

QUALIFIED PERSONAL RESIDENCE TRUSTS

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I. LEGISLATIVE BACKGROUND

As these materials were being submitted for publication, the Obama Administration had announced plans to propose legislation to keep the federal estate tax exemption equivalent at \$3.5M for 2010 (instead of the scheduled one year repeal under EGTRRA) and to keep that exemption amount for 2011 forward (as opposed to the current scheduled reduction to \$1.0M under EGTRRA). New Hampshire was also proposing a state estate tax of 8% on estates in excess of \$2.0M (HB691) and some renewed Legacy and Succession tax (HB543).

In 2005, the United States House had voted to permanently repeal the federal estate tax as of 2010. The United States Senate had scheduled a vote just prior to its adjournment in late July, 2005 to do the same. That vote was postponed until the Senate reconvened in September, 2005. However, given the cost of hurricane relief in the Gulf region, that vote was postponed until early June, 2006. In early June, the Senate failed to garner enough votes to bring consideration of repeal to a vote. In July, 2006, Senate Republicans attached an amendment to a minimum wage bill which would have increased the estate tax exemption equivalent to \$5,000,000.00 and \$10,000,000 per couple (with the surviving spouse using the first spouse's unused exemption, thereby eliminating the need for a by-pass trust) and/or reduce the estate tax rate to as little as 15% (the capital gains rate). That proposal fell 3 votes short of consideration. The Senate Republican leadership had vowed to revisit repeal in the next legislative session after the first of 2007 and/or to work on compromise legislation in the 2007 session which could have raised the exemption amount in 2011 to \$5,000,000 per person and \$10,000,000 per couple (with the surviving spouse using the first spouse's unused exemption, thereby eliminating the need for a by-pass trust) and/or reduced the estate tax rate to as little as 15% (the capital gains rate). Those plans were put on hold when the

Republicans lost control of the House and Senate during the 2006 mid-term elections. Now, given the change in control of both the House and the Senate and the White House coupled with the costs of ongoing war efforts, ongoing deficit concerns, stimulus strains on the budget and the general uncertainty of a down economy, repeal appears to be off the table for now. Congressman Charles Rangel, who heads the House Ways and Means Committee, has given recent statements further confirming this.

Even if the Senate does vote to make estate tax repeal permanent as of 2010 or thereafter, or raises the exemption to a large enough amount that most clients are exempt from the tax, the following materials are relevant for several reasons.

First, client assets may be at artificially low right now and the practitioner has to consider future growth.

Second, highly valued estates need to be concerned with deaths occurring before 2010.

Third, even if repeal is made permanent, state estate taxes are at issue. In fact, many states have indicated that they will raise their state estate tax rates and/or lower their exemption amounts to make up for the loss of revenue which those states currently receive under the federal estate tax. Massachusetts and Maine are two such examples. New Hampshire may follow and is considering such a proposal as set forth in HB691 (8% tax on estates over \$2.0M).

For clients who remain concerned about potential estate taxes, the use of freezes and discounts remain as strong planning tools.

II. FREEZES AND DISCOUNTS IN GENERAL

A. Freezes. An estate freeze generally occurs when a person, during their lifetime, transfers an interest that they have in real or personal property, or in an entity, to another person (generally their offspring or other intended heir), wherein the grantor retains the right to receive fixed payments from the grantee or a trust established for the grantee's benefit. The grantee keeps the balance of the asset after the grantor receives the required fixed payment from the asset. For example, in the case of a limited liability

company, the Grantor may retain partial ownership in the form of a managing membership interest entitling the Grantor to continue to receive a portion of the profits of the company and/or a management fee.

There are many benefits to an estate freeze. For gift tax purposes, the value of the grantee's interest is discounted to reflect the grantor's retained interest. Additionally, all appreciation in the asset in excess of the grantor's frozen retained interest value passes to the Grantee without transfer tax.

Practitioners using estate freezing techniques need to be mindful of the restrictions imposed by Chapter 14 of the Code (Section 2701 et seq.). Chapter 14 was designed to curb abuses in estate freezing transactions where the transaction could result in the grantee's interest being undervalued. Undervaluation results because of the grantor's ability to administer trust property in a manner that would reduce the amount of property or payments returned to the grantor far below the valuation tables which the IRS uses to assume retained return rates.

For example, on January 1, 1988, Grantor transferred \$500,000.00 in stock to an irrevocable trust and retained income rights for ten years with a remainder to the Grantee. Under the rates in effect at the time (and prior to the enactment of Chapter 14), Grantor's retained interest would have been valued at a discount rate of 10%. Therefore, Grantor would be treated as having received a payment of \$50,000.00 per year for each year of the ten year term of the trust. This would result in Grantor having a retained interest valued at \$307,230.00, with a taxable gift of \$192,770.00. If the trustee invested the assets in the trust to produce little or no accounting income to be returned to Grantor (such as non-dividend paying growth stocks), Grantor's interest would be overvalued and Grantee's interest would be undervalued for gift tax purposes. In reality, Grantee received the entire \$500,000.00 principal and all of the growth on that money as a remainder interest. Grantor had no income added back to their estate, thereby transferring the entire asset and its growth while taking a discount for the value of the gift/transfer made.

Chapter 14, enacted in 1990, was designed to curb the above type of transaction. Chapter 14 provides that in the case of a transfer, any interest retained by Grantor will be assigned a value of \$0 for transfer tax purposes unless the interest is a “qualified interest.” An interest is a “qualified interest” only if it has a right to a guaranteed payment.

As a result of Chapter 14, estate freeze strategies will be successful only if the property transferred can achieve earnings in excess of the assumed interest rate as set forth by the IRS in valuing the Grantor’s retained interest or if the transfer is outside the scope of Chapter 14 (as in the case of a Personal Residence Trust).

The gifting of interests in real property through a QPRT is designed to freeze the value of the gifted amount in the estate of the Donor since all growth in the real property after the date that the gift is calculated will occur in the hands of the remaindermen of the trust as the ultimate Donee and not in the estate of the Donor.

B. Discounts. Generally - Discounted gifting has been a hot focus area in estate planning as both an estate tax savings device and as a way to leverage discounted gifting. This is especially important given the \$1.0M per person lifetime gifting limitation and the desire of clients to leverage that limitation.

Discounts are generally available when an owner of an asset transfers only a partial interest in that asset. A transfer of a partial interest generally involves an owner gifting less than all of an asset. In a business context, usually the gift involves a transfer of a non-controlling interest. The idea is that, while the business may have a certain overall value, the transfer of only a partial/non-controlling interest in the business will have a value of less than the value of the overall business divided by the percentage gifted. For example, a gift of a twenty percent interest in a business which has an overall value of \$1,000,000 is a gift valued at less than \$200,000. The reason is that the gift may be reduced by marketability and control discounts.

In other words, the sum of the parts is less than the value of the whole. After all, if the Donee was a purchaser buying only a portion of a company that Donee would discount the purchase price to reflect the fact that the Donee has no voting control in the company and that the company interests would be hard to resell to a third party without the remainder of the company interests.

For transfer tax purposes, a gift of less than the whole is sometimes called a minority or partial interest gift.

In a QPRT the discount comes from the fact that the remainder beneficiaries are only receiving a remainder interest in the real property (itself a fraction of the whole) and that the remainder beneficiaries have to wait for that remainder (thereby resulting in a discount for the time value of money or net present value).

The freeze comes from the fact that the value of the real property is calculated at the time that the QPRT is established and the gift is based upon this snapshot of value. As the property hopefully grows in value, that growth escapes transfer tax consideration.

III. PERSONAL RESIDENCE TRUSTS (PRT) AND QUALIFIED PERSONAL RESIDENCE TRUSTS (QPRT) AS A DISCOUNT AND FREEZE TECHNIQUE

A. Generally. Code section 2702(a)(3)(ii) and the regulations at §25.2702-5 establish and set forth the requirements of PRTs and QPRTs. Unlike a GRAT or a Defective Grantor Trust, nothing is paid to the grantor during the term of the trust, and all appreciation in the residence benefits the remainderman (ultimate beneficiaries). These trusts create a way of leveraging the federal gift/estate tax exemption. By means of a PRT/QPRT, an individual can remove a major asset from that individual's taxable estate, and yet have the transfer valued for gift tax purposes at only a fraction of the value of the underlying asset. PRTs/QPRTs are sometimes called "house GRITs." The GRIT stands for "grantor retained income trusts."

A common example may be that a parent places a house in a trust, reserving the right to live in the house for a fixed term of years. At the end of the term of years, the residence passes to the chosen beneficiaries (typically the children). Alternatively, it can be retained in trust for the benefit of the children and then pass to others, such as grandchildren in a generation skipping plan. The parent can reserve the right to rent the house back from the trust after the term of years expires, but the parent must pay fair market rent. If the parent dies before the end of the fixed term of years, however, the trust terminates and the house comes back into the parent's estate. At that point, the house will be included at its full fair market value.

When a parent sets up a PRT/QPRT, the parent has effectively made a gift to the children. Gifts are normally subject to gift tax (or, in the alternative, they use up some of the parent's federal exemption). But what is the amount subject to gift tax? For example, if the parent has given away a \$500,000.00 house the gift tax value is much lower because the children do not receive the house immediately. The children get nothing until the end of the term of years, and then they get the house only if the parent is still living. The parent can discount the value of the gift to reflect the delay between the time the parent places the house in the trust and the time the children actually get it. A further discount is allowed because of the possibility that the parent might die before the term of years, and the children will never get the house at all. Thus, for gift tax purposes, the parent hasn't given away his or her whole house, he or she has given away only a "contingent remainder interest" in the house, which is worth much less than the total house.

The applicable calculation of the Grantee's contingent remainder interest (and, therefore, gift) is based on the number of years of the trust and applicable rates under Section 7520. When interest rates are high, the gift tax value of a PRT/QPRT gift is low. When interest rates are low, the gift tax value is higher. The longer the period of the trust, the higher the gift value. The shorter the period of the trust, the lower the gift value.

Many practitioners believe that 2009 is a great time to establish a QPRT because of the "perfect storm" combination of extremely low interest rates and home values being at either artificial or depressed lows.

B. Example. Consider a 65 year old parent who places his \$500,000.00 home in a ten year QPRT. If he did this in December of 2001 (and assuming the applicable rate is 7.0%) he is deemed to have made a taxable gift of only \$187,230.00. If exactly the same transaction had occurred in December of 2002, and assuming the rate at that time is 8.8%, the taxable gift value would have been \$158,465.00; almost \$30,000.00 lower.

C. Practical Considerations. There is a tradeoff in making this kind of gift. If the parent does not live until the end of the specified term of years, the entire house comes back into his estate at its then fair market value. The transaction will not have accomplished any estate tax savings. The family is no better (or worse) off than if the

parent had done absolutely nothing. The only "actual loss" will have been the legal fees to set up the transaction, although that is a factor to be considered with the client. Of course, the client could buy a term life insurance policy to protect the family in case a premature death wipes out the anticipated savings from a QPRT.

The donor should choose a term of years which the donor is most likely to survive. For a 65 year old person, a ten-year trust term would be reasonable. If the donor is 80 years old, a two or three-year term would be more typical. Because of the way the IRS valuation tables operate, a PRT/QPRT "works" to save estate taxes regardless of how old the donor is at the time he or she sets it up, as long as he or she lives to the end of the specified term of years. Therefore, it is a good planning device for people of any age who are interested in saving estate taxes. Since, however, it only works if the donor survives for the term of years; it is not advisable for someone whose health is below average for his or her age.

The PRT/QPRT would generate more savings if the parent were permitted to buy the house back from the trust for fair market value shortly before the term ends. That way, the parent would get his or her house back and could live there without paying rent. The cash the parent would use to buy the house (which may be considerable) would move out of the parent's estate into the hands of the children. The parent would keep the house, which then gets a stepped up basis at the parent's death, or the parent could start over by creating a new PRT/QPRT with the same house. The parent's purchase of the house from his own trust would not generate income taxes on the sale for either the parent or the trust.

Unfortunately, the IRS prohibits donors from buying back a house they have gifted to a PRT/QPRT. Therefore, if the house has a low income tax basis, the estate tax savings may be wiped out by capital gains taxes. Of course, by being required to pay fair market value rent to the children at the end of the trust term, the parents are able to get additional money out of their estate without that money being deemed a gift to the children. The children will receive this rent as income to them.

The typical candidate to set up a PRT/QPRT is an individual who owns a valuable home and is willing to give the home to the children in order to reduce estate taxes. The individual's health should be at least average for his or her age group. If the home has a high income tax basis, this candidate is ideal.

Another tactic for those who are serious about reducing taxes is for the parent to gift only a partial interest in a residence to the PRT/QPRT. While the entire house may have a high value, there is virtually no market for a fractional interest in a residence. Thus, the valuation of the gift is discounted. With a series of transfers, the children may end up owning the entire high value residence even though each individual gift had a low value for gift tax purposes through the combination of the PRT/QPRT discounts and the valuation discounts applied to fractional interests.

D. Drafting Considerations in Establishing PRTs and QPRTs. There is a limit of two PRTs (including QPRTs) per grantor. Reg. §25.2702-5(b). Trusts holding fractional interest in the same residence are treated as one trust. One of the two residences must be the grantor's principal residence. Reg §25.2702-5(c)(1).

A personal residence is defined at Reg §25.2702-5(b)(2) - 5(c)(2). If the residence is not the grantor's primary residence, then the same must be a "residence" as defined by Code section 280A(d)(1). As such, the grantor must reside in the property for the greater of 14 days per year or 10% of the days the property is rented. The grantor cannot count family members residing at the property in satisfying this requirement. Once placed in the trust, the grantor does not have to continue to satisfy this obligation as long as the property is being held for the grantor's use. The residence may be rented during the term of the trust. A property which includes separate rentable space (such as an apartment) can also be a residence. See PLRs 199916030, 199906014, 9816003, 9741004 (rented rooms). Reasonable adjacent land may also be included within the definition of residence. If too much land is included, however, Code section 2702(a) applies and no value is given to the grantor's retained interest. The personal residence does not include personalty within the residence.

The PRT trust document must prohibit it from holding any asset other than one residence to be used or held for use as a personal residence by the grantor during the term of the trust and any insurance proceeds or condemnation proceeds therefrom. The residence is considered “held for use” if it is not occupied by any person other than the spouse or a dependant of the grantor and is available for use by the grantor.

A QPRT may hold some cash in addition to the residence. Cash must be held only to pay expenses payable within 6 months, to buy the initial residence within 3 months of being placed in the trust, or to buy a replacement residence within 3 months. There is a requirement that the contract to buy the initial or replacement residence must be entered into before the date of the QPRT. The QPRT may also hold insurance or condemnation proceeds. All cash proceeds used to pay expenses or buy a residence must be held in a separate account. Any income of the trust must be distributed to the grantor at least annually, and any income in excess of expenses must be paid out to the grantor at least quarterly.

In drafting the QPRT document it is advisable to permit the trust to hold proceeds of sale so that a sale does not result in the termination of QPRT status. If the property in the QPRT is sold, the money must be reinvested in a new residence within 2 years, or the proceeds must be paid to the grantor or placed in a GRAT. Generally, converting the QPRT to a GRAT is a good planning device if the trust is going to lose its QPRT status. As a result, the QPRT is more flexible than the PRT and will generally be the better choice. If the client, however, does not mind risk and does not want to convert to a GRAT if the residence is sold during the term of the trust, the PRT may be a better option.

Reminder: For all QPRTs established after May 16, 1996, Reg §25.2702-7 provides that the grantor or the grantor’s spouse or any entity controlled by the grantor may not purchase the residence from the trust during the term of the trust or at any time thereafter.