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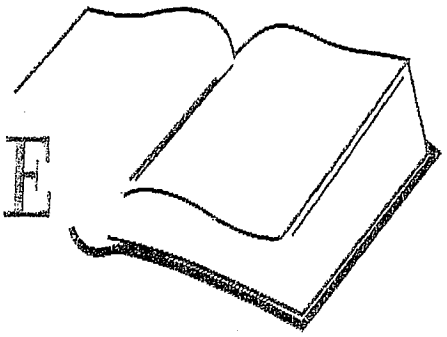

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Comparing QPRTS to IDGTS: Depressed Property Values and Low Interest Rates Offer Opportunities

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For taxpayers seeking to transfer real property in the most tax efficient manner, now is an excellent time to take advantage of depressed real property values.

Devaluation of any asset may be unfavorable for a taxpayer's balance sheet, but such devaluation creates an exciting tax planning opportunity. By transferring the devalued real property out of the taxpayer's estate, the taxpayer locks in (or freezes) the asset's depressed value for estate and gift tax purposes and reduces the overall tax on the transfer of the asset. Given the declines in real property values over the past few years, clients should consider locking in these reduced values for transfer tax purposes.

Taxpayers wishing to take advantage of devalued real property values have a number of options, including, but not limited to, transferring the property to or in trust for one or more beneficiaries, using a qualified personal residence trust (QPRT) or selling the house to an intentionally defective grantor trust (IDGT) (referred to herein as an IDGT House Sale). While a current gift of the property to the taxpayer's beneficiaries will freeze the value of the residence for transfer tax purposes, it does

so at a higher present tax cost than if the taxpayer employs a QPRT or an IDGT House Sale in connection with the transfer. Approximately 10 years ago, Ken Ziskin authored an excellent article comparing QPRTs to IDGT House Sales, but little has been published on this subject since that article. Given changed property values, diminished interest rates, and several favorable rulings on IDGTs, this article seeks to shed new light on the technique. See Kenneth A. Ziskin, *The Home Security Trust ™- Better than a QPRT on Steroids*, TRUSTS AND ESTATES (October 2000).

A number of factors are involved when deciding whether to use a QPRT or an IDGT House Sale. While a QPRT is a powerful estate planning tool and a tax efficient means of transferring a taxpayer's residence, planners should compare the use of a QPRT with an IDGT House Sale, coupled with a lease-back to the taxpayer. Comparing and contrasting a QPRT to an IDGT House Sale is particularly important now, as the interest rate environment has a significant impact on the relative tax utility of the two techniques.

Generally, QPRTs are less tax efficient in times of low interest rates (like now), as the value of the retained interest is lower when interest rates are lower — and thus the value of the gift is greater when interest rates are lower. Conversely, IDGT House Sales are more tax efficient in times of lower interest rates, as the interest payments on the note (the amounts that must be repaid to the grantor) are much smaller compared to the payments when there are higher interest rates.

Thus, in this time of depressed real property values, low interest rates, and other factors explained in further detail below, more clients should consider IDGT House Sales.

QPRTs in General

Qualified personal residence trusts are specifically authorized under the Code and Treasury Regulations. See Treas. Reg. § 25.2702-5(c)(9). When employing a QPRT, the taxpayer transfers his or her primary or secondary residence to an irrevocable trust (the QPRT) and retains the right to use the transferred residence for a fixed term of years (the QPRT Term). Upon the expiration of the QPRT Term, the residence passes to one or more remainder beneficiaries, or trusts for their benefit. Should the taxpayer die during the QPRT Term, the value of the entire residence will be included in the taxpayer's estate for estate tax purposes, leaving the taxpayer in the same position he or she would have been in if the taxpayer had never engaged in the transfer at all. Generally, see Natalie Choate, THE QPRT MANUAL: THE ESTATE PLANNER'S GUIDE TO QUALIFIED PERSONAL RESIDENCE TRUSTS, Ataxplan Publications 2004);

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but see Jeffery A. Baskies and Justin M. Savioli, *Recent Ruling Adds a New Dimension to QPRT Planning*, ESTATE PLANNING (Feb. 2009) (discussing *Private Letter Ruling 200919002* addressing how a QPRT for life coupled with a sale of the remainder may avoid inclusion in the taxpayer's estate).

Additionally, with QPRTs, typically the residence will be distributed to and administered as part of the taxpayer's estate if the taxpayer dies during the QPRT term. This reversion further increases the value of the retained interest and decreases the value of the gift. Like the value of the term interest, the actuarial value of the reversion is affected by interest rates; however, they act in opposite directions. When interest rates are lower the term interest value will be lower, but the value of the reversion will be higher. With QPRTs, however, the effect of the interest rate generally more significantly affects the value of the term interest than the value of the reversion.

The valuation of the gift to a QPRT is directed under Chapter 14 of the Code. Generally, the taxpayer is treated as having made a transfer of the full value of the interest in the residence transferred, minus the value of the qualified retained interests (the term interest and reversion), the values of which are determined under IRS actuarial tables. As noted above, the interest rate (section 7520 rate) in effect at the time the transfer is made to the QPRT significantly affects the deemed value of the taxpayer's retained right to use the residence and the retained reversion under the IRS tables.

When interest rates are higher, the value of the taxpayer's retained interests will be higher; conversely, when interest rates are lower (as they are now), the value of the retained interests will be lower. When evaluating the effectiveness of a QPRT in higher versus lower interest rate environments, the retained right to use the property typically affects the value of the residence for gift tax purposes to a greater extent than the taxpayer's reversion. Hence, it is generally more tax favorable for a taxpayer to employ a QPRT in a higher interest rate environment.

Illustrations:

QPRT in a Low Interest Rate Environment

Assume a 71 year old taxpayer (Albert), wants to fund a QPRT having a 7 year QPRT Term with his $2 million residence in July 2010 when the section 7520 rate is 2.8 percent. The value of Albert's retained right to use the property during the QPRT Term would be equal to $316,320, and his reversion would be equal to $402,840. Therefore, the total gift made at the time of contribution will be $1,280,840 ($2 million - $316,320 - $402,840).

QPRTs in Higher Interest Rate Environments

Assume the same taxpayer, Albert (who was then 71 years of age), decided to transfer his personal residence having a fair market value of $2 million to a QPRT during a higher interest rate environment when the section 7520 rate was 6 percent (as it was in July of 2007, for example). Assume the QPRT had the same QPRT Term of 7 years. The value of Albert's retained right to use the property during the QPRT Term would have been equal to $598,460, and his reversion right would have been equal to $391,580. Therefore, the total gift made at the time of contribution would have been $1,009,960 ($2 million - $598,460 - $391,580), which is approximately $270,000 less than the same transfer to the same trust with just a 3.2 percent differential in interest rates.

Assume the same taxpayer, Albert (who was then 71 years of age), decided to transfer his

personal residence having a fair market value of $2 million to a QPRT during a higher interest rate environment when the section 7520 rate was 8 percent (as it was in July of 2000, for example). Assume the QPRT had the same QPRT Term of 7 years. The value of Albert's retained right to use the property during the QPRT Term would have been equal to $746,300, and his reversion right would have been equal to $367,600. Therefore, the total gift made at the time of contribution would have been $886,100 ($2 million - $746,300 - $367,600), which is nearly $400,000 less than the same transfer to the same trust with a 5.2 percent differential in interest rates.

While a QPRT offers numerous benefits, it is important to remember that it has its limitations. Transferring one's residence to a QPRT will freeze the property's value for transfer tax purposes only if the taxpayer survives the entire QPRT Term. I.R.C. § 2036. Moreover, with a QPRT, the taxpayer is prohibited from reacquiring the residence, which can be a frustrating proposition for some clients. Additionally, under the estate tax inclusion period (ETIP) rules, a taxpayer will not be permitted to allocate any GST tax exemption to the QPRT until after the QPRT Term has expired. I.R.C. § 2642(f)(3). Finally, the remainder beneficiaries will receive a basis equal to the lesser of (a) the fair market value of the property at the time it is transferred or (b) the taxpayer's basis in the property at the time of the transfer. I.R.C. § 1015.

Many of these inherent limitations of QPRTs can be overcome with the use of properly structured IDGT House Sales.

IDGT House Sales in General

An IDGT is an irrevocable trust that intentionally violates one or more of the rules specified in sections 671 through 678 of the Internal Revenue Code. As a result, all the income tax events associated with the trust (e.g., income, deductions, credits, etc.) are attributed directly to the grantor, and the grantor is personally liable for the payment of any income tax on income produced in the IDGT. *Rev. Ruls. 85-13 and 2004-64.* The grantor often transfers assets to an IDGT in return for a promissory note that bears interest at the applicable federal rate (AFR) under section 1274. When selecting assets to transfer to an IDGT, the goal is to transfer assets that will produce income and/or appreciate in value at a rate in excess of the payments owing under the note. This goal is somewhat easier to achieve in an IDGT than a QPRT because the short-term and mid-term AFR are lower than the section 7520 rate (which is 120 percent of the mid-term AFR). Further, the promissory note can be a balloon note, requiring interest-only payments for a number of years. The trust can also be given the right to prepay the note at any time, stopping any future interest payments that would have otherwise hampered the growth of the trust assets.

Because the grantor and the IDGT are treated as the same person for income tax purposes, the sale will be entirely ignored for income tax purposes. If a taxpayer sells his or her residence to an IDGT in return for a promissory note, the trust should own sufficient other assets to avoid an argument that the property should be included in the taxpayer's estate under section 2036 if the taxpayer should die while the note is still outstanding. Many commentators believe that to satisfy this requirement, the IDGT should be initially funded with other assets having a value equal to at least ten percent of the fair market value of the trust property after the assets are sold to the trust. See Michael D. Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note—An End Run Around Chapter 14?*,

32ND U. MIAMI PHILIP E. HECKERLING INST. ON EST. PLAN., ch. 15 (1998); Byrle M. Abbin, *[S]He Loves Me, [S]He Loves Me Not—Responding to Succession Planning Needs Through a Three-Dimensional Analysis of Considerations to be Applied in Selection From the Cafeteria of Techniques*, 31ST U. MIAMI PHILIP E. HECKERLING INST. ON EST. PLAN., 1300.1 (1997), *Private Letter Rulings 9535026* (Sept. 1, 1995) and *9515039* (April 14, 1995); see also Elliott Manning and Jerome M. Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 T.M. EST., GIFTS AND TR. J. 3, 17 (1999) (arguing that 20 percent is safer). Therefore, for most plans, before a residence is sold to the IDGT, the trust should own other assets having a value equal to at least ten percent (10 percent) of the fair market value of the trust after the sale of the residence. Alternately, commentators have suggested beneficiary guarantees of approximately ten to twenty percent of the amount being financed might also suffice to lend credibility to the trust and assure that the trust assets are removed from the grantor's gross estate. See Milford B. Hatcher, Jr., and Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, J. TAX'N, v. 92 (March 2000).

While the trust cannot hold the property for the benefit of the taxpayer without risking the property being included in the taxpayer's estate for estate tax purposes, nothing should prohibit the taxpayer from leasing his or her residence back from the IDGT for fair market rent. Some commentators have asserted a sale for adequate and full consideration (even if the taxpayer remains whether paying rent or not) should not cause estate inclusion of the residence. Howard Zaritsky, TAX PLANNING FOR FAMILY WEALTH TRANSFERS: ANALYSIS WITH FORMS ¶11.08[1]. Moreover, a number of cases and rulings indicate that although subject to close scrutiny, a gift of a residence coupled with a lease-back at fair market rent should not cause estate inclusion under section 2036. See, for example, *Estate of Barlow v. Comm'r*, 55 T.C. 666 (1972), *acq.* 1972-2 C.B.1; *Estate of DuPont v. Comm'r*, 63 T.C. 746 (1975), among others.

In the context of expiring QPRTs, there have been a number of rulings supporting the proposition that the residence should not be included in the grantor's estate under section 2036 so long as the grantor rents the property for full fair market rent. See, for example, *Private Letter Rulings 200825014, 200822011, 199931028, 9827037; 9249014; 9425028*, and *9433016*; Natalie Choate, THE QPRT MANUAL, 3.7.01and 4.6.04. The rental payments to the IDGT may even further reduce the taxpayer's estate and any rental payments made could then be invested and allowed to grow inside the trust and completely outside of the taxpayer's estate. This technique effectively freezes not only the value of the residence transferred but also any assets transferred thereafter in satisfaction of the rental payments made under the lease (to the extent they exceed the expenses the trust pays for the residence, including any debt amortization).

Moreover, assuming the note involved in the transaction requires only payments of interest, then in a period of low interest rates, it is very likely the rental payments will exceed the interest payments owing under the note. Thus, the IDGT should be able to pay the expenses of the residence from the rental payments and still be able to satisfy any payments owing under the note. Finally, because the grantor and the IDGT are considered to be the same person for income tax purposes, the rental payments made and the note interest payments will be ignored for income tax purposes.

Comparing QPRTs to IDGT House Sales

Tax Certainty. While QPRTs are explicitly sanctioned under the Code and Treasury Regulations and we have clear guidance as to how they work, the law surrounding IDGTs is murkier. The good news is over time planners have become more comfortable with the use of IDGTs, and a number of rulings over the past decade (particularly *Rev. Rul. 2004-64* and *Rev. Rul. 2008-22*) have provided planners greater comfort in their use. Additionally, the flexibility that IDGTs offer make them a very alluring alternative for planners as well as their clients. However, when comparing the two techniques, clearly the tax consequences of QPRTs are more clearly defined.

Revaluation. A significant concern when employing either an IDGT House Sale or a QPRT is a possible challenge by the IRS of the valuation of the asset transferred. In a QPRT, this revaluation would increase the value of the gift. On the other hand, planners crafting IDGT House Sales for their clients may attempt to overcome this concern by including defined value formula clauses (in the trust, the purchase and sale agreement or both) providing that if the IRS does revalue the asset transferred, any excess gift will pass in a way that does not trigger additional gift tax (e.g., to a charity, a spouse, or another trust over which the grantor has a power of appointment). Howard Zaritsky, TAX PLANNING FOR FAMILY WEALTH TRANSFERS: ANALYSIS WITH FORMS ¶12.07[3][d][v]. Defined value formula clauses should be distinguished from the revaluation clauses rejected in *Commissioner v. Proctor* and other cases because nothing is returned to the grantor upon the revaluation. *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944); *Ward v. Comm'r*, 87 T.C. 78 (1986); *Harwood v. Comm'r*, 82 T.C. 239 (1984), *aff'd*, 786 F.2d 1174 (9th Cir. 1986); and *Estate of McLendon v. Comm'r*, T.C. Memo 1993-459, *rev'd*, 77 F.3d 477 (5th Cir. 1995); see also *Revenue Ruling 86-41*. The gift is a completed transfer at the time it is made, and the determination of the excess of the value of the transferred property over the amount that the grantor intended to transfer to the IDGT is a matter solely between the different beneficiaries (the IDGT and the other beneficiaries). A number of recent cases indicate that at least some defined value formula clauses do not violate public policy and could be a signal that not only have estate planners and clients become more comfortable with IDGTs but so too have the courts. See *McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006), *rev'g* 120 T.C. 358 (2003); *Christiansen v. Comm'r*, 104 A.F.T.R. 2d 2009-7352 (8th Cir. 2009), *rev'g* 130 T.C. 1 (2008); and *Petter v. Comm'r*, T.C. Memo. 2009-280. No court has found that formula clauses cannot violate public policy, but these cases have sustained well-drafted defined value clauses against such attacks. It is also interesting to note that the *Petter* court was confronted with a defined value formula clause in connection with a sale to an IDGT and not only did the court validate the formula clause at issue but it also made mention that the trust had been funded before the sale transaction with a gift of assets having a value equal to ten percent of the property sold.

Basis Issues and Repurchase of Residence. As mentioned above, the remainder beneficiary or beneficiaries of a QPRT have a basis in the residence equal to the lesser of (a) the fair market value of the property at the time it is transferred or (b) the taxpayer's basis in the property at the time of the transfer. Because the sale of the residence is ignored for income tax purposes, the outcome in a sale transaction is very similar, and the IDGT will have a basis in the asset equal to the grantor's basis at the time of the transfer. One way in which the outcome is slightly different and where there is a benefit of an

IDGT House Sale when compared to a QPRT is the avoidance of a possible step down in basis if the fair market value at the time of transfer is less than the client's basis. Under *Revenue Ruling 85-13,* the sale to the IDGT should be completely ignored for income tax purposes, and thus a step down in basis should not occur.

Another important difference between the two techniques is that a QPRT must forbid the taxpayer from reacquiring the residence, but an IDGT House Sale carries no similar restriction. In fact, many trusts used in IDGT House Sales will likely be IDGTs precisely because of the client's retained right to reacquire the trust asset (the residence), triggering grantor trust status under section 675(4)(C) of the Code. Because of this, one of the rules that can make the irrevocable trust used in the IDGT House Sale a grantor trust for income tax purposes (an IDGT) can also help to overcome the difficulty with carry-over basis. Whether there is a carry-over basis due to a QPRT transfer or an IDGT House Sale, many clients will prefer that their beneficiaries inherit the residence with a stepped up basis after their death instead of the carry-over basis from the transfer. Due to the QPRT's required restrictions on the grantor reacquiring the residence, achieving a stepped up basis on the residence transferred can be easily achieved only with the IDGT House Sale.

Under section 675(4)(C) of the Code, the grantor will be treated as the owner of the trust assets for income tax purposes when a person acting in a non-fiduciary capacity (and without the approval or consent of anyone in a fiduciary capacity) has the right to reacquire trust assets by substituting other property of an equivalent value. As long as the trustee has a fiduciary duty to ensure that the replacement assets are of an equivalent value, it appears that the grantor holding this power will not cause the assets to be included in the grantor's estate. *Rev. Rul. 2008-22.*

Therefore, it is possible for the grantor (or perhaps the grantor's spouse) in an IDGT House Sale to hold this power and subsequently to reacquire the transferred residence and substitute assets having an equivalent value with a much higher tax basis. This will have the effect of removing those high basis assets from the grantor's estate and, assuming the grantor continues to own the residence until the grantor's death, permitting the residence to receive a stepped-up basis at the time of the grantor's death. I.R.C. § 1014. (Note that any discussion of a stepped-up basis assumes the reinstatement of section 1014 either retroactively or in January of 2011.)

In addition to the basis issues, the ability to repurchase the residence may be very important to some clients. Anecdotally, many advisors have shared stories over the years of clients with expiring QPRTs complaining about their inability to repurchase their homes. The complaints centered on the desire to not have to pay rent and/or on emotional frustration with "giving up" the home. Furthermore, in Florida in particular, the risk of losing the homestead/"Save our Homes" tax benefits have caused many clients to wish they could buy their homes back from their QPRTs.

Thus, there may be state law reasons, federal income tax reasons, and a variety of non-tax reasons why clients might prefer to have the ability to repurchase the residence — causing the IDGT House Sale to be the favored technique.

Fractional Interest Discounts. A technique that many estate planners employ both when using a QPRT or an IDGT House Sale is transferring fractional interests in the residence. A number of cases over the years have ruled on the proper applicable discount for fractional interests in real property. See Paul Hood, *LISI Estate Planning Newsletter #1642 (May 18, 2010) at*

http://www.leimbergservices.com. Copyright 2010 Leimberg Information Services, Inc. (LISI) (noting "Since 1990, the following cases have come out of the Tax Court: *Amlie Est. v. Comm'r* (2006 estate tax case - 15 percent), *Forbes Est. v. Comm'r* (2001 estate tax case - 30 percent), *Shepherd v. Comm'r* (2000 gift tax case - 15 percent), *Reichardt Est. v. Comm'r* (2000 estate tax case - 10 percent), *Stevens Est. v. Comm'r* (2000 estate tax case - 25 percent), *Bush Est. v. Comm'r* (2000 estate tax case - 10 percent), *Barge Est. v. Comm'r* (1997 estate tax case - 28 percent), *Cervin Est. v. Comm'r* (1994 estate tax case - 20 percent), *LeFrak v. Comm'r* (1993 gift tax case - 20 percent), *Pilsbury Est. v. Comm'r* (1992 estate tax case - 15 percent), and *Zabel v. Comm'r* (1990 gift tax case - 10 percent)"). Generally, these cases have found a reasonable discount somewhere between ten and thirty percent. In a recent Tax Court case, a husband and wife transferred their 50 percent tenant-in-common interests in their Hawaiian residence to their respective QPRTs. *Ludwick v. Comm'r*, T.C. Memo 2010-104. The taxpayers' expert argued that a discount of 30 percent was appropriate. The IRS's appraiser argued for an 11 percent discount. The Tax Court was not persuaded by either the taxpayers' appraiser or the IRS's appraiser. Instead, the judge independently analyzed the factors relevant to the discount and determined that 17 percent was the proper applicable discount. While 17 percent is lower than the taxpayers' hoped for, it is still a favorable outcome for taxpayers who had an appraisal that did not impress the court.

The availability of discounting should be available whether using a QPRT or an IDGT House Sale if a fraction of the property is transferred and/or multiple trusts are used. Thus, for any client considering transferring his or her residence to a QPRT or to an IDGT House Sale, fractional interest transfers and related discounting opportunities should be considered.

GST Planning. As noted above, due to the ETIP rules, there is no way to leverage the GST exemption with a QPRT. An IDGT House Sale, however, permits the GST tax exemption to be leveraged. When the client forms and funds the IDGT via a "seed" gift, GST exemption may be applied to that gift. Additional exemption is not required when the residence is sold to the IDGT as the transfer is not a gift but a sale for fair market value.

Thus, the property and other assets held in the IDGT are permitted to appreciate and grow over time, while remaining completely exempt from any future GST tax. Naturally, the longer the funds are permitted to remain in the trust, the greater the trust funds should increase in value, further enhancing the GST tax exemption leverage benefit. Moreover, as the IDGT is taxed as a grantor trust, the assets are essentially growing "tax free" as the income tax is being paid by the grantor from other assets (further reducing the grantor's estate). This potentially super-charged GST tax leveraging may prove to be the biggest benefit of using the IDGT House Sale over a QPRT.

Estate Inclusion. Another major benefit of the IDGT House Sale over the use of a QPRT is that even if the taxpayer does not survive the term of the note, the assets transferred to the IDGT should not be included in the taxpayer's estate at his or her death — although the unpaid balance of the note will be included. When one compares this outcome to what would occur if the taxpayer died during the QPRT term (with the entire trust corpus being included in the taxpayer's estate), merely having the unpaid balance of the note included in the taxpayer's estate appears to be a significantly superior outcome for the taxpayer. Thus, assuming the property appreciates during the QPRT or during the IDGT House Sale, the consequences at

death are more tax favorable with the IDGT House Sale.

No Limit. Another benefit of the IDGT House Sale is there is no limit on the number or types of residences one can sell. While QPRTs are limited to a primary and secondary residence, IDGT House Sales may be formed without any limit on the number of homes sold/transferred. Moreover, with an IDGT House Sale (unlike a QPRT) the property does not have to be exclusively a residence. Thus an IDGT House Sale may be viable in cases where a QPRT might not (e.g., a multiplex dwelling). One concern, however, is the issue of "seeding" the IDGT sale. If one believes a seed gift is necessary (or at least viable guarantees are required), then while there may be no limit on the number or type of residences sold, there is a limit on the value of the residences that are sold to the IDGT House Sale trust.

Conclusion

With the recent decreases in real property values coupled with the historically low interest rate environment, now is an opportune time for planners to discuss IDGT House Sales with clients. Moreover, particularly for any clients considering QPRTs, planners must consider/address the possible alternative of an IDGT House Sale to a standard QPRT transaction. In the current interest rate environment, IDGT House Sales seem to be the more powerful of the two techniques. However, given recent develops in the law on IDGTs and the flexibility and other advantages of the IDGT House Sale technique, it appears IDGT House Sales should always be considered as a potential alternative to QPRTs, regardless of interest rates.

As the estate planning community and the courts become more accustomed to the use of IDGTs, the IDGT House Sale strategy should become a more favored wealth transfer planning technique, and an increasing number of planners should evaluate the efficacy of IDGT House Sales with their clients.

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