

The Washington Report

Wealth Transfer Edition

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With Home Prices Soaring – A QPRT Alternative Worth Revisiting – The Remainder Purchase Marital Trust

MAJOR REFERENCES: Internal Revenue Code §§ 2702 & 2523

MARKET TREND: Interest rates remain somewhat elevated, and homes are continuing to appreciate at record levels. Many successful members of the baby-boomer generation are desiring to pass along residences and vacation homes to the next generation but have heard stories of mixed experiences with the Qualified Personal Residence Trust (“QPRT”) and are seeking an alternative.

SYNOPSIS: QPRTs provide a way for taxpayers with appreciating residential real estate to transfer such real estate to the next generation at a discounted value. However, the highly inflexible and cumbersome rules relating to QPRTs often taint the benefits. One alternative, the remainder purchase marital trust (“RPM Trust”), may be able to take the best aspects of the QPRT while maintaining greater flexibility.

TAKE AWAYS: QPRTs are a tried-and-true, statutory approach to transferring a residence to the next generation. There is, however, a more flexible option in the right circumstances, the RPM Trust, but the added flexibility comes with giving up the statutory certainty of a QPRT.



QPRTs – THE “WHAT” AND THE “WHY”

A QPRT allows someone to transfer ownership of a primary residence or vacation home out of their taxable estate to family members at a discounted value. Ownership of the residence is transferred to an irrevocable trust for an initial term during which the transferor may continue to live in the residence, rent-free. The initial term is a period of years chosen by the transferor, but if the transferor does not outlive the term, then the residence returns to their taxable estate (undoing the planning benefit). There is mortality risk associated with the technique.

Because the family members don't receive the residence until a future date, the value of the interest transferred for gift tax purposes is discounted by the IRS using the Section 7520 rate such that only a fraction of the value of the transferred property is treated as a gift. The higher the interest rate environment, the greater the discount, and the more potential transfer tax savings. Similarly, the longer the term, the greater the discount and potential transfer tax savings (but it comes with an increased risk of not outliving the term); a balancing act to be sure. Once the QPRT term begins, the value of the residence is in effect, “frozen,” meaning that any future appreciation on the residence passes outside of the transferor's taxable estate. Consequently, the strategy is very effective with a highly appreciating asset.

Real estate remains a highly appreciating asset class – especially in low-tax states like Florida and Texas, and resort towns across the country. The ability to work remotely has driven this appreciation even more. Clients can mitigate the estate tax cost of holding this appreciating asset class while retaining the use of the real estate (at least for a term); for many a terrific feature. Relatively high interest rates, and highly appreciating real estate values create an ideal environment to utilize a QPRT for transferring primary or vacation residences to the next generation at minimal transfer tax cost.

QPRT MECHANICS

A QPRT is a relatively low risk method of transferring a personal residence to beneficiaries at a reduced value for estate and gift tax purposes because it is statutorily blessed by the IRS as an “exception” to the general treatment of transfers to family members.

Internal Revenue Code (“IRC”) § 2702

Normally a donor must make a completed gift to have the asset removed from their taxable estate. The donor cannot retain an interest in the gifted asset. The QPRT is a statutory exception to this rule. IRC § 2702 provides a special rule when an individual makes a “transfer in trust” to (or for the benefit of) a “member of the individual's family” and the transferor retains an interest in the trust. In such a case, IRC § 2702 values the retained portion at zero so the result is the value of the entire asset is treated as gifted for transfer tax purposes.

For example, if a parent transfers \$1,000,000 to a trust for the benefit of his or her children, and retains a right to the income for a term of 15 years, the parent will be treated as making a gift of the full \$1,000,000 to the trust (rather than the remainder value subsequent to the income interest).



IRC § 2702 provides an exception to this rule (the “QPRT Exception”) for a transfer of an interest in a personal residence trust if the transferor retains the right to use the trust owned residence as a personal residence for a term of years. The QPRT Exception allows the value of the term interest to be determined under traditional valuation principles using the IRS §7520 rates, rather than being deemed zero.

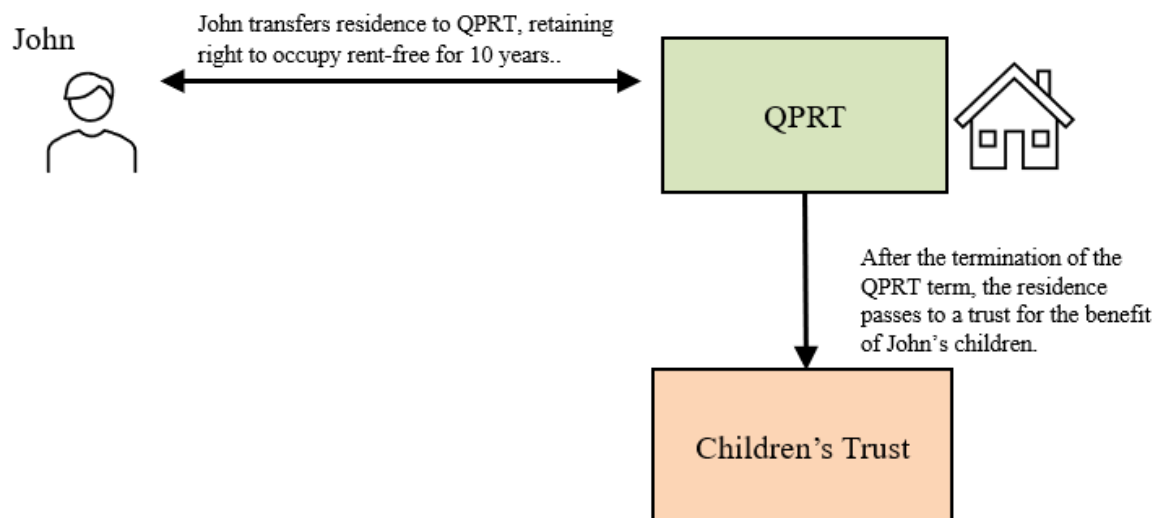
Internal Revenue Code (“IRC”) § 2702

The QPRT Exception allows the transferor to transfer the full value of the residence for the transfer tax cost of only the remainder interest (e.g., the longer the term, the lower the remainder interest’s value). The transfer to the QPRT also shifts any appreciation from the date of the transfer to the remaindermen.

The bonus - the transferor is able to live in the residence rent-free during the QPRT term and may remain in the residence and pay fair market value rent even after the QPRT term ends.

Example. John, age 55, owns a personal residence worth \$2 million, and transfers the residence to a QPRT with a ten-year term in December 2024, when the IRS 7520 rate is 5.0%. The remainder interest after the ten-year term passes to a trust for the benefit of John’s children. At the end of the ten-year term, the house is worth \$3 million. Here are the results:

Value of Retained Interest	\$772,174
Value of Gift (Present Value of Remainder)	\$1,227,826
Value at End of Ten-Year Term	\$3,000,000
Total Value Transferred (Value at End of Term Less Gift)	\$1,772,174
Transfer Tax Savings	\$708,870



Because the QPRT is statutorily blessed by the IRS, it produces a predictable result with minimal risk – as long as the somewhat rigid guidelines are followed.



QPRT DOWNSIDES

QPRTs require strict compliance with the statutory and regulatory scheme. Running afoul of the QPRT rules can jeopardize the transfer tax savings. Typical areas that cause issues in the lifecycle of a QPRT include:

- If the intended residence has a mortgage, a QPRT may not work (given the historic low interest rates of the COVID-era, even the most well-to-do homeowners may still be carrying a low interest mortgage);
- The transferor must outlive the term of the QPRT, or the entire value of the property is included in the transferor's estate (i.e., mortality risk);
- Specific rules must be followed regarding holding any asset other than the residence which can complicate the payment of routine operating expenses;
- If the transferor determines they no longer want the property, specific rules must be followed regarding replacement property;
- Similarly, there are specific rules dealing with capital improvements during the QPRT term which can make a capital project on a residence an even larger undertaking;
- At the end of the QPRT term, the transferor may dislike having to pay rent to live in "their" house; and
- If the transferor does not outlive the QPRT term, the entire value of the property is pulled back into the transferor's taxable estate, effectively placing them back where they started.

MITIGATING MORTALITY RISK – QPRT AND LIFE INSURANCE

One of the largest downsides to planning with a QPRT is the mortality risk that the transferor does not outlive the chosen term. This risk can be mitigated through the use of life insurance held in an irrevocable life insurance trust ("ILIT") outside of the transferor's taxable estate. A simple term policy mirroring the QPRT term could be added to mitigate the risk of the inclusion of the value of the transferred QPRT property during the QPRT term. However, this not only adds additional costs to the transaction, but also further administration.

If the transferor does not survive the QPRT term, the life insurance can provide value at (or exceeding) the lost value of the QPRT transfer.

THE QPRT ALTERNATIVE – REMAINDER PURCHASE MARITAL TRUSTS

An alternative to the QPRT which provides similar transfer tax benefits, but more flexibility and no mortality risk, is the RPM Trust.

How the RPM Trust Works

The RPM Trust involves two steps occurring simultaneously: (1) the transferor contributes property to a marital trust in which the transferor's spouse has a term interest; and (2) a grantor trust ("**children's trust**") purchases the remainder interest for fair market value.



IRC § 2523

The gift to the marital trust is structured to qualify for the federal gift tax marital deduction, but not be included in the spouse's taxable estate. This removes the value of the present interest from the transfer tax system at no gift tax cost.

IRC § 2523(b) provides that no gift tax marital deduction is allowed if, upon the occurrence of an event or on the lapse of time, the beneficiary-spouse's interest in the transferred property will end, and as a result, the property passes to another person *for less than adequate and full consideration in money or money's worth*. This exclusion to the gift tax marital deduction is avoided because the children's trust "purchases" the remainder interest for adequate and full consideration.

The Result

The RPM Trust allows the transferor to retain usage of their residence through his or her spouse, while transferring the remainder interest to the next generation (similar to a QPRT). If the transferor does not have an existing grantor trust for the benefit of his or her descendants with sufficient assets to purchase the remainder interest, he or she will need to create such a trust and make a gift of the necessary assets.

The Benefits

The benefits of the RPM Trust compared to a QPRT are:

- Removes the mortality risk associated with a QPRT; the planning will be successful regardless of whether the transferor outlives a term of years;
- The transferor's spouse can maintain their interest through death, eliminating the need to rent the residence for fair market value;
- The remainder interest can be GST exempt from inception; and
- The RPM Trust can sell the residence at any time without the QPRT restrictions.

Again, one material difference between the RPM Trust and the QPRT is that the QPRT is a statutory blessed planning technique – meaning that if the rules are followed, it is nearly certain the IRS will respect the transaction, whereas the RPM Trust is not a statutory planning technique, and has not been overtly approved by the IRS, which inherently carries more risk than a QPRT.

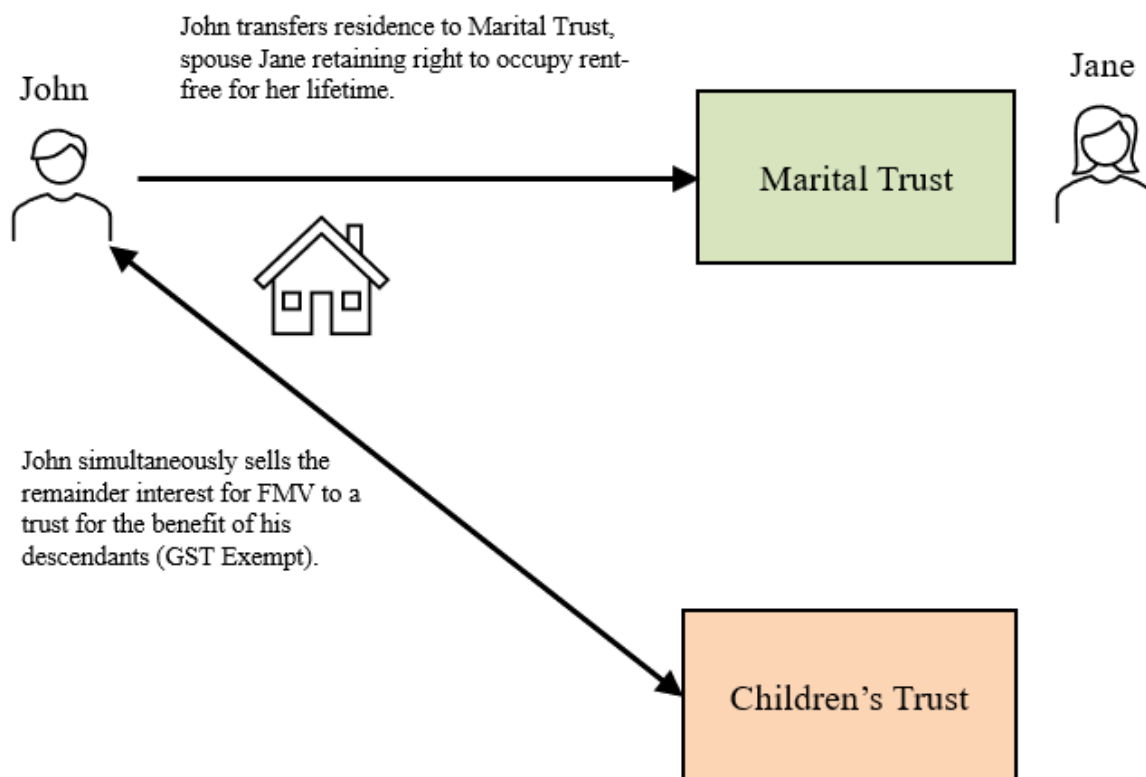
Good Planning Candidates

The RPM Trust would work particularly well as a QPRT alternative for clients who (1) have increased mortality risk due to age or health; or (2) want to make a transfer of the remainder interest but are uncertain if the current property will be retained or disposed of.

Example. John, age 55, owns a personal residence worth \$2 million, and transfers such residence to a marital trust for the benefit of his wife Jane, for her life and simultaneously sells the remainder interest to a trust for the benefit of John's children ("Children's Trust") in December 2024, when the IRS 7520 rate was 5.0%. Jane lives 27 years to her life expectancy, and the property appreciates 4% each year. Here are the results:



Value of Retained Life Interest	\$1,464,304
Sale Price to Children's Trust (Present Value of Remainder)	\$535,696
Value of Property at End of Jane's Life	\$5,766,737
Total Value Transferred (Value of Property at End of Jane's Life Less Sale Price)	\$5,231,041
Transfer Tax Savings	\$2,092,416



Because the RPM Trust planning does not require setting a term of years and incurring mortality risk, Jane is able to use the residence rent-free for the remainder of her life which freezes the value and shifts appreciation outside of her taxable estate.

TAKE AWAYS

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