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Summer/Fall 2022 Gift Tax Series: **Volume 4: The Renaissance of the QPRT**

As has been noted in earlier installments of this series, the current estate and gift tax exemption of \$12.06mm is at a historically high level and is set to sunset at the end of 2025.¹ This combination of facts means that many high net worth individuals are trying to find ways to take advantage of the exemption now before it's gone. But not everyone has the ability to part with \$12mm of investment assets right now!

One technique that may be worth consideration is the **Qualified Personal Residence Trust** ("QPRT").² Equity in personal use real estate is frequently a large balance sheet asset. For reasons that are explained below, QPRTs have not been a very popular estate planning technique over the last several years because the gift tax benefits are diluted in low interest rate environments. But the recent dramatic increase in interest rates combined with residential real estate values holding strong are likely to make QPRTs more attractive to estate planning practitioners again. More on that below.

First, it's important to understand the basics of the wealth transfer technique. A QPRT is a device that enables a donor to remove the value of a home from the donor's taxable estate at a reduced transfer tax cost, while retaining the enjoyment and benefits for a stated period of time. The benefits are greatly enhanced when the residence is anticipated to appreciate in value. In other words, you transfer the title of your home into an irrevocable trust, and the trust grants back to you the right to continue to live in the home for a defined period of time.

Structure of a QPRT. To establish a QPRT, a donor transfers his or her interest in a residence to an irrevocable trust in which the donor retains the right to use and occupy the property for a specified number of years (the "use period"). At the expiration of this period, the property passes to the remainder beneficiaries (usually, the donor's children and more remote descendants), either outright or in further trust. If the donor desires to remain there after the use period expires, the expectation is that the children would lease the property back to the donor at a fair market rent. To facilitate this lease, the trust might provide that the property will continue to be held in trust for the children after the use period. While the concept of paying rent to your kids might be off-putting, the rent

¹ It is worth noting that the IRS just released its inflation adjustments for 2023, and the estate and gift tax exemption will leap from \$12.06mm per person up to \$12.92mm per person.

² The definitive text on QPRTs, The QPRT Manual, was written by Natalie Choate and is often referred to as the "QPRT Bible" in the estate tax practitioner circles.

further reduces your taxable estate and infuses the trust with cash to fund the home's expenses.

If a residence is owned jointly (or as community property) by one or more individuals, each individual may create his or her own QPRT by contributing that individual's interest to a separate QPRT. Conversely, the individuals (particularly married couples) may create a QPRT by each individual transferring his or her interest to a single QPRT. Unfortunately, the tax benefits of the QPRT are achieved only if the donor survives the use period. That is, if one spouse transfers a residence into a QPRT created by both spouses and then fails to survive the use period, the survivor will lose all of the potential tax savings. An alternative method that is particularly useful for married couples is for one spouse to transfer ownership of the property to the other so that it is wholly owned by one spouse, who would then transfer the entire property into the QPRT. We generally recommend that each spouse transfer his or her interest to separate QPRTs. This way, if one spouse fails to survive the term, at least one-half of the benefits can still be achieved through the surviving spouse's QPRT. The risk of surviving the use period can be further diversified by each spouse creating multiple QPRTs of varying use periods for that particular residence.

Gift Tax Consequences. Generally, transfer tax is assessed on a gift's fair market value at the time of the gift. The transfer tax cost of creating a QPRT is reduced, however, because the donor is giving to others only the remainder interest, which is the interest passing to the donor's children (the remainder beneficiaries) at the end of the use period. In other words, the gift's value is the fair market value of the residence less the value of the rights the donor retains to occupy the residence during the use period (as determined by reference to the appropriate Internal Revenue Service valuation tables).

For example, assume a 50-year-old donor owns a residence with a fair market value of \$2,000,000. The following chart demonstrates the approximate values of a gift to the remainder beneficiaries. We have varied results in two ways to highlight different manners in which the gift tax benefits can be supercharged. All else being equal, those variables are (i) the length of the use period and (ii) the applicable interest rate, called the Section 7520 Rate.

QPRT USE PERIOD	GIFT TAX EXEMPTION USED AT 2.0% ³	GIFT TAX EXEMPTION USED AT 4.8% ⁴
10 YEARS	\$1,535,580	\$1,171,284
15 YEARS	\$1,305,540	\$869,711
20 YEARS	\$1,075,620	\$625,801
25 YEARS	\$840,940	\$427,301

³ The Section 7520 Rate was 2.0% in March 2022. Rev. Rul. 2022-4.

⁴ The Section 7520 Rate has jumped to 4.8% for November 2022. Rev. Rul. 2022-20.

As one might expect, the QPRTs with shorter use periods will achieve smaller tax benefits. It's also worth noting that higher interest rates make a QPRT a more appealing technique for estate planning purposes.

While both interest rates result in a reduced transfer tax cost than if the donor had gifted the residence to his children outright (a \$2,000,000 gift), these values show that the QPRT creates a smaller gift, and thus greater tax savings, when the applicable rate is higher.

If the donor decides to create a QPRT with a 20-year use period when the applicable rate is 2.0%, a gift of \$1,075,620 would be made; whereas, if the donor had created the QPRT when the applicable rate is 4.2%, the amount of the gift tax exemption expended for the same transfer is \$625,801. That's a difference of nearly \$400k just because the applicable rate has moved 220 basis points in 8 months.

Moreover, the transfer tax savings will be greater if the property appreciates after the time of the gift. For example, if the property has a fair market value at the donor's death of \$3,500,000 (which would be conceivable if the donor died after the 20-year use term), the transfer tax savings would increase further. In such an event, the estate tax savings is not just the difference between the FMV today of \$2mm and the gift tax value of \$625,801. In that instance, the transfer tax savings would also include the \$1.5mm in appreciation between the transfer and the donor's death.

Estate Tax Consequences.

If the donor survives the use period, the entire value of the home is outside of the estate of the donor at the time of his later death. If the donor does not survive the use period, however, the entire transaction is essentially unwound. The property then reverts to the donor's estate and passes under the terms of the donor's will, causing the property's value as of the donor's date of death to be included in his or her estate. Any gift tax paid on the gift to the QPRT would be credited against the donor's estate tax liability. In other words, beyond the time and cost incurred in establishing the QPRT and having somewhat restricted control of the property after the use period, there is relatively little risk associated with this planning option. But the opportunity costs associated with predeceasing the term makes it advisable to set the term of the use period comfortably less than the donor's realistic life expectancy.

Income Tax Consequences to Beneficiaries.

Another consideration in deciding whether to pursue this technique is the income tax consequences to the remainder beneficiaries (presumably, the donor's descendants). Upon the QPRT's termination, the remainder beneficiaries' basis in the property will be equal to the donor's original basis, which is generally the cost of acquiring the property, plus any adjustments. Assuming that the remainder beneficiaries sell the residence shortly after the QPRT terminates, they will realize a taxable gain on the sale.

If, instead, the donor does not utilize a QPRT, and the property passes to those same beneficiaries at the donor's death, they would receive a “step-up” in basis. That is, their basis would be equal to the fair market value as of the date of the donor's death. Thus, no gain would be realized if the property were sold shortly after the donor's death.

Despite the potential gain on the property's sale, use of a QPRT will still benefit the remainder beneficiaries (assuming the donor outlives the use period) if the transfer tax savings are greater than the potential income tax liability. This factor will depend on the beneficiaries' income tax rates, the donor's marginal estate tax bracket, the donor's basis in the property, and the appreciation potential of the property. Given that capital gains historically have been taxed at rates significantly less than the estate tax rates, there should be a substantial net benefit to the remainder beneficiaries.

Miscellaneous Issues:

1. **Donor Cannot Reacquire Residence.**

During the QPRT's term and any other period in which the trust is classified as a grantor trust (meaning that all of the trust's income is taxed to the donor), the trust instrument must prohibit the donor from purchasing or otherwise reacquiring the residence from the QPRT. Thus, the only way the donor can subsequently own the residence is to survive the QPRT's term and then make sure that the trust is no longer being taxed as a grantor trust.

2. **Sale of Residence.** During the term of the trust, the trustees of the QPRT may sell the originally contributed residence. Within two years from the sale, the proceeds must be used to purchase a replacement residence. Note that, if the property is sold, the donor should be able to exclude up to \$250,000 of capital gain on the sale, since the trust is a grantor trust (meaning that the donor is treated for tax purposes as owning the residence or his or her share of the residence).

3. **Termination of QPRT Status.** If a replacement residence is not purchased within 2 years or if the trust ceases to hold a residence during the term, then the trust will cease being a QPRT and must convert to a grantor retained annuity trust (GRAT). In that event, the trust would have to pay an annuity to the donor for the remainder of the QPRT's term.

4. **Appraisal.** Before pursuing this project, we recommend that a donor obtain a formal real estate appraisal of the residence. A qualified appraisal is important to defend the value placed on the gift of the remainder interest should it be called into question by the IRS. While a broker's opinion of value might actually be a more accurate reflection of the value at the time of transfer, an appraisal provides greater security in the event of a gift tax challenge.

5. **Mortgaged Property.** While it is “doable,” transferring an encumbered personal residence is far more complicated and dramatically increases the “hassle factor.”

If there is any outstanding debt on the property, the use of a QPRT should be carefully considered.

6. **Limit of Two (2) QPRTs.** As a rule, a donor cannot transfer more than two properties to QPRTs, and one of them must be the primary residence if two QPRTs are created and funded.

Often, we hear estate and gift tax practitioners opine that a QPRT transaction isn't attractive in lower interest rate environments. On a relative basis, those advisors are correct that all things being equal, a higher rate environment is more favorable for QPRTs. But a favorite saying of ours is "don't let perfect be the enemy of good." As you can see from the example above, even lower rates still offer an appealing transfer tax benefit to considering a QPRT. When combining the gift tax savings with (i) the removal of future appreciation from the estate of the donor and (ii) the possibility of further estate tax reductions through the use of fair market rental value being paid to the QPRT from the donor after the QPRT term ends, the strategy can create meaningful estate tax savings. Add to that the fact that we are in the midst of the first rising interest rate environment this country has seen in several decades, and the popularity of this estate planning technique may be about to experience a resurgence.

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