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This periodic publication highlights developments and trends in trusts and estates from a practical viewpoint based on IPB's experience. This issue focuses on legislative and regulatory developments. Our goal is to share our insights with wealth and philanthropy advisors, corporate fiduciaries, accountants and other advisors in a way that is accessible and actionable. We welcome feedback and additions to our mailing list (*ipb@ipbtax.com*).

Estate Planning with Personal Use Real Estate

By Leslie Bradenham

The looming threat of a reduction in the lifetime exemption from Federal estate and gift taxes, either due to sunsetting January 1, 2026 or sooner via affirmative legislative action, has resulted in most high-net-worth clients exploring ways to use their entire $12.06 million exemption before it is cut in half. But even for the very wealthy, $12.06 million is a substantial sum with which to part. As a result, many clients have been exploring how to use their exemptions without giving away liquid assets, and real estate is a natural choice. Gifting personal use real estate can be complex and requires careful navigation of estate and gift tax rules, but it can be a good option for some clients.

Gifting the Entire Interest

The Basics

A donor can simply gift her entire interest in a residence outright to one or more children or other beneficiaries. Alternatively, a donor can gift the real estate to a trust for the benefit of children and more remote descendants (or others). Gifts in trust can be beneficial for a variety of reasons, including protection from the claims of creditors, removal of assets from the beneficiaries' taxable estates, and removal of assets from the reach of the generation-skipping transfer (GST) tax. In either case, if the client gifts a 100% interest in mortgage-free real estate, the gift transfer itself is straightforward. A current fair market value real estate appraisal will be required to substantiate the value of the gift, a real estate deed transferring the property to the recipient individual or trust must be prepared and properly recorded, and a gift tax return will be required to report the transaction. Clients should be advised regarding real estate transfer and deed recordation taxes that could apply, but in most states there is an exemption for gift transfers.

Continued Donor Occupancy

If the donor wishes to continue occupying the home, the transaction becomes more complicated. Payment of fair market value rent will typically be required. This is because, pursuant to IRC § 2036, property given away during a client's lifetime will be included in the client's taxable estate if he retains a continued right to the income or enjoyment of the property. To avoid this result, in most circumstances we advise the client to enter into a written lease agreement with the donee and pay fair market value rent, as established by an independent appraisal. This appraisal is important not only to substantiate that full value is being paid, and thus no rights are retained that would trigger estate inclusion under IRC § 2036—but also to ensure that the client is not paying too much in rental payments, thereby risking an argument that additional, disguised gifts are being made.

Not only is a formal written lease the best practice for avoiding estate and gift tax issues, it is also an efficient way to transfer additional wealth to beneficiaries. The lease payments are not taxable gifts when made and reduce the value of the donor's estate for estate tax purposes. Moreover, if the real estate was gifted to a trust that is classified as a "grantor trust" for income tax purposes, the rental income received by the trust is not subject to income tax.

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While leaseback of the gifted residence is almost always recommended for the reasons discussed above, where the real estate is gifted to a trust for which the grantor spouse is a beneficiary—often referred to as a "Spousal Lifetime Access Trust" or a "SLAT"—rental payments are likely unnecessary. The theory is that the grantor spouse's continued use of the property with the beneficiary spouse is a "natural incident to the marital relationship".[1] Therefore, the rent-free use of the property together with the donee spouse after the gift does not itself give rise to an implied agreement that the donor has retained the right to use or enjoy the property.[2] Accordingly, many practitioners feel comfortable that a donor spouse can continue to occupy real estate gifted to a SLAT without paying rent, so long as the donee spouse is living there with the donor.

This, in turn, raises the question of whether, after gifting the property to a SLAT, a grantor spouse *can* pay 100% of the rent for continued occupancy with the donee spouse without making unintended gifts. Where the lease arrangements give the donor spouse the right to exclusive possession and/or the trust agreement does not prohibit a beneficiary, i.e., the donee spouse, from paying rent, this risk is likely small. As such, clients with the resources to do so will often choose to pay rent despite the SLAT structure for the estate planning benefits these payments provide. Those that do not, however, must be advised that, if the donee spouse predeceases the donor, rent will be needed for continued occupancy by the surviving donor spouse to avoid the risk of inclusion for estate tax purposes.

Gifting a Portion of Residential Real Estate

Gifts of Fractional Undivided Interests

A donor need not gift her entire interest in a residence. Dividing the property into *successive* interests, and gifting the remainder interest while retaining a life estate, is precisely what IRC § 2036 is designed to prevent. Gifts of successive interests to family members are further frustrated by IRC § 2702, which values the gift of a remainder interest at the property's full value. A donor can, however, transfer a *concurrent* interest in residence without tripping these provisions. Indeed this type of transfer is common, and can result in significant transfer tax savings.

Using this technique, the donor will transfer fractional undivided interests in the property to one or more individuals (or one or more trusts for their benefit). Each such transfer to a donee will be made by real estate deed, which must be recorded in the land records. Following the gift, the donor and the donee(s) will own the residence as tenants-in-common ("TIC").

With TIC ownership, all the cotenants have the right to possess the property, and any cotenant can unilaterally sell, encumber, gift, or devise his or her property interest without the consent of the other cotenants. Importantly, any one cotenant can veto decisions with respect to the parcel as a whole. Each cotenant also has the right to force a partition of the property, which in the case of a single residence will mean a sale of the property and distribution of the proceeds to the cotenants in proportion to the ownership share.

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[1] *Union Planters Nat'l Bank v. United States*, 361 F.2d 662, 666 (6th Cir. 1966).

[2] *Id.*; *see also Estate of Gutchess v. Commissioner*, 46 T.C. 554 (1966) ("[T]he spouses' joint occupancy of a home after an interspouse transfer of the residence is insufficient in and of itself to indicate the existence of an agreement for retained enjoyment."); *Stephenson v. United States*, 238 F. Supp. 660, 667 (W.D. Va. 1965) ("[T]he mere fact that the decedent lived in the house after he transferred it to his wife is neither sufficient evidence to infer an agreement nor is it sufficient to satisfy the requirement of retention of possession or enjoyment as set out by Section 2036.")

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Given these characteristics, the value of the gifted TIC interests will be discounted due to lack of marketability and lack of control.[3] These fractional undivided interest gifts also qualify as gifts of a present interest, so donors without remaining exemption could use this method to transfer real estate over time using discount-leveraged annual exclusion gifts. Importantly, however, an appraisal must be obtained to support the discounted valuation of the fractional interests. An appraisal of these interests will require an appraisal of both the underlying real estate and of the fractional interest, and thus annual exclusion gifting can incur significant appraisal fees.[4]

Even where only TIC interests are gifted and the donor retains an undivided fractional interest in the property, it is still important to be mindful of IRC § 2036 inclusion concerns, though the law here is fairly taxpayer friendly. A donor's post-gift, rent-free use of the property invites an argument for estate inclusion, but if the donor's use is not to the exclusion of the cotenants, case law suggests this would not run afoul § 2036.[5] Moreover, the value of the TIC interest retained by the donor will be included in the donor's taxable estate under § 2033 in any event. Accordingly, so long as the donor's rent-free use of the property is not disproportionate to his or her retained TIC interest in the property, adverse transfer tax results should be avoided.[6] Donors should clearly delineate these arrangement in a Tenants in Common Agreement, and if a donor's use will be in excess of his or her percentage interest, then a formal lease with fair market rent should be used as described above. In all cases, the property expenses should be allocated pro rata among the cotenants based on their percentage ownership.

Utilizing LLCs

Rather than gifting the real estate itself, a donor might instead consider utilizing a Limited Liability Company ("LLC") or Family Limited Partnership ("FLP"). This will involve forming an LLC, transferring the property to the LLC via real estate deed, and later gifting interests in the LLC rather than in the underlying real estate. The use of an LLC in conjunction with transfers of real estate can provide many benefits.

As an initial matter, even where the client intends to make a one-time gift of 100% of his or her interest in a residence to a single trust, the LLC structure will serve to insulate the other trust assets from liability that may arise from ownership of the property. Where multiple fractional transfers are contemplated, the LLC structure will reduce administrative costs. The gifts can be accomplished with simple assignments of LLC interests, together with periodic amendments to the LLC operating agreement reflecting the changed ownership, rather than via preparation and filing of real estate deeds in the land records. In addition, the LLC agreement can be used to set rules for property management, usage, and transfer of ownership, which will help set the donor's family up for long-term success.

As with the TIC arrangement, if the client wishes to gift less than his or her entire interest in the property at the outset, or gift to more than one beneficiary (or separate trusts for such beneficiaries), using the LLC structure will allow the client to leverage those fractional interest gifts. Specifically, discounts for "lack of control" and "lack of marketability" are achievable under

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[3] While the IRS has attempted to argue that the valuation discount for TIC interests should be limited to the cost of partition, the courts have consistently rejected this position. See Estate of Brocato v. Commissioner, T.C. Memo 1999-424, 78 T.C.M. (CCH) 1243; Barge v. Commissioner, T.C. Memo 1997-188, 73 T.C.M. (CCH) 2615; Estate of Baird v. Comm'r, 416 F.3d 442 (5th Cir. 2005).

[4] This expense can be mitigated by timing the annual gifts in December of Year 1, January of Year 2, December of Year 3, January of Year 4, and so forth, such than an appraisal is needed only every 2 years.

[5] See, e.g., Wineman Estate v. Commissioner, T.C. Memo 2000-193, 79 T.C.M. (CCH) 2189; Estate of Powell v. Commissioner, T.C. Memo 1992-367, 63 T.C.M. (CCH) 3192.

[6] See Rev. Rul. 79-109, 1979-1 CB 297.

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current law for gifts of minority interests in properly structured and respected LLCs. These combined discounts often range from 15%-35%, thus significantly reducing the value of the property for gift tax purposes. As with gifts of fractional undivided interests in the underlying real estate, gifts of LLC interests holding real estate will require contemporaneous real estate and entity-level appraisals to substantiate discounts when the LLC interests are gifted, which can be costly.

It is important to note that the IRS views family LLCs with skepticism, and has successfully challenged their use in estate planning transactions on several occasions. In some instances this has resulted in invalidating the discount claimed for the transfer, and in others it has resulted in estate inclusion under § 2036. [7] To avoid these adverse results, caution is warranted on several fronts. First, as was the case with outright gifts of the entire interest and with TIC gifts, the donor's continued use of the property must be handled appropriately. If the client gifts 100% of the LLC to a trust for descendants or outright to such beneficiaries, then the client should enter a formal lease for full fair market value rent with the entity. If less than all of the LLC interests are gifted, a lease agreement for fair market rent will be needed if the donor occupies the underlying real estate for a duration of the year that exceeds his or her percentage ownership. As with TIC ownership, regardless of the donor's use, the LLC members should allocate expenses *pro rata* based on percentage interest.

In addition, when utilizing an LLC, the donor is well advised to clearly respect the separate nature of the LLC and other formalities, and to not retain too much control over the LLC (particularly with respect to distributions and liquidation). Further, it is important that there be legitimate, nontax reasons for the creation of the LLC. In the case of an LLC designed to hold real estate, liability protection and facilitating the family's long-term retention of the property qualify as valid, nontax purposes. However, donors and their advisers must be careful not to undermine these legitimate purposes when structuring the transaction. For example, where the creation and funding of the LLC occurs on the same day as the gifting of the LLC interests, the IRS may make a step transaction argument to ignore otherwise legitimate valuation discounts.[8] Clients should wait a reasonable period after creation and funding of the LLC before gifting the LLC interests.

As a final point regarding use of LLCs, note that there is a risk the IRS will challenge the use of the annual exclusion when a donor gifts LLC interests in this context.[9] While certain steps can be taken to help ensure gifts of LLC interests will be deemed present interest gifts that qualify for the annual exclusion—such as giving the donee a "put right" for a limited time after the transfer, eliminating restrictions on transfer for a limited time, or by substituting a right of first refusal for the transfer restrictions—these techniques undermine the desired discounts. Because of these challenges, and because incremental annual exclusion gifts of LLC interests will require repeated costly appraisals, it is typically advisable for clients using an LLC to gift real estate to instead make larger, one-time gifts of these interests.[10]

<u>Qualified Personal Residence Trusts</u>

As an alternative to the techniques described above, the donor could instead gift the property to a Qualified Personal Residence Trust ("QPRT"). This type of trust is a creation of statute, and it is an exception to the general rule noted above that a donor cannot gift a successive property interest to family members without triggering adverse transfer tax consequences. The QPRT must meet many technical requirements set forth in the statute in order to qualify for this special treatment.[11]

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[7] *See Estate of Strangi v. Commissioner*, 85 TCM (CCH) 1331 (2003); *Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005); *Estate of Powell v. Commissioner*, 148 T.C. 392; *., Senda v. Commissioner*, 433 F.3d 1044 (8th Cir. 2006).

[8] *See, e.g., Senda v. Commissioner*, 433 F.3d 1044 (8th Cir. 2006).

[9] *See Hackl v. Commissioner*, 335 F.3d 664 (7th Cir. 2003); *Price v. Commissioner*, T.C. Memo 2010, 99 T.C.M. (CCH) 1005; *Fisher v. Commissioner*, 105 AFTR2d 2010-1347 (S.D. Ind. 2010).

[10] If a client is without sufficient headroom in their remaining lifetime exemption from estate and gift tax to do this entirely by gift, she could sell the LLC interests to a capitalized grantor trust.

[11] *See* IRC § 2702.

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With a QPRT, the donor transfers his or her residence to the QPRT but reserve the right to occupy the residence for a period of time (the QPRT term). The value of the gift for gift tax purposes is equal to the fair market value of the residence at the time the QPRT is funded, less the actuarial value of the donor's retained term, based on the donor's age and the current IRS § 7520 rate. When QPRT term expires, the residence passes to the donor's family members. If the donor dies before the end of the QPRT term, however, the full value of the residence will be included in the donor's estate.

Assuming the donor survives the QPRT term, title to the residence passes to the beneficiaries and the donor's ownership interest in the property ends. As with other gifts of real estate discussed above, however, the donor can lease the home from the trust for its fair market rent after the QPRT term expires. Notably, in the past the IRS has gone so far as to find that a donor's reserved right to rent the residence for fair market value after the expiration of the QPRT term for the donor's remaining lifetime did not trigger estate inclusion under § 2036.[12]

QPRTs have been somewhat out of favor in recent years due to the historically low interest rates. Specifically, the lower the interest rate, the lower the value of the donor's retained right to use the residence during the QPRT term, and the higher the value of the gift of the remainder interest. As interest rates likely rise of the near term, the QPRT will likely become a more attractive wealth transfer strategy.

Conclusion

This article only touches on some of the ways in which donors can approach gifting their personal residences and vacation properties, and the complex transfer tax provisions that must be navigated in doing so. Despite the challenges that can arise when gifting this type of asset, high net worth clients seeking to use up their lifetime exemption from estate and gift tax while preserving liquidity may find the benefits outweigh the complexities involved.

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[12] PLR 200822011.

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