refer to other sections of this paper.

Since publication of *The QPRT Manual*, I have received many questions about QPRTs. Some of these are reflected in the "Q&A" format of some portions of this paper.

A. What a QPRT is

A qualified personal residence trust, or "QPRT," is an irrevocable trust that holds no assets other than an interest in one personal residence of the trust donor (and certain other related assets; see ¶ 3.2.01(1) of *The QPRT Manual* for details), and that otherwise complies with the requirements of Reg. § 25.2702-5(c).

When an individual gives his residence to a QPRT, he makes a gift to his descendants, but also holds something back: Specifically, the donor reserves the right to occupy the residence for a certain period of time (the QPRT term). When that term expires, ownership of the residence will pass to the remainder beneficiaries of the trust. Typically, the QPRT also provides that, if the donor dies before the end of the QPRT term, the trust terminates and the residence reverts to the donor's estate. Therefore, the remainder beneficiaries receive the trust property only at the end of the term, and will not receive it even then if the donor dies prior to that time.

Why would someone make such an odd form of gift? Because the structure of our gift tax system makes the QPRT gift a "tax bargain" for the donor. The donor gets a discount, in computing the value of his taxable gift, for the interests he retains. If he survives the QPRT term, the entire

property is out of his estate—even though he paid gift tax on only a discounted value. If he does not survive the QPRT term, the residence comes back into his estate and the QPRT did not save any taxes; but the taxes in that case are no higher than if the donor had never made the gift at all.

So the answer to "Why?" is: The QPRT is a gift-tax bet that the donor cannot lose. Either the donor wins or he "gets his money back."

B. Why QPRTs exist

Once upon a time, donors could make gifts to their descendants of remainder interests in any type of property (marketable securities, a business, tangibles, etc.) and receive similar advantageous discounts for gift tax valuation purposes. Such gifts were called "GRITs" (for grantor retained income trust). In 1990, Chapter 14 was added to the Code, establishing certain "special valuation rules" for gift tax purposes. Among other provisions, the new § 2702 decreed that a gift to the donor's descendants would be valued without any discount for any interests retained by the donor other than interests that took the form of required payments of a fixed dollar or percentage amount. Thus the GRIT was killed and replaced by the grantor retained annuity trust (GRAT) and grantor retained unitrust (GRUT).

But § 2702 contained an exception. The new valuation rule would not apply to a trust that contained no asset other than an interest in a personal residence of a person holding a term interest in the trust. § 2702(a)(3)(A)(ii). The IRS followed with a regulation expanding the statute's limits, allowing the valuation discounts to be applied to a trust that held a residence and certain permitted amounts of cash (for expenses, and/or sale proceeds of the residence, etc.) IF the trust complied with the details of this regulation. See Reg. § 25.2702-5(c). So the "qualified personal residence trust" (QPRT) was born. A "personal residence trust" (PRT) is slightly different; see Reg. § 25.2702-5(b) and Appendix B.

C. Warning regarding transfer tax calculations

This paper "went to bed" in October 2012. Accordingly, the estate tax and generation-skipping transfer (GST) tax laws and rules are assumed to be as they are currently. The exception is the "client memo" in Appendix A which is based on 2009 estate tax law and an assumed continuation of 2009 estate tax law rules (expectations that have not come to pass as of the time this paper is written). It is expected that estate and gift tax rules will change effective in 2013 but the new form is as yet unknown.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107-16) ("EGTRRA") substantially amended the federal estate and GST tax laws beginning in 2002. However, EGTRRA contained a "sunset" provision, § 901, eliminating all of EGTRRA's changes effective beginning in 2011. "TRUIRJCA" (in 2010) extended the sunset date until 12/31/12. The effect of this sunset provision is to reinstate, for deaths and transfers in 2013 and later, the estate and GST tax rules that were in effect prior to EGTRRA, including an estate tax exemption of only $1 million and a top tax rate of 55%.

All estate tax calculations in this paper are based on the reinstatement of pre-EGTRRA rules and rates (except as noted with respect to Appendix A). These calculations may or may not be accurate based on the state of the law as it actually exists at the time this paper is read.

All tax calculations were performed using the two software programs that are indispensable for estate planners, the highly recommended *NumberCruncher*® (www.leimberg.com) and *TigerTables*® (www.tigertables.com). These programs overlap; I use each to check the other.

II. WHY QPRTS ARE THE BEST ESTATE TAX SHELTER

A. Easy, safe, guaranteed

There are few easy ways to reduce estate taxes. “Annual exclusion gifts” to family members are a good start, but must continue over many years to make a dent in the tax bill for a large estate. Life insurance offers an advantageous way to fund the tax bill, but does not actually reduce the bill. Family limited partnerships face serious risk of IRS challenge. GRATs depend for success on having investments that outperform the rate of return the IRS uses to value partial property interests. Charitable split-interest gifts provide tax relief only for the charitably inclined client.

Enter the QPRT. It is a genuinely tax-favored way of making use of the client’s gift tax exemption. It is not an exotic or cutting-edge device that will generate an astronomical legal bill. Although the IRS can quibble over details of any gift, the QPRT is a “safe harbor” technique, following a detailed road map laid out by the IRS in its own regulations, so there is no risk of IRS challenge to the basic plan. Although it is most favorable in a high-interest-rate climate, it is still a tax bargain even when interest rates are low. It does not depend on achieving a particular investment return; it works even if the asset stays flat (or declines somewhat) in value.

The QPRT does require a particular type of asset namely, a residence; but nearly everyone who is wealthy enough to care about estate taxes owns a residence. The QPRT’s risks are easily understood, and some can be insured against. The tax savings can be significant.

B. How to save $864,000 of estate tax on a $1 million asset

See PART I(D) regarding the tax rates and computation software used in this example.

Jeanette is a 65-year-old widow with four adult children. Having seen her parents’ estates devastated by estate taxes, she is determined to avoid that result for her own children. She meets regularly with members of her estate planning team (lawyer, accountant, and financial planner/ investment advisor) to discuss estate tax-reduction strategies. One result of these discussions is that, in November, 2010, Jeanette gives her residence, a condominium worth $1 million, to a qualified personal residence trust, or QPRT (pronounced “KEW-pert”).

The trust provides that Jeanette may continue to live in the condo rent-free for the 15-year term of the trust. During that term, Jeanette will be sole trustee of the trust, and continue to pay all expenses of the condo (such as property taxes and condo association fees), so for the next 15 years her living arrangements will not change. If Jeanette decides to sell the condo, the sale proceeds will belong to the trust. In that case, the trust can either reinvest the proceeds in another residence for Jeanette to live in, or pay Jeanette a cash annuity for the balance of the 15-year term.

At the end of the 15 years, if Jeanette is still living then, things will change. At that point, her four children become the "beneficial owners" of the trust. Jeanette will continue as trustee, and she will still have the option to live in the trust-owned residence, but she will have to start paying rent to the trust just as any other tenant would. The rent will flow through to her children as trust beneficiaries.

Because Jeanette has made a gift to her QPRT, she must file a gift tax return for 2010. Even though the condominium she gave away is worth $1 million, the value of her gift, for gift tax purposes, is only about $459,000. There is no gift tax payable because her gift is less than her $1 million lifetime gift tax exemption amount.

While Jeanette is setting up her QPRT, her same-age friend Marla, who owns an identical condo unit down the hall, and is just as wealthy and estate tax-averse as Jeanette, is doing no estate planning. Marla is going to "wait and see"—maybe the estate tax will go away.

Flash forward 25 years, when Jeanette and Marla die. It turns out the estate tax never was repealed. Jeanette continued to live in her trust-owned condominium for the rest of her life, paying rent to the trust for her occupancy for the last 10 years. Both women's condominiums appreciated about four percent per year and are now worth $2.6 million each. Each woman has about $7.4 million of other net assets in her federal gross estate. Marla's condominium is included in her estate for estate tax purposes. Jeanette's condo, though, is out of her estate; her children inherit it without paying any estate tax. As a result, Marla's children pay $3,727,400 of federal estate tax; Jeanette's children pay only $2,863,400, a savings of $864,000. *The QPRT saved $864,000 of federal estate taxes for Jeanette's children.*

That's not even counting the $100,000 a year in rent Jeanette paid to her children for the 10 years that she lived after the end of her 15-year QPRT term. The children had to pay income tax on that $1 million of rental income, but (if their income tax rate is lower than the estate tax rate they would have had to pay if they had *inherited* this money from Jeanette rather than receiving it as rent) the rental arrangement saved substantial additional taxes—without even considering the appreciation that the children earned by investing the rent payments they received from Jeanette. That appreciation would have been part of Jeanette's taxable estate had she not paid rent to her children.

The QPRT Jeanette created in 2010 does have some quirks. If Jeanette had died before the end of the 15-year term, the trust's assets would have "reverted" to her estate; in effect the trust would have been cancelled in that case, and not produced any estate tax savings. Another quirk is that if any of Jeanette's children had died prior to the QPRT term's end, that child's issue would not have received a share of the QPRT; the trust would pass only to Jeanette's living children (see PART III). These odd provisions were required (under our complicated tax law system) to preserve the tax-saving objective of the trust. Jeanette blunted their effect by buying some term life insurance: on her own life (to provide the children with a cash payout if they did not receive anything from the trust because she didn't survive the QPRT term), and on her children's lives (so that if a child did die prematurely, and lost his or her share of the QPRT, the child's heirs would receive insurance cash instead).

C. The QPRT valuation discounts

Jeanette's QPRT saved estate taxes because Jeanette received certain "discounts" in valuing her gift to the QPRT. Even though the residence she contributed to the trust was worth $1 million, for gift tax purposes it was only worth $459,000 because of these discounts.

The discounts represent Jeanette's retained interests in the residence. Since she retained the right to live in the residence for 15 years, she got a discount for that "retained income interest." After all, her children have to wait 15 years to receive the residence, so they are not receiving something worth $1 million right now. It's as if Jeanette gave them only part of the residence; she kept part of it for herself, so she doesn't have to pay gift tax on that part because she didn't give it away.

The other discount Jeanette received in computing her gift taxes was a discount for her "retained reversion." She retained the right to get the property back (i.e., to have it come back into her estate, where it could be used to pay her debts or where she could change her mind about who to leave it to) if she happens to die in less than 15 years.

Because of these discounts, Jeanette pays gift tax on only a fractional part of the residence's value. Yet if she survives for 15 years the entire asset is out of her estate, not just the fractional part she paid gift tax on.

D. Gift vs. split purchase of, or sale of remainder in, residence

This paper focuses on a parent's GIFT of his residence to a QPRT. A QPRT can also be used in a different way: For the split purchase of a life estate and remainder in a residence (by a parent and issue respectively), or for the sale of a remainder interest in a personal residence by a parent to his/her issue (or a trust for their benefit)

Larry and Kitty Example: Trust X purchases a residence, "Hellas Acres," for $1 million in November 2010. The § 7520 rate for that month is two percent. Trust X provides that Larry (age 65) has the right to exclusive occupancy of the residence for life, with all the rights and obligations of a life tenant in real estate under applicable state law. Trust X complies with the IRS's definition of a qualified personal residence trust.

Larry moves into Hellas Acres on the day of the purchase, and from then on it is his principal residence. Trust X provides that, upon Larry's death, Hellas Acres will pass to his daughter Kitty (or to Kitty's estate, if Kitty is not then living). The $1 million purchase price for Hellas Acres is supplied to Trust X by Larry and Kitty in proportion to the relative values of their interests in the trust as determined by IRS tables. The IRS tables provide a life estate factor of .28589 for a person age 65, meaning that Larry's life estate in Hellas Acres is worth $285,890 (.28589 × $1,000,000); accordingly, Larry contributes $285,890 towards the purchase price. Kitty's interest is a remainder interest after the life of a person age 65; this is the inverse of the life estate factor, or .71411, so Kitty contributes $714,110 towards the purchase price.

Here is the expected tax treatment of this transaction. The special valuation rules of § 2702 do not apply to this trust because the only asset of the trust is the residence of a person holding a term interest in the trust, i.e., Larry. § 2702(a)(3)(A)(ii). If the trust did not fit within the "personal

residence trust" exception to § 2702, the transaction would be treated as a transfer of the entire property to the trust by Larry, followed by a sale of the remainder to Kitty. § 2702(c)(2). The § 2702 special valuation rules (see PART I(B)) would then apply, eliminating the tax benefits of the transaction.

On Larry's death, his life estate expires, so there is no asset to be included in his estate from this transaction. The $285,890 he contributed to the trust has been removed from his estate without payment of any transfer tax.

Larry's and Kitty's position is that neither Larry nor Kitty made a gift to anybody upon creation of Trust X because each contributed only the exact number of dollars that corresponded to the value of his or her own interest in the trust. See *Magnin v. Comm'r*, 184 F. 3d 1074 (9th Cir. 1999); PLRs 9841017, 2001-12023. When you pay full consideration for what you receive, there is no gift. Therefore, the theory of this device is that the IRS cannot attack the transaction as a gift (by Larry) with retained life estate that would be includible in his estate under § 2036 (see PART IV(D)).

Does this really work? Despite some taxpayer victories in court, the IRS might attack the split-purchase on the grounds that the life beneficiary (Larry in this example) has not paid "full consideration" for his interest unless he contributed the *full value of the property* (as opposed to merely the value of his life interest). The IRS, in PLR 2001-12023, refused to rule on how § 2036 applied to the split-purchase transaction. Most experts think the IRS would lose on this issue and that the split purchase is therefore probably a safe technique. In PLR 2001-12023, the IRS conceded that there was no gift involved; if there is no gift involved then § 2036 does not apply.

One quirk: in PLR 2001-12023, the QPRT provided that, if the residence was sold, the proceeds had to be invested in a replacement residence. There was no requirement or option for the trust to convert to a GRAT (see PART IV(A)). The reason for this was the necessity of avoiding estate inclusion under the Code's annuity provision (§ 2039); see PART IV(H).

Practitioners view the split purchase technique (or sale of remainder, in the case of an existing residence; see below) as having four advantages over the QPRT, namely:

1. **No taxable gift.** Unlike the QPRT, the split purchase does not require the parent to pay gift tax or to use any of the parent's gift tax exemption. There is no gift at all, since each party pays consideration corresponding to the value of his or her interest in the trust.

2. **No requirement parent survive.** For a QPRT to work to save any taxes, the parent must survive the QPRT term. See ¶ 4.6.01 of *The QPRT Manual*. Therefore, with a QPRT, it is hoped that the donor lives for a long time after the gift, at least until after the term expires. With a split purchase, in contrast, the sooner the parent dies after the transaction, the better (at least tax-wise). This makes the split purchase more appropriate than the QPRT for a parent who has poorer-than-average health, as long as he is not "terminally ill." (Though generally the IRS actuarial tables *must* be used for valuing interests with actuarial contingencies, these tables *may not* be used to value an interest dependent on the life of someone who is "terminally ill." A reversion, remainder, or life income interest dependent on the life of someone who is terminally ill must be valued based on his *actual state of health.* A person is terminally ill if "there is at least a 50 percent probability that…[he] will die within 1 year." Reg. § 25.7520-3(b)(3).)

3. **No "ETIP rule."** Because of the "ETIP rule" (see PART III(A)), a QPRT cannot be used to leverage the parent's GST exemption. A split purchase, in contrast, can be done jointly between the parent and a grandchild or generation-skipping trust.

4. **Parent does not have to pay rent.** With a split purchase, since the parent has purchased his life estate for full consideration, you avoid the "distasteful requirement" [description used by M. Gordon "Bud" Ehrlich, Esq., Boston, Nov. 7, 1999] that the parent must pay rent to his children if he wants to continue living in the residence after the QPRT term ends (see PART IV(D)). Since there is no gift involved in a split purchase, there is no need to be concerned about a "gift with retained life estate" resulting in estate inclusion.

All of the foregoing is true and sounds great, but there are drawbacks.

One drawback of the split purchase technique is that the remainder beneficiaries must come up with the money to pay for their share of the purchase price. If the remainder beneficiaries cannot afford the purchase, then it may be necessary for the parent to give the remainder beneficiaries sufficient assets to enable them to buy into the transaction. This will involve payment of gift taxes, thus eliminating one supposed advantage of the split purchase over the QPRT; it also may create a problem under the "step transaction" doctrine (see ¶ 4.4.06 of *The QPRT Manual*), if the IRS decides that what "really" happened was that the parent gave the property to the children and retained a life estate (resulting in estate tax inclusion under § 2036).

Another drawback is, in an environment of historically low interest rates, the relative value of the remainder interest increases, thus increasing the price the children must pay to buy that interest. Split purchases, like QPRTs, are more attractive when high interest rates make remainder interests "cheap."

If the parent already owns the residence, practitioners accomplish the same results obtained with a split purchase by having parent convey the property to a personal residence trust (PRT; see Reg. § 25.2702-5(b) and Appendix B) in exchange for cash paid to the parent by the PRT's remainder beneficiary equal to the value of the remainder; see PLR 2007-28018 for an example of this technique. In this ruling, as in PLR 2001-12023 discussed above, the IRS refused to rule on how § 2036 would apply at the parent's later death. Yet the IRS conceded that there was no gift involved; if there is no gift involved then § 2036 does not apply. PLRs 2007-28018 and 2008-40038 each similarly "blessed" the sale of the remainder interest in an existing residence, using a QPRT.

If the donor's descendants have enough money to chip in for their share, is the split purchase through a QPRT (or sale of a remainder in a QPRT) a better tax deal than a gift of the residence to the QPRT with no cash back? That is questionable. Despite its sex appeal (no gift tax! no rent to be paid! no estate inclusion!), the split purchase does not necessarily save any taxes. In contrast, a QPRT is virtually guaranteed to save taxes, if the donor survives the term and dies with an estate large enough to be subject to estate taxes. The split purchase may save estate taxes only if the parent dies prematurely, and could cost the family *increased* taxes if the parent lives longer than IRS actuarial tables predict. Thus, clients considering this technique should carefully examine the economics before proceeding.

Here is why the split purchase is not a sure-fire tax bargain. Suppose Larry lives exactly as long as the IRS tables assume he will, which is about 17 years. (The factor for an income interest for a fixed term of 17 years (.28537) is almost exactly equal to the factor for a life estate at age 65 (.28589).) Kitty could have invested the money she put into this venture ($714,110), for the same period of time, in some other asset that returns two percent. At the end of the 17 years, Kitty's investment would have grown to about $1 million. So Kitty has received absolutely nothing from the split purchase that she couldn't have received with some other investment that gave her an investment return equal to the § 7520 rate over the same period of time that the IRS predicts Larry is going to live.

Split-purchase-lovers counter this by arguing that, "The residence will not stay flat in value; it will appreciate, and all the excess value will pass to Kitty, transfer tax-free!" If we assume that residences always appreciate, or at least that this residence will appreciate, whatever appreciation occurs during Larry's life will eventually pass to Kitty without transfer tax.

Of course, Kitty could have invested her $714,110 in some other residence (that Larry wasn't living in) and gotten the same wonderful rate of appreciation; but with the split purchase Kitty is getting (eventually) all the appreciation on a *$1 million investment* and she only had to put up $714,110. With the split purchase, Kitty has no expense associated with acquiring the appreciation that is expected to occur on the part of the purchase financed by Larry (and no transfer tax cost on any of the appreciation). Thus, the split-purchase can be a transfer tax bargain *if* the residence appreciates. Kitty of course loses if the residence *de*preciates; but that risk exists with any investment.

Kitty's other risk is that Larry could live longer than the IRS tables predict. The IRS tables predict that Larry is going to live to age 82. If Larry lives to age 92, Kitty's rate of return declines because she has had to wait an extra 10 years to get paid. On the other hand, if Larry dies prematurely, Kitty's rate of return increases.

The bottom line: The split purchase of (or sale of remainder interest in) a personal residence is most attractive for a parent who: owns or is contemplating buying a new residence that is expected to appreciate in value in the future; has children, grandchildren, or trusts for their benefit that can afford to buy the remainder interest; does not want to have to pay rent to live in his home; is willing to give up the future appreciation to (and share control with) his family members or a fiduciary; and is unlikely to live longer than the average life expectancy for his age but is not "terminally ill" (see PART II(D), #2, for definition).

III. THE BAD PART: GENERATION-SKIPPING PROBLEMS

For complete explanation of how the GST tax applies to QPRTs, see Chapter 5 of *The QPRT Manual*, from which this PART III is excerpted.

A. The problem

QPRTs would be easy to draft if it weren't for the generation skipping transfer (GST) tax. The GST tax operates in an odd and frustrating way as applied to QPRTs, creating a messy problem if a child of the QPRT donor dies after the commencement of the QPRT term. While that will rarely

happen, it *could* happen with any QPRT. Accordingly, QPRTs must be drafted so that, if this unfortunate event does occur, it will not have disastrous tax consequences.

The "ETIP rule" and "deceased parent exception" combine to create the most difficult planning problem we have with QPRTs. The ETIP rule makes it disadvantageous to use QPRTs as a generation-skipping vehicle; but the way the deceased parent rule operates with a QPRT makes it hard to prevent generation-skipping transfers from occurring under the trust if a child of the donor dies after the commencement of the QPRT.

The QPRT is drafted, signed, and funded at the beginning of the QPRT term, yet (thanks to the way the ETIP and predeceased parent rules work) this irrevocable document must embody GST planning based on valuations and beneficiary identities that will not be finalized until (at the earliest) the end of the QPRT term.

It would be nice if the QPRT could be used to leverage the donor's GST exemption the same way it leverages the donor's gift tax exemption (see PART II(B)) but it does not work that way. For *gift tax* purposes, the donor's gift transfer is complete when the residence is transferred to the QPRT. Reg. § 25.2511-2(b). The *gift tax* value is finally established as of that date, and that value is a discounted value because of the donor's retained interests.

However, the donor cannot make the QPRT forever GST tax-exempt, at the time of his gift, by allocating to the trust an amount of his GST tax exemption corresponding to the discounted gift tax value. What's different about QPRTs is the "ETIP" (estate tax inclusion period) rule. The "ETIP" is the period during which, if the donor died, the transferred property would still be included in his estate (or his spouse's estate). § 2642(f)(3), (4); Reg. § 26.2632-1(c)(2). The Code provides that, for purposes of determining the trust's inclusion ratio, "any allocation of GST exemption to such property shall not be made before the close of the estate tax inclusion period…." § 2642(f)(1).

With a QPRT, by definition, the QPRT property will be included in the donor's gross estate if the donor dies during the QPRT term, under § 2036(a)(1), as a gift with retained possession (see ¶ 4.6.01 of *The QPRT Manual)*. Thus, a QPRT is subject to the ETIP rule for the entire QPRT term. *Any allocation of GST exemption to a QPRT cannot take effect until the end of the QPRT term.*

The ETIP rule poses a major problem for QPRTs: The valuation of the trust assets for purposes of allocation of GST exemption cannot occur until the end of the term, *at which time the valuation discounts for the donor's retained interests will no longer be available* (because those retained interests will have expired) *and* the value of the residence may have increased.

Under the so-called "deceased parent exception," if there is a child of the donor who is already deceased at the beginning of the QPRT term, the descendants of that deceased child "move up" a generation. For GST tax purposes, they are assigned to a generation one level above their real level. § 2651(e)(1). Thus, children of the donor's deceased child will not be "skip persons," and later distributions to them will not be taxable as generation-skipping transfers. But generation assignment using this deceased parent exception takes place *at the time the transfer is complete* for gift (or estate) tax purposes. Accordingly, in case of a gift to a QPRT, generation assignments take place when the QPRT is created, *not* when the QPRT term expires.

However, if a child of the donor dies *after* the commencement of the QPRT, his or her descendants do *not* move up a generation. So, the children of a child of the donor who dies after the commencement of the QPRT term are still skip persons. Thus there is a disconnect between the time generation assignments are irrevocably fixed (at the commencement of the QPRT term) and the time

that distributions to the donor's grandchildren (if permitted or required by the trust) could occur (namely, at or after the expiration of the QPRT term).

This disconnect creates a major vulnerability for any QPRT that uses the most popular form of ultimate wealth-distribution (in non-QPRT trusts), which is "to my then-living issue." If the QPRT simply requires distribution "to my then-living issue" at (or after) expiration of the QPRT term, and a child of the donor has died after the date of the original QPRT gift, there will be a "taxable termination" for GST purposes at the end of the QPRT term, as funds flow to the children of the deceased child. § 2612(a).

B. The solutions

When drafting a QPRT, the practitioner should take care to dispose of the remainder interest in as GST tax-efficient a manner as possible in light of the client's circumstances and goals. Because of the ETIP rule and deceased child problem, GST planning for QPRTs focuses on either avoiding generation skipping altogether (preferred for most clients) or trying to minimize the amount of exemption needed to shelter any shares passing to skip persons (best for some clients).

This PART III(B) summarizes the recommended, acceptable, and not-recommended approaches. Each approach has its advantages and drawbacks; which solution is best for which client depends on that client's degree of wealth and attitude towards the GST exemption. The approaches are listed more or less in the order of their potential transfer tax efficiency. However, transfer tax efficiency is not the only thing to be considered when drafting a QPRT. PART III(C) provides a brief guide to who uses (or should use) which approach.

★★ Recommended: Approach #1: QPRT remainder passes to "spray" trust for issue, if a child died during QPRT term. Under this flexible and tax-efficient Approach, the QPRT remainder passes outright to the donor's issue living upon termination of the trust—*unless* that disposition would result in a GST-taxable event (because a child of the donor died after the QPRT was initiated), in which case the trust property stays in a "continuation trust" for two more years. The continuation trust is a "spray" trust for the donor's issue, that allows the trustee, working with the donor and/or the donor's spouse, to use the distribution power to cause each descendant to receive an equal amount of assets, hopefully without incurring GST tax or using any GST exemption.

★★ Recommended: Approach #2: QPRT remainder passes only to living children. Under this Approach, the QPRT assets pass *only* to the donor's living children (i.e., only to non-skip persons) at the end of the QPRT term, so no GST exemption will need to be allocated to the QPRT under any reasonably foreseeable circumstances. The donor would then plan to make compensating gifts from her other assets to the issue of a child who died after the QPRT began (if that contingency occurred).

★★ Recommended: Approach #3: Force deceased child's share of QPRT remainder into the deceased child's gross estate, to make him the new "transferor" of that asset for GST purposes. As with Approach #2, the goal of this Approach is to avoid the necessity of allocating any of the QPRT donor's GST exemption to any part of the trust. Unlike #2, this Approach seeks also to avoid the need to make compensating gifts (from other assets) to the issue of a child who dies during the

QPRT term. Under Approach #3, if a child of the donor dies after commencement of the QPRT term, leaving issue, the share of the deceased child is left to the deceased child's estate. The theory is that, because the deceased child's share of the QPRT is now includible in his or her federal gross estate, the deceased child becomes the new "transferor" of the asset for GST purposes, and thus transfers from him to his children (the donor's grandchildren) are not generation-skipping. For a variation of this Approach, see PLR 2006-17002 (Appendix C), where two QPRTs that were to pass to the donor-spouses' four daughters would pass to the estate of the last daughter to die if all daughters died before the end of the QPRT term.

★ **Acceptable: Approach #4: Have separate trust shares for each child from the outset; allocate some of the donor's GST exemption to the separate share of a deceased child, if necessary.** This Approach is suitable for a donor who values simplicity, and having the QPRT pass to all her issue, more than making the best possible use of her GST exemption. Under this Approach, the donor creates a separate QPRT (or a separate and independent share within a single QPRT; see ¶ 5.6.02 of *The QPRT Manual*) for each of her living children, then gives a fractional portion of the residence to each such trust or share. Each child will receive his or her share upon expiration of the QPRT term; however, if a child dies after commencement of the QPRT term, and as a result the deceased child's share passes to the deceased child's issue, the donor will allocate some of her GST exemption to the share passing to the issue of the deceased child after the ETIP expires.

☹ **Not recommended: QPRT remainder left entirely to skip persons.** For reasons explained at ¶ 5.2.01 of *The QPRT Manual*, the QPRT should not be structured as a generation-skipping trust for the client's grandchildren and more remote descendants.

☹ **Not recommended: QPRT remainder left to "my then living issue."** For reasons explained at ¶ 5.2.02 *The QPRT Manual,* the QPRT remainder should not be left simply to "my issue then living." For a client who wants the QPRT to pass to all his issue, use Approach #4 instead.

C. Who uses/should use which approach?

Which Approach should practitioners use for which client?

A wealthy, tax-sensitive client typically wants to maximize the value of his GST exemption. Such a client does not want to use any of his GST exemption for a QPRT. This type of client should use Approach #1, #2, or #3.

A less wealthy or less tax-focused client may want his QPRT, like the rest of his estate, to pass to his issue, in the simplest most straightforward way possible; though interested in reducing estate taxes, so he can pass as much of wealth as possible to his children, maximizing the wealth passing to grandchildren is not one of his goals. This client may prefer Approach #4.

Some practitioners would like to use one approach for all their clients. Unfortunately there is no one simple risk-free works-great-for-everybody solution to the QPRT-GST problem. Approach #1 comes closest, being the most sophisticated and flexible, but Approach #1 probably does not make sense for a client who has only one child (see PART IV(F)), for whom Approach #3 should be considered.

On the other hand, Approach #1 is the only one that does not require special custom drafting to accommodate the situation of a client who has a child who died before the QPRT commences, leaving issue, so it is particularly recommended in that situation.

A major attraction of Approach #2 is that the donor does not have to deal with anyone other than his own children, making this appealing for a donor who plans to continue living in the house the rest of his life and prefers not to have to deal with an independent trustee or with possible heirs of a deceased child.

In the real world, which approach *do* most donors use?

Approach #1, while it is used by expert practitioners, does not appear in private letter rulings. Approach #4 also does not explicitly appear in private letter rulings, but then again many rulings do not specify the remainder provisions of the QPRT.

Approaches #2 (leave QPRT to living children only) and #3 (force remainder into the deceased child's estate) are well-known and apparently popular. A survey of published letter rulings reveals that many donors adopt Approach #2: see PLRs 9425028, 9441039, 9645010, 9730013, 9739010, 2001-21015.

The QPRT forms in a leading treatise, Howard Zaritsky's *Tax Planning for Family Wealth Transfers: Analysis with Forms* use Approach #3 only. Approach #3 was used in PLR 2001-12018.

There are many letter rulings in which the QPRT is described as passing to "issue" (not merely to "children"), which may mean that these practitioners used Approach #4 or may mean that they are ignoring the GST problems; see PLRs 9722009, 9544018, 9609015, 9626041, 9714025, 9718007, 9741004, 9817004, 9818014, 2005-19006, 2006-13006, and 2007-16008.

IV. DRAFTING FOR PROBLEMS YOU DIDN'T KNOW YOU HAD

In 2003, the IRS issued a "Sample Qualified Personal Residence Trust" suitable for a one-donor QPRT. Rev. Proc. 2003-42, 2003-1 C.B. 993. A trust that is "substantially similar" to the IRS sample will be recognized by the IRS as a valid QPRT. Trusts that contain additional "substantive" provisions not explicitly blessed in the IRS sample form, or that omit provisions included in the IRS sample, are not necessarily disqualified—they are just not "assured of qualification under the provisions" of Rev. Proc. 2003-42. Either way, the IRS "generally will not issue a letter ruling on whether a trust with one term holder qualifies as a QPRT." Rev. Proc. 2008-3, 2008-1 I.R.B. 110, Sec. 4.01(52). (The IRS has made an exception to this no-rulings rule for "reverse QPRTs"; see discussion of PLR 2008-14011 in Appendix C.)

How important is it for a QPRT to follow the IRS sample QPRT form language? Not very. Drafting a trust that complies with the QPRT regulation is not difficult. The advantage of using the IRS sample language is that doing so should make any eventual audit of the trust that much smoother; the auditing agent can easily compare your document with the IRS sample, and see that your QPRT conforms and qualifies.

On the other hand, without tweaking, the IRS form will not work in certain cases (such as when the QPRT is to be funded with a fractional interest in the residence rather than the entire residence, or when part or all of the residence may be rented to others). Also, the IRS form does not deal with the most difficult part of drafting a QPRT, the disposition of the remainder interest (see PART III). Finally, drafters may consider changes in the IRS form to deal with various points not

covered in the IRS form (see B–F below) or because the IRS form goes beyond the requirement of the QPRT regulation in prohibiting sale (as well as "commutation") of the donor's interest (see "G" below).

A. Multiple GRAT conversions

For explanation of why a QPRT might have to convert to a GRAT, see PART VII, discussion of "Option #1."

What if the QPRT sells the residence, reinvests part of the proceeds in a replacement residence and converts the rest of the proceeds to a GRAT, and then later the QPRT sells the replacement residence, and all or part of the proceeds of that second sale are also to be converted to a GRAT? The QPRT regulation does not mention this subject, but Rev. Proc. 2003-42 does: It says appropriate adjustments must be made to the GRAT conversion formula in the case of a second or later GRAT conversion, though it does not say what those adjustments are.

The following is an excerpt from IRS's sample QPRT form, also used in the sample QPRT trust in The QPRT Manual:

MULTIPLE GRATs. Because it may be possible to have more than one cessation of qualification during the term of the QPRT, the Trustee shall create and fund a separate GRAT for each cessation and each GRAT shall be administered as a separate share of the trust in accordance with Article [number] below.

B. QPRT sells residence; donor wants to buy TWO replacement residences

Shirley Example: Shirley contributes the big old family home in Suburbia, Massachusetts, to a 10-year QPRT. In Year 6 of the term, she decides to sell the big old family home for $800,000 and replace it with two new residences, a $450,000 condo apartment in Boston and a $350,000 condo apartment in Sunny, Florida. The QPRT can sell the old house and buy *one* of the new residences as a replacement, but it cannot buy both of them, due to the requirement in the regulations that the governing instrument of a QPRT "must prohibit the trust from holding, for the entire term of the trust, any asset other than *one* residence...." Reg. § 25.2702-5(c)(5)(i) (emphasis added). The balance of the proceeds must be converted to a GRAT.

This will be an awkward transaction because, in order to purchase both new residences, Shirley will have to find the resources elsewhere to buy the second one; she cannot use the proceeds of the sale of the big old family home to buy both. Presumably she will use part of the proceeds of the sale of the big old family home to buy the more expensive of the two replacement residences (the $450,000 condo in Boston). Perhaps she can take out a mortgage to buy the condo in Florida, and use the annuity payments made to her under the GRAT to repay the mortgage.

Shirley's dilemma could be avoided by splitting the QPRT, prior to sale of the original residence, into two separate identical trusts, each holding an undivided interest in the original residence. This type of split-up or "severance" would have to be authorized by the trust instrument, state law, or judicial proceedings. Then the two QPRTs acting together could sell the old residence,

and each trust could reinvest its share of the proceeds in a different replacement residence. Possibly a severance of the trust into two identical trusts, each holding a proportionate share of the sale proceeds, would work even after the original residence was sold, with each of the new trusts buying a replacement residence.

The following is an excerpt from the sample QPRT trust in The QPRT Manual:

SEVERANCE OF TRUST. The Trustee may at the time of establishing any trust or trust share under this instrument or at any later time divide such trust or share into two or more separate shares or trusts. Each such separate share or trust shall be held and administered as a separate trust, on all the same terms and conditions provided for such trust or share prior to its division, but the Trustee may exercise its discretion differently with respect to the separated shares regarding such matters as distributions and investments.

C. What if spouse appoints to a skip person?

In many cases, the QPRT donor gives his spouse a special power of appointment by will over the QPRT property. The intent is to increase the flexibility of the estate plan; the spouse may be able to make "corrections" that the donor is not allowed to make. But what if, upon reading the spouse's will, it is discovered that the spouse appointed the QPRT to grandchildren, causing a taxable termination? To avoid that, limit the spouse's power so he/she can appoint only to non-skip persons!

The following is an excerpt from the sample QPRT trust in The QPRT Manual:

UPON SPOUSE'S DEATH. Upon the Transferor's spouse's death (or upon the expiration of the term of the QPRT otherwise than by reason of the Transferor's death, if such expiration occurs later than the death of the Transferor's spouse), the Trustee shall distribute the principal of the trust to such person or persons, and in such proportions, as the Transferor's spouse shall have appointed, by written instrument delivered to the Trustee during the Transferor's spouse's lifetime, from among the class consisting of the Transferor's issue who are not "skip persons" (within the meaning of Chapter 13 of the Code) with respect to the Transferor's gift(s) to this trust. Any property not fully and effectively so appointed by the Transferor's spouse shall be administered as provided in Section [number].

D. What if donor stays in the residence after the end of the term?

If a parent gives his residence to his children, subject to "an understanding by all parties at the time of the transfer that the [parent] would retain the use of the property," and in accordance with this understanding the parent continues to occupy the residence rent-free for the rest of his life, the residence will be included in the parent's gross estate on his death. This is a classic gift-with-retained-life-income-interest, fully includible in the estate under § 2036. Rev. Rul. 70-155, 1970-1 C.B. 189. Furthermore, if a parent gives his residence to his children, and the parent continues to

occupy the residence rent-free, the IRS *infers the existence of such an understanding* among the parties, even if there is nothing in writing. Rev. Rul. 78-409, 1978-2 C.B. 234.

This imputed-understanding rule applies just as much in the case of a gift of a residence *made via a QPRT* as it does to an *outright gift* of a residence. Once the QPRT term ends, if the parent-donor is to continue living in the residence, it is *essential* that the parent-donor pay fair market value rent for his use; see PLR 2008-22011 (Appendix C). (For exception to this rule when the donor's spouse has occupancy rights after the end of the QPRT term, see ¶ 3.6.03 of *The QPRT Manual*.) This rental arrangement should be established in writing *prior to the end of the QPRT term* so it is obligatory on the parent-donor the moment the parent's occupancy rights under the QPRT expire.

Arabella Example: Arabella gave her home to a 10-year QPRT. At the end of the QPRT term, the trust terminated, and title passed to her four children as remainder beneficiaries. Arabella continued to live in the home. Her lawyer had sent Arabella several letters prior to the expiration of the QPRT term about the necessity of signing a lease and paying rent for her continued occupancy, but she had not gotten around to responding to that letter when she died one week after the QPRT term expired. Since she was still living in the house after title had passed to her children and her QPRT occupancy rights had expired, and since the children had not initiated action to either evict her or collect rent from her, and since she had not paid any rent for her one-week's occupancy, the IRS asserted an estate tax on the residence, saying that (as per Rev. Rul. 78-409) there was an "understanding" among the parties that she could continue to occupy the property even after ownership passed to the children, and therefore the residence is includible in her estate under § 2036.

The IRS's claim that there was an "understanding" that Arabella could occupy the property for life rent-free for life is just a presumption based on the fact that, at the time of her death, she WAS exclusively occupying the property, without paying rent, even though she supposedly had given away the property to the children via the QPRT. The parties can rebut this presumption, if they can produce evidence that (despite appearances) there was no such agreement. The family needs to show that the parent did not "retain possession," but rather that the children had the sole right to possession, and the children then granted that possession to the parents. In one case, for example, the family produced evidence that the parent's financial circumstances had changed substantially after the gift, and so the children allowed the parent to stop paying rent for that reason, even though the original agreement had been that the parent would pay rent (and the parent had in fact paid rent for two years, before changed circumstances made him unable to pay). *Estate of Barlow*, 55 T.C. 666 (1971), acq., 1972-2 C.B. 1.

The problem for most families in this situation is that they do not have any evidence that there was no "understanding" that the parent could continue to occupy the property rent-free for life. What evidence could Arabella's children produce to prove that there was no such agreement or understanding? Possibly the lawyer who drafted the QPRT could testify to that effect, but unless he actually met with and talked to the children at the time the QPRT was created he probably would not know what their "understanding" was.

The absence of an understanding would have to depend on the children's testimony. What would they say about this? Were they aware of the QPRT and were they expecting to get possession of (and/or rental income from) the property at the end of the term? How would they explain their

failure to take action at the end of the term to enforce their rights? (In the Arabella situation, the children could explain that they fully intended to enforce their rights, but just had not had time to do so during the week since the QPRT term ended.)

In *Estate of Margot Stewart* (not a QPRT case), the decedent had given a 49 percent interest as tenant in common in her Manhattan town house to her son. Mother and son co-occupied the house both before and after the gift. IRS argued that the decedent-donor's retained rent-free use caused estate inclusion, relying on the fact that the use and occupancy of the building did not change at all following the gift. The IRS won on this argument in the Tax Court (T.C. Memo 2006-225, discussed in Leimberg *Estate Planning Newsletter* #1043), but lost in the Second Circuit. The appeals court ruled that the IRS erred in relying on mere co-occupancy to establish an implied agreement that the donor would retain enjoyment of all of the gifted property. Since the son "manifestly enjoyed" the use of part of the house, the case was remanded to the Tax Court to establish what portion, if any, of the gifted 49 percent the decedent had retained enjoyment of. The case contains much discussion of prior cases, the proper standards to be applied, and the burden of proof. *Stewart v. Comm.*, 106 AFTR 2d 2010-5710 (8/9/10).

In PLR 2006-17002 (see PART VII(#10)), the IRS apparently didn't even raise this argument. The evidence showed that the donors' daughters (the remainder beneficiaries of the QPRT) did not even know they were entitled to ownership and possession of the property at the end of the QPRT term, and accordingly could not have been found to have agreed to relinquish rights they didn't know they had!

Despite the favorable outcome for some taxpayers when they contest the IRS presumption, the moral is that the QPRT donor should sign a lease for his post-QPRT-term occupancy *before* the QPRT term expires. If Arabella's QPRT had included the following provision, obligating the donor to pay rent if she stays in occupancy after the QPRT term regardless of whether the parties have signed a formal lease, her estate might have avoided this fight with the IRS despite Arabella's negligence in not formalizing a lease arrangement for her post-QPRT-term occupancy.

The following is an excerpt from the sample QPRT trust in The QPRT Manual:

TRANSFEROR'S OPTION TO RENT.

This Section shall apply after expiration of the term of the QPRT **[Add the following if the Transferor's spouse has a life estate in the Residence following expiration of the QPRT term:** and after expiration of the Transferor's spouse's right to income of the trust**]**.

(1) Transferor shall have the option to rent any Residence held by the Trust for its fair market rental value. "Fair market rental value" shall mean the rent a willing tenant would pay to a willing lessor, neither being under any compulsion to act, to lease the Trust's entire interest in the Residence, free and clear of any trusts, mortgages or other encumbrances. The Transferor's tenancy under this option shall be from month to month, or for such other term as the Trustee and the Transferor may from time to time agree, and shall be upon the standard terms used in leases of comparable

residential real estate in the vicinity of the Residence, such as (if applicable) payment of a security deposit and advance rental, restrictions on subletting, and lessor's remedies.

(2) The option to rent shall be exercised by delivering written notice to the Trustee; provided, that if the Transferor remains in possession of a residence owned by the trust beyond the expiration of the QPRT term, and beyond the end of any other period of time (such as the term of a prior lease with the trust) that he was in occupancy as a matter of right, or at the sufferance of another person who occupied as a matter of right, such continued occupancy by the Transferor shall be deemed an exercise of the Transferor's option to rent hereunder and the Trustee shall be entitled to receive rent for such occupancy and shall be entitled to all other rights of a landlord under the standard terms used in leases of comparable residential real estate in the vicinity of the Residence.

(3) The "fair market rental value" of any residence owned by the trust shall be determined by one of the following methods:

(a) If at the applicable time there is an Independent Trustee serving, the "fair market rental value" shall be as determined by agreement between the Transferor and the Independent Trustee or, if they are unable to agree within 10 days of the exercise of the Transferor's option to rent, by appraisal by a qualified appraiser selected by the Independent Trustee.

(b) If at the applicable time there is no Independent Trustee serving, the "fair market rental value" shall be as determined by agreement between the Transferor and the Current Beneficiaries, or, if they are unable to agree within 10 days of the exercise of the Transferor's option to rent, by appraisal by a qualified appraiser selected by the Current Beneficiaries.

(c) For purposes of this section, a "qualified appraiser" means a licensed real estate broker or manager who has at least five years' experience renting and/or managing rentals of comparable residential properties in the market where the Residence is located.

(d) The reasonable expense of any appraisal shall be paid by the Transferor.

(4) The Transferor's option to rent shall expire on the Transferor's death. The Transferor may not assign this option but may relinquish it at any time, temporarily or permanently.

(5) If there is more than one Current Beneficiary, the vote of a plurality in interest of the Current Beneficiaries, with legal guardians (other than the Transferor) acting for minors and other legally incompetent persons, shall be considered the act of the Current Beneficiaries.

(6) At any time when a residence held by the trust is not being rented to the Transferor, the Trustee shall be entitled to rent the Residence to others, free and clear of any option…

(7) If, after having exercised the Transferor's option to rent, the Transferor then defaults and fails to fulfill the Transferor's obligation to rent the Residence, or if the Transferor defaults in the Transferor's obligations under the terms of the Transferor's tenancy and fails to cure the default within 30 days, or repeatedly defaults under the terms of the Transferor's tenancy, the Transferor's option shall expire permanently. This section shall not be deemed to limit any other remedies the Trustee may have on account of such default.

E. The Catch-22 of the donor's option to purchase

The donor can retain an option to buy the residence back from the trust (or a right of first refusal, which is an option to buy the residence once the trustee has decided to sell it) after the expiration of the QPRT term, *provided* that the following conditions are met:

1. In the case of QPRTs created after May 16, 1996, any repurchase right can take effect only after the QPRT term and after the trust has ceased to be a grantor trust.

2. Any repurchase right must require the donor to pay fair market value for the residence. Fair market value for this purpose is determined as of the time the option is exercised, *not* as of some earlier date (such as creation of the QPRT). If the option would allow the donor to buy the property at some price less than the fair market value of the property on the date the option is exercised, the donor's right to such a bargain purchase would be an asset of his estate, thus undermining the purpose of the QPRT which is to get the entire value of this property out of his estate.

3. The option may be exercised only with the consent of the trustee acting in its fiduciary capacity.

Because of Reg. § 25.2702-5(c)(9), a QPRT created after May 16, 1996, must prohibit sale of the residence to the grantor, the grantor's spouse, or various entities controlled by either of them, both during the QPRT term and at any time thereafter when the trust is a grantor trust. This regulation may make it impossible ever to give the grantor an unrestricted option to buy the residence or a right of first refusal, because an option or right of first refusal right gives the donor the "power to reacquire the trust corpus by substituting other property of an equivalent value." Such a power makes the trust a grantor trust under § 675(4), unless the grantor's exercise of the power requires the consent of someone acting in a fiduciary capacity. That is the reason for condition #3 in the above list. See ¶ 3.2.07 and ¶ 7.2.04 of *The QPRT Manual* for more discussion.

The following is an excerpt from the sample QPRT trust in The QPRT Manual:

ADDITIONAL REQUIREMENTS FOR SALE OF RESIDENCE. Notwithstanding any other provision hereof, the Trustee's power to sell the Residence shall be limited as provided in this Section (C). Failure to comply with this Section (C) shall not invalidate any sale of the Residence. If there is any sale of the Residence by the Trustee that is in violation of this Section (C), the Transferor's sole remedy shall be against the Trustee; the Transferor shall have no remedy against the purchaser of the Residence or the purchaser's successors in title. The Transferor shall hold harmless any buyer of the Residence from the Trust against any claim by the Transferor or his heirs or assigns based on the Transferor's rights under this Section (C). The Transferor shall be deemed to have waived the Transferor's rights under this Section (C) if the Transferor is in default on any of the Transferor's obligations to the Trust for a period of more than 30 days following notice of such default, or in the event of three or more defaults by the Transferor in any 12-month period.

(1) TRANSFEROR'S CONSENT REQUIRED DURING QPRT TERM OR WHEN TRUST IS A "GRANTOR TRUST." During the retained term interest of the QPRT, or at any time after the termination of the retained term interest in the QPRT while the trust is treated as owned in whole or in part by the Transferor or the Transferor's spouse under sections 671 through 678 of the Code, the Trustee may not sell the Residence without the written consent of the Transferor. Such consent may be given before or after any sale, and the Transferor may waive this right permanently or temporarily by written notice to the Trustee. The Transferor shall be deemed to have consented to any sale if the Transferor does not notify the Trustee of the Transferor's refusal to consent thereto within 30 days after receiving written notice of the Trustee's intent to sell, provided, that such notice of intent to sell shall provide notice of the intended purchase price and other terms. Following the Transferor's consent to a sale, the Trustee shall be free for a period of 12 months to sell the Residence for the price specified in the Trustee's notice of intent to sell (or for any higher price) without being required to seek a further consent of the Transferor under this paragraph.

(2) TRANSFEROR'S RIGHT OF FIRST REFUSAL AT OTHER TIMES. At any time when paragraph (1) does not apply, the Trustee may sell the Residence to such persons, at such times, and on such terms as the Trustee deems advisable and in the best interest of the trust beneficiaries, in the exercise of its fiduciary judgment; provided, that the Trustee may not sell the Residence without first offering it for sale to the Transferor on the same terms and conditions on which the Trustee proposes to sell the Residence to a third party. Alternatively, the Trustee may, in the exercise of its fiduciary judgment, before offering the property for sale to others, offer it for sale to the Transferor at its then fair market value as determined by appraisal. The Transferor may waive this right of first refusal permanently or temporarily by written notice to the Trustee. The Transferor shall be deemed to have waived the Transferor's right of first refusal with respect to any sale if the Transferor does not exercise the Transferor's right of first refusal (by written notice to the Trustee, accompanied by appropriate tender of payment) within 30 days after receiving written notice of the Trustee's intent to sell, provided, that such notice of intent to sell shall state the intended sale price (or appraised value, as the case may be) and all other terms. Following the Transferor's waiver with respect a

proposed sale by the Trustee, the Trustee shall be free for a period of 12 months to sell the Residence for the price specified in the Trustee's notice of intent to sell (or for any higher price) without being required to again offer the property to the Transferor under this paragraph.

F. What if all the donor's children die prior to expiration of the QPRT term?

If all the potential non-skip beneficiaries die before the end of the QPRT term, then there is no place for the remainder interest to go without triggering a GST tax. See PART III. Consider giving the donor an "extra" reversion in this case.

The following is an excerpt from the sample QPRT trust in The QPRT Manual:

Notwithstanding any other provision hereof, if at any time prior to the expiration date specified above there shall be no Child of the Transferor living, the trust shall terminate upon the death of the Transferor's last surviving Child, and, in that event, the Trustee shall distribute the trust property to the Transferor.

G. IRS sample QPRT form prohibits sales as well as commutations

A QPRT must prohibit "commutation (prepayment)" of the donor's interest. Reg. § 25.2702-5(c)(6). Though "commutation (prepayment)" is not further defined in the transfer tax regulations, it is generally understood to mean terminating the trust and dividing up its property among the beneficiaries in proportion to the then-current actuarially-determined values of their respective beneficial interests. See for example (in the IRS's pension regulations) Reg. § 1.401(a)(9)-6(e)(4); (f), Examples 7 and 8.

In its sample QPRT form, the IRS prohibits not only commutation and prepayment but also *sale* of the donor's interest. Rev. Proc. 2003-42, 2003-1 C.B. 993, Section 4, Article II(B)(7) ("The Transferor's interest in the annuity amount may not be sold, commuted, or prepaid by any person."). This additional prohibition is *not* required by the QPRT regulation and seems to represent an IRS attempt to block off legitimate estate planning moves that the Service has belatedly decided it doesn't like. Since it is desirable to preserve all planning options not prohibited by the regulation, it is recommended that the IRS sample form not be followed on this point.

The following is an excerpt from the sample QPRT trust in The QPRT Manual.

NO COMMUTATION. Commutation (prepayment) of the Transferor's interest in the annuity amount is prohibited. The Trustee's obligation to make any annuity payment is limited to the value of the GRAT at the time such payment is due.

H. Limiting estate inclusion after GRAT conversion

For explanation of why a QPRT might have to convert to a GRAT, see PART VII, discussion of "Option #1."

If the donor's death during the QPRT term occurs after the QPRT has converted to a GRAT, some practitioners have long argued for an estate tax result more favorable than 100 percent inclusion. Their argument would apply whenever the proceeds of sale of the QPRT residence that are not to be reinvested in another residence exceed the amount necessary to support the required annuity payments to the donor. The theory was that the trust should be includible in the donor's estate *only to the extent of the funds necessary to generate sufficient income to pay the annuity payments*, because the donor has not "retained the income" of the excess over that amount.

In PLR 2002-10009, the IRS ruled that, even though this argument was correct under § 2036, the entire trust fund is still includible in the donor's estate under a different Code section, § 2039 (annuities). However, the IRS later reversed its position; the current rule is: "The portion of the trust's corpus includible in the decedent's gross estate for Federal estate tax purposes is that portion of the trust corpus necessary to provide the decedent's retained use or retained annuity, unitrust, or other payment (without reducing or invading principal) as determined in accordance with Sec. 20.2031-7 (or Sec. 20.2031-7A, if applicable). The portion of the trust's corpus includible in the decedent's gross estate under section 2036, however, shall not exceed the fair market value of the trust's corpus at the decedent's date of death." Reg. § 20.2036-1(c)(2)(i), as amended July, 2008 (T.D. 9414).

Typically, QPRTs provide that, if the donor dies before the end of the QPRT term, the trust terminates and all the trust assets revert to the estate of the donor. Instead, the QPRT could provide that, if the donor's death occurs after the QPRT has converted to a GRAT (though still prior to the end of the QPRT term), the transferor's estate is not entitled to the entire trust fund. Rather, the estate is entitled to receive only the portion of the trust fund needed (based on IRS valuation rules in effect as of the GRAT conversion date) to produce income sufficient to support the donor's annuity.

I. Income tax reimbursement language required—no, forbidden!

A grantor trust can be a good wealth-transfer device. The donor pays income tax on income the donees receive, thus further depleting the donor's estate and increasing the donee's estate, without gift tax. The IRS has never been happy with the use of the grantor trust rules to transfer wealth gift tax-free.

In the past, the IRS apparently refused to rule favorably on some grantor trusts unless the trust instrument contained a clause requiring the trustee to distribute, to the grantor, the funds required to pay the grantor's income taxes caused by grantor trust status; see, *e.g.*, PLR 9447036. Rulings earlier than PLR 9447036 do not mention such a clause; see, *e.g.*, PLR 9402011. One speculates that this provision was not spontaneously added to the QPRT by the taxpayer in PLR 9447036 but rather was imposed by the IRS as a condition of ruling on the grantor trust status of the QPRT. Other QPRT letter rulings with similar tax-reimbursement language include PLRs 2000-01015, 9838017, and 9504021.

In PLR 9444033 (not a QPRT ruling), the IRS stated that, if a grantor trust did *not* contain such reimbursement language, the donor would be making an additional gift to the trust every time he paid the income tax he owed (under the grantor trust rules) on the trust's income; however, the IRS later (in PLR 9543049) modified PLR 9444033 to delete that statement.

The IRS also ruled in the past (see, *e.g.*, PLR 1999-22062—not a QPRT ruling) that such reimbursement language did *not* give the grantor a retained right to the trust's income that would cause the trust to be included in the grantor's estate under § 2036(a).

In Rev. Rul. 2004-64, 2004-27 I.R.B. 7, the IRS did an about-face, and ruled that a donor's retained *right* to be reimbursed by a trust for income taxes owed by the donor on the trust's income would cause inclusion of "the full value of Trust's assets at" the donor's death to be included in the donor's estate under § 2036(a)(1). The result would be the same even if the donor did not retain that right in the trust instrument, but nevertheless had that right under applicable state law (unless the trust instrument negated the state law right).

Because this rule represented a 180° turn from its previous position, the rule was applied prospectively only; the IRS "will not apply the estate tax holding…adversely to a grantor's estate with respect to any trust created before October 4, 2004."

The rule for trusts created after October 3, 2004, applies if the trust's reimbursement of the donor for income taxes due on the trust's income is *mandatory*. On the other hand, if the trustee merely has *discretion* to reimburse the donor for income taxes paid on the trust's income, "assuming there is no understanding, express or implied, between…[the donor] and the trustee regarding the trustee's exercise of discretion, the trustee's discretion to satisfy…[the donor's] obligation would not *alone* cause the inclusion of the trust in…[the donor's] gross estate for federal estate tax purposes.…regardless of whether or not the trustee actually reimburses" the donor. Rev. Rul. 2004-64 (emphasis added).

While that discretionary power "alone" would not cause estate inclusion, it could trigger estate inclusion in combination with other powers or circumstances—for example, if the donor has the power to remove the trustee and appoint himself as trustee, or if the effect of the power is to make the trust assets subject to the claims of the donor's creditors.

How does Rev. Rul. 2004-64 affect QPRTs? The possibility that the trust could generate income not distributable to the donor, on which the donor would owe income taxes, becomes an issue only if the residence is sold to a third party and the gain is not sheltered by § 121, or if the QPRT converts to a GRAT and receives income in excess of what is distributed to the donor under the annuity, or if the trust continues as a grantor trust after the term ends. In these situations, it is desirable from an estate planning perspective for the trust *not* to reimburse the donor for income taxes on the trust's income. The donor's payment of such income taxes out of his own pocket decreases his future taxable estate, and increases the relative value of what the donees receive—without incurring gift tax. However, if the donor does not want to sign up in advance for an unknown (and potentially large) amount of future income taxes, the trust could authorize the independent trustee (or even require the trust) to reimburse the donor for income taxes on the trust's income during the QPRT term; the downside is that a required reimbursement makes the trust includible in the donor's estate, but it's already includible in his estate if he dies during the term. After the term, it would be best to avoid reimbursement language, and rely on other provisions that

would enable the donor or his spouse to "switch off" the grantor trust status if it becomes burdensome.

J. Draft for amendability!

As will become evidence in PART VII, the ability to make post-gift changes in the QPRT arrangements can be extremely helpful. The drafter can facilitate such "amendability" by using the following clause. This clause specifies that the transferor reserves the right to sell or give away his retained interest. He almost certainly has that right "automatically" under state law, since the donor cannot "spendthrift" his own interest, but it can be helpful to have those rights spelled out in the instrument. Also, the purpose of including spendthrift clauses with respect to the *non-donor* beneficiaries is to prevent them from selling their interests and to thwart their creditors; neither of these goals is defeated by allowing beneficiaries to transfer their interests *within the family group* as this clause does.

Also consider including some amendment power. Of course the donor must not retain any amendment power; and no person should be given a power that would allow the power-holder to make an amendment that would reduce the value of the donor's interest without the donor's consent;. See ¶ 3.5.05 of *The QPRT Manual* for the reasons for these limitations.

If these provisions are not included, the parties can turn to state law which may allow the amendment of a trust if all beneficiaries and the trustee agree; but in that case it is most helpful if the trust does not have any unborn or unascertained beneficiaries, since obtaining their "consent" would undoubtedly require probate court proceedings. For a ruling in which the parties were allowed to modify the remainder provisions of a QPRT (and other irrevocable trusts), see PLR 2008-04013 (Appendix C).

The following is an excerpt from the sample QPRT trust in The QPRT Manual:

SPENDTHRIFT PROVISION; DISCLAIMERS

(1) The Transferor reserves the right to assign or transfer, by gift or otherwise, any interest in this trust held by the Transferor.

(2) Any other beneficiary hereof may assign or transfer, by gift or otherwise, any interest in this trust held by such beneficiary to the Transferor's spouse or to any descendant of the Transferor. Except as provided in the preceding sentence, a beneficiary may not sell, pledge, or otherwise transfer any part of his interest in this trust, and the Trustee shall not recognize any such other transfer attempted. The interest of a beneficiary (other than the Transferor) in this Trust shall not be subject to be taken by creditors by any process whatever.

(3) Any person may disclaim his interest in this trust by means of a "qualified disclaimer" within the meaning of section 2518 of the Code. In the case of a qualified disclaimer, the property or interest disclaimed shall pass as provided by the law applicable to such disclaimers. Any

beneficiary may at any time and from time to time relinquish all or part of any interest in or power over this trust he holds or anticipates receiving by means of a written instrument delivered to the Trustee, identifying the section of the trust that creates the interest relinquished, regardless of whether such act constitutes a qualified disclaimer under state or federal law, and regardless of whether such person has previously accepted the interest or power so relinquished. If the relinquishment does not meet the requirements of a qualified disclaimer (or a disclaimer under applicable state law), the section of the trust that creates the interest so relinquished shall thenceforth be applied and interpreted as if such person had died on the effective date of the relinquishment.

K. Keeping grantor trust status after term ends

After the QPRT term ends, the QPRT is no longer a QPRT; it is just like any other irrevocable trust. Therefore there is nothing particularly distinctive about how grantor trust status is achieved for a post-QPRT QPRT versus any other kind of irrevocable trust. For discussion of how best to achieve or maintain grantor trust status, see PLR 2006-03040 (discussed in Leimberg's *Estate Planning Newsletter* #921); PLR 2007-30011 (discussed in Leimberg's *Estate Planning Newsletter* #1156); overview discussion in Leimberg's *Estate Planning Newsletter* #1157 (8/1/07), by Jonathan E. Gopman, et al; and IRS Notice 2007-73 (discussed in Leimberg's *Estate Planning Newsletter* #1161).

V. RESIDENCE; MORTGAGES; OTHER OPERATIONAL ISSUES

A. Residence held in a single-member LLC

Question: Client's home is owned by a single-member LLC (limited liability company), for probate avoidance and liability reasons. Can the client's interest in the LLC be transferred to a QPRT? Or do we have to take the residence out of the LLC to set up a QPRT?

Answer: "The Internal Revenue Code prescribes the classification of various organizations for *federal tax purposes*. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." Reg. § 301.7701-1(a)(1). Emphasis added; note that the provision applies for all "federal tax purposes," not just income tax purposes.

Reg. § 301.7701-3(a) provides that "A *business* entity that is not classified as a corporation…(an eligible entity) can elect its classification for federal tax purposes as provided in this section.…an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner." Reg. § 301.7701-2(a) defines "business entity" as "any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under Sec. 301.7701-3) that is not properly classified as a trust under Sec. 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code."

The term "business entity" does not imply that the disregardable entity provisions apply only for purposes of business activities and business taxes. For example, a single-member LLC can be

disregarded for purposes of determining the eligibility of its owner for the exclusion of gain on sale of a principal residence. Reg. § 1.121-1(c)(3)(ii).

Thus, it appears initially that there is no problem philosophically with treating a residence owned through a disregarded single-member LLC into a QPRT. However, when the ownership of a single-member LLC that owns a personal residence is transferred to a QPRT, query whether it is still a "single-member LLC." The LLC is now owned by a trust that has MULTIPLE beneficiaries. The fact that the trust is disregarded for federal income tax purposes (because it is a grantor trust) does not necessarily mean that the trust is "disregarded" for purposes of whatever determinations are required to assure that the entity is considered "single-owner" for purposes of applicable state law and of Reg. § 301.7701-3. Accordingly, I would not proceed to fund a QPRT with an LLC interest without getting an IRS ruling.

B. Confusion between "used" and "held for use" as donor's residence

One sentence of Reg. § 25.2702-5(c)(7)(i) says that "A residence is held for use as a personal residence of the term holder so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence." In the article "QPRTs for Co-Tenancy Interests: Do They Work?", 6 *California Trusts and Estates Quarterly* No. 3 (Fall 2000), p. 4, by John A. Hartog and Linda L. McCall, the authors cite two instances of clients who owned undivided interests in residences. In both cases, the client's issue or trusts for their issue held the rest of the ownership. The IRS advised in both cases that the residences could not be transferred to QPRTs because "the client did not have the exclusive right to occupy the property required under" Reg. § 25.2702-5(c)(7)(i).

Despite what these taxpayers were apparently told, the QPRT regulation does *not* require that, in order to qualify as a donor's residence, the donor must have the exclusive right to occupy the property. Rather, Reg. § 25.2702-5(c)(7)(i) says only that the QPRT trust instrument must provide that the trust will cease "to be a qualified personal residence trust if the residence ceases to be used *or held for use* as a personal residence of the term holder" (emphasis added). The purpose of the next sentence, the one quoted and the beginning of this section and in the Hartog/McCall article, is only to define the term "*held for use.*"

To determine whether a property is "used" as the donor's residence, we look at Reg. § 25.2702-5(c)(2)(iii). This regulation tells us that, *in order to be transferred to a QPRT in the first place*, the residence must be the donor's actual personal residence. That means that its *primary use* is as the donor's residence when occupied by the donor, and its *primary use* is as a residence when it is not occupied by the donor. There is no option to transfer to a QPRT a structure that is merely "held for use" as the donor's residence, but neither is there any requirement that the donor have exclusive occupancy rights!

Only once the QPRT is up and running do we get to Reg. § 25.2702-5(c)(7)(i). That regulation (discussed at ¶ 2.2.04) deals with what happens if the donor ceases to use the property as his residence after the QPRT has already begun. Then, as a matter of grace, the IRS allows the QPRT to continue (despite the residence no longer being the donor's actual residence) *provided* it is "held for use" as the donor's residence…and the definition of "held for use" involves the exclusive occupancy by the donor and/or his spouse and dependents.

When a residence is owned by the would-be QPRT donor as a co-tenant with other owners, there are problems regarding whether the property can be placed in a QPRT; see ¶ 2.3.02 of *The QPRT Manual*. But those problems do not arise from Reg. § 25.2702-5(c)(7)(i)! Fortunately, the IRS seems to have straightened out on this issue since these authors' clients' negative experience in 2000; current rulings appropriately refer to the *primary use* requirements for qualification as a personal residence, rather than an *exclusive occupancy* test. See e.g. PLRs 2006-26043, 2007-29004.

C. Give adult children ownership interests, so they can occupy

Some practitioners use fractional interests as a way to give the donor's adult children an independent right to occupy the property.

For example, if, at the time the QPRT is to be created, one or more nondependent children are sharing occupancy of the residence with the would-be QPRT donor, some practitioners recommend that the donor make outright gifts to his children of small fractional interests in the residence, followed by the gift of the donor's remaining undivided interest to a QPRT. The purpose of this approach is to give the children (as, now, co-owners) their own occupancy rights in the residence. The theory is that their occupancy by right as co-owners would entitle the children to continue living in the residence (without causing the trust to lose its QPRT status) even if the donor goes into a nursing home (and so ceases to use the residence as his personal residence; if the donor ceases to use the residence as his personal residence, it can maintain its "QPRT status" only if it is "held for" the donor's use as a residence). There are two drawbacks to this technique.

First, it is not clear that this technique works for its intended purpose. Occupancy of the residence by the donor's nondependent children, *even if they are occupying as rightful co-owners*, appears to violate the IRS's requirement that, in order to be considered "held for the use" of the donor, the property must be "not occupied by any other person (other than the spouse or a dependent of the [donor])."

Second, if the donor continues to be the sole occupant of the property, the fractional interests that he gave to his children will be brought back into his estate under § 2036 unless he pays fair market value rent to the children for the right to exclude them from possession. If property that he gave away is brought back into his estate, he wasted the gift tax he paid (or the gift tax exemption he used up) by making those gifts to them). Paying rent to avoid that result involves the complications of computing, paying, and (for the children) paying income tax on that rent.

D. How do you buy a replacement residence that's more expensive?

The QPRT regulation allows a QPRT to provide that, if the residence is sold during the term, and the donor reinvests part or all of the sale proceeds in a new personal residence within two years, the trust will continue as a QPRT as to the new residence. However, the sale-repurchase transaction never quite happens as neatly as the regulations seem to anticipate. Either the new house is more (or less) expensive than the old, or the donor buys the new residence before selling the old.

If the new house is *less* expensive than the old, the trust must partially "convert to a GRAT"; see PART IV(A), (B).

If the new residence is *more* expensive than the old, there are five possible ways to proceed (additional cash gift to QPRT, joint purchase with QPRT, joint purchase followed by gift to existing QPRT, joint purchase followed by establishing new QPRT, and loan to QPRT). Which is recommended depends on the circumstances: How much additional money is required to complete the purchase? Is the donor interested in making an additional gift via a QPRT? If not, is he willing to part with at least the future appreciation on the new residence?

1. **Donor gives cash to existing QPRT.** The simplest approach is for the donor to contribute the additional purchase price as a new gift to the QPRT. When the additional cash needed to complete the purchase is modest, it doesn't matter much which approach the donor uses, and he should just do whatever seems the least complicated. However, it is more advantageous to use Approach #3 or #4 if the additional amount is large enough to make such complications worthwhile.

2. **Joint purchase with QPRT.** If the additional amount required to complete purchase of the new residence is substantial, then the donor should buy the new residence jointly with the QPRT. Following the purchase, the QPRT will be owned jointly by the QPRT and the donor as tenants in common, with their respective undivided interests in proportion to their respective contributions to the purchase price of the new residence. This joint ownership can continue until the end of the QPRT term, unless the donor wishes to go one step further and make an additional gift (see the next two approaches). The joint purchase (not followed by an additional QPRT gift as described in #3 or #4) is the best approach to use if the donor cannot afford (or for some other reason does not want to make) an additional QPRT gift to his children.

3. **Joint purchase, followed by gift to existing QPRT.** Following the joint purchase (see #2), if the donor feels generous and wants to make another QPRT gift, he can contribute his undivided interest in the new residence to the existing QPRT. He should be entitled to a fractional-interest valuation discount for this gift. This approach would make sense if the existing QPRT has a sufficiently long remaining term to make the gift tax valuation discounts for the donor's retained interests worthwhile; otherwise, see #4.

4. **Joint purchase followed by gift to a new QPRT.** The donor (individually) can buy the new residence jointly with the QPRT, as in #2, then contribute the portion of the residence he owns individually to a new QPRT. He should be entitled to a valuation discount for a "fractional interest gift" for this gift. The advantage of doing it this way (rather than simply making an additional gift to the existing QPRT) is that the term of the new QPRT can be optimized, and the new QPRT can be up-to-the-minute in terms of current tax-saving techniques, legal provisions, and the donor's desires. The drawback of a new QPRT is the additional legal fees in drafting the new trust.

5. **Loan from donor to QPRT.** The existing QPRT could borrow sufficient money from the donor to enable the QPRT to complete the purchase of the new residence. The interest rate

on the loan should be the minimum required under § 7872, to avoid making a taxable gift (a taxable gift can result from a "below-market" interest rate). Interest payments on the loan during the QPRT term have no income tax effects because the QPRT is a grantor trust, so any interest payments the donor makes (as part of his payment of trust expenses during the term) are recycled right back out to him with no income tax being paid by either him or the trust.

E. Why not use life insurance?

Let's deal with the QPRT's toughest negatives, and how to ameliorate these with life insurance.

The first negative is that the QPRT does not save taxes unless the donor survives to the end of the QPRT term.

The second negative is that, because of the unfortunate way the generation-skipping transfer (GST) tax works with QPRTs (see PART III), there is a strong incentive to have the trust property pass only to the donor's *living* children, and, if a child of the donor dies during the QPRT term, provide for that deceased child's issue with other gifts or bequests (outside the QPRT).

Both of these negatives could be ameliorated with a life insurance program. A separate trust could be created as a companion to the QPRT. The trust would contain, first, a term insurance policy on the life of the QPRT donor. The term of the policy would match the term of the QPRT. The face amount of the policy could equal the estimated estate tax savings it is hoped the QPRT will produce. With this policy in place, the QPRT changes from a "cannot lose" bet to a "must win" bet. Either the family will gain the tax savings of the QPRT or (if they lose that due to the donor's premature death) they will gain the insurance proceeds.

The same trust or a separate trust could hold insurance policies on the lives of the donor's children. This helps solve the "QPRT-GST tax dilemma," especially if the client solves that problem by leaving the QPRT to his living children only (see PART III(B), "Approach #2"). If a child of the donor dies before the QPRT ends, and so forfeits his or her share of the QPRT, that child's issue or other heirs can be compensated from the insurance proceeds received by this trust.

F. Mortgaging the QPRT-owned residence

I receive many questions about QPRTs and mortgages, involving either funding a QPRT with a residence that is subject to a mortgage or refinancing a residence already held in a QPRT. ¶ 2.7 (pages 105–110) of *The QPRT Manual* deals with placing mortgaged property in a QPRT. This section begins:

"It is perfectly legal, and acceptable to the IRS, for a QPRT-owned residence to be subject to a mortgage. The QPRT regulation even specifies that the donor can give the trust (and the trust can hold) cash to make mortgage payments, within limits. Reg. § 25.2702-5(c)(5)(ii)(A)(i)…. If the donor transfers the residence to the QPRT when the residence is subject to a mortgage the donor has made a gift of only the equity in the transferred property (value of transferred property minus the outstanding debt secured by the mortgage). See Reg. § 20.2053-7, § 20.2056(b)-4(b) (these are estate

tax regulations; there is no specific gift tax regulation on this valuation issue). The problem with having a mortgage on the QPRT residence is that any subsequent mortgage principal payment by the donor constitutes an additional gift to the trust, because it reduces the debt to which the property is subject, thus increasing the trust's equity dollar for dollar.…"

The QPRT Manual then has various methods of dealing with that problem, each with pluses and minuses—the best and preferred method being to pay off the mortgage prior to transferring the house to the QPRT. But many donors don't like that approach, as the following questions show:

Question #1: My client is contributing mortgaged property to his QPRT. He plans to get around the "gift" problem by paying *only the interest portion* of the mortgage payments; his children, who are the remainder beneficiaries of the QPRT will pay the principal portion. Since the monthly mortgage payments are paid by automatic withdrawals from his bank account, which is highly convenient, he plans to continue that, and have the children reimburse him annually. Is that permissible?

Answer: From the QPRT *donor's* point of view, the only requirement is to make sure that his payments of principal are not considered additional gifts to the QPRT. If he has a written agreement from the children that they will reimburse him annually for the principal portion of the payments, then he hasn't made gifts—he's made loans. Interest-free loans can be treated as gifts (see § 7872), so you need to nail down that aspect.

From the *children's* point of view, they are making gifts to the donor by paying the principal portion of the mortgage payments. First of all, they are giving their parent an interest in that money (because he has the right to occupy the residence rent-free during the QPRT term). Second, if the QPRT donor dies before the end of the QPRT term, the residence reverts to his estate (at least, that is what the typical QPRT provides). Thus, by making principal payments on the mortgage the children are taking the risk that the principal they have thus contributed to this trust could revert to the donor, causing a financial loss to them.

To avoid such complications and undesirable side effects that I recommend either paying off the mortgage before the QPRT transaction, or else having the donor make all the mortgage payments during the term in the form of interest-free loans to the QPRT, to be repaid on expiration of the QPRT term; see ¶ 2.7.03 of *The QPRT Manual*.

Question #2: Parents want to transfer their appreciated residence to a QPRT subject to a mortgage. The parents just want to be rid of ownership of the residence AND be rid of the mortgage. So the children are agreeing to pay off the mortgage when it comes due (it's interest-only now; the parents would continue to pay the interest during the QPRT term). The residence will go outright to the children at the end of the QPRT term, whether it ends because the term expires or because the parents die. We assume this is treated as a part-gift, part-sale, of the property, but because the QPRT is a grantor trust there should be no gain recognized. Comments?

Answer: I agree this would be treated as a part gift-part sale of the residence by the parents, but I don't see that the QPRT (grantor trust) is the "part buyer"; the children are the ones assuming liability for the mortgage. Therefore, gain would be recognized by the parents. You will need to

determine how the parents' basis is allocated between the gift portion and the sale portion, and whether the sale portion is eligible for the § 121 gain exclusion. Finally, by having the house pass to the children if the parents die prior to the end of the QPRT term, you are giving up the donor's "reversion" that is usually a substantial part of the gift-tax discount that makes a QPRT gift attractive.

Question #3: Client transferred her home to a 10-year QPRT. Now, in Year 5, she wants to refinance the home. The refinancing won't result in any increase or decrease in the size of the mortgage, just a lower interest rate and longer term. Even though the trust instrument permits this, the bank (mortgage lender) is "insisting" that the property be deeded out of the trust for one day into the donor's name, so the refinancing can be done in her name (as the original mortgage was done). The bank is fine with the property then being conveyed right back into the QPRT. Can that be done?

Answer: Refinancing the property is permissible since it is just a renewal and revision of the loan terms, without adding to the principal amount. But taking the residence out of the QPRT for one day for purposes of the refinancing is not acceptable. The QPRT trustee has fiduciary obligations. It cannot just "lend" the trust's only asset to an individual (even if that individual is the donor and income beneficiary) for 24 hours. That is completely out of the question. Ask the bank whether it serves as trustee for individuals and families, and if so whether in that capacity it is comfortable with turning over the trust assets to the trust beneficiaries on a temporary basis, to be returned to the trust by nightfall. If the bank answers yes, then I don't want to hire that bank as my trustee.

This problem cannot be cured by giving the trustee the donor's written pledge to return the property, secured by other assets, because the QPRT is forbidden to hold any assets other than the residence and certain cash amounts; it cannot hold an IOU from the donor. The only way I can see that you could do this would be for the trust to sell the house to the donor for full fair market value, then buy it back the next day for the same price, but if the QPRT was created after May 6, 1996, the governing instrument must prohibit a sale of the house to the donor (see PART IV(E)).

Question #4: Donor transferred residence to a QPRT subject to a "home equity line of credit" (HELOC). Before creation of the QPRT, all parties agreed that the donor could continue to draw on the HELOC and any payments from the lender (if made to the QPRT) would be distributed to the donor, who would remain contractually liable to pay off the HELOC when due. Is it permissible for the QPRT to temporarily hold cash paid out by the bank under the HELOC? I note that Reg. § 25.2702-5(c)(5)(ii)(A) permits the QPRT to hold cash and requires that cash in excess of the QPRT's needs for certain specified expenses must be distributed to the donor quarterly.

Answer: Here are the problems with this scheme. First, there is no blanket permission to hold random amounts of cash as long as these are distributed to the donor quarterly. The regulation you cite permits additions of cash *solely* in the amount required to cover anticipated expenses. The provision for distribution of the excess cash to the donor only operates if the expenses turn out to be less than were reasonably anticipated. Second, there is an issue regarding whether there was a completed gift to the extent the donor reserved the right to essentially borrow the property back by drawing on the HELOC. Third, where the donor has guaranteed to pay back the HELOC from his

personal funds, so the QPRT and its remaindermen are not liable for that debt, there is an issue whether the QPRT holds an impermissible asset, namely, the donor's IOU. These issues may not necessarily be fatal, but you will need to work through each of them before proceeding.

VI. PROBLEMS AT THE STARTING GATE

This PART VI looks at "cleanup" situations: After the QPRT is created or supposedly created, the parties discover that things were not done properly at the creation.

A. QPRT deed never recorded

Question: Mother signed a QPRT trust, and filed a gift tax return reporting the gift of her residence to the 10-year QPRT. It is now Year 9 and we started to prepare a lease to allow mother to continue in occupancy with payment of fair market rent to the children-remaindermen, when we discovered that mother never signed a deed conveying the residence to the QPRT (or if she signed it, it was never recorded and is now lost). Do we have a completed gift or not?

Answer: That would be determined under your state's law. In *Estate of Margo Stewart*, T.C. Memo 2006-225, for example (not a QPRT case), a deed gifting an undivided interest in real estate was never recorded, but the gift was still held to be complete under applicable state law (New York). See Leimberg *Estate Planning Newsletter* #1043. This case was appealed and overruled on a different issue; see PART IV(D).

Sometimes a trust instrument purports, in itself, to make the real estate subject to the trust. For example, some trusts are in the form of a declaration of trust in which the owner of the residence would "declare" "I hereby declare that I hold the following real estate [description of residence] in trust upon the following terms and conditions," etc. Under some states' laws, if that document is signed with specified formalities it can be recorded and is effective to make the property subject to the trust. So you need to research how your state's law would apply to the documents that were actually signed.

Alternatively, you may need to get a state court to create the missing documents nunc pro tunc, if it is clear no state-law-acceptable conveyance did occur, and if your state courts are willing to step in and do or complete what the parties thought they already did; the question would be whether the children, as remainder beneficiaries of the QPRTs acquired enough rights (through whatever verbal and written exchanges did take place) to force the mother to carry out the QPRT gift. You will generally need to get a judgment of your state's highest court that the transfer to the trust was completed in order to be sure the IRS will accept it.

B. Gift tax return never filed

Question: Client created a QPRT in 1995 but never filed a gift tax return. The QPRT term ended in 2005 and the children now own the house. Do we need to file gift tax returns for 1995? There was no tax due because the gift would have been less than the donor's gift tax exemption amount. An appraisal based on 1995 data would presumably be difficult at this late date.

Answer: Yes a gift tax return should be filed for the 1995 gift. Aside from the question of what benefits might arise from starting the statute of limitations running, the main consideration is that no future gift tax return (or estate tax return) can be filed without reporting all prior taxable gifts, so that 1995 return must be prepared sooner or later. Yes an appraisal now based on 1995 "comparables" will be a little difficult, but it will be even more difficult in 10 or 20 years, so I would suggest getting it over with now.

C. QPRT set up before residence exists

Question: In 2002, client purchased a residential lot for $500,000 and conveyed it to a QPRT, then started constructing a residence on it. The residence was completed (total cost: $400,000; he paid the bills directly out of his own pocket), and he moved in, a year later, in 2003. This has been his principal residence since then. The QPRT term will expire in 2012. Is this a valid QPRT?

Answer: The question is whether this trust was a QPRT at the time the gifts to it were made.

The problem is that, unless the donor was living in a tent pitched on the vacant lot at the time of the gift, this property was not his residence until it was built, so it was not his residence at the time of the gifts into the QPRT. Is that necessarily fatal to QPRT status? And if it is fatal, could the trust possibly qualify as a PRT (see PART I(B) and Appendix B)?

If the trust was not a valid QPRT, then the donor is not entitled to discount his gifts to the trust to reflect his retained interests; he would have to report the full face value of the gifts ($900,000). See § 2702 and PART I(B).

A QPRT is a trust the governing instrument of which prohibits the trust from holding any asset other than the donor's personal residence plus specified amounts of cash to be used for specific purposes, plus (under certain circumstances) sale proceeds. The donor violated the terms of the "governing instrument" by transferring a vacant lot to the trust. The QPRT regulation does not have much leeway for the trust to hold a "future residence" and does not contemplate this situation.

So the trust held something it was prohibited from holding. Does that make the trust "not a QPRT?" Presumably the IRS would say yes, but I have not found any ruling covering this situation. He did purchase the lot and construct the building with the intention of making it his residence; that was the only use ever contemplated for this property and it did in fact become his residence as soon as it was completed. The statute refers to a "residence *to be used as* a residence" by the donor. Thus it seems your client was within the spirit of the statute if not within the letter of the regulation.

A QPRT is permitted to hold cash for the purchase of a residence within three months, provided there is a contract in place for such purchase. Reg. § 25.2702-5(c)(5)(ii)(A)(1)(iii). This suggests that a QPRT can be a QPRT even when it does NOT hold a residence, provided it acquires the residence within three months. An argument could be made that any transfers he made to the trust within three months prior to moving in the residence qualify for the QPRT discounts under this provision.

For future reference, what this individual *should have done* was to buy the lot and build the house in his own name, and transfer the residence to the QPRT only once it was complete and he had moved into it.

VII. 50 WAYS (WELL, 10 WAYS) TO LEAVE YOUR QPRT

Confession: I haven't drafted a new QPRT in years. All of my QPRT work these days involves unraveling existing QPRTs. Here are the reasons I've seen that some donors wish to undo their QPRTs. These situations can arise during the QPRT term and/or after the term has ended. The donor's children may or may not be willing to cooperate with attempts to change the plan.

Situation 1: Due to a decline in the value of the donor's assets and/or increase in the estate tax exemption, the donor no longer is concerned about reducing federal estate taxes. In fact, the potential estate tax savings is less than the potential loss of the "stepped-up basis" the children would receive for income tax purposes if they inherited the residence rather than receiving it as a gift. **The QPRT no longer makes sense** as a tax-saving proposition.

Situation 2: Regardless of the tax effects, **the donor can no longer afford** to give up this asset and/or pay rent to live there. He needs to sell the house, keep the proceeds, and downsize, or at the very least he needs to stay in the house rent-free.

Situation 3: Regardless of the tax effects, and even though the donor can afford the gift, the **donor is no longer comfortable** with the idea of giving away his home and/or paying rent to his children to be allowed to stay there.

Situation 4: The **donor has become estranged** from the child-donee and (though the donor can afford the gift and benefit from the estate tax savings) does not want the child to get the residence, or does not want the child to receive it outright.

Situation 5: Due to a **decline in the donor's health**, there is concern that the donor may not survive the QPRT term and the expected tax savings may be thereby lost.

If just "living with" the existing QPRT and honoring its terms is no longer a viable or acceptable alternative to the donor-client, here are ten ways to modify the QPRT. See Appendix A for a sample memo to a client summarizing some of these options (and one more).

1. Convert to a GRAT (and maybe accelerate the annuity)

If the QPRT-owned residence is sold and the sales proceeds are not reinvested in a replacement residence for the donor within two years; or if the residence ceases to be used or held for use as the donor's residence; the QPRT is required to pay an annuity to the donor for the rest of the QPRT term. This is called "converting to a GRAT." Reg. § 25.2702-5 (c)(8)(i); see ¶ 3.4 of *The QPRT Manual.* The donor can trigger this requirement by selling the residence and not reinvesting the proceeds or by moving out of the residence and causing it to be rented to someone else.

The payments the trust must pay to the donor are the payments the donor would have received if the trust had been a GRAT from the beginning, with the donor's retained interest being

the same value as the donor's retained interest in the QPRT. These payments are calculated using the § 7520 rate and IRS estate/gift tax mortality rates that were in effect at the time of the original gift, *not* at the time of the conversion to a GRAT. Make sure the gift-tax computing software you are using recognizes these rules; the latest versions of both *NumberCruncher*® and *TigerTables*® (see PART I(D)) correctly take this into account.

The conversion normally has the effect of reducing the transfer tax savings of the QPRT, because the annuity payments pile up in the donor's estate, and each payment reduces the value of the remainder ultimately passing to the donees, but this result can be acceptable if the donor needs the money (Situation #2), or no longer cares about estate tax savings (Situation #1), and/or needs to take an action that does not require the children's consent (because they are not cooperating).

If the donor has unanticipated financial needs (Situation #2), the donor may want to accelerate the annuity payments. If the trust permits amendments (see PART IV(J)), the trust could be amended to permit such acceleration. Even without a formal amendment, possibly the trustee could allow the donor to have a lump sum equal to the present value of the future annuity payments. If the donor dies within the term, such a prepayment harms noone assuming the entire trust reverts to the donor's estate in those circumstances anyway (but see PART IV(H)). If the donor survives the term, the remainder beneficiaries have not "lost" anything, assuming the lump sum paid to the donor in lieu of his future annuity payments was correctly valued.

2. Amend or revoke the trust

Since a QPRT is irrevocable, the donor cannot simply revoke it, unless (possibly) it was entered into under duress or undue influence, or while mentally incompetent or laboring under a misapprehension regarding the facts or legal effects. See applicable state law for grounds for undoing (or amending) a trust or gift. In Massachusetts, for example, the state's highest court allowed a donor to amend an irrevocable QPRT to change the remainder beneficiaries from her grandchildren to her children on the grounds that no one could possibly have intended to incur the enormous GST tax that would be caused by having a QPRT remainder pass to "skip persons." See *Simches v. Simches,* 423 Mass. 683, 671 NE 2d 1226, 96-2 USTC ¶ 60,251 (1996).

3. Commute the beneficiaries' interests

See PART IV(G) regarding "commuting" the beneficiaries interests. Since commutation would be an obvious remedy in case of the donor's declining health (Situation #5), the regulation requires a QPRT to prohibit commutation. A PRT can permit commutation, apparently (see Appendix B). Even if commutation itself is not allowed, if the parties can give or sell their interests to each other (see PART IV(J), "Drafting for Amendability"), they can terminate the trust.

A concern with commutation is the income the donor would realize as a result. See PLR 2007-33014 (not a QPRT ruling), in which the IRS ruled that, upon commutation of the interest of the donor and life beneficiary of a charitable remainder trust, the donor-beneficiary realized long-term capital gain equal to the entire commutation proceeds; the donors were not allowed to offset any basis against the gain.

4. Donor buys the remainder interest from the children

The value of the children's remainder interest at the time of the transaction is determined using the IRS's gift tax valuation methods, and the donor then purchases this interest from them, thus causing the donor to become the sole immediate owner of the residence and terminating the trust. The donor gets his house back, the children are fairly compensated, and there is no gift. The children may have to pay income tax on the entire sale proceeds. This approach can work well for Situation #3 (donor is still rich, he just wants his house back) or #5 (decline in health). It may not be helpful if the donor cannot afford the purchase price (Situation #2), though depressed real estate values and low mortgage interest rates may make the property more affordable than previously.

5. Donor sells his retained interests to the children

The value of the donor's retained interests at the time of the transaction are determined using the IRS's gift tax valuation methods, and the donor then sells these to the children, thus causing them to become the sole immediate owners of the residence and terminating the trust. This can work in Situation #2 (donor needs money) IF the children are richer than the parent, AND the donor either moves out of the house or starts paying fair market value rent to continue to live there. The income tax consequences need to be determined. This is probably not a preferable choice in Situation #5 (declining health) because it would be better for the donor to die with the residence (rather than cash) in his estate to get the stepped-up basis.

6. Donor gives his retained interests to the children

This course of action could make sense in Situation #5 (donor's declining health) IF the following circumstances exist: The donor's retained interests can be valued using the IRS actuarial tables (i.e., he is not "terminally ill"; see PART II(D), #2, for definition); and the donor is expected to live for three or more years beyond the date of the gift (see § 2035(a)) but does not have a good chance of surviving all the way to the end of the QPRT term.

7. Children give their remainder interests back to the parent

This approach sacrifices the hoped-for estate tax savings of the QPRT, and in fact costs "extra" in terms of transfer taxes because the children typically have to either pay gift tax or use up some of their lifetime exemptions to make the gift. For more discussion of this approach, see Appendix A.

The children may be using this approach because they want to get a stepped up basis for the property when they inherit it from the parent (see #8 below). Note, however, that the basis step-up under § 1014(a) does NOT apply to property that the decedent acquired, within a year prior to his death, from the heir of the property (or such heir's spouse). § 1014(e). Thus, if the children give the residence back to the parent, and the parent then dies leaving the house to the children, the children will get a stepped-up basis only if the parent survived for at least a year following the gift-back.

8. Donor stays on in the residence after the term, without paying rent

This normally has the estate tax effect described at PART IV(D): The residence will be included in the donor's estate under § 2036 as a gift with retained possession. Some families use this approach in Situation #1 because they *want* the estate tax inclusion in order to get a stepped-up basis for income tax purposes. But this result is not guaranteed, as the following discussion shows.

Generally, for income tax purposes, "the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent" is "the fair market value of the property at the date of the decedent's death." § 1014(a)(1).

§ 1014(b) lists various types of property deemed to be acquired from a decedent, including "property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is *required to be included* in determining the value of the decedent's gross estate under chapter 11 of subtitle B…." Emphasis added. Although § 2036 is not specifically mentioned in § 1014(b), it is generally recognized that property includible in a decedent's estate under § 2036(a) is considered property acquired from the decedent for purposes of the basis provisions of § 1014(a). See Rev. Rul. 66-283, 1966-2 C.B. 297, and PLR 2002-40018.

As noted previously (see PART IV(D)), for *estate tax purposes*, there is a presumption that a parent who continues to reside in a residence he has transferred to his children does so pursuant to an "understanding" that he would do so. For *estate tax purposes*, the IRS enforces a legal presumption that the continued occupancy was "retained" by the parent-donor, thus causing estate inclusion of the property under § 2036(a). However, the children cannot simply assume that estate inclusion *automatically* entitles them to a stepped-up basis under § 1014(a). A presumption that the *IRS* is entitled to use for *estate tax purposes* cannot be used by the *taxpayer* to establish *income tax basis*. For income tax purposes, the taxpayer has the burden of proving that the property was *required* to be included in the estate. *Hahn v. Comm'r*, 110 T.C. 140 (1998), § 3(b). Thus, even if the parents stay in residence for life (rent-free) after expiration of the QPRT term, the burden of proof would be on the children to establish that the parents "retained" possession of the residence.

9. **Reverse QPRTs: The children give the parent the use of the house via a series of one-year-term QPRTs**. For discussion of this alternative, see Appendix A, discussion of "Option #6," and Appendix C, discussion of PLR 2008-14011.

10. PLR 2006-17002: For best result, do everything wrong!

This is an extraordinary ruling, where everything was done right to fix a situation where everything had gone wrong.

1. Husband and wife each conveyed a one-half interest in their joint principal residence to mirror-image eight-year QPRTs. Under both trusts, upon expiration of the terms, the residence was to pass outright to the couple's four daughters.

2. If all daughters were deceased upon the expiration of the QPRT term, the remainder would pass to the estate of the last daughter to die.

3. Subsequently, the wife "developed severe health problems and became distressed regarding the loss of Residence on the termination of the QPRTs." So, eight months before the two trusts were to expire, the spouses, as trustees, wrongfully conveyed the residence to their own respective revocable trusts. The daughters "were not consulted, advised of, or aware of" this transfer. They were apparently not even aware of the original QPRT transfer. They became aware of both transfers only several years later, when the residence was being sold. At that time, the daughters on advice of counsel demanded that the sale proceeds be paid to them. The father died meanwhile; his estate and the mother agreed to settle the matter by paying the sale proceeds to the daughters.

The IRS ruled that there was no gift from parents to the daughters in the disposition of the settlement proceeds, because the daughters were legally entitled to this money. The IRS also ruled there was no gift from the daughters to the mother and father arising from the parents' wrongful re-taking of the property because the daughters were not aware of it and did not consent to it, so they did not "relinquish or otherwise transfer" their remainder interests.

When parents retain possession of the gifted property, rent-free, following the "gift," the IRS normally imputes an implied agreement that the parents could remain in the property, thus causing inclusion of the property in the parent's estate under § 2036. See PART IV(D). That presumption did not apply here, apparently, because the daughters (being unaware of the QPRTs altogether, apparently) were not parties to any such "agreement."

The daughters accepted, in full settlement of their claims, the sale proceeds of the residence. Apparently they were not compensated for the missing rent the parents never paid for the parents' post-QPRT-term occupancy. Thus, by doing absolutely the wrong thing (stealing the residence back from their own QPRTs), the parents achieved an estate plan nirvana denied to the rest of us—they enjoyed life-long (in the case of the father at least) rent-free occupancy of the residence, but still kept the property out of the estate!

Appendix A: Advice to Client re Unwinding QPRT Gift after the Term

Note Regarding Tax Law Assumptions Used in this Memo

This "Advice Memo" is adapted from an actual client memo prepared in early 2009. At that time it was generally assumed (as stated in this memo) that the transfer tax laws, rates, exemptions, etc. that applied in 2009 would be continued in effect for 2010 and later years as a result of expected Congressional action prior to the end of 2009. As we all now know, that expected action never occurred. The recommendations and conclusions in the memo would be different in the environment of a $1 million (as opposed to $3.5 million) estate tax exemption that is currently scheduled to exist beginning in 2013. The memo is included in this paper because, despite the miserable failure of past predictions, estate planners still tend to predict a return of the 2009 estate tax law (under which the recommendations in this memo would make sense)…and to show the folly of relying on estate planners' predictions.

To: Mr. & Mrs. John Doe
From: Natalie B. Choate, Esq.
Date: March 19, 2009
Subject: Alternatives for dealing with expired QPRT: Preliminary tax advice.

The qualified personal residence trusts that hold title to your home have, at this point, expired. Upon expiration, ownership of the residence passed to your three children equally. However, you have continued to live in the residence. Although you are continuing to pay all expenses of the residence, you have not paid any rent to the children.

You have changed your minds about many of the points that went in to planning the QPRT 10 years ago. Primarily because of the increase in the federal estate tax exemption, and the decline in the value of your assets (including the QPRT-owned residence), you are less concerned about estate taxes than you were 10 years ago. Also, even if some tax savings is possible, you are not as comfortable with paying rent to continue living in the residence as you thought you would be when the QPRT was established.

This memo looks at six alternatives for dealing with the residence now that the QPRT term has expired:

Option 1: Do nothing. Continue the status quo: Parents continue to reside in the residence for the rest of their lives, paying the expenses but not paying any rent. No further paperwork is signed or recorded anywhere.

Option 2: Honor the terms of the QPRT. The trustees deed the house to the children in recognition of their ownership, and the parents continue to live there under a lease that obligates them to pay full fair market value rent to the children for their occupancy.

Option 3: Parents buy the residence from the children. The parents buy the residence back from the children for its fair market value, giving the children cash or promissory notes or other equivalent consideration. The children give up their claims to the house, and deed the house back to the parents.

Option 4: Children give the house back to the parents. The children give up their claims to the house, and deed the residence back to the parents, as a gift.

Option 5: The children give the parents a life estate in the residence. The children retain their ownership, but make a gift to the parents of a life estate in the residence, so the parents have the legal right to continue to live there for the rest of their lives, rent-free.

Option 6: "Reverse" QPRTs. The children each year give the parents the right to live in the house for one year rent-free, using a series of one-year QPRTs.

Detailed discussion

The following discussion contains several factual assumptions and estimates of values. This memo constitutes preliminary tax advice. Once an approach is decided upon, each assumption must be verified and documented, and all applicable values must be supported by professional appraisals, to support the tax treatment of whatever approach has been selected.

FACTS AND ASSUMPTIONS:

The current estimated fair market value of the house is $1 million. The parents' *basis in the house* for income tax purposes, based on their purchase price many decades ago plus cost of improvements, is estimated to be $100,000.

For deaths in 2009, the federal estate tax exemption is $3.5 million, creating the potential for a husband and wife to exempt up to $7 million of assets. Though this exemption amount is currently scheduled to expire at the end of 2009, the expectation in this memo is that the federal estate tax exemption will be made permanent at this level. (If the federal estate tax exemption is reduced substantially below $3.5 million, the conclusions in this memo would not be valid.)

The parents' combined assets, including the residence, have a total estimated value at this time of under $7 million. Thus, the expectation is that the parents are no longer concerned about federal estate taxes in connection with the residence, since, unlike when the QPRT was created, their combined assets are under the presumed exemption level.

Also for deaths in 2009 (and after 2010), under current law, a beneficiary who inherits an asset takes the date-of-death value of the asset as his or her basis for income tax purposes. The expectation in this memo is that this so-called "stepped-up basis" will also be made permanent. Again, if "stepped-up basis" for inherited property ceases to be part of the federal tax law, the conclusions in this memo would not be valid

This memo deals only with federal tax consequences. Estate, gift, and income tax consequences under your state's laws should also be considered.

Option 1: Do nothing.

The purpose of a QPRT is to get the residence out of the parents' estates for estate tax purposes. This purpose is achieved if the parents survive the QPRT term, because at that point the gift of the residence to the children is complete—provided the parents *either* move out of the residence (surrender possession to the new owners, i.e., the children) *or* pay the children rent (at fair market value rates) for the parents' continued occupancy of the residence.

If the parents *do not* move out (or start paying rent), then it is *highly probable* that § 2036 will apply, so that the property (even though the parents "legally" have given it away to the children) is still in the parents' estates, under § 2036. [See PART IV(D).]

If the residence is included in the parents' estates under § 2036, then the children would normally be entitled to a "stepped-up basis" for income tax purposes, i.e., their basis for computing their gain when they sell the residence should be equal to the date-of-death value. This basis (estimated $1 million) would be more favorable to the children upon their ultimate sale of the residence than taking over the parents' basis (estimated $100,000), which is what would happen if the children acquire their ownership via gift rather than inheritance (see Option 2). [See discussion of § 1014 at PART VII(#8).]

Thus, the advantages of Option 1 are expected to be:

- No need to incur any legal or appraisal fees now—just continue on as before.
- No adverse federal estate tax consequence (since you do not care about the estate tax consequences).
- Possibility of favorable income tax consequences for the children upon their ultimate sale of the property.

The primary drawback of Option 1 is the vulnerability of the parents' occupancy to creditors of the children, and to the children's wishes. Under Option 1, the children have legal title to the property. Thus, a creditor of a child would be able to seize that child's share of the house and possibly force a sale of the property. A child's ex-spouse could wind up with that child's share of the house in divorce proceedings, and force a sale of the property. A child could die and leave his/her share of the house to some third party. Or one or more of the children could simply change their minds and decide to sell the property and/or evict the parents. How likely these types of scenarios are to occur, and what weight to give to that risk, are matters that only you as parents can determine.

The secondary risk of Option 1 is that the income tax benefits cannot be guaranteed. See discussion of § 1014 at PART VII(#8).

Option 2: Honor the terms of the QPRT. The trustees deed the house to the children in recognition of their ownership, and the parents continue to live there under a lease that obligates them to pay full fair market value rent to the children for their occupancy.

If the parents pay full fair market value rent to their children for the parents' occupancy of the property, then the house (as well as the rental payments) would definitely be out of the parents'

estates, because payment of rent negates the presumption that the parents retained the right to occupy the property rent-free. This would eliminate federal estate tax on the residence. This is usually the best and recommended option for a QPRT, because of the favorable estate tax results. However, when estate taxes are not a concern, this option becomes less appealing.

Note that if Option 2 is adopted now (several months after the QPRT term expired), but rent is not paid retroactively to the expiration of the QPRT term (to confirm that the intent was for there to be no retained interest by the parents), then there is some possibility that starting to pay rent NOW (prospectively only) would be considered a "release" of a retained life interest, in which case the "guaranteed" estate tax result would not apply unless the parents survive for more than three years after they start paying rent.

The income tax consequences of Option 2 would be fairly unfavorable. The parents would not get any income tax deduction for their rental payments to the children. The children would have to pay income taxes on the rental income, but could take deductions for the property taxes and other expenses to at least somewhat offset that income. The children's basis for computing depreciation deductions, and for computing gain on the sale of the residence, would be a "carryover basis" (i.e., it would be the same as the parents' basis—estimated $100,000). They would not be entitled to "stepped-up basis" (estimated $1 million).

If the parents cannot afford to or do not want to pay the rent in cash, they could pay it with a series of promissory notes. The children would still have to report these notes as income, even though they would not be receiving any cash to help them pay taxes on that income. The notes should create estate tax-deductible debts against the parents' estates, thus reducing estate taxes.

As tenants of the children, the parents would have the legal right to exclusive occupancy of the residence for life (subject to the obligation to pay rent). Thus, a child, or the heir, creditor, or ex-spouse of a child, could not evict the parents. However, if a child does lose his/her interest in the residence (through sale, creditor seizure, death, or divorce), the parents could end up with a "stranger" as their landlord.

Option 3: Parents buy the residence from the children. The parents buy the residence back from the children for its fair market value, giving the children cash or promissory notes or other equivalent consideration. The children give up their claims to the house, and deed the house back to the parents.

With restored ownership of the house, the parents would have no concerns about their children's activities such as selling the house, seizure by creditors, dying and leaving the house to someone else, or divorce. The parents could deduct the property taxes on their income tax return, and have the sole power to decide whether to sell the house.

The house would unquestionably be included in the parents' estates for estate tax purposes and receive a stepped-up basis on the parents' death if they still own the house then and leave it to the children (assuming stepped-up basis is still in the law). The purchase price that the parents paid would be out of their estates, thus reducing federal estate taxes (if the estates would otherwise be large enough to be taxable).

The drawback of Option 3 is that the parents would have to pay the $1 million purchase price to the children. This Option is ruled out if the parents either don't want to do or cannot afford to pay for the property. The parents could pay the purchase price by means of a promissory note to the

children, which the parents would pay off over time; in some cases, that approach solves the affordability problem.

The other drawback of Option 3 is that the children would have to pay capital gains tax on the estimated $900,000 of capital gain. At 15% that would be $135,000 of taxes, plus any applicable state income tax. If the parents pay by means of an instalment note, the gain tax could also be paid in instalments, but then the children would also have to pay income tax on the interest on the note (and be vulnerable to possibly increasing income tax rates).

Option 4: Children give the house back to the parents. The children give up their claims to the house, and deed the residence back to the parents, as a gift.

With restored ownership of the house, the parents would have no concerns about their children's activities such as selling the house, seizure by creditors, dying and leaving the house to someone else, or divorce. The parents could deduct the property taxes on their income tax return, and have the sole power to decide whether to sell the house.

The house would unquestionably be included in the parents' estates for estate tax purposes. The children would receive a stepped-up basis on the parents' death if they still own the house then and leave it to the children (assuming stepped-up basis is still in the law)—provided that the parents survive for at least a year following the gift. (If an heir inherits property that such heir gave to the decedent, and the decedent died within a year after the gift, the heir does NOT get the stepped-up basis. The parents might consider buying a term life insurance policy to cover this risk.)

The drawback of this approach is that the children would be making a taxable gift to the parents, which would use up some of the children's own gift/estate tax exemptions. They would have to file gift tax returns. The amount of each child's gift would be: one-third of the fair market value of the house (estimated $1 million ÷ 3 = $333,333), reduced by an appropriate discount for the lack of marketability of a partial interest.

The appropriate discount must be established by an appraisal, but assuming it's 20%, that would bring each child's gift down to $266,666. The gift is made to two people (the parents) so there would be two annual exclusions of $13,000, or $26,000, available, reducing the "taxable gift" (in this example) to $240,666. This would reduce each child's future federal estate tax exemption from $3.5 million to $3,259,334. Assuming a child's eventual future estate exceeds the exemption amount, and assuming a marginal federal estate tax bracket of 45 percent, the gift would eventually "cost" the child's estate 45 percent times $240,666 (for example), or $108,300.

Option 5: The children give the parents a life estate in the residence. The children retain their ownership, but make a gift to the parents of a life estate in the residence, so the parents have the recognized legal right to continue to live there for the rest of their lives, rent-free.

The only advantage this option has over option 4 is that it reduces the amount of each child's taxable gift. Instead of giving the entire house, the children are giving away only the value of a life estate for the joint lives of the parents.

I do not recommend this option. The primary advantages of having the parents either "keep the house" or "get the house back by gift or purchase" would be that the children would (probably

or certainly) get a stepped-up basis for income tax purposes by having the house included in the parents' estates for estate tax purposes. That result would be jeopardized by having the children now formally give the parents a legal life estate in the house. By having the children formally make a gift of the life estate, the parties are "proving" that the parents did not "retain" the right to occupy the house for life. Such a gift would "prove" that the children are NOT entitled to a stepped up basis, because they acquired the property by gift and are now partially giving it back.

A legal life estate would complicate the title of the property in case of any future mortgage or sale. Because life estates are not common, the income tax and property ownership effects would need to be researched at every turn. While the parents would have the unquestioned right to life occupancy, a child could lose his or her "remainder interest" in the house to a creditor or divorcing spouse or in case of death, with the result that the "landlord" of the property would be a stranger to the parents.

Option 6: Children each year give the parents the right to live in the house for one year rent-free, using a series of one-year "reverse QPRTs."

This is really a variation of Option 5, but since the gift to the parents is structured as a series of annual gifts rather than one big gift of the right to occupy for life the children might not have to use up any of their own estate tax exemptions. The annual gifts could be structured so that each child's annual gifts to the parents was within the $13,000/year annual exclusion amount.

Obvious drawbacks are the necessity of drafting annual deeds and short-term QPRT trusts; and the same drawbacks as Option 5, namely, that this approach "proves" that the parents did NOT retain a life estate in the house (so the children are not entitled to a stepped-up basis for the property); and the possibility that a child's death, divorce, or lawsuit could leave the parents in a house owned by a stranger.

Option 6 is highly recommended for QPRT donors where the parties want to reinforce the original QPRT (and keep the house OUT of the parent's estate), but the parent can't afford to pay rent. In your case, it is preferred to have the house IN the parents' estate, so this option has no appeal.

Appendix B: QPRT–PRT Comparison

This chart shows the differences between personal residence trusts (PRTs) and qualified personal residence trusts (QPRTs). Citations to Reg. § 25.2702-5 begin with -5; "Reg. § 25.2702" is omitted. Column A describes the provision with a cross reference to the section of *The QPRT Manual* that discusses it. Column B shows what the QPRT is permitted to do with respect to that topic (with citation). Column C indicates either that the PRT rule is the same ("Same") or what the PRT rule is if it is different.

A. Provision	B. QPRT	C. PRT
Definition of personal residence. ¶ 2.1	Principal residence plus one other residence, or undivided interest in either. -5(c)(2)(i).	Same. -5(b)(2)(i).
"Home office," certain part-year rentals. ¶ 2.4.02, ¶ 2.2.03.	Permitted. -5(c)(2)(iii).	Same. -5(b)(2)(iii).
Appurtenant structures (¶ 2.5.04), adjacent land (¶ 2.5.02–2.5.03).	Permitted. -5(c)(2)(ii).	Same. -5(b)(2)(ii).
Residence must be "used or held for use" as donor's residence. ¶ 2.2.04.	Definition at -5(c)(7)(i), second sentence.	Same definition; -5(b)(1), second sentence.
Maximum number of residences in trusts at one time ¶ 2.1.05.	Two. -5(a)(1).	Same. -5(a)(1).
Reformation of trust to comply with regulation. ¶ 7.1.01.	Permitted. -5(a)(2).	Same. -5(a)(2).
Spouses may contribute to same trust. ¶ 4.4.05(2).	Yes. -5(c)(2)(iv).	Same. -5(b)(2)(iv).
Trust income distribution. ¶ 3.2.01(4).	Required annually. -5(c)(3).	No provision on this subject.
Trust distributions to persons other than donor. ¶ 3.2.01(5).	Must be prohibited. -5(c)(4).	No provision on this subject.

Assets trust may hold in addition to residence. ¶ 3.2.01(1).	Cash for expenses, improvements, purchase of residence. -5(c)(5)(ii)(A). Improvements to residence. -5(c)(5)(ii)(B). Proceeds of sale of residence. -5(c)(5)(ii)(C). Casualty insurance policies. -5(c)(5)(ii)(D). Proceeds of casualty insurance, condemnation awards. -5(c)(5)(ii)(D).	ONLY "qualified proceeds," defined as proceeds of casualty insurance or condemnation awards, but must be reinvested in two years. -5(b)(3).
What happens if trust property ceases to be donor's residence (or permitted proceeds are not reinvested within two years). ¶ 3.3.04.	Residence (or unreinvested proceeds) distributed to donor outright or in the form of annuity payments. -5(c)(7).	Unclear. Trust forbidden to hold property that is not donor's residence (or "qualified proceeds"). -5(b)(1).
Commutation of donor's interest. ¶ 3.2.06.	Prohibited. -5(c)(6).	No provision, so a PRT may either permit or prohibit commutation.
Sale of residence. ¶ 3.3.01.	Permitted, subject to exception below, provided trust contains certain provisions regarding proceeds. -5(c)(7)(ii).	Sale of residence, or any other transfer of the residence, not permitted during the term. -5(b)(1), third sentence.
Sale of residence to donor, spouse, controlled entity during the term. ¶ 3.2.07.	Prohibited. -5(c)(9).	Not applicable, because *all* sales are prohibited during the term (see above).
Sale of residence to donor, spouse, controlled entity after the term. ¶ 3.2.07.	Prohibited so long as trust is a "grantor trust." -5(c)(9).	Same. -5(b)(1), fourth and fifth sentences.
Conversion to a "GRAT." ¶ 3.4.	Permitted for trust assets that lose "QPRT status." -5(c)(8)(ii).	Not applicable.

Appendix C: QPRT Private Letter Rulings

Appendix C of *The QPRT Manual* contains a list of every QPRT private letter ruling ever published, from the first one (9151046) through the publication date of *The QPRT Manual* in 2004. Here are selected QPRT rulings issued since *The QPRT Manual* was published. Cross references ("¶") refer to sections of *The QPRT Manual*.

2005-19006. 1. GST tax: remainder to "issue." 2. Extension of time granted for late allocation of GST exemption to a QPRT. 3. Split gifts.

The remainder beneficiaries of the QPRT were not just the term-holder's children but also her grandchildren. The husband and wife elected on their gift tax returns to split their gifts (see ¶ 4.4.02). They were not advised by their "tax professionals" to allocate GST exemption to the QPRT, nor did they file any gift tax return for the year the QPRT term expired (and the ETIP ended). The IRS granted them extensions of time to make the applicable elections.

2006-13006. Not specified whether residence was principal or "other." 1. Fractional interest conveyed. 2. Allocation of GST exemption.

1. Taxpayer conveyed a one-half interest in her residence to a QPRT.

2. Upon expiration of the QPRT term, the property was held in further trust for the taxpayer's child for a term of years. If child survived that term, the property would be distributed outright to child; otherwise it would be held in further trust for child's descendants. A gift tax return was filed for the transfer to the QPRT. No GST exemption was allocated at that time, either intentionally or automatically. Due to the amendment of § 2632, however, an automatic allocation of GST exemption to the trust occurred upon expiration of the QPRT term. Taxpayer's advisors failed to advise her to make the election out of automatic allocation, so the IRS granted her an extension of time to elect out.

2006-17002. Principal residence. 1. Reciprocal trusts (not). 2. GST tax avoided. 3. Breach of trust by donor-trustees; remainder beneficiaries enforce the QPRT.

See PART VII(#10) for summary and discussion of this ruling.

2007-16008. Type of residence not specified. 1. Potentially generation-skipping trust established. 2. Gift-splitting. 3. Extension of time granted for GST exemption allocation.

1. The remainder beneficiaries of the donor spouse's QPRT were three separate trusts for the benefit of the donor's three children and their respective issue.

2. The spouses filed gift tax returns agreeing to split their gifts.

3. The spouses did not allocate GST exemption to the trusts on their gift tax returns reporting the original gift, because of the ETIP (see ¶ 5.2.01). They "failed" to allocate exemption to the trust for the year when the QPRT term and ETIP expired. They were granted an extension of time to make the allocation because apparently they relied in good faith on a qualified tax professional.

2006-17035. Vacation residence. 1. Appurtenant structure. 2. Acreage. 3. Multiple parcels; subdivided property. 4. Commercial vs. residential use. 4. Conservation easement.

The only ruling sought, and granted, was whether the transferred property constituted a personal residence.

1. The structures besides the single-family residence were a "bathhouse" ("a roof over a small outdoor bathtub") and a "pavilion" ("one-room structure with no plumbing").

2, 3. The property was "on an island that is agricultural, rural and sparsely populated. Property consists of two contiguous parcels totaling X acres which constitute a portion of a larger tract owned by Settlor." The structures were on one of the parcels and the sole access road extended across the other parcel. The size of the property was "comparable to that of nearby properties used for residential purposes." There is no indication whether the settlor's other land was excluded from the QPRT because the settlor didn't want to contribute it, or the IRS wouldn't let him.

4. "No commercial activity is conducted" on the property.

5. The settlor was going to place a qualified conservation easement on the property prior to conveying it to the QPRT.

2006-26043. Second residence. 1. Structures. 2. Multiple parcels; subdivided property.

The only ruling sought, and granted, was whether the transferred property constituted a personal residence.

1. The structures besides the single-family residence were a detached garage, artist studio, and bunk house.

2. Grantor proposed to subdivide his property, and transfer only one of the subdivided parcels to the QPRT. The parcel constituted more than one lot for property tax purposes. The amount of acreage +of the total parcel and parcel to be conveyed to the QPRT are not revealed in the published version of the ruling; the IRS concluded that the size of the parcel was "comparable to that of properties in proximity to Parcel used for residential purposes," so the acreage was "reasonably appropriate."

3. The property was used "exclusively" as the grantor's second residence; though the grantor allowed "guests to vacation in the guest house" (would that be the bunk house?), no part of the property was "rented out for commercial purposes," and "No individual other than Grantor has the right to use or occupy Property." The IRS ruled the property satisfied "the primary use requirements of section 25.2702-5(c)(2)(iii)" (see ¶ 2.1.01).

2007-28018. Second residence. 1. Sale of remainder interest in PRT. 2. Structures. 3. Multiple parcels; subdivided property.

This extremely important ruling shows how to get the benefits of a "split purchase" for an existing property the parents already own (which *The QPRT Manual* ¶ 1.4.05 said couldn't be done!), through sale of a remainder interest in the QPRT.

1. The residence was to be conveyed by husband and wife to a joint PRT in which they retained a joint and survivor life estate. The transfer to the PRT was to be in exchange for consideration paid by a separate Purchasing Trust. The Purchasing Trust would pay them "cash and marketable securities" with an aggregate fair market value equal to the remainder interest in the PRT, computed based on the § 7520 rate and an expert appraisal of the property. Upon the death of the surviving spouse, the property would pass to Purchasing Trust, of which the beneficiaries were the

spouses' issue. The trustee (not husband or wife) could also distribute "corpus" to charity during the life of husband or wife. Purchasing Trust had been established by husband "in Year __"; it is not clear how far in advance of the PRT transaction Purchasing Trust was established, nor how or when it received sufficient funding to carry out the purchase of the remainder.

The taxpayers sought three rulings: that the property was a personal residence; that the transfer of the residence to the PRT qualified for the exception to the special valuation rule of § 2702, under the PRT exception; and that the transaction did not constitute a gift, because adequate consideration was received for the remainder interest. The IRS granted all three rulings. However, the IRS expressed "no opinion" regarding whether the trust would be includible in the estate of either spouse under § 2036.

PLR 200840038 similarly approves the sale of remainder interest in a residence using a QPRT and a "Purchasing Trust."

2. The structures on the property to be conveyed to the PRT were main living quarters, pool house, guest cottage "with no bedrooms or kitchen," garage, and barn with two attached guest rooms "which are used by guests in the summer and by the Property's caretaker in the winter."

3. Husband and Wife owned the original property through a nominee trust, which they proposed to terminate. Following termination, this property would be owned by the spouses as tenants by the entireties. Following this conveyance, they would subdivide the property into two parcels, one of which, "approximately a acres of land," on which all the above structures were located, would be conveyed to the PRT.

2007-29004. Other residence. 1. Subdivided property. 2. Conservation easement. 3. IRS refusal to rule.

1. Grantor would subdivide his property and convey only one parcel to the QPRT. No indication of the size of either parcel, or why grantor was not conveying the entire property to the QPRT.

2. The grantor proposed to place a conservation easement on the parcel that was NOT being conveyed to the QPRT.

3. The IRS ruled favorably on the status of the property as a "residence," but refused to rule on whether the trust was a QPRT or the retained annuity (if the QPRT converted to a GRAT) would be a qualified annuity interest, citing Rev. Proc. 2007-3 (the update to Rev. Proc. 2003-42, Section 3, discussed under the heading "Form 1" of Appendix B of *The QPRT Manual* (p. 353)).

2007-51022. Not specified whether residence is "principal" or "other." 1. Structures. 2. Acreage. 3. Conservation restriction. 4. QPRTs holding fractional interests. 5. Nominee trust. 6. Occupancy by others (tenant).

1. Structures: There were seven buildings on the property: main house, two free-standing garages, a maintenance building, two greenhouse buildings, and a Caretaker House.

2. The property is "approximately a acres in size…assessed as one parcel for local property tax purposes and is similar in size and configuration to other nearby properties." Oddly, the ruling does not recite that the similar nearby properties were residences.

3. "Property is subject to a conservation restriction that restricts future use and development…to preserve its natural, open and scenic condition and maintain its character."

4, 5. The grantor proposed to convey the property to a nominee trust of which the beneficiaries would be three QPRTs holding fractional interests "in the nominee trust."

6. The grantor proposed to rent the Caretaker House to an unrelated third party for $d. The grantor would provide "no services…other than ordinary maintenance" to the tenant. The IRS ruled that the property was a personal residence because "The primary use of Property is as a residence of Grantor."

2008-04013. Court-approved modification of QPRT remainder provisions blessed by IRS.

The parties were allowed to modify the remainder provisions of a QPRT (and other irrevocable trusts) through a court procedure under applicable state law "to better serve the interests of Child A and Child B [the primary remainder beneficiaries of the QPRT] and to reduce administrative costs," without adverse tax consequences. See ¶ 7.1.01.

2008-14011. "Reverse" QPRT. Not specified whether this was a principal or "other" residence.

This QPRT involved mother's residence which she gave to a 10-year QPRT. At the end of the 10-year term, the property vested in son and daughter, and mother retained occupancy, leasing the property from son and daughter. Now son and daughter proposed to contribute the property to a one-year QPRT, of which mother would be the term-holder, with the right to occupy the property rent-free for one year or until the earlier death of one of the (both?) settlors.

Normally, the IRS will not rule on whether a trust constitutes a QPRT, because the IRS has issued sample QPRT forms taxpayers can rely on. The IRS agreed to rule on this one because of the unusual facts, and did rule favorably. However, the IRS expressed "no opinion" about whether the residence would be included in mother's estate under § 2036 if she died during the one-year QPRT term.

Why was this done? An educated guess: Mother didn't want to (or could not afford to) pay rent to the children at fair market value for her continued occupancy of the residence. If she stayed on without paying rent, there would be a serious risk of the property's being included in her estate as a gift with retained life estate, since the IRS would "presume" there was an agreement all along for her to stay on rent-free. The one-year QPRT doesn't preclude the IRS from raising this argument if mother dies during the term, but it does provide pretty good evidence that the mother's occupancy rent- free was not due to a prior agreement—it was due to a post-QPRT temporary gift back by the children. A one-year term might have been chosen to keep the gift tax value of the children's gift low, possibly within the annual exclusion amount.

Following this pioneering "reverse QPRT" ruling, the IRS issued a rush of PLRs approving similar "upstream" transfers from children to parents for short-term QPRTs after the end of the "real" QPRT term: **2008-16025**, **2008-48003, 2008-48007, 2008-48008, 2009-01019, 2009-04022, 2009-04023.**

2008-22011. Principal residence. 1. Large acreage. 2. Fractional interest. 3. Grantor rents property back from trust after QPRT term—no estate inclusion.

1. The residence was situated on a certain number of acres in a zoning district "intended to preserve agricultural and wildlife lands while permitting single family residential development…." The IRS

ruled that “Residence qualifies as a personal residence” because “the size of Residence is comparable to that of other properties in the vicinity of Residence used for residential purposes.”

2. The grantor and spouse owned the residence as tenants in common. Grantor proposed to transfer his interest to the QPRT.

3. The trust gave the Grantor the right to rent the residence for renewable one year terms for market rent determined by an independent professional appraisal, following the QPRT term. The IRS ruled Grantor’s continued use or possession “of Residence will not result in the inclusion of Residence in Grantor’s gross estate under sections 2033, 2035, 2036, 2038 or 2041,” if “pursuant to a lease agreement Grantor pays fair market value rental…assuming there is no express or implied understanding that Grantor may retain use or possession of Residence whether or not rent is paid.”