

TITLE: Reverse QPRTS To The Rescue

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EXECUTIVE SUMMARY:

Qualified personal residence trusts (“QPRTs”) have now been in the Code for almost twenty years. They have excellent estate tax and asset protection planning benefits. However, empirical evidence suggests that they are dramatically underused. One reason may be the fact that the parents must pay rent when the QPRT term ends. In a startling 2008 private letter ruling, the IRS blessed a structure that follows §2702(a)(3)(A)(ii) to create what has colloquially been referred to as a “reverse” QPRT. Tax lawyers should become knowledgeable about this structure because it may make many more taxpayers comfortable with the use of QPRTs.

FACTS:

The First Ruling.

Natalie Choate and Steve Leimberg reviewed PLR 200814011 (April 4, 2008) in *Leimberg Estate Planning Newsletter* 1273 (April 14, 2008). The basic facts were as follows: Mom established a 10 year QPRT. The 10 year term ended. The beneficiaries – son and daughter – contributed the home to an irrevocable trust. The trust provided Mom with the right to live in the residence for one year free of rent. The IRS agreed to value the children’s gift to Mom under the QPRT rules, so the gift was probably quite small. This “reverse” QPRT eased the sting of Mom having to pay rent. (Perhaps Mom’s financial circumstances had worsened during the 10 year term.)

The authors (Choate and Leimberg) cautioned about “A Fly In The Ointment”: would the IRS argue for inclusion of the residence in Mom’s estate? There was – and still is – no answer. Presumably the IRS will argue for estate tax inclusion if the reverse QPRT was always intended – from the moment Mom began the original QPRT – as a way to allow her to remain in the residence until her death without the need to pay fair market rent.

The Later Rulings.

In the nine months since PLR 200814011, there have been at least seven more favorable rulings on similar facts:

PLR 200816025 (April 18, 2008);

PLR 200848003 (November 28, 2008);

PLR 200848007 (November 28, 2008);

PLR 200848008 (November 28, 2008);

PLR 200901019 (January 2, 2009);

PLR 200904022 (January 23, 2009); and

PLR 200904023 (January 23, 2009).

Note #1: Sole Author. Interestingly, all eight PLRs were written by Lorraine Gardner, Senior Counsel, Branch 4, Office of the Associate Chief Counsel (Passthroughs & Special Industries).

Note #2: Repetitive Rulings Unusual. As noted by authors Choate and Leimberg, the IRS will usually not issue rulings on whether a trust with one term holder satisfies the QPRT requirements because the IRS provided taxpayers with sample trust provisions for QPRTs. See §4 of Rev. Proc. 2003-42, 2003-1 C.B. 993. The IRS - by sending out repeated guidance – must be trying to make the tax community comfortable with “reverse QPRTs.”

Note #3: Continued Estate Tax Caution. Each of the eight rulings contains virtually the identical warning: “...no opinion is expressed or implied concerning whether the transfer of Residence to Trust 2 would result in Residence being included in the gross estate of Mother under §2036.”

Question #1: Given the similarity of the facts and the closeness in time of the rulings, were these all submitted by one law firm?

Question #2: Now that we have seen these eight rulings, is there a reason for anyone else to submit a “reverse QPRT” for a ruling? Don’t we now have enough comfort that – other than estate tax inclusion – the structure, at least in theory, works? (Remaining problem: the calculations. See below.)

COMMENT:

The Current Need For QPRTs.

These are tough times economically. Clients are scared. Clients with businesses may have loans on which they have made personal guarantees. They are afraid of losing their homes. The home is often the most emotionally significant asset to the family, especially to the non-working spouse. This is a time when clients are motivated to establish estate tax planning structures, in part, due to these structures' collateral benefits: the same structures that reduce the value of assets for estate tax purposes also reduce the attractiveness of those assets to a currently unforeseeable creditor.

Of course tax lawyers must not help clients enter into a fraudulent transfer. A taxpayer who transfers a home to a QPRT on the eve of bankruptcy may end up losing the homestead exemption. However, there is at least one intriguingly favorable case involving QPRTs.

In In re: Thomas J. Earle, Jr. et al. Mr. and Mrs. Earle had lost their home in a tax sale in 1994 and redeemed it in 1997. In 1998, Mrs. Earle transferred it to a 20 year QPRT. Less than 4 years later the Earles filed under Chapter 13 of the Bankruptcy Code. A creditor moved to (i) change the proceeding to Chapter 7; and (ii) set aside the QPRT as done "with actual intent to hinder, delay, or defraud creditors" in violation of Alabama's fraudulent transfer statute.

The court carefully analyzed the various "badges of fraud." The testimony of the professionals who arranged for the QPRT was crucial to the outcome which was favorable to Mr. and Mrs. Earle. The Form 706 for Mrs. Earle's mother-in-law's estate, which had incurred significant estate taxes, was due in January, 1998, a few months before the Earle QPRT was formed. Mrs. Earle had consulted an accountant and an attorney regarding that estate. The accountant "planted" the QPRT idea in her head. The attorney testified about significant estate tax liability and liquidity concerns. That attorney suggested that Mrs. Earle consider a QPRT to reduce her own potential estate tax liability. It was extremely important to the court that the professionals suggested the QPRT. It showed that the Earle QPRT was not created in a vacuum. The estate tax reason for forming the QPRT at the time that they did helped to overcome the allegation that the home was transferred into the QPRT primarily for the purpose of delaying, hindering, and defrauding the creditors of the bankrupt debtor.

Example: John and Joan

Problem. In 1993 John was a 55 year old, successful architect. However, he was concerned that a project on which he had worked might have problems. He was aware of colleagues who had been drawn into litigation between unhappy owners and builders. His CPA sent him to our office for counseling.

Assets. The largest assets John had were (i) his pension plan, (ii) investment property in California and Colorado and (iii) his Santa Barbara residence overlooking the ocean. We (i) confirmed that he had a rank and file employee (an adult child) covered by his corporate retirement plan and (ii) established a family limited partnership (with a corporate GP owned by an irrevocable trust for the children) to own the investment property. Then we discussed his home which had \$1,000,000 of equity (and no mortgage).

Alternatives. We discussed various options, including:

- (i) doing nothing (too terrifying);
- (ii) giving the home to a children's trust, filing a 709 for the \$1,000,000 gift, and renting it back (paying rent to the children starting immediately seemed too expensive for them);
- (iii) selling the home to a children's trust and renting it back (caution Estate of Maxwell, 98 T.C. 594 (May 13, 1992), which illustrates the §2036 risk);
- (iv) contributing the home to the family limited partnership and renting it back for its appraised fair rental value (with the attendant §2036 risk); and
- (v) a QPRT.

QPRT Analysis. We concluded that the QPRT had the best combination of advantages and disadvantages which include, but are not limited to, the following:

Advantages:

- (i) paying rent would be postponed until the end of the QPRT term;
- (ii) the gift would be reduced by a longer QPRT term;
- (iii) if they need to get money to their children, the QPRT trustee can borrow on the home and transfer the money to the remainder beneficiary (the irrevocable trust for the children), which accelerates a portion of the gift;
- (iv) in the absence of a finding that the transfer to the QPRT was fraudulent, a judgment creditor could only attach that which John and Joan retain (can a creditor convince a judge to evict John and Joan and put in the creditor's own tenant? By then the creditor will probably be ready to negotiate for pennies on the dollar);

- (v) recording the deed transferring the residence to the QPRT trustee gives notice to the world for purposes of starting the statute of limitations on fraudulent transfers; and
- (vi) on a sale of the home, John and Joan are entitled to the income tax advantages available for a principal residence;

Disadvantages:

- (i) John and Joan could not use the equity of the home for retirement purposes;
- (ii) variation on (i) - John and Joan cannot withdraw equity for emergencies;
- (iii) any refinancing would be more difficult as lenders do not like to lend to irrevocable trusts;
- (iv) cannot list the home itself as an asset on a financial statement;
- (v) contributions to the QPRT to make improvements to the residence may constitute additional gifts (there are other ways to handle this situation).

Construction Of The QPRT. John and Joan were both 60. The home was community property. In October, 1993, the §7520 rate was 6%. The value of the gift of a 15 year term was \$141,535 for each spouse. (At that time the each spouse had a credit of \$192,800 which allowed the first \$600,000 to be excluded from gift tax.) The remainder beneficiary was an irrevocable trust for the benefit of their 5 children.

Note #1: we did not first give an undivided 5% interest to the children's trust, having the parents pay rent for the 5%, and having a business appraiser opine on the value of two 47.5% tenancy in common interests. However, that would have been a good way to reduce the value.

Note #2: why did we not use a longer term to postpone the payment of rent even longer? With the benefit of hindsight we should have used a 20 year term. However, when creditor protection is an issue, a shorter term means that the parents have retained less value. Also, note that we just had a client die 19 days short of the end of a 20 year term. In other words, you can never be certain what will work.

The Creditor Concerns. Over the 15 year period we met with John and Joan on three occasions to review their planning. The lawsuit between the owner and builder had occurred, but John had been omitted except as a witness. He phased down his business and entered a happy retirement by age 70.

End Of QPRT Term. In November, 2008, our calendar system kicked out a reminder about the termination of the John and Joan QPRTs. John hired a local real estate appraiser to determine the fair rental value of their home, now worth \$5,000,000. (Ocean views in Santa Barbara have not been greatly impacted by the real estate recession.) The rental market is thin, so the appraiser could not give us a solid fair rental number but, instead, a range of \$15,000 to \$25,000 per month. Suffice it to say John, now age 70, who has been retired for several years, does not have the financial wherewithal to pay \$180,000 to \$300,000 per year in rent. He is currently spending \$7,500 per month on the house (a home of that size requires a certain amount of upkeep). However, that would leave a shortfall of \$90,000 to \$210,000 per year.

Scotch Tape. We cast about for ways to handle the situation. First, of course, we went searching for a better appraiser (meaning a lower, per month, estimate of fair rental value). We had some success: we were able to firm up the \$15,000 per month, the lower end of the first appraiser's range. Second, we considered having John increase the distributions he was taking from his pension plan. Third, we suggested that he charge a management fee to the family limited partnership to improve his share of the distributions. (The children's trust now has 40% of the limited partnership interests.) However, once he received the increased funds from the pension and the partnership and used them to pay rent to the children's trust – his landlord – he would need the children to make gifts back to him each year so that he could (i) pay his income taxes (which were increased by those distributions) and (ii) have money on which to live. All in all, it was do-able, but not a terrific result.

Reverse QPRT To The Rescue. At the end of November the three newest reverse QPRT PLRs came to our attention, and we realized we had a workable rescue. We decided on the following approach:

Pay Rent. John and Joan entered into a 3 month lease to pay fair rental value to the children's trust. They had enough money, from various sources, to be able to afford \$15,000 per month for the first 90 days. That gave us enough time to structure the new "reverse QPRT."

Construct The Reverse QPRT. This is how we believe you determine the value of the gift from the children to the parents using Estate Planning Tools 2009.00 (what we still refer to as "NumberCruncher" since we've been subscribers for about 50 years). Starting from the top:

- (i) the transfer date is 2/2009;
- (ii) the §7520 rate is 2%;

- (iii) the principal is \$5,000,000 (for the two spouses occupying the house together);
- (iv) the "Grantor's Current Age" is 70, even though, in the case of a reverse QPRT, the 70 year old is not the grantor. Also, the grantor's age is irrelevant to the value of the gift;
- (v) the "Second Age (0 if none)" is irrelevant;
- (vi) the "Term of Trust" that we selected was 5 years – a 5 year lease seems reasonable under the circumstances, given the property and their ages (and the rental appraisal);
- (vii) we unchecked the box "With Reversion?" since we believe that does not calculate the gift properly for a reverse QPRT; the house will not be "reverting" to the 70 year old. When the tenant dies the lease could terminate; however, it is unclear how, using this software, to calculate the difference in the gift, and we do not want to engage in calculations by hand).

The other two variables in the software (After-Tax Growth and Comb. Death Tax Bracket) do not impact the gift tax calculation. Where do you find the result? When you are calculating a reverse QPRT you must examine the "Value of Nontaxable Interest Retained by Grantor." In this case it produced a very acceptable \$471,345 gift.

As Steve Leimberg pointed out to us while we were struggling with these calculations, the gift from the children to the parents in the reverse QPRT is eligible to be offset by the children's annual gift tax exclusion because it is a gift of a present interest. Treas. Reg. §25.2503-3(b) provides that "An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property."

As a result, on these facts we had 5 children X 2 parents X \$13,000 = \$130,000 of annual gift exclusion available to offset a \$471,345 gift. That left \$341,345 divided among 5 children who were only too happy to file gift tax returns each using \$68,269 of their respective lifetime transfer tax exclusions to give their parents a 5 year rent free usage of the home.

Note: In situations like this where children may not be happy to make a gift to their parents, we find that the threat of disinheritance provides a strong motivation. We usually suggest that the parents consider the law firm as an alternate beneficiary. Unfortunately, California Probate Code §21350 (the anti-Gunderson legislation), makes that difficult.

End Of The 5 Year Term? When the 5 year lease term ends, we will want to make sure that John and Joan pay rent for some appropriate period of time before discussing another QPRT. However, what might the next reverse QPRT look like?

Reverse QPRT #2. Assume that in 5 years, due to the trillion dollar deficits the U.S. is currently running, the §7520 rate will be 10%. The home will then be worth \$10,000,000. John and Joan will then be 75 years of age. What will reverse QPRT #2 look like?

First, given the magnitude of the dollars involved, we may have no choice but to lease John and Joan less than 100% of the residence. This may provide the basis for a tenancy in common discount for the value of the tenancy interest.

Second, setting that aside, the value of a 5 year tenancy would be \$3,790,210. Who knows what the annual gift tax exclusions will have been increased to by then under the cost of living adjustments? Who knows what the lifetime gift tax exclusions will be at that time? If the lifetime gift exclusions remain at \$1,000,000, John and Joan's children will still have the opportunity to offset this gift by filing 709s and not paying a gift tax. It seems clear that by the time we get to Reverse QPRT #3 the children will start paying gift taxes at 45%.

Is A Reverse QPRT Better Than Cheap Rent?

Assume John and Joan are not comfortable with the idea of a reverse QPRT. After all, they have waited 15 years to get the equity in the residence out of their estate and they may not wish to jeopardize that wonderful estate tax result by entering into a structure which – on the face of each of the 8 PLRs – faces uncertainty under §2036. Would they be better off paying the rent that they can afford to pay and having the children file gift tax returns for the balance?

John and Joan can afford to pay \$90,000 per year, which is ½ of the fair rental value. Dividing the \$90,000 shortfall by 5 children = \$18,000 per child. Each child would offset that by that child's annual gift tax exclusion of \$26,000, so – at least in theory – no gift tax return would be due. Assume that continued every year until the surviving parent died. Would the IRS argue that there was never an intent to pay fair rent so that it was, in substance, an arrangement for the parents to retain the right to live in the house that causes inclusion under §2036? The answer must almost certainly be "yes."

Conclusion.

When the QPRT ends the residence should be appraised and the parents should pay the fair rental value pursuant to a written lease for a reasonable period of time. ("Reasonable" is the word that lets you know that someone is a lawyer. To a layman it is gibberish; to a lawyer it's a black and white, defined term.) Once that reasonable term lease

ends, the children should be able to safely – meaning without the IRS being able to successfully argue for the inclusion of the residence in the parents' estates under §2036 – enter into a reverse QPRT for a short period of time. (“Short” is measured by reference to the parent’s life expectancy at the time.)

The availability of reverse QPRTs should make this excellent technique more attractive to our clients.

CITES:

PLR 200814011 (April 4, 2008); PLR 200816025 (April 18, 2008); PLR 200848003 (November 28, 2008); PLR 200848007 (November 28, 2008); PLR 200848008 (November 28, 2008); PLR 200901019 (January 2, 2009); PLR 200904022 (January 23, 2009); PLR 200904023 (January 23, 2009); IRC §2702(a)(3)(A)(ii); Reg. §25.2702-5(c)(2); §4 of Rev. Proc. 2003-42, 2003-1 C.B. 993. In re Earle, 307 B.R. 276 (2002).