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Food For Thought: The Zeroed-Out QPRT?

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As many of us know, the Qualified Personal Residence Interest Trust, or “QPRT,” is a common estate planning tool. An individual contributes his or her residence to a trust, but retains the right to live in the residence for a term of years (e.g., 10 or 20 years). The contribution of the residence to the trust is a gift, but the gift is reduced by the value of the individual’s retained interest, so the gift is much less than the actual fair market value of the residence.

The creation of the remainder interest typically constitutes a taxable gift by the grantor of the trust. This can limit the utility of a QPRT if a client already has used his or her $1 million lifetime gift tax exemption, or if the value of the remainder interest would exceed $1 million. For example, a $10 million New York City apartment will generally create a remainder interest of greater than $1 million if transferred to a QPRT (the calculation depends, of course, on the QPRT term of years, the discount rate in effect, the client’s age, etc.). This client may not be able to create a traditional QPRT without triggering a gift tax.

One planning technique that a client at this level might wish to consider is a “zeroed-out QPRT.” With a zeroed-out QPRT, the individual retains certain rights (ie, a limited power of appointment) over the remainder interest so that the initial transfer of the property to the trust is not a gift at all. In other words, the actuarial value of the remainder interest is not gifted away and remains in the grantor’s estate. But if the individual survives the term of the QPRT, the future appreciation in value of the residence will be removed from the individual's estate. Only the actuarial value of the remainder interest at the beginning of the trust term should be includible.

Let us return to the above example of a $10 million New York City apartment and assume the client is 65 years old and creates a 15 year QPRT to own the property. The remainder interest is allocated to its own trust, and the client retains a limited power of appointment over it. Based on the current actuarial tables, the grantor's retained interest will be worth approximately $6 million and the remainder interest will be worth approximately $4 million. There should be no gift at the time of transfer due to the grantor's limited power of appointment over the remainder.

Now let us assume that the client survives the term, and when the client dies at 81, the property has a value of $17 million. On these numbers, the amount includible in the client's estate should be only the original $4 million remainder. All of the appreciation in the property has occurred outside of the client's estate.

One downside to this technique is that the donees will receive the property with a carryover basis and not receive a step-up (assuming the step-up rules apply). Since the estate tax is greater than the capital gains tax, this generally does not present an issue, though it is worth noting that the scheduled increase in capital gains rates will worsen the income tax effects of a sale of the property.

The zeroed-out QPRT is an interesting application that may be a worthwhile consideration for certain clients. Please contact us if you would like to discuss this technique.

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