QUALIFIED PERSONAL RESIDENCE TRUSTS (QPRTS) AND GRANTOR-RETAINED-ANNUITY TRUSTS (GRATS)

1 OVERVIEW

1.1 Grantor-retained-interest trusts ("GRITs") have existed for many years, but the tax laws have gradually changed, and many of the GRITs that used to exist do not save taxes under current law. Not including charitable trusts, the most common GRITs that are used today are the "qualified personal residence trust" ("QPRT") and the "grantor retained annuity trust" ("GRAT"). These trusts are used by people who are looking to reduce the federal transfer taxes (gift, estate, and generation-skipping taxes) that would apply to lifetime gifts or transfers triggered by death. Before using a QPRT or GRAT, it is common for an individual to first consider tax planning in their revocable trusts, creating a life insurance trust, or implementing an estate-reducing gift-giving program, perhaps using gifts or sales of interests in business entities. A QPRT and/or a GRAT might be an additional tax-reduction tool to consider.

1.2 It is important to understand that QPRTs and GRATs involve a period of time (the "settlor's term") during which the settlor (i.e., trust creator) retains a benefit that has an actuarial value. When a QPRT or GRAT is created, a gift tax is applied to the then current fair-market value of the property contributed to the QPRT or GRAT, reduced by the actuarial value of the settlor's interest. The calculation of the values is based on an assumed interest rate that is known as the §7520 rate that is set each month by the IRS.[1] The QPRT or GRAT is an effective tool to reduce the gift and estate tax when actual return on the trust assets exceeds the §7520 rate.

2 QUALIFIED PERSONAL RESIDENCE TRUST (QPRT)

2.1 A "qualified personal residence trust" or "QPRT" is an irrevocable trust into which you, the settlor, make a gift of residential property. The residential property can be your primary residence, a vacation home, or a partial interest in either.

2.1.1 You will retain the right to use the residence for a set number of years, which we will call the "settlor's term".

2.1.2 After the settlor's term, the trust can continue for the benefit of designated "remainder beneficiaries", such as the settlor's children, or it can terminate with an outright distribution of the residence (or its sale proceeds) to one or more designated beneficiaries. After the settlor's term, you, as settlor, can no longer live in the home unless the trustee of the trust chooses to rent the home to you.

2.2 As mentioned above, the objective of a QPRT is to transfer the residence with a reduced transfer-tax cost. If you retain your residence until your death, the value will be subject to the federal estate tax, and if the residence is expected to increase in value during your life expectancy, the estate tax due at the time of your death would potentially be higher than a gift tax paid now.

2.2.1 For federal gift-tax purposes, the transfer of a residence to a QPRT is a taxable gift, but it represents a gift of a future interest to the remainder beneficiaries. For valuation purposes, the appraised value of the home is "discounted" or reduced by the

---

[1] The §7520 rate is equal to 120% of the "applicable federal midterm rate".

actuarial value of the settlor's right to live in the residence during the settlor's term. The IRS-prescribed valuation formula takes into consideration the current applicable federal interest rate[2] and the settlor's life expectancy. The longer the settlor's term, the lower the gift-tax value will be.

2.2.2 While designating a longer settlor's term may reduce the tax, a QPRT does not work if the settlor dies during that term. If the settlor dies during the term, the residence reverts to the settlor's estate or revocable trust, and the residence will be subject to the estate tax as though the QPRT never existed. Some people characterize QPRT as a "win-or-tie gamble" with the IRS because you either save taxes with the QPRT or the QPRT is ignored. (In the interest of full disclosure, a failed QPRT is not exactly a "tie" because you will lose the time, effort, and expense of setting up the QPRT.)

2.3 During the settlor's term, you can be the trustee, and the trust will be treated as a "grantor trust" for federal income tax purposes, which means that you will be entitled to any deduction for mortgage interest and property taxes.[3]

2.4 If you contribute a mortgaged residence to a QPRT, you have two options as to how to deal with the mortgage.

2.4.1 First, you can calculate the gift by first deducting the unpaid mortgage balance and then apply the QPRT-valuation formula on the net equity that you own. If you do that, any additional principal payments you make on the loan will be treated as additional gifts to the trust.

2.4.2 Second, you can agree to remain personally liable for the mortgage loan and then calculate the gift as if there were no loan. That will result in a higher gift tax value of the residence, but additional loan payments will not be considered gifts to the trust. This is the option we recommend.

2.5 At the end of the settlor's term, the residence can be retained for your spouse's benefit. If you are not married or if your spouse does not survive you, we generally recommend that the trust continue with a friendly trustee who will rent the home to you if you desire to continue to use the home. The trust can be designed so that the trust continues as a grantor trust so that the rental payments that you make are not treated as taxable income to the trust or its beneficiaries. *If you live in the home, you must pay fair-market rent in order to avoid paying the estate tax on the full value of the home at the time of your death.*

2.6 ILLUSTRATION:

2.6.1 Assume that:

---

[2] The rate used for QPRT valuations is referred to as the "§7520 rate", which is a rate determined each month equal to 120% of the "applicable federal midterm rate". As of the date of this memo, the §7520 rate could be found at http://www.leimberg.com/software/7520rate.html.

[3] Under federal income tax law, the settlor (also grantor) of a "grantor trust" is treated as the owner of trust assets as if the trust did not exist.

(a) JONATHAN DOUGH, age 67, owns a home that is valued at $750,000.

(b) Jon will live to age 85, at which time the home will be worth $1.2 million.

(c) In ten years, at Jon's death, the exclusion for both taxes will be $6.2 million, and the tax rate is 40%.

(d) Jon has already used up his applicable exclusion, and all transfers will be subject to either the gift or the estate tax.

2.6.2 If Jon does nothing, his estate will include the $1.2 million home, and the tax on the transfer will be $480,000 (40% of $1.2 million).

2.6.3 If Jon establishes a QPRT when the §7520 rate is 2.2%, and he selects a 5-year term (because no one really knows the date of his or her death), the gift-tax value of the home will be $601,304, and the gift tax will be $ 240,522, representing a tax savings of $239,478 over the do-nothing scenario.[4]

2.6.4 If Jon selects a 9-year term, the gift-tax value would be $481,394, and the gift tax would be 40% of that or $192,558. (By selecting a longer term, the taxable gift and the gift tax are reduced.)

2.6.5 If Jon is married and owns the home jointly with his wife, they can each prepare a separate QPRT for a half-interest in the home. Even if one spouse dies before the end of the settlor's term, the other spouse's QPRT may still work.

2.7 QPRTs are subject to a number of complex rules that are too numerous to consider here, but there are some key rules you should be aware of:

2.7.1 A QPRT cannot own an interest in more than one residence, and no one can have more than two QPRTs at the same time.

2.7.2 A QPRT cannot hold other investments other than some cash to cover residence-related expenses.

2.7.3 If the home is sold during the settlor's term, the Section 121 gain exclusion will apply, but the trust will convert into a grantor retained annuity trust unless the home is replaced within two years.

2.7.4 The trust must prohibit the trustee from selling the residence back to the settlor.

3 GRANTOR RETAINED ANNUITY TRUST (GRAT)

3.1 A "grantor retained annuity trust" is an irrevocable trust into which you, the settlor (the trust's creator), make a gift of income-producing property and retain the right to receive regular annuity payments during a term of years ("the settlor's term"). After the settlor's term,

[4] The savings is actually more than that because the gift tax is paid on the net transfer to the recipient, where the estate tax is paid on the gross value, including the tax itself.

the trust can continue for the benefit of designated "remainder beneficiaries", such as the settlor's children, or it can terminate with an outright distribution of the residence (or its sale proceeds) to one or more designated beneficiaries.

3.2 As mentioned above, the objective of a GRAT is to transfer assets with a reduced transfer-tax cost. If you retain the assets until your death, the value will be subject to the federal estate tax, and if the assets are expected to increase in value during your life expectancy, the estate tax due at the time of your death would potentially be higher than a gift tax paid now.

3.2.1 For federal gift-tax purposes, the transfer of assets into a GRAT is a taxable gift, but it represents a gift of a future interest to the remainder beneficiaries. For valuation purposes, the market value of the assets is "discounted" or reduced by the actuarial value of the settlor's right to receive the annuity payments during the settlor's term. The longer the settlor's term and the higher the annuity payment rate, the lower the gift-tax value will be.

3.2.2 While designating a longer settlor's term may reduce the tax, a GRAT only partially works if the settlor dies during that term. If the settlor dies during the term, the annuity payments must be paid to the settlor's estate during the balance of the settlor's term, and the actuarial value of the remaining payments will be subject to the federal estate tax.[5]

3.2.3 Increasing the annuity payment can reduce the gift tax value, but it also increases what you are getting back into your taxable estate as the annuity payments are made.

(a) It is important to fund a GRAT with income-producing assets because a GRAT must have enough cash to pay the regular annuity payments. If the assets in the trust do not produce income that is sufficient to pay the annuity payments, then the assets themselves will have to be distributed. A GRAT can ultimately implode if all of its assets have to be distributed to make the annuity payments. To trigger any transfer-tax savings, the rate of return (including income and appreciation) on the property must exceed the §7520 rate.

(b) At the end of the settlor's term, you cannot have any interest in the GRAT or its assets. The trust can be designed so that the trust does or does not continue as a grantor trust so that you can pay the income tax on trust income without triggering a gift tax.

3.2.4 ILLUSTRATION:

(a) Assume that:

---

[5] This scenario describes what has been called the "Walton GRAT" because of a court case involving the Walton family. Before the Walton case, a GRAT failed and all of its assets were distributed to the settlor's estate if the settlor died during the term. Since that case, GRATs have been designed to continue the annuity payments into the settlor's estate rather than just having the entire trust revert to the settlor's estate.

(1) JAYNE DOUGH, age 67, owns an office building that is valued at $750,000. The building generates net rent of 5% a year, and it appreciates 3% a year in value.

(2) Jayne will live to age 85. The office building will have appreciated to $1,013,884. In addition, during that period, Jon's estate will have received $446,404 in rental income (assuming the 5% rent keeps up with the appreciating value of the property).

(3) Jon has already used up his exclusion, and so all transfers will be subject to either the gift or the estate tax.

(4) At Jon's death, the estate tax rate is 40%.

(b) If Jayne does nothing, his estate will include the office building and accumulated income for a total of $1,460,288. The estate tax on that will be $584,115.

(c) If Jayne establishes a GRAT when the §7520 rate is 2.2%, and he selects a 5-year term and a 5% annual payout, the gift-tax value of the home will be $572,826, and the gift tax will be $229,130, representing a tax savings of $354,985 over the do-nothing scenario.[6]

(d) If Jon selects a 9-year term with the same 5% payout, the gift-tax value would be $444,330, and the gift tax would be 40% of that or $177,732.

3.2.5 To deal with low profitability in early years of a GRAT, a more complex GRAT can involve annuity payments that increase over the years, and that technique can be illustrated for you to see if that type of GRAT may be a better technique in your situation.

3.3 A "near-zero" GRAT is a GRAT that has a gift tax value of near zero. For example, if we use the same assumptions given in paragraph 3.2.4 except to change the payout to 21.1659%, the gift-tax value of the 5-year GRAT is three cents. A near-zero GRAT is used with a term as short as two years.

3.3.1 The near-zero GRAT makes sense only if the actual return on the trust's property is significantly higher than the §7520 rate, and it requires enough cash to be able to make the high annuity payments.

3.3.2 If the §7520 rate is 2.2%, on a contribution of $750,000, the annuity payable to the settlor on a five-year GRAT would be $155,444 each year, which would return $778,713 to the settlor, which is more than originally contributed.

(a) In the scenario where the income and appreciation made the trust property worth $1 million, the remainder beneficiaries would receive the trust property virtually tax free. (Using an income-producing office building will not usually provide enough liquidity to make this happen, but a near-zero GRAT has

---

[6] The savings could be more than that because the gift tax is paid on the net transfer to the recipient, where the estate tax is paid on the gross value, including the tax itself.

worked with highly appreciating marketable securities, business interests, and even racehorses.)

(b) In contrast, if the actual return is at or below the §7520 rate, all of the trust would be paid out to the settlor, and the remainder beneficiaries would get nothing.

3.4 A "rolling GRAT" strategy involves using a series of near-zero GRATs with a settlor's term of two years. In some years, the annuity payments will result in having nothing left in the GRAT, and the annuity payments are given to a new near-zero GRAT. In years where the combination of earnings and appreciate provided a return that exceeds the §7520 rate, there is substantial wealth for the remainder beneficiaries even after the annuity payments are made. For years, federal politicians have threatened to prohibit rolling GRATs by requiring a minimum term of 10 years, but it does allow for some significant wealth transfers in appropriate situations.[7]

3.5 GRATs are subject to a number of complex rules that are too numerous to consider here, but there are some key rules you should be aware of:

3.5.1 Assets cannot be added to the GRAT once it is initially "funded".

3.5.2 The trustee and settlor cannot agree to "commute" (i.e., terminate the trust early) by prepaying the settlor's annuity in a lump sum.

3.5.3 The annuity cannot be paid using a promissory note or option.

3.5.4 The settlor must be the only beneficiary of the trust entitled to receive distributions during the settlor's term.

4 COORDINATION WITH OTHER PLANNING

4.1 A GRAT is funded with income-producing property, and in some cases, that income-producing property could be an interest in a closely held business entity that either operates an active trade or business or is an investment-holding company. A qualified business appraiser may determine that the fair market value of a minority interest in a business entity that is not publicly traded should reflect a valuation "discount" for lack of marketability and for lack of voting control. If that is true, the effectiveness of the GRAT might be increased. The use of business entities in estate planning is beyond the scope of this memo, but it is important to note that the IRS does not favor valuation discounts, and care must be taken to do this correctly.

4.2 QPRTs and GRATs both have a "settlor's term" during which the settlor of the trust is entitled to benefits from the trust, but it is anticipated that the settlor's term will expire before the settlor dies.

4.2.1 If the settlor dies before the settlor's term expires, an estate tax will be due on the property of the QPRT or GRAT. To cover that possibility, a policy of term life

[7] See "Rolling Short-term GRATs Are (Almost) Always Best", which is an excellent article on the effectiveness of a rolling GRAT strategy written by David L. Weinreb and Gregory S. Singer. The article appeared in the August 2008 issue of *Trust & Estates* magazine. At the time of the preparation of this memo, the article could be found at https://rushforthfirm.info/pdf/RollingGrats.

insurance that does not expire until after the "settlor's term" might be purchased by an ILIT to provide temporary insurance coverage sufficient to pay for the estate tax that will be triggered on the property held in a QPRT or GRAT at the time of the Settlor's death if the death occurs during the settlor's term. In other words, you can hedge your bet on outliving the settlor's term of a QPRT or GRAT by having insurance to cover the additional tax just in case you do not.

4.2.2 If the settlor does survive the settlor's term, the QPRT or GRAT can provide that its property will be transferred into an existing irrevocable life insurance trust ("ILIT") at the end of the settlor's term. By having the QPRT or GRAT pour into an ILIT after the settlor's term, the income-producing property of the QPRT or GRAT can reduce or eliminate the need to make additional contributions to the ILIT in order for the trustee of the ILIT to pay insurance premiums. If the ILIT is designed as a grantor trust, there can be additional benefits, such as avoiding the payment of income tax on rent paid for the use of the residence formerly owned by a QPRT.

5 CONCLUSION.

If you have a taxable estate that includes one or more homes or investment assets that you are willing to part with during your lifetime after a term of years, a QPRT or GRAT may be a tool that can help you do that with a lower net tax than would apply if you were to retain those assets until your death.

RUSHFORTH FIRM LTD.

Telephone: 702-255-4552 | Fax: 702-255-4677
Office: 5550 Painted Mirage Road, Suite 320, Las Vegas, NV 89149-4584
E-mail: office@rushforthfirm.com
Web sites: https://rushforthfirm.info/ | https://rushforthfirm.com

© Copyright 1999-2020 Rushforth Firm Ltd. *[Version of May 29, 2020]*