THE LEGAL INTELLINGENCER

QUALIFIED PERSONAL RESIDENCE TRUSTS: AN ESTATE PLANNER'S TOOL IN A HIGH INTEREST RATE ENVIRONMENT

May 2, 2024
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With interest rates continuing to rise, qualified personal residence trusts (QPRTs) have become a useful estate planning tool that is especially effective in a high interest rate environment. A QPRT is an irrevocable trust that is designed to exclusively hold a primary or secondary residence for a set term. During the term, the creator of the trust (the settlor) retains the right to live in the residence, and after the expiration of the term, the residence automatically passes to a beneficiary (known as the remainder beneficiary). The remainder beneficiary may be an individual or individuals or a trust or trusts.

QPRTs are most appealing for individuals who have, or will have, a taxable estate for estate tax purposes at the time of their death. Currently, the federal estate tax exemption is $13.61 million per individual, but on Jan. 1, 2026, the federal estate tax exemption will automatically drop to approximately $5 million per individual, adjusted for inflation. Unless Congress acts, many individuals who would not otherwise be subject to the federal estate tax at their death will suddenly become subject to the federal estate tax in 2026.

An individual may use some of his or her $13.61 million exemption during lifetime through gifting, and to the extent the exemption is not used during life, the individual may utilize the remaining exemption at death. From an estate planning perspective, planners ideally try to leverage an individual's exemption during lifetime rather than waiting until after death when assets may have appreciated significantly.

QPRTs are an ideal tool to leverage an individual's estate and gift tax exemption. Because the settlor retains the right to use the residence transferred to the QPRT during the term of the trust, the value of the settlor's present interest in the QPRT is not a taxable gift. The value of the gift is instead equal to the value of the remainder interest in the residence. Based upon the remainder calculation, the remainder interest decreases as interest rates increase. For example, if in April 2024 a 70-year-old transferred a $1 million property into a QPRT with a 10-year term, the value of the settlor's retained interest would be approximately $559,000, and the value of the remainder interest would be approximately$441,000. The settlor will have transferred a property worth $1 million to the QPRT, but the value of the gift and the amount of exemption used on the transfer would only be $441,000. At the conclusion of the term, the remainder beneficiaries receive the full $1 million property at a gift tax cost of only $441,000 of exemption. If the property appreciates in value at the conclusion of the 10-year term, then all of the appreciation would occur outside of the settlor's estate and would at that time pass gift and estate tax free to the remainder beneficiaries.

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BENEFITS OF A QPRT

The most significant benefit of a QPRT is the leveraging of an individual's estate and gift tax exemption. When transferring a property to a QPRT, the gift tax cost to the settlor is only a fraction of the full fair market value of the property at the time of transfer. And, by transferring the property during a settlor's lifetime, any appreciation on the property will grow outside of the settlor's taxable estate.

The settlor also benefits from a QPRT by maintaining the ability to use the property during the term of the QPRT. During the term, the settlor will have peace of mind that no beneficiary may force the settlor out of the property. The settlor could also customize the length of the term of the QPRT based upon the settlor's expected period of use of the residence. If an older settlor knows that he or she will only use the residence for a set period of time, the settlor could create a term to match those expectations.

While QPRTs are designed to hold a personal residence, the residence may be sold during the term of the trust. If anew residence is not acquired within two years of the sale of the sold residence, then the QPRT will convert into retained annuity trust and will pay an annual annuity to the settlor for the remainder of the term. Most importantly, the failure to acquire a new residence neither destroys the prior planning or gift to the QPRT nor inadvertently brings all of the assets back into the settlor's taxable estate.

Even after the expiration of the term of the QPRT, a settlor could enter into a lease agreement with the remainder beneficiaries to use the residence. While a lease agreement would likely be an income taxable event for the remainder beneficiaries, the lease payments could be an additional estate planning mechanism to shift assets out of the settlor's taxable estate to the remainder beneficiaries without using the settlor's estate and gift tax exemption.

A QPRT is a grantor trust for income tax purposes. As a grantor trust, the QPRT is treated as if it was the grantor for income tax purposes. If the residence is sold during the term of the QPRT, then the settlor would pay the income tax liability, rather than the trust paying such tax. By the settlor paying the income tax incurred by the trust, the trust is not depleted by any income tax liabilities of the trust, and the settlor's estate is further reduced without any additional gift tax consequences. If the remainder beneficiary was also structured to be a grantor trust as to the settlor, then future lease payments between the settlor and the grantor trust would not be income taxable to the remainder beneficiary grantor trust.

DISADVANTAGES TO A QPRT

The greatest risk to a QPRT is selecting the length of the term of the QPRT. The longer the term, the larger the amount retained by the settlor, the smaller the remainder, and the smaller the taxable gift. Ideally, one would choose a longer term to reduce the size of the taxable gift.

In order for QPRT planning to be successful, however, the settlor must survive the term of the trust. If the settlor survives the term, then the residence will remain outside of the settlor's estate for estate tax purposes at the conclusion of the term. If the settlor does not survive the term, then the residence will be included in the settlor's estate for estate tax purposes and the purpose of the QPRT planning will not have been accomplished. The key to selecting a term is to select a term long enough to achieve a lower gift of the remainder yet short enough that the settlor will survive the term.

While a residence transferred to a QPRT may have a mortgage on it, it is recommended that only properties without a mortgage be transferred to a QPRT. If a mortgaged property was transferred to a QPRT, every monthly mortgage payment would be considered an additional taxable gift by the settlor. Aside from the added difficulty in tracking and calculating monthly gifts to the QPRT during the term, the monthly mortgage payments could ultimately undermine the tax benefits to creating a QPRT.

In general, when assets are gifted during an individual's lifetime, the recipient of the gift takes the donor's tax basis, or carry-over basis, in the gifted property. If an individual holds appreciated property until his or her death and dies owning the appreciated property, then the individual's basis would be stepped up (or down) based upon the fair market value of the property on the date of the decedent's death. The step up in basis could serve to eliminate all built in gain in low-basis assets.

With a QPRT, the transferred residence will retain the settlor's tax basis. Assuming that the settlor survives the term of the QPRT, the basis of the residence will not be stepped up or down at the settlor's death, which potentially causes an income tax burden for the remainder beneficiaries if the carry-over basis was low. If the settlor does not survive the term of the QPRT, then the residence will be included in the settlor's estate for estate tax purposes and the residence will receive a step up or down in basis.

Ultimately, QPRTs are an outstanding planning tool for a primary or secondary residence of individuals with a federally taxable estate. While QPRTs have their disadvantages, the current high interest rate environment may prove to be a limited window of opportunity to leverage an individual's estate and gift tax exemption and transfer the future appreciation of a residence out of one's taxable estate.

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