Worth It Episode 10: You Can Turn Your Home Into Major Estate Tax Savings

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In this episode of Worth It, Proskauer associates Jacob Wonn and Nathalie Stenmark discuss qualified personal residence trusts (also known as "QPRTs"), how they work, what the potential benefits are and why clients might consider this particular estate planning technique. With the current rising interest rate environment, there has been a renewed interest in QPRTs, so be sure to tune in!

Jacob Wonn: Hello and welcome to Worth It, a podcast brought to you by Proskauer's Private Client Services Group, covering a wide range of topics concerning estate planning, wealth transfers, important legal developments, and other issues our clients frequently face when organizing their estates. My name is Jacob Wonn and I'm an associate in Proskauer's New York office. In this episode we'll be discussing qualified personal residence trusts also known as QPRTs, how they work, what they do, what the benefits are, and why clients might consider this particular estate planning technique right now. Joining me for this episode is Nathalie Stenmark, Associate in Proskauer's Los Angeles office. Welcome Nathalie.

Nathalie Stenmark: Thank you for having me, Jacob.

Jacob Wonn: Thanks for joining today, Nathalie. Could you just tell us what is a QPRT exactly, and how does it work?

Nathalie Stenmark: Right. So, a qualified personal residence trust, also known as a QPRT is a gifting technique where an individual transfers an interest in a personal residence to a trust, making a gift of the remainder interest while retaining the exclusive use of the residence for a term of years. The QPRT will freeze the value of the taxpayer's residence at the time he or she creates the trust, and this can result in significant tax savings. So, let me take you through the different steps of the QPRT.

Step one is to create the QPRT for a term of years and designate remainder beneficiaries. The grantor will then contribute the residence to the trust thereby creating a taxable gift at that time. Now the trust can be funding using either a principal residence, a vacation home, or secondary residence or a fractional interest in either of those. The fair market value of the residence is discounted for gift tax purposes but note that this gift does not qualify for the annual gift tax exclusion since the transfer of the residence to a QPRT is not a gift of a present interest.

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Then the second step is the use of the residence. The grantor retains the exclusive rent-free use possession and enjoyment during the term of the QPRT. The grantor pays any ordinary recurring expenses such as the property taxes, insurance, and minor repairs, however, if the grantor makes a capital improvement the cost is treated as an additional gift to the trust and the amount of the taxable gift is based on the fair market value of the improvement as well as the remaining term of the QPRT so that’s something to keep in mind.

Then step three, for the QPRT technique to be effective for estate tax purposes the grantor must outlive the term of the trust. If the grantor dies before the trust term expires, the date of death value of the QPRT will be included in the grantor’s estate and be subject to estate tax. However, the grantor’s estate will receive full credit for any tax consequences of the initial gift to the QPRT, so really the grantor is no worse off than if he or she had not created the QPRT in the first place so minimal risk there.

Finally, the termination of the QPRT if the grantor outlives the term of the trust, the residence will pass to the beneficiaries at the end of the term. This can be either directly to the beneficiaries or a trust established for their benefit. At the end of the QPRT term, the grantor can lease the residence back from the beneficiaries at fair market rent thereby allowing the grantor to continue living the residence. Note that these rental payments that the grantor makes will also further reduce the value of his or her estate, so it's an opportunity to get more money across the tax fence.

Jacob Wonn: Interesting. That's really helpful background, Nathalie. Thank you. I understand that QPRTs in recent years were not as popular or common, but the interest in them is resurging among estate planers and I was wondering if you could explain why that is and why now is a good time to create a QPRT.

Nathalie Stenmark: Of course, and I'll get into the tax mechanics and the benefits in a minute, but just high level, when interest rates rise the value of the right to remain in the residence increases and this results in a lower gift as the higher value of the right to remain in the residence is subtracted from the fair market value of the residence of the time of the gift. The current rising interest rate environment has resulted in a renewed interest in QPRTs. We're seeing more and more clients engage in this type of planning.

So, the value of the grantor's retained right to live in the personal residence is determined actually using statistical tables published each month by the IRS and the value of the retained interest will depend on prevailing interest rates, the length of the trust term, and the age of the grantor, and as the term increases, the value of the grantor's retained interest also increases resulting in a decrease in the amount of the actual gift made. The federal interest rate under code section 7520 is one of the main factors that drive the favorable tax outcome of valuing the gift of the residence. So, as I was saying, the higher the federal interest rate, the lower the gift value and the lower the potential gift tax. Conversely, a low federal interest rate usually translates into lower estate tax savings which is why we haven't seen this technique be used as much in the recent years when we've had low interest rates.

Jacob Wonn: So, thanks for explaining how those different factors impact the tax benefits of the QPRT but I guess it's a little hard to grasp in the abstract and I'm wondering if you might be able to provide a more concrete example of how this might work.

Nathalie Stenmark: Absolutely. So, take an example of a $10 million house with a section 7520 interest rate of 5% with a grantor aged 65, and a term of 20 years. Based on these factors, the value of the retained interest would be about approximately $8.1 million, and the taxable gift, which is the present value of the remainder interest will be approximately $1.9 million. So, the potential death tax savings based on these factors and circumstances would be 3.25 million and that's without factoring in any growth in the house. If we factor in a 5% annual growth in the property, then the estate tax savings would be 9.9 million, so significantly higher.

Jacob Wonn: That’s impressive. So essentially the value of the remainder interest is what gets taken out of the grantor’s estate and is allowed to grow tax free. Is that right? So, that’s what produces the tax savings.

Nathalie Stenmark: Exactly. So, you take the value at the end of the term and then you subtract out the taxable gift, so under this example, that will be 1.9 million and then you multiply that by 40%, the current estate tax rate, and that’s how you get to the tax savings.

Jacob Wonn: Okay. Interesting. So, I guess moving on from these more technical tax-based aspects, I think it would be helpful for listeners to know a little bit more about specific requirements relating to QPRTs or pitfalls that could cause a QPRT to be unsuccessful or invalid. So, for example I know that the QPRT has to be used as a personal residence during the term, right. Could you explain how that works?

Nathalie Stenmark: Of course. So, one of the requirements as you just mentioned, is that the property must be used as a personal residence. If the property ceases to be used as a personal residence, then the trust will cease to be a QPRT all together and the trustee must distribute the assets outright to the grantor or convert the QPRT into a grantor retained annuity trust, a GRAT. For instance, while leasing a portion of the property to an unrelated third party will not result in disqualification in and of itself as long as the property remains the grantor’s personal residence. Now what does this mean? For a property that is occasionally rented, the taxpayer is deemed to use a dwelling unit during the taxable year as a residence if such taxpayer uses the unit or a portion thereof for personal purposes for a number of days that exceeds the greater of 14 days or 10% of the number of days during the year for which the unit is rented at a fair market value.

Jacob Wonn: So, you said this term dwelling unit in the test for whether the residence is treated as the grantor’s personal residence. What exactly does that mean?

Nathalie Stenmark: So, the term dwelling unit is defined to include house, an apartment, a condominium, a mobile home, boat or similar property that provides basic living accommodations, so it's quite a broad term.

Jacob Wonn: Okay. And what about if you have a larger estate that’s not just a house but if there are other buildings or land or other connected property. Does that factor into the analysis?

Nathalie Stenmark: Right. So, a personal residence may include certain additional property used by the term holder, the grantor for residential purposes and certain factors will be taken into consideration such as the residence’s size and location. So, for instance the IRS has ruled that a personal residence may include a tennis court or swimming pool and it can also include a main house and a guest house, but it all depends on the facts and circumstances and the size of the property itself.

Jacob Wonn: Okay. And so, the property has to be used as a personal residence during the term of the QPRT. Does that mean that the grantor isn't allowed to sell the property? Can it still be sold during the term and if so, what happens?

Nathalie Stenmark: If the personal residence is sold, the sales proceeds must be reinvested into a new residence. If that does not occur, then again, the QPRT will convert into a GRAT or the assets must be distributed out to the grantor.

Jacob Wonn: Okay. And you said before at the start of this, that each QPRT has a term and the grantor needs to survive for the entire term or else it fails. Can you explain what happens if the grantor dies during the term?

Nathalie Stenmark: Right, so that is yet another requirement of the QPRT for it to work. If the grantor dies before the expiration of the trust term the entire value of the personal residence will be included in the grantor’s estate for estate tax purposes. And as I mentioned before, this is not really a significant risk because in that event, the grantor would merely be in the same position that he or she would have been in if the QPRT had not been created in the first place, but you're not going to get the benefits of the QPRT.

Jacob Wonn: Alright, so we talked about all of these tax benefits that make a QPRT quite attractive and I'm curious if you have a grantor with multiple houses, if they say have ten houses could they put each one into a QPRT and realize these benefits for each one?

Nathalie Stenmark: A person can only transfer two personal residences to a QPRT and also any commercial property or non-real property such as fixtures and appliances they won’t count and the grantor cannot transfer an interest into a personal residence to the same trust, rather a separate trust must hold the interest in separate residences. However, a person can contribute fractional interest in the same residence to different QPRTs.

Jacob Wonn: And is there any benefit to doing that, to contributing a fractional interest as opposed to the whole residence?

Nathalie Stenmark: Yes, so there are two main benefits to doing this using fractional interests. The first being as a hedge against the possibility of premature death. For example, a taxpayer might create three QPRTs with terms of 5, 10 and 15 years, then the taxpayer could transfer one-third interest in his or her residence to each of those trusts. If he or she dies after let’s say 12 years, only the one-third interest in the last QPRT is included in his or her estate so that’s one reason to do the fractional interest. Another reason to gift fractional interest in a residence is to get additional gift tax savings. For instance, if husband and wife retitle their personal residence as tenancy in common, then after such retitling each spouse can then create his or her own QPRT by transferring his or her 50% tenancy in common interest in the personal residence to his or her respective QPRT. So, because each spouse is transferring undivided tenancy in common interest to the QPRT a further discount may be available in valuing each spouses’ interest in the residence for gift tax purposes.

Jacob Wonn: What about the situation where there's a mortgage on the house that’s contributed to the QPRT. How does that factor into things?

Nathalie Stenmark: If the residence transferred to the QPRT is subject to a mortgage that won’t disqualify it but there may be some added complexity in accounting for the mortgage payments and note here when I say mortgage payments, I'm referring to the principal payments. Interest payments are fine; they have no consequences.

Jacob Wonn: Okay.

Nathalie Stenmark: But for purposes of determining the value of the gift of the remainder interest, the mortgage on the properties generally must be taken into consideration so that would be the initial instance when you're valuing the gift. And then the grants will be treated as making further contributions to the trust and consequently a further gift with each mortgage principal payment. So, if possible, paying off the mortgage before transferring the residence to a QPRT might be advisable depending on all the facts and circumstances or if it's possible to just have interest payments be made during the term that will simplify things from an accounting perspective.

Jacob Wonn: So, one other question, going back to the potential sale of the residence during the QPRT term, you know normally under code section 121 a person selling their principal residence is allowed to exclude a certain amount of gain from their gross income so they have some income tax savings from that. Is that still available if the residence is placed in the QPRT?

Nathalie Stenmark: Right, so a QPRT is a grantor trust for income tax purposes, and this means that the trust is not a separate taxpayer and all the income or capital gain during the term is tax to the grantor and reported on his or her personal income tax return. So, what this means is that any gain recognized on the sale of a principal residence that has been transferred to a QPRT may qualify for the $250,000 or $500,000 gain exclusions in the sale of a principal residence provided that all the other internal revenue code section 121 requirements are met. And again, the exclusion of gain does not apply to the sale of a property that is not a principal residence such as a vacation home.

Jacob Wonn: So, we’ve generally been talking about a lot of positives and tax benefits to creating a QPRT, but I’m just wondering if there are any other downsides that estate planners and clients should be aware of?

Nathalie Stenmark: One thing to keep in mind is if the remainder beneficiaries sell the residence after the expiration of the term, they may incur a significant income tax liability. If the QPRT had not been created and the children for instance if they were the beneficiaries, inherited the residence at the grantor’s death they would have received a step up in basis to the value of the property at the grantor’s date of death but if the grantor survives the QPRT term and it goes to the remainder beneficiaries there is not step up in basis and the children’s basis carries over from the grantor so it really depends on the long-term goals of the clients, the grantors, their children, what they think their—what they believe the future plans for the house may be.

Jacob Wonn: So, Nathalie as I mentioned at the top of the episode, you're an associate in our LA office so you primarily practice California law and I’m curious if there are any unique considerations that go into QPRT planning in California or any particular advantages of doing that in California?

Nathalie Stenmark: It's interesting that you should bring that up and I'm not sure if you've heard, but sales to grantor trusts of houses in the city of Los Angeles are about to get a lot more expensive after April 1, 2023. There is a new additional 5.5% recording tax for homes sold for $10 million and above and an additional 4% recording tax for homes sold for between $5 million and $10 million. I'm telling you in the city of Los Angeles there are many homes that are worth more than $5 million so this impacts a lot of homes. For instance, if you were to sell a $10 million home to an irrevocable grantor trust now the cost to record the deed would be $606,000 under the new rules that are about to take effect versus $56,000 under the current rules.

Jacob Wonn: That's a huge difference.

Nathalie Stenmark: Huge difference. Notably the new recording tax does not apply if a home is transferred for no consideration, so contributing that same $10 million to a QPRT is now $550,000 cheaper than a sale of that same house to an irrevocable grantor trust so it really is something to factor in when you're running the numbers.

Jacob Wonn: Right. Okay, well, it's really interesting to hear about this and I think it will be very helpful for our clients and listeners to know. It sounds like all around a QPRT can be a pretty attractive option, a good estate planning technique in a number of situations so it's good to know that this option is available in appropriate cases and hopefully our listeners find it helpful as well. Is there anything else that you want to say before we wrap up?

Nathalie Stenmark: No, I think that's everything. Thank you so much for having me on the show today.

Jacob Wonn: Yeah. Thank you for coming and I hope you have enjoyed your visit to New York. And with that, we'll wrap up this episode of Worth It. We hope you enjoyed this podcast and please join us for future episodes. If you would like to receive notifications when new episodes are available, please visit our website Proskauer.com and click the subscribe to our publications link at the bottom of any page. Thank you for listening.

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