The Techniques and Troubles of Giving Away the Family Home

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"A house is not a home." --- Polly Adler

"A man's home is his castle." -- proverb

A. Why People Give Away or Bequeath Their Homes

Clients transfer one or more of their residences to their children and grandchildren for a variety of reasons.

1. Estate tax planning

Some make such transfers for estate tax planning purposes. By giving away the house today, the future appreciation will not be subject to gift or estate taxation. For example, assume John, who is 50 years old, gives his house worth $1,000,000 to his children. At John's death 30 years later, the house is worth $2.4 million, assuming growth at 3% per year. By giving away the home now, $1.4 million escaped gift and estate taxation.

2. Can't/Won't give up other assets

John could have given away other assets worth $1,000,000 that perhaps would have grown at a faster rate. If he gave away a stock portfolio that appreciates by 8% per year, his children would have accumulated $10 million after 30 years (ignoring income taxes). Such a gift would have excluded $9 million from gift and estate taxes.

However, John may be unwilling or unable to transfer liquid assets. They may be in a retirement plan that cannot be transferred. John may be an officer of a public company and does not want to have to disclose the transfer of company stock. Or John may need the liquid assets to live on and eventually retire comfortably.

Unlike a gift of stock, John may transfer his house while still having the ability to use it through one of several approaches, which will be discussed below.

3. To pass on the "family compound"

Regardless of estate and gift tax consequences, one may wish to gift or bequeath a family home in order to ensure the children and future generations continue sharing and enjoying the residence. A home can have great meaning to family members, as it is the place of family gatherings, family milestones and life events. Strong memories are evoked when one thinks of the home they grew up in, both good and bad. Or perhaps it is a vacation home where the children learned to swim in the lake and now return for the holidays with their own families. Further, one's goal may be to establish a place that the entire family can continue to get together

in the future so the children remain close, and the grandchildren have an opportunity to spend time with their cousins.

The owners, wishing to see the home preserved as a way of preserving those good times and memories, and so that their grandchildren can have the same experiences, may leave the home to the children or to a trust for their benefit. It doesn't matter if it is a family compound in Kennebunkport, or a two-room cabin on a lake in the Wisconsin North Woods, the objective is the same. It is not necessarily to preserve an asset with great monetary value, but one with great sentimental value.

B. Practical Problems of Giving or Bequeathing a Home

There are many practical issues that must be considered before transferring ownership of a residence: (1) Do the children want the house? (2) Can the donor use the house after transferring ownership? (3) How will disputes over use be resolved? (4) Who will bear the costs of maintaining the residence? I will address each in turn.

1. Do they want it?

First and foremost, clients must ask themselves (and perhaps their children) whether their children *want* the house. Perhaps it isn't as sentimental a place for the children as it is for the parents. Or maybe one or more of the children have moved across the country-- or across the ocean-- and are unlikely to use the residence. Or perhaps the children's spouses *hate* going to the rickety old cabin 8 hours away! Or maybe the children have acquired their own vacation residences that they'd rather visit.

Further, what if two children want the house, but a third child has no interest in using it? Is it fair to leave an asset worth hundreds of thousands or millions of dollars to all three children, perhaps consuming liquid assets to pay the estate tax, when it is worthless to the third child unless sold? In such cases, one should consider leaving the house to those children that wish to own it and leave other assets of equal value to the other children.

2. Use by donor after transfer

If the owner gives away full ownership of a residence during his or her lifetime, can he or she continue to use or live in the home? If the transfer was a gift and the donor continues to live in or use the house until his or her death, the home may be included in his estate at death under Code Section 2036. That Code section "includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer…under which he has retained for his life…the possession or enjoyment of, or the right to the income from, the property." An express or implied understanding that the decedent would retain possession or enjoyment constitutes a retained interest for the purposes of Code Section 2036.[1]

There are several solutions to avoid estate inclusion.

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[1] See Treasury Regulations Section 20.2036-1(c)(1)(i).

a. <u>Retain an ownership interest</u>

First, the donor could retain an ownership interest, for example by giving away 50% of the residence. In this case, the donor would be entitled to use the residence by virtue of his part ownership.

To be clear, the donor should not make the donees joint owners with rights of survivorship (JTWROS). Under Code Section 2040, the full value of property owned by a decedent in JTWROS is included in his or estate *except* to the extent the other joint owners *paid* full and adequate consideration for their interest (except for JTWROS between spouses). Retitling a residence this way constitutes a taxable gift but provides no estate tax benefits. Rather, the donor could retain an interest as a tenant-in-common, with the donor and done each owning an undivided interest in the residence.

It should be clear that the donor does not have exclusive use of the residence, and that the other owners have the same access and right to use the residence as the donor. A "use agreement" among the owners may help serve as evidence of such an arrangement, discussed below. But if the donor transfers an interest in his primary residence, continues living there full time and the donees never exert any rights over or use the residence, the IRS will have a strong argument that Section 2036 applies. The Second Circuit made this point in *Estate of Stewart v. Commissioner*, No. 07-5370 (2d. Cir. 2010), when it said:

> In residential transfer cases, "[i]n determining whether an implied agreement or understanding existed between the parties …. the courts have found two factors to be particularly significant: **continued exclusive possession by the donor and the withholding of possession from the donee.**" *Estate of Spruill v. Comm'r* [Dec. 43,904], 88 T.C. 1197, 1225 (1987); accord *Guynn v. United States* [71-1 ustc ¶12,742], 437 F.2d 1148, 1150 (4th Cir. 1971). The presence of both those factors is so damning that in cases where a decedent transfers a residential property but continues to live in it to the exclusion of the donee, the estate taxpayer has lost in **every case** of which we are aware because the taxpayer could not meet its burden. [emphasis added]

On the other hand, the court went on to say that "co-occupancy of a residential premises by the related donor and donee is highly probative of the absence of an implied agreement."

In *Stewart*, the Second Circuit reversed and remanded the Tax Court's decision that an implied agreement existed between Margot Stewart and her son Brandon, that triggered inclusion of a portion of a transferred interest in a Manhattan brownstone in Margot's estate under Code Section 2036.

Margot owned a five-story brownstone in Manhattan. She and Brandon lived on the first two floors and rented the upper three floors to a commercial tenant. In the fall of 1999, Margot and Brandon met with an estate planning attorney who suggested that Margot gift a portion of the Manhattan brownstone to Brandon. Margot was diagnosed with pancreatic cancer in December and a few months later in May 2000, she signed a deed transferring a 49 percent

tenant-in-common interest in the brownstone to Brandon. She and Brandon continued to live in the first two floors.

Margot died just six months later and her estate reported a 51 percent interest in the brownstone on the estate tax return, which was subject to a 42.5 percent discount for lack of control and marketability. The IRS issued a notice of deficiency claiming that the value of the entire brownstone (without any valuation discount) was includible in Margot's gross estate under Code Section 2036 because she had retained possession or enjoyment of the transferred 49 percent interest.

The Tax Court held that Margot and Brandon had an implied agreement that she would retain the economic benefits of the 49 percent interest she transferred and, as a result, the full value of the brownstone was includible in her estate under Code Section 2036.

The Second Circuit agreed that Margot had retained possession or enjoyment due to an implied agreement with Brandon of at least some portion of the 49 percent interest in the brownstone. The court noted, however, that Code Section 2036 isn't "all or nothing" and according to the Treasury regulations, if Margot only retained possession or enjoyment of a part of the 49 percent interest, the amount included in her gross estate is only a corresponding proportion of the 49 percent interest. The Second Circuit held that the Tax Court's failure to assess all of the facts and circumstances regarding the transfer and the subsequent use of the property to determine what part of the 49 percent was included in the gross estate was clear error.

Specifically, the Second Circuit held that Margot and Brandon's cohabitation in the brownstone both before and after the transfer alone didn't indicate an implied agreement. Since Brandon continued to reside in the brownstone, he exclusively enjoyed all the residential portion of the 49 percent interest transferred to him.

Finally, the court noted that "if Brandon had not lived in the Manhattan property for the entire time between the transfer and Decedent's death, it would certainly not have been clear error had the Tax Court found an implied agreement that Decedent could have excluded Brandon from the Manhattan property during her life."

Stewart demonstrates that any continued use by the transferor is indicative of an implied agreement. Therefore, a *use agreement* or *lease* is imperative if the donee will not be using the residence concurrently with the donor.

b. <u>Spouse as beneficiary of recipient trust</u>

Second, the donor could transfer the house to a trust for the benefit of his spouse and children. As a beneficiary of the trust, the spouse could use/live in the residence, and as part of that use could allow the donor to stay with her. However, if the spouse predeceases the donor, the donor could no longer use the residence for free.

The IRS could argue that such an arrangement was tantamount to an implied agreement that the donor could continue using the residence for his lifetime. In Revenue Ruling 70-155,[2] an

[2] 1970-1 C.B. 189.

elderly father continued to live rent-free in a residence that he had transferred to his son and daughter-in-law. The ruling holds that the father's continued occupancy of the residence rent free until his death was a retained economic benefit resulting inclusion in his estate under Code Section 2036. However, the ruling states that where the donor and donee are spouses, the co-occupancy does not itself support an inference of an agreement or understanding as to retained possession or enjoyment by the donor. The ruling cited *Estate of Gutchess v. Commissioner*,[3] where the court held that the value of a residence transferred from the donor to his spouse 11 years before the donor died is not includible in the donor's gross estate under Code Section 2036 even though the spouses continued to reside in the residence until the donor's death. The court found that no agreement with respect to the occupancy was implied from the fact that the spouses continued to reside in the residence after the transfer.

Similarly, in Letter Ruling 9735035[4], the IRS held:

> In the present case, the taxpayer proposes to transfer residential property to a trust for a 20-year term. If the taxpayer and his spouse survive the 20-year term, the property is to pass in further trust. Under the terms of the latter trust, his spouse is granted the right to use and possess the residence during her lifetime. At her death the property is to pass to the taxpayer's children. As set forth in Rev. Rul. 70-155 and *Estate of Gutchess*, if the taxpayer continues to live in the residence with his spouse after the term of the residence trust and then predeceases his spouse, the property will not be includible in his gross estate under §2036. No agreement with respect to the occupancy will be implied from the fact that the taxpayer and his spouse continue to reside in the residence."

c. <u>Lease the residence</u>

Third, the donor could lease the residence from the donee(s). Code Section 2036 does not apply unless there is an express or implied agreement that the donor will retain the use of the residence. An arm's length lease for adequate consideration is not tantamount to the donor "retaining" use of the residence.

Private letter rulings indicate that the donor could contractually reserve a first option to lease the residence. In Letter Ruling 9626041 (April 2, 1996), the trust into which a residence passed at the end of a qualified personal residence trust, or "QPRT," contained a provision giving the donor the right to lease the residence for fair market rent. The rulings held that such a provision would not cause the residence to be included in the donor's estate under Section 2036.[5]

[3] 46 T.C. 554 (1966) [CCH Dec. 28,067], acq 1967-1 C.B. 2.

[4] June 2, 1997.

[5] "We conclude that, if either or both of the taxpayers survive the 15-year term of their trust and continue to live in the residence leasing the residence for fair market value rent, the interest in the property that each taxpayer transfers to his or her trust will not be includible in that taxpayer's gross estate under §2036." PLR 9626041 (April 2, 1996).

In the case of a lease, it is beneficial if the residence is transferred to a grantor trust. Aside from the usual trust benefits of control and creditor protection, it also simplifies the lease. Rather than multiple children who all own an interest being lessors, the trust is the sole lessor. There is only one party with which to negotiate and contract. In addition, because transactions between a grantor and grantor trust are ignored for income tax purposes,[6] the rent will not be taxable income to the trust. If the donor leases the property directly from his children, the rent will constitute taxable income to them.

3. **Who will bear the costs of maintaining the residence?**

How will costs such as utilities, property taxes, repairs and maintenance be paid? If the residence is leased (whether to the donor or unrelated third parties), the rental income may be sufficient to cover these expenses, and possibly even build a reserve for repairs.

What if the property does not generate income, or the income is insufficient to cover all the expenses? What if major repairs are required, such as a new roof? If the property is owned by a trust with other liquid assets, those assets could be used to cover these expenses. Otherwise, the family members will need to cover these expenses out of pocket. This could become a major source of conflict, as some may not be able to afford the expense, and some may object to having to pay it because they don't use the house as much as the others (or at all). Then there is the issue of actually collecting the funds from the family members, and if one does not pay, the burden increases on the others.

Alternatives include (a) charging family members an annual fee and/or a usage fee, which may produce a more fair result, or (b) endowing the trust with sufficient funds to pay the anticipated expenses in the future via bequest or life insurance.

Of course, just because one can transfer a house for the benefit of multiple generations, it does not mean the house will physically last multiple generations. After 50, let alone 100 years, the house will need major renovations, and may even need to be razed and rebuilt. Technology, building codes and design tastes will change. The family will need to agree on these changes, and determine how to pay for them.

4. **Use Agreements**

We teach our children to share their toys, but a house is completely different. Mayhem can erupt when a grown child shows up at the summer cottage with his spouse and children only to find it is occupied by his sister and her family. The home has only three bedrooms with five beds, and with both families present there are 10 people. The sister doesn't see eye to eye with her sister-in-law, and the brother's children are in high school and college while the sister's children are in pre-school and grade school. Co-occupancy isn't possible, practical or desirable.

A "use agreement" needs to be in place to avoid such situations. Moreover, as explained above, if the donor retains an interest in and continues to use the residence, a use agreement can

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[6] Rul. Rul. 85-13.

serve as evidence that all the owners have the same access and right to use the residence as the donor.

a. <u>Establishing the use agreement</u>

In theory, the donees (*e.g.*, the children) could agree on the terms of a use agreement. However, the process alone could divide the family-- the opposite effect the shared home was supposed to have. The children may not have an equal desire to use the home, or pay the expenses associated with home ownership. On the other hand, all of them may want to use it during school holidays, or over the long Independence Day holiday.

A better approach is to build the agreement into the transfer. For example, the residence could be transferred to a trust that contains rules regarding the beneficiaries' use of the house. Alternatively, the use agreement could be built into the operating agreement of a partnership or limited liability company (LLC) to which the residence is transferred.

The latter approach is easier to amend, and if ownership of the LLC changes (*e.g.*, distributed out of a trust or sold to another person or trust), the new owner receives his interest subject to the operating agreement. For example, the donor could transfer the home into an LLC and then give LLC interests to his children or a trust for their benefit. The LLC agreement could contain rules and terms regarding use of the home and how expenses will be paid. Any lease by the donor (or anyone else) would be executed by the LLC rather than all the owners, and the LLC can provide liability protection to its members.

b. <u>Terms of use agreement</u>

A comprehensive use agreement should specify:

- How often, and for how long, one may use the residence each year.
- A system to reserve dates to use the house. It could specify that if a family member cannot reserve the same week (*e.g.*, New Years Eve) two years in a row if another family member wants the same week.
- How costs such as utilities, taxes and maintenance will be shared. Will family members pay an annual fee and/or a usage fee? Will they prohibited from using the residence if they don't pay?
- The vote required to renovate or improve the residence and how those costs will be allocated.
- The conditions under which the residence may be sold, if at all.

Voting itself can be complicated. The use agreement should specify who has a vote and what vote is required. For example:

(i) Vote required: If a vote is required to sell the house, is it a majority, supermajority or unanimous vote? If only one of out five children has an interest in keeping the house, should he be able block the sale?

(ii) Who votes: If only one child is still living, should he or she have the sole vote whether to keep or sell the residence, or should it require a majority vote of all the donor's descendants? In the latter case, a child with a large family could outvote everyone else. Should each "family line" have a vote (where a "family line" consists of a child and his descendants)? That would give all the children's families an equal vote, but the potential for deadlock still exists.

C. How to Give Away a Home

There are several methods to transfer ownership of a residence in a tax-efficient manner.

1. Gift

One could simply give away part or all of the residence. During 2011 and 2012 (at least), each person has a $5 million gift tax exemption, or $10 million total between spouses or partners. Five to ten million dollars is more than enough to transfer 99.9% of the homes in the world free of gift tax. It's a simple and clean transaction without moving parts.

The donor's basis in the residence carries over to the donee, but could be increased if gift tax is paid.[7] To ensure maximum basis to the donee, one should keep detailed records of the original cost of the residence and all capital improvements made over the years, such as kitchen renovations and the additional room built over the garage.

Making the gift to grantor trust provides a number of benefits. First, as mentioned above, the donor's spouse could be included as a beneficiary to avoid paying rent while the spouse is living. Second, the trust can protect the residence from the beneficiaries' creditors. Third, if the donor leases the residence, there is only one lessor and the lease payments are not taxable income to the trust. Fourth, the grantor could repurchase the residence from the trust in the future without triggering capital gains tax, and the residence's basis could then be stepped-up in his estate. Fifth, the trust agreement could contain the rules regarding usage and cost sharing.

Making a gift and then leasing back the residence can transfer significant wealth to the donees. If the fair market rent exceeds the property taxes and costs of maintaining the residence, the excess profit to the donees is a form of wealth transfer. The vacation home market in particular area can have very high rents at peak season. For example, a client recently transferred a vacation home to a trust for his children. The gift was $3.5 million, based on a professional appraisal. The market rent for this home during the summer months is about $50,000 per month, and a yearly lease could yield $250,000 per year. However, the annual maintenance costs and property taxes total $100,000, leaving annual $150,000 profit to the trust.

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[7] See Code Section 1015.

2. <u>Transfer partial interests</u>

One could transfer a partial interest in the residence, such as a 50% tenancy-in-common interest, and retain the balance. As explained above, this is a way for the donor to potentially continue using the residence. Or, one could transfer the entire residence by giving partial interests to several donees, whether individuals or trusts. Both approaches could reduce the gift tax value of the residence through "partial interest discounts."

In *Ludwick v. Comm'r,*[8] the Tax Court upheld, but reduced, minority interest discounts on the value of two tenancy-in-common interests conveyed to separate qualified personal residence trusts (QPRTs) by a husband and wife. Andrew and Worth Ludwick owned a vacation home in Hawaii as tenants-in-common. In 2005, they each created a QPRT to which they each transferred their respective undivided 50 percent interest in the home. On their gift tax returns, they each applied a 30 percent discount to the interest they transferred. In determining the deficiencies in gift tax resulting from these transfers, the IRS allowed a discount of only 15 percent and at trial, the IRS argued for a discount of no more than 11 percent.

The standard for determining the fair market value of a property interest for gift tax purposes is set forth in Regulation Section 25.2512-1 as the price at which the interest would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having knowledge of the relevant facts. Impediments or restrictions on the ability to sell or liquidate the interest may reduce its value. The Tax Court in *Ludwick*, however, wasn't convinced by the analysis employed by either the taxpayers' or the IRS' expert of how the restrictions inherent in a partial interest in real estate should affect its value. The taxpayers' expert summarized a variety of undivided interest transactions but failed to explain the specifics of the transactions or how the discounts were calculated. He also compared the property at issue to 10 real estate limited partnerships that the court deemed irrelevant. The IRS' expert fared no better. He relied on four sales of undivided interests in the eastern United States, a broker survey in which several brokers gave summaries of discounts, a second broker survey regarding public tenancy-in-common investments and a study of tender offers for majority interests in public companies. The court found that all of the above was either irrelevant, or conclusory and unsupported.

Noting that Hawaii law allows for partition of real property, the court ultimately determined that a willing buyer would consider only (1) the time and cost of partition (that is, the cost to sever the interests by a judicially mandated sale and distribute the proceeds to each tenant), and (2) the time and costs incurred to sell the property if no partition were necessary. The court found that a buyer would expect a partition to be necessary about 10 percent of the time, take two years to resolve (including one year to sell the property) and cost an amount equal to 1 percent of the value of the property. The court further estimated that the costs to sell the property, regardless of whether a partition action was necessary, would equal 6 percent of the property's value. The court also reasoned that a buyer would take into account the costs of maintaining the property until the property was sold and the parties had stipulated that the property's annual operating costs were approximately $350,000. Finally, the court found that a

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[8] TC Memo 2010-104 (May 10, 2010).

buyer would demand a return no greater than 10 percent to account for the marketability risk inherent in an investment in the property interest.

The parties stipulated that as of the date of the transfers, the property had a fair market value of $7.25 million. Assuming a 3 percent annual growth rate in the value of the property, the court calculated the value of an undivided 50 percent interest in the property in two ways as illustrated below: first, assuming that a partition was necessary, and second, assuming that no partition was necessary.

If Partition is Not Necessary:

Years	**Operating Costs** **($350,000 / year total)**	**Selling Costs (6%)**	**Sale Proceeds** **(3% annual growth rate)**	**Total**	**Present Value** **(applying a 10% discount rate)**
1	($175,000)	($217,500)	$3,733,750	$3,341,250	$3,037,500

If Partition is Necessary:

Years	**Operating Costs** **($350,000 / year total)**	**Partition Cost (1% over 2 years)** **and** **Selling Costs (6%)**	**Sale Proceeds** **(3% annual growth rate)**	**Total**	**Present Value** **(applying a 10% discount rate)**
1	($175,000)	($18,125)	-	($193,125)	($175,568)
2	($175,000)	($235,625)	$3,845,763	$3,435,138	$2,838,957
Total:					$2,663,389

The court then calculated a weighted average of the two values, assuming that the likelihood of partition would be 10 percent (($3,037,500 x .9) + ($2,663,389 x .1) = $3,000,089), which resulted in a discount of just over 17 percent (1-($3,000,089/$3,625,000) = 17.24%).

In the wake of *Ludwick,* it is unclear whether the "cost of partition" approach championed by the court is now *the* method, as opposed to simply *one* method, for valuing fractional interests in real property. At the very least, one can safely say that valuation reports for such interests should at least address the relative merits of the cost of partition approach as it applies to the situation at hand and if not employed, a well-supported explanation for its lack of applicability should be included.

Compare the recent case of *Estate of Adler v. Commissioner*[9]. In that case, the Tax Court stated:

> Whether property should be valued as a whole or as separate fractional interests — with appropriate discounts for split ownership — depends on <u>when</u> the interests are separated. If ownership is split during the decedent's lifetime, the interest the decedent retained is valued separately. If the split occurs only at death, the property is valued as a whole — without a discount for split ownership. (emphasis added)

Therefore, if an entire residence is included in one's estate and is bequeathed in equal shares to five people, despite the fact that each person inherits only a one-fifth interest, the residence value is not discounted for estate tax purposes. Estate tax is assessed on the value of the asset in the estate, irrespective of who inherits it and how. However, gifts of one-fifth interests to five different people during one's life would give rise to valuation discounts because gift tax is assessed on what each donee received.

The Adlers paid dearly to learn this lesson. Axel Adler owned approximately 1,100 acres known as "Rancho Aquila" in Carmel, California. In 1965, he gave an undivided one-fifth interest in the property to each of his five children. However, in the deed he reserved for himself the full use, control, income and possession of the property. After the gift, Adler continued to live on the property and paid all expenses. None of the children resided there or interfered with his use in any way. In 1991, one of his children deeded her one-fifth interest back to Adler. So at the time of his death, he owned a one-fifth interest in the property himself and his other four children owned the other four-fifths.

Adler's estate tax return listed his one-fifth interest in the property subject to a 32% marketability discount and a 16% minority interest discount. Further, the estate also reported the value of each of the other one-fifth interests owned by his children on Schedule G to the Form 706, subject to a 22% marketability discount and 16% minority interest discount (it is not clear from the opinion why the marketability discount was 32% versus 22% for the interest owned by Adler versus the interests owned by his children). Adler included his children's interests because his express retained right to use the property rendered them includible in his estate under Code Section 2036.

The Tax Court held that Code Section 2036 treats a transfer of the property subject to a decedent's right to possession or enjoyment as actually occurring at death, not during life. As a

[9] TC Memo 2011-28 (Jan. 31, 2011).

result, the Tax Court held that (1) Adler was to be treated as if he had retained the entire interest in the property for his life and transferred the four interests to his four children at his death and (2) 100% of the value of the children's interests and his interest was includable in his gross estate, without any valuation discount. The Court distinguished this case, where Adler retained full control of the property, from a an earlier case (*Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999), where blocks of stock owned by a surviving spouse and a QTIP trust for her benefit were valued separately because the surviving spouse did not "possess, control or have any power of disposition over" the stock in the trust.

Finally, one should not give interests to identical trusts, or the IRS will argue that the interests transferred to the trusts should be aggregated, possibly eliminating discounts. For example, if one gives 50 percent of a residence to each of two identical trusts for the benefit of all of his children, the IRS will likely aggregate the interests to the two trusts, since the trusts have no effect other than to reduce the value. On the other hand, 50 percent could be given to a trust for one child and 50 percent given to a trust for another child without this risk.

3. Sale

One could sell part or all of the residence to one or more individuals or trusts for cash and/or a note. If the residence is sold to a trust with other assets, the sale would provide liquidity for the grantor. In addition:

- If the grantor sells a tenancy-in-common interest, in the residence, the portion sold would be subject to valuation discount, as explained above.

- The note could be serviced by the trust using its other investments, by leasing the residence to third parties and/or to the grantor, or by usage fees paid by family members.

- If the trust is a "grantor trust," the grantor will not realize taxable gain or loss on the sale, taxable income on the note interest, or taxable income on lease payment form the grantor because transactions between a grantor and grantor trust are ignored for income tax purposes.[10] Moreover, the grantor pays the income tax on the net income from leases to third parties.

However, the trust's required payments under the note should not be designed to match or tied to the income generated by leasing the residence. Otherwise, the IRS may argue that it was not a bona fide sale, but rather a transfer of the residence with a retained interest in the income.[11]

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[10] Rul. Rul. 85-13.

[11] See *Lazarus v. Commissioner*, 58 T.C. 854 (1972), acq. 1973-2 C.B. 2, aff'd 513 F.2d 824 (9th Cir. 1975). See also *Ray v. U.S.*, 762 F.2d 1361 (9th Cir. 1985) (holding that the most important factor leading to the conclusion that the transaction was a transfer in trust with a retained life estate rather than an annuity was the tie-in between the trust income and the payments to be made); *Greene v. U.S.*, 237 F.2d 848 (7th Cir. 1956) (holding that where the taxpayer transferred property to his children in exchange for children's promise to pay taxpayer greater of income from property or $3,000 in any year, in substance the taxpayer retained the right to the income from the property transferred); Rev. Rul. 68-183, 1968-1 C.B. 308 (ruling that although the transaction

4. QPRT

A residence could be transferred to a "qualified personal residence trust," or "QPRT." A QPRT is a trust to which one transfers a personal residence and retains the right to use the residence for a term of years, after which ownership passes to the remaindermen (*e.g.*, children or a trust for their benefit). If spouses together own a residence, they may transfer their interests to the same QPRT so long as the trust instrument prohibits anyone else from holding a term interest in the trust at the same time as either spouse.

Transferring a residence to a QPRT delays the ultimate transfer to the children, but reduces the gift in the process. For example, if a gift of a $2 million residence to a 10 year QPRT by a person age 60 is **$1,295,640** (at a 7520 rate of 2.8%). If the residence appreciates by 4% per year, it will be worth $2.96 million at the end of the 10 year term.

The older the grantor (and thus the greater likelihood he won't survive the term), the longer the term and the higher the 7520 rate, the smaller the gift. For example, a transfer of the same $2 million residence to a 15 year QPRT by a 70 year old when the 7520 rate is 5% would result in a gift of only **$443,380**! If the residence appreciates by 4% per year, it will be worth $3.6 million at the end of the 15 year term.

If the grantor survives the term, the residence is not included in his or her taxable estate. If, however, the grantor does not survive the term, the residence is included in his or her taxable estate pursuant to Code Section 2036, eliminating any estate tax benefits. This is because Section 2036 includes the value of property transferred by a decedent in which he retained the possession or enjoyment for his life or a period that did not end until his death.

For older clients, a short term QPRT can trigger a surprisingly small gift. A transfer of a $2 million residence to a 3 year QPRT by a 90 year old person triggers a gift of **$1,073,680** (at a 7520 rate of 2.8%)**--** about the same as a 13 year QPRT by a 60 year old!

Regulations Section 25.2702-5(c) requires the governing instrument of a QPRT to contain several provisions, which are described below. Revenue Procedure 2003–42[12] contains a sample QPRT.

a. QPRT Assets

The QPRT may only hold one residence to be used as a personal residence by the term holder. Such residence must be either the principal residence of the term holder,[13] "one other

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purported to be a sale of the stock to the trust by the grantor for an annuity, in substance it was a contribution of stock to the trust with the reservation of an income interest in the trust for life because the current income yield from the stock purchased was exactly equal to the annuity payment.

[12] 2003–23 I.R.B. 993.

[13] As defined in Code Section 1034.

residence" of the term holder,[14] or an undivided interest in either. For this purpose, QPRTs holding fractional interest in the same residence are treated as one QPRT.

Some interpret this to mean that if a taxpayer has created QPRTs on two residences, he can never create another. However, this does not appear to be accurate for two reasons. First, a taxpayer could create a QPRT on his primary residence, and years later (perhaps after that QPRT has ended), create a QPRT on his new primary residence. The regulations permit creating a QPRT for a "principal residence" and there is no ostensible limit on the number. The only actual limit is imposed by Regulation Section 25.2702-5(a), which provides that a trust that otherwise meets the requirements of a QPRT is not a QPRT if *"at the time of the transfer"* the term holder already holds interests in two trusts that are QPRTs. Therefore, as long as the taxpayer does not concurrently have term interests in more than one QPRT, there is no limit to the number of residences he can transfer via a QPRT. The reference to "one other residence" in Regulation Section 25.2702-5(b)(2)(i)(B) is consistent with this because if the principal residence is already in a QPRT, the taxpayer could create a QPRT with only one other residence.[15]

The QPRT can hold cash in certain circumstances:

First, cash may be added to and held by the QPRT, but not in excess of the amount required to defray expenses, mortgage payments, or improvements already incurred or reasonably expected to be incurred within the following six months or to be used to purchase a personal residence within the following three months (provided that the trustee has already entered into a contract to purchase the residence). The trustee must distribute any cash held which is in excess of the permitted amounts at least quarterly to the term holder. In addition, within 30 days following termination of the term interest, the trustee must distribute to the term holder any cash held for the payment of expenses that is not used to pay trust expenses due and payable on the date of termination.

Second, the trustee may retain any sale proceeds from the residence for up to two years from the date of sale for the purchase of another personal residence for the term holder.

Third, the trustee may (1) hold one or more insurance policies on the residence and (2) retain any casualty insurance proceeds and proceeds from an involuntary conversion of the residence received by the trustee in a separate account for up to two years, for the repair, improvement, or replacement of the residence.

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[14] Which meets the requirements of Code Section 280A(d)(1) without regard to Section 280A(d)(2). Code Section 280A(d)(1) requires the other residence be used by the term holder for personal purposes for the number of days which exceeds the greater of (1) at least 14 days per year or (2) 10 percent of the number of days during the year such residence is rented out.

[15] The introduction to T.D. 8395 in which final regulations were published says, "The final regulations adopt the suggestion of commentators that an individual be permitted in certain circumstances to hold term interests in more than two personal residence trusts (or qualified personal residence trusts)."

b. Prohibited Sales and Transfers

The governing instrument of a QPRT must prohibit selling or transferring the residence to the grantor, the grantor's spouse, a trust treated as owned in whole or in part by the grantor or grantor's spouse under Code Sections 671 through 679, or any entity "controlled" (as defined in Regulations Sections 25.2701-2(b)(5)(ii) and (iii)) by the grantor or grantor's spouse. This is to prevent the grantor of a residence trust from repurchasing the residence in a non-taxable transaction that avoids capital gains tax (e.g., by purchasing it from a grantor trust) and retaining it until death, at which time the residence's basis is stepped up to its fair market value.

If the residence is transferred to another grantor trust upon or after the expiration of the retained term, such other trust must contain the same prohibitions on transfers.

c. Ceasing to Be a QPRT

The trust will cease to be a QPRT if the residence ceases to be used, or held for use, as a personal residence of the term holder. A residence is considered held for use as the term holder's personal residence so long as it is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence.

An example in the Regulations indicates that if health reasons force the term holder to enter a nursing home, the trust will not cease to be a QPRT as long as the residence is available at all times during the term for his or her use, without regard to his or her actual ability to use it, and so long as no one other than a spouse or dependent resides there.

Moreover, if the residence is sold and the proceeds are used within two years to acquire a new personal residence, or if the residence is damaged or destroyed and the insurance proceeds are used within two years to repair or replace the residence, the trust will continue to qualify as a QPRT.

A residence will not fail as a "personal residence" merely because a *portion* of the residence is used for another purpose (including use in a trade or business), provided that such use is *secondary* to use as a residence of the term holder. For example, the IRS has held that leasing a portion of a residence to a third party will not preclude such residence from qualifying as a "personal residence."[16]

If the trust ceases to be a QPRT, it must terminate, and the trustee must either distribute the trust property to the term holder within 30 days or convert it into a qualified annuity trust for the remainder of the term. Similarly, if any sale or insurance proceeds remain unexpended within two years of the sale or damage, the unexpended proceeds must be distributed to the term holder or convert them into a qualified annuity trust.

[16] *See, e.g.*, Ltr. Ruls. 9816003 (Apr. 17, 1998), 9741004 (Oct. 10, 1997).

d. Continued Use Following the QPRT Term

Following the term of a residence trust or a QPRT, there are several ways to provide for the grantor's continued use of the residence after the end of the QPRT term if the grantor so desires. If the residence passes to a trust of which the grantor's spouse is a beneficiary, the spouse may continue to live in the residence rent-free, and the grantor may reside with him or her rent-free, just as the grantor's spouse was able to reside with the grantor rent-free before the end of the income term.

In Letter Ruling 9735035 (June 2, 1997), the taxpayer transferred a home to a QPRT, and if the taxpayer and his spouse survive the 20-year term, the property would pass to a trust which granted the spouse the right to use and possess the residence during her lifetime. Citing Revenue Ruling 70-155 and *Estate of Gutchess v. Commissioner*,[17] the ruling held that “if the taxpayer continues to live in the residence with his spouse after the term of the residence trust and then predeceases his spouse, the property will not be includible in his gross estate under §2036. No agreement with respect to the occupancy will be implied from the fact that the taxpayer and his spouse continue to reside in the residence.” However, following the spouse's death, or if the spouse is not a beneficiary of the trust, the grantor must pay rent to the trust in order to continue living in the residence.

In either case, the rent payments by the grantor to the trust (or the grantor's descendants) are, in effect, tax-free gifts to the beneficiaries (or the grantor's descendants), and if the trust that owns the residence after the QPRT term is a grantor trust, the trust will not recognize rental income for income tax purposes. If the trust is not a grantor trust, the rent will be taxable income to the trust.

It may be preferable to not include the spouse as a beneficiary of the trust after the QPRT term because rent payments can begin sooner, which is another way to transfer wealth.

As noted earlier, using a single trust will make it easier for the grantor to lease the residence, in that the grantor will only need to negotiate or contract with one trustee rather than several individuals or trustees. The grantor could enter into an agreement at the time the residence trust or QPRT is created, giving the grantor an option to lease the residence for fair market rent after the QPRT term.[18] Alternatively, the residence trust or QPRT agreement itself could give the grantor the option to lease the residence for fair market rent after the QPRT term.[19]

e. Joint Purchase QPRTs

In Letter Rulings 9841017, 200112023, 200728018, 200840038 and 200919002, the IRS ruled on what can be called a "joint purchase QPRT." By structuring a QPRT in the manner

[17] 46 T.C. 554 (1966).

[18] *See* Ltr. Ruls. 9425028 (Mar. 28, 1994), 199916030 (Jan. 22, 1999), 199931028 (May 10, 1999).

[19] *See* Ltr. Ruls. 9425028 (Mar. 28, 1994), 9626041 (Apr. 2, 1996), 199925027 (Mar. 25, 1999).

described in these rulings, the taxpayers not only avoided making a taxable gift to the remainder beneficiaries upon creation of the QPRT, but they may have eliminated the mortality risk associated with a QPRT. In the process, they also solved the general impediment to QPRTs: many clients do not want to be forced to pay rent at the end of the QPRT term.

In Letter Rulings 9841017 and 200112023, the QPRT provided that a husband and wife would have the right to live in the residence during their lifetimes, and at the death of the survivor, the residence would pass to their son. The husband, wife and son each contributed cash to a QPRT equal to the present value of their respective interests in the trust, and the trustee used the cash to purchase a personal residence. The IRS made three rulings. First, the IRS held that no gift was made by husband and wife to the son upon the creation of the QPRT. Because the trust qualified as a QPRT, Code Section 2702(a) did not apply and thus the value of the interests retained by the parents and the remainder purchased by the son were determinable under Code Section 7520. Because the son paid an amount equal to the value of the remainder under Code Section 7520, no gift was made to him.

Second, the IRS held that the trust property would not be included in husband's and wife's gross estates under Code Section 2033 because their interests in the QPRT terminated at their deaths. Third, the IRS ruled that because the trust did not provide for the conversion of the trust estate into an annuity to benefit the term interest beneficiaries, Code Section 2039 would not cause the property to be includible in either parent's estate. (If it ceased to qualify as a QPRT, the proceeds would be distributed to the parents rather than converted to an annuity.) It appears that the IRS determined that the retained right to live in the residence did not constitute an "annuity or other payment" under Code Section 2039.

Thus, by creating a joint purchase QPRT, the couple retained the right to live in the residence for their lives (rather than for a fixed term that could end before their deaths), avoided paying gift tax on the transaction, and eliminated the possibility that the QPRT would fail due to their untimely deaths.

Letter Rulings 200728018, 200840038 and 200919002 reached similar conclusions where the life estate holders were to contribute a residence they already owned to the trust, rather than contributing cash with which the trust would purchase a residence. In each ruling, a husband and wife would transfer a residence to a trust that met the requirements of a QPRT. Husband and wife retained use of the residence until the survivor's death, after which the residence would be distributed to a trust for the benefit of their children (the "Purchasing Trust"). Purchasing Trust paid husband and wife an amount equal to the value of the remainder interest each is transferring to Purchasing Trust, determined based on the fair market value of the residence and the Section 7520 tables. In each ruling, the IRS noted that the transaction comes within the purview of the "joint purchase rule" of Code Section 2702(c)(2), such that the transaction is treated as a transfer by husband and wife of their respective remainder interests in the residence coupled with the retention by each of a life interest in property. However, the IRS ruled that husband's and wife's retained interests will be valued using the Section 7520 tables and that the transactions would not result in a gift by either husband or wife to Purchasing Trust.

In each of these letter rulings, the IRS explicitly refused to address whether Code Section 2036 would apply. Section 2036 does not apply to the extent an interest in property was

transferred in a bona fide sale for full and adequate consideration. The rulings held that no gift was made because the remaindermen paid for their interest; that same consideration should put the transaction within this exception to Section 2036. Where the grantor already owned the residence, the consideration was paid to the grantor, falling within the Section 2036 exception. Where the grantor and the remaindermen contributed cash to the QPRT which then purchased the residence, Section 2036 *should not apply* at all because the life interest holders in the QPRT did not transfer anything to the remaindermen, by gift or sale.

The better approach would be to avoid Section 2036 altogether. Therefore, if the grantor already owns the residence, the grantor and remaindermen should contribute cash to the QPRT which then purchases the house from the grantor. In that case, Section 2036 has no application.

f. Multiple QPRTs

One could transfer interests in a single residence to more than one QPRT. Doing so could reduce the mortality risk of the QPRTs, and reduce the overall gift. For example, one could transfer 50% of a residence to a 10 year QPRT and 50% to a 15 year QPRT. If the grantor dies in year 11, the first QPRT will have successfully transferred 50% of the residence out of the estate, but the second QPRT will have failed.

However, after the 10 year term has expired, the taxpayer must pay fair market rent for the 50% that is now out of his estate to avoid estate inclusion under Section 2036, even though he still has the right to use 50% of the home under the remaining QPRT. See Letter Ruling 9714025 (Jan. 6, 1997).

Similarly, spouses could each transfer part of the residence to separate QPRTs. For example, the husband and wife could transfer 50% of a residence to separate 10 year QPRTs. If the husband dies in year 9 but the wife survives the 10 year term, the wife's QPRT will have successfully transferred 50% of the residence out of the estate, but the husband's QPRT will have failed.

However, assume husband predeceases his QPRT term, and as a result 50% of the house passes outright to wife. If wife survives her QPRT term and continues to live in the home, she must pay fair market rent for the 50% she transferred to avoid estate inclusion under Section 2036, even though she is a co-owner of the home. See Letter Ruling 9626041 (April 2, 1996).

In both cases, the value of the interests transferred to the QPRTs could be subject to valuation discounts as partial interests in the residence. (See discussion above.) However, the remaindermen of the QPRTs should not be the same party; otherwise the IRS could argue that the gift consisted of the remainder interest, and because a single remainderman received 100% of the remainder interest, a valuation discount is not warranted.

5. **RPM Trust**

An alternative to a QPRT is a Remainder Purchase Marital (RPM) Trust. As has been previously discussed in various articles[20], the RPM Trust is an efficient vehicle to transfer wealth to the trust remaindermen free of gift and estate tax. An RPM Income Trust may be used as an alternative to a QPRT to transfer a residence to the next generation even more efficiently and without the statutory restrictions applicable to a QPRT. In particular, an RPM Income Trust can eliminate mortality risk (and even using mortality risk to the remaindermen's advantage) and provide greater flexibility than a QPRT.

a. **Summary of RPM Trusts**

An RPM Trust is designed to qualify the spouse's interest for the gift tax marital deduction without subjecting the property of the RPM Trust to estate tax at the spouses' death. As a result, at the end of the stated term, the trust property passes to the remaindermen (the grantor's children or a trust for their benefit) free of gift and estate taxes.

The RPM Income Trust works as follows. The grantor transfers property (such as a personal residence) to the RPM Trust, giving his or her spouse an income interest in the RPM Trust for life or term of years, and simultaneously sells the remainder interest to a trust for his children's (or others') benefit. If the RPM Trust owns a residence, the "income interest" is the right to live in the residence.

For example, husband transfers a $2 million residence to an RPM Trust that entitles his 60 year old wife to use the residence (or the income from the trust) for 10 years, or until her death, if sooner. At a 7520 rate of 2.8%, the trust for the children would need to pay the husband $1,547,260 for the remainder interest. If the same residence was put into a 10 year QPRT, the gift would be only $1,295,640-- about $250,000 less. The remainder interest costs more in this RPM Trust because the wife's death does not eliminate the trust benefits, but actually would be a windfall to the remaindermen: they receive the house sooner and free of estate tax.

Alternatively, the RPM Trust could have a fixed term so that use of the house or the income is for the benefit of the wife or her estate if she is not living-- similar to a fixed term GRAT that continues to pay to the grantor's estate. In that case, the remainder would cost $1,517,396, which is still about $220,000 more than the QPRT gift.

Finally, the RPM Trust could last for the spouse's lifetime. In that case, the remainder would cost only $1,145,080 (again, assuming age 60, and 2.8% rate). This is about $150,000 *less* than the gift from the QPRT.

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[20] Deborah V. Dunn and Alison E. Lothes, RPM Trusts: Reduction of Valuation Risk, Tax Management Estates, Gifts and Trusts Journal, Vol. 33 No. 5 p. 191; David A. Handler and Deborah V. Dunn, GRATs and RPM Annuity Trusts: A Comparison, Tax Management Estates, Gifts and Trusts Journal, Vol. 29 No. 4 p. 175; David A. Handler and Deborah V. Dunn, RPM Trusts: Turning the Tables on Chapter 14, 139 Tr. & Est. July 2000; Deborah V. Dunn and Katherine M. Cunningham, Advantages to Back-Loading: An Analysis of Back-Loaded Annuity Payments from a CLAT or RPM Annuity Trust, Tax Management Estates, Gifts and Trusts Journal, Vol. 29 No. 6 p. 263.

The spouse's interest qualifies for the gift tax marital deduction.[21] Even though the property will pass to a recipient other than the spouse after the term ends, because the transfer of the remainder interest is for "adequate and full consideration in money or money's worth," the bona fide sale exception to the terminable interest rule of Code Section 2523(b) applies. The price paid by the remaindermen equals the present value of the property transferred to the RPM Trust reduced by the value of the spouse's income interest, determined in accordance with Section 7520.

b. An RPM Trust Eliminates Mortality Risk of a QPRT

In contrast to the QPRT, the RPM Income Trust does not have mortality risk. As stated above, with an RPM Income Trust, the income interest is gifted to the grantor's spouse and the remaindermen (or a trust for their benefit) purchase their interest from the grantor for "adequate and full consideration in money or money's worth." Since the grantor has not retained any interest in the trust, Section 2036 does not apply to bring the value of the property back into his taxable estate if he does not survive the trust term.

Not only can the mortality risk be eliminated with an RPM Income Trust, it can also be used to the *advantage* of the remaindermen. Since there is no risk of 2036 inclusion, an RPM Income Trust can be structured so that the term lasts until the earlier of (1) a term of years or (2) the grantor's death. With this type of RPM Income Trust, the remaindermen could receive the property early if the grantor does not survive the term of years, providing a possible "windfall" to the remaindermen. Of course, the price of the remainder interest must be increased to reflect the potential windfall.

One of the largest drawbacks of the QPRT is that it entails a large taxable gift, using the grantor's gift tax exemption or triggering a hefty tax bill. If the remaindermen already have the assets to pay for the remainder interest, an RPM Trust could be funded without a taxable gift. Otherwise a taxable gift to the remaindermen in advance may be required. However, due to the lack of mortality risk and the potential for a windfall, the grantor can stretch the length of the RPM Trust term, decreasing the value of the remainder interest and the purchase price paid into his estate. An RPM Trust could be structured to have the same remainder value as a QPRT with a shorter term.

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[21] Code Section 2523(b)(1) ("Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, such interest transferred to the spouse will terminate or fail, no deduction shall be allowed with respect to such interest (1) if the donor retains in himself, or transfers or has transferred (for less than an adequate and full consideration in money or money's worth) to any person other than such donee spouse (or the estate of such spouse, an interest in such property…"; Treas. Reg. 25.2523(b)-1(b) ("Section 2523(b) provides that no marital deduction shall be allowed with respect to the transfer to the donee spouse of a "terminable interest" in property, in case the donor transferred (for less than adequate and full consideration in money or money's worth) an interest in the same property to any person other than the donee spouse (or the estate of such spouse) and by reason of such transfer such person (or his heirs or assigns) may possess or enjoy any part of such property after the termination or failure of the interest therein transferred to the donee spouse").

c. **No Administrative Restrictions**

Another advantage of an RPM Income Trust over a QPRT is the ability for greater flexibility and customization. A QPRT is subject to restrictions[22] that may limit its utility for certain clients, including:

- The QPRT may only one personal residence (discussed above).
- The QPRT must prohibit sale or transfer of the residence to the grantor, the grantor's spouse, or a grantor trust as to either (discussed above).
- Additions of cash to the QPRT are limited to only those amounts required to pay trust expenses or for improvements already made or to be paid within 6 months from the date of the addition.
- The trust will cease to be a QPRT if the residence (a) ceases to be used, or held for use, as a personal residence of the term holder; (b) is sold and a new personal residence is not purchased within two years; or (c) is damaged or destroyed and the insurance proceeds received are not used to replace or repair the residence or to purchase a new residence within two years.
- If the trust ceases to be a QPRT due to the above reasons, the QPRT must terminate and the trustee must either distribute all trust property outright to the term holder or convert it into a qualified annuity trust for the remainder of the term.

Because none of the interests in the RPM Income Trust are "qualified interests" under Section 2702, it is not subject to these restrictions. The RPM Trust is flexible. As a result:

- An RPM Income Trust may be funded flexibly with different types of property, even those that wouldn't qualify as a personal residence.
- A sale of the residence to the grantor, his spouse or grantor trusts is not prohibited.
- The use of the residence does not need to be as a personal residence-- the residence could be rented to third parties, for example.
- Sale of a residence during the term of the RPM Income Trust will not cause termination or require a mandatory annuity.
- The grantor may add more property to the RPM Trust through a subsequent gift and sale.
- The trustee may use insurance proceeds or sale proceeds as he or she deems best.

Lastly, since a QPRT can only be established with the grantor's principal residence or one other residence, the grantor is essentially limited to two QPRTs. The RPM Income Trust, in

[22] See Treasury Regulation § 25.2702-5(c)

contrast, offers a valuable solution for clients who have multiple residences they would like to transfer.

d. Grantor Can Live With Spouse

Finally, as discussed above, the grantor's use of the home owned by the RPM Trust-- as the spouse of the beneficiary-- should not be treated as an implied agreement allowing the grantor's retained use of the home under Code Section 2036. Letter Ruling 9735035 (June 2, 1997), Revenue Ruling 70-155 and Estate of Gutchess v. Commissioner all hold that, where the donor and donee are spouses, the co-occupancy does not support an inference of an agreement or understanding as to retained possession or enjoyment by the donor. However, following the spouse's death, or after the RPM Trust term, the grantor must pay rent to the trust in order to continue living in the residence.

D. Generation Skipping Tax (GST) Issues

Finally, unless the house is transferred to a trust that is GST exempt, when the last non-skip person (e.g., child) dies leaving only grandchildren and more remote descendants as beneficiaries, a GST taxable termination will occur and then entire trust value is subject to GST tax. Therefore, to pass a residence down multiple generations, GST exemption will need to be allocated to the trust.

While the donor's children are living, the grandchildren could be beneficiaries of the trust and use the residence without triggering GST tax. Their use should not be considered a "taxable distribution" because nothing is actually distributed from the trust. The "rental value" should not be deemed to be distributed to the grandchild for GST purposes either, by analogy to the DNI (distributable net income) rules. Rent-free use by a grandchild of a house owned by a trust should not be treated as DNI to the grandchild. The trust did not receive any income, and therefore should not have a deduction equal to value of the grandchild's use. If all of the trust's actual income were distributed to the beneficiaries and deducted as DNI (or if the trust had no other income), the beneficiary's rent-free use could not trigger an additional DNI deduction, as it is limited to the trust's taxable income.[23]

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[23] Ferguson, Freeland, & Ascher, Federal Income Taxation of Estates, Trusts, and Beneficiaries §6.5.3.4.2 (2d ed. 1993), opine that the law is reasonably clear and that this use of the trust's property is not a distribution at all. See also *Commissioner v. Plant*, 76 F.2d 8 (2d Cir. 1935); Carson v. United States, 317 F.2d 370 (Ct. Cl. 1963); *DuPont Testamentary Trust v. Commissioner*, 62 T.C. 36 (1974), aff'd in part and rem'd in part, 514 F.2d 917 (5th Cir. 1975), on remand, 66 T.C. 761 (1976), aff'd, 574 F.2d 1332 (5th Cir. 1978) (all involving the more limited question whether a trust or estate's payment of expenses to maintain such property should be treated as income to the beneficiary residing in it; only DuPont suggested that the actual residence was income to the beneficiary, and DuPont resolved the case on other grounds); *Prince Trust v. Commissioner*, 35 T.C. 974 (1961) (trust-owned residence was not income producing because beneficiary lived in it rent free).