Dealing with QPRTs in a divorce

Qualified personal residence trusts may pose complex issues if grantor’s marriage is dissolved.

A qualified personal residence trust (QPRT) has become a mainstay of estate planning, but it can pose complex income, gift and estate tax issues if a grantor’s marriage is dissolved and that possibility had not been taken into account when the QPRT was established. For instance, the transfer of retained QPRT interests may be necessary to achieve equity upon divorce without incurring adverse tax consequences; however, practitioners may find inflexible QPRTs difficult to unwind by the spouses or disclaimed by their beneficiaries and they could, in some instances, result in an unintended reduction or forfeiture of intended tax benefits either to them or to the estate, particularly when minors or unborn descendants are involved. Those, and other key issues relating to property settlement in noncommunity-property states, and various ways they may be addressed, are explored in this article.

A discussion of all of the technical aspects of a QPRT is not possible here, but the strategy generally works like this. A parent contributes a primary or vacation home to an irrevocable trust under which the parent retains free use for a specified term (“residency interest”), after which the parent retains complete ownership of the home vests in his or her children, or is held in trust for them. If the parent survives the term of the residency interest, the entire value of the home escapes estate tax at the parent’s death, which, depending on the value of the home at that time, could result in a significant tax savings for the family.

For gift-tax purposes, a contribution of the residence to the QPRT constitutes a gift, the value of which is measured by the fair market value of the home at the time of contribution less the present value of the residency interest. A QPRT providing a residency interest term of 15 years for a parent whose age is 50 would cause the gift to approximate 40% of the value of the home, based on current Internal Revenue Service (IRS) tables. So long as the gift value does not exceed the parent’s unused $1 million federal gift tax exemption, no federal gift tax is payable.

Most clients are aware of the disadvantage of a QPRT if a parent does not survive the term: The value of the home will be subject to estate tax at the parent’s death. Although any gift-tax exemption amount applied to the initial gift will be restored, the opportunity to have used the exemption for another gift of appreciating property for the children is lost.

There is, however, another unfortunate event, not often considered at the time the QPRT is created, that could reduce or even forfeit the intended estate tax benefit. If spouses become divorced during the residency term, the probability of which could exceed the probability of death within that period, and the home, or the residency interest, is treated as marital property even though held by only one spouse, the division of that interest could be difficult.

Four options

Most attempts at resolving this issue on divorce have involved the following four options:
The spouses seek to unwind the QPRT, restoring the entire home as a marital asset subject to equitable division between them.

The spouses agree to leave the QPRT intact, thereby preserving the estate tax benefit for their children, but purchase the home from the QPRT with other marital funds, and then divide the home as part of the marital estate.

The spouses agree to leave the QPRT intact, but have it sell the residence, so that the residency interest, under most QPRTs, is converted to a stream of annuity payments subject to division between the spouses.

The spouses agree to leave the QPRT intact, but value the residency interest and award other marital property of equal value to the spouse not holding that interest.

Because a QPRT is an irrevocable trust, the first option, of unwinding it, may be difficult and forfeits the estate-tax savings benefit. Having the children disclaim their interests in the QPRT is one way to unwind, but this can be difficult to execute, particularly when minors or unborn descendants are involved. Also, the disclaimer generally would constitute a taxable gift. The parties instead might seek a court order rescinding the trust, but the court must find a basis for such relief, such as the characterization of the entire home as a marital asset notwithstanding its conveyance to a QPRT, or that other equities exist to compel distribution of the home to the spouses.

The second option might be adopted, except the spouses may not be in a position to purchase the home from the QPRT at its then fair market value with other marital assets. Also, capital gains tax payable by the trust on the sale may be too burdensome. For QPRTs created after December 1997, IRS regulations preclude either spouse from purchasing the home unless the QPRT is treated as a separate taxpayer for federal income tax purposes.

A purchase of the home, therefore, will require that the QPRT first be converted to a separate taxpayer, and that tax be paid on the gain resulting from the sale. The benefit of the capital gains exclusion for individuals selling a principal residence is not available for a QPRT that is a separate taxpayer.

A QPRT generally may be converted to a separate taxpayer without too much difficulty, but a discussion of the various techniques to accomplish this is beyond the scope of this article. Finally, under the second option, the estate-tax benefit of the QPRT may be diminished because a QPRT holding the sale proceeds of a residence ordinarily would be required to pay an annuity to the parent for the remaining residency term, reducing the value of the children’s interests.

The effect of the third option is very much like that of the second, except that other marital assets are preserved. Also, unless the spouse who wishes to keep the home has sufficient separate property to allow him or her to be the purchaser, the home no longer remains in the family.

The fourth option preserves the estate-tax benefit of the QPRT, but may not be workable if the spouse who has the residency interest has no desire to retain it. If, however, the other spouse is willing to accept the remaining residency interest against his or her share of the marital estate, might it be possible to transfer the remaining residency interest from the original holder to the other spouse without adverse tax effect? The answer appears to be yes.

Transferring QPRT interests

Typically, the spouse who creates a QPRT ("grantor spouse") would hold other interests or rights in addition to the residency interest. For example, to reduce gift tax on the creation of the QPRT, the grantor spouse might retain the right to have the home returned to his or her estate ("reversionary interest") if the grantor spouse failed to survive the residency term.

Since the reversionary interest would obviously affect the transferee spouse’s enjoyment of the residency interest, it is important that both the residency interest and the reversionary interest be transferred to the spouse. The reversionary interest should be transferred, and not merely relinquished, because it directly affects the value of the children’s remainder interest in the QPRT. If relinquished, a taxable gift to the children would likely result.

In addition to the residency interest and reversionary interest, the grantor spouse may have retained other rights, such as the right to continue to use the home after the expiration of the residency term for fair market rent, the right to act as trustee of the QPRT, the right to remove or appoint trustees and the right to receive notice. These “administrative” rights should not be overlooked, and should be either transferred or relinquished. Unlike the residency and reversionary interests, relinquishment of the foregoing administrative rights should not constitute a taxable gift because their existence or nonexistence does not affect the value of the children’s remainder interests for tax purposes.

Transferability issues

Are the interests or rights transferable? Obviously, the QPRT agreement should be reviewed to determine what prohibitions might exist on the assignment of the grantor spouse’s rights and interests. If the QPRT adopts the form agreement published by the IRS in Rev. Proc. 2003-42, 2003-1 CB 1993, transfer may be difficult because ¶ (B)(7) of Art. II of the form expressly prohibits the sale of such interests. A transfer incident to divorce is probably a sale, albeit a nontaxable one under IRC § 1041. It is worth noting that the IRS form in this respect is more restrictive than what is required under IRS regulations.
for a valid QPRT.

The regulations prohibit the commutation of the residency interest, but do not appear to prohibit the assignment of a grantor spouse's interests or rights in the QPRT to a person who will use the home as a personal residence. If the QPRT agreement contains a provision much like ¶ (B)(7) of the IRS template, the parties may need to seek judicial reformation or look to state statute for authority to amend the QPRT agreement. See, for example, New York Est. Powers and Trusts § 7-1.9.

It is unlikely that the QPRT agreement will expressly authorize the transfer of any administrative rights, such as the right to rent the home after the residency term expires or the right to remove or appoint trustees. Nevertheless, a simple relinquishment of those rights by the grantor spouse should be sufficient to ensure that the transferred interests will not be subject to his or her continued exercise of those rights.

Various tax implications

For income tax purposes, the transfer of the grantor spouse's rights in a divorce context should be treated as a sale of a capital asset for full and adequate consideration. See, McAllister v. Comm'r, 157 F. 2d 235 (2d Cir. 1946), cert. denied 330 U.S. 826 (1947), and Rev. Rul. 72-243, 1972-1 CB 1972. Nevertheless, because those transfers would be incident to divorce, no gain or loss should be recognized on the transfer pursuant to IRC § 1041.

As for the gift- and estate-tax implications, so long as the residency and reversionary interests are transferred to the other spouse, who will use the home as a personal residence, the continued qualification of the QPRT for federal gift- and estate-tax purposes should not be jeopardized. The IRS regulations dictating the requirements for a valid QPRT do not require that the residency or reversionary interest be held by the original transferor of the QPRT, nor do they preclude a transfer of those rights. They only require that the person holding those rights use the home as his or her personal residence for the remainder of the residency term.

With respect to the administrative rights discussed above, because they are not required provisions for a valid QPRT, and their existence or nonexistence does not affect the value of the beneficiary's interests in the QPRT, their assignment or relinquishment should not jeopardize the validity of the QPRT or how the gift was valued at its inception. Moreover, there should be no reason to be concerned whether the transferred interests or rights to the other spouse will qualify for the marital deduction in order to avoid a gift tax, because transfer of those interests and rights incident to divorce will be deemed to be a transfer for full and adequate consideration and not a gift under IRC § 2516.

In addition, some states or localities might view the transfer of the residency and reversionary interests as a transfer of an interest in real estate, subject to state and local transfer taxes. Many states and localities exempt transfers incident to divorce.

Considerations in drafting

Although unpleasant, it is far easier to address how a QPRT will affect the marital rights of the spouses before it is signed than to be faced with an unhappy client and inflexible agreement if a divorce occurs. In many cases, a residence contributed to a QPRT was previously held by the spouses jointly or as marital property. Instead of each spouse creating a separate QPRT, one spouse often conveys his or her interest to the other spouse, who then creates a QPRT and alone retains the residency and reversionary interests. The spouse not holding those interests should be advised that there is no certainty the residency and reversionary interests will be treated as marital property in event of divorce.

When drafting a QPRT for a married spouse, attorneys should consider the following three points:

■ If a spendthrift clause is to be used, the agreement should exclude transfers of QPRT interests among family members. Also, the QPRT should not contain a prohibition on sale of the grantor's retained interests as found in the IRS form.

■ The agreement should require that certain administrative rights terminate upon divorce, such as a spouse's right to act as trustee, to remove or appoint trustees or to rent the home after the residency term expires, unless both spouses then agree otherwise. Termination of the right to rent could be particularly important to make sure that the home contributed to the QPRT when the spouses are happily married does not become the principal residence of an outsider if the spouse holding the residency interest remarries.

■ If the spouses share a particular emotional attachment to the home, the QPRT might require both spouses to purchase the home from the QPRT at market value with marital funds in the event of divorce unless both spouses then agree otherwise. Although the gains on the sale will be taxed, it may substantially preserve the value and estate-tax benefit of the QPRT for the children, and restore the entire home as a marital asset subject to equitable division between the spouses. If the gain is too large, the spouses would have the opportunity to jointly elect out of the purchase.

Although a QPRT may be an effective estate-planning device, it poses unique problems in the event of a divorce. Practitioners and clients should give careful consideration to the provisions incorporated in the original trust agreement. In addition, the transfer of the retained interests may be just the solution necessary to achieve equity upon divorce without incurring adverse tax consequences.

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