HOME SWEET HOME:
PLANNING ISSUES FOR RESIDENCES

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Mending Wealth Transfer Strategies (With Help From $5,120,000 Exemptions), Meeting of ABA Taxation Section, Estate and Gift Taxes Committee, San Diego, California (February 17, 2012)

Home Sweet Home: Planning Issues for Residences, Denver Estate Planning Council, Denver, Colorado (Nov. 17, 2011)

Supercharge Your Estate Planning Techniques with Investment, Tax, Asset Protection and "Second Look" Engineering, Joint Meeting of ABA Taxation Section and ABA Real, Property, Trust and Estate Law, Denver, Colorado (co-presenter) (October 22, 2011)

Recent Developments in Estate Planning, Meeting of ABA Taxation Section, Estate and Gift Taxes Committee, Washington, D.C. (co-presenter) (May 6, 2011)

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Recent Developments in Estate Planning, Meeting of ABA Taxation Section, Estate and Gift Taxes Committee, Lake Las Vegas, NV (co-presenter) (January 18, 2008)

Recent Developments in Estate Planning, Joint Meeting of ABA Taxation Section and ABA Real Property, Trust and Estate Law, Estate and Gift Taxes Committee of ABA Taxation Section, Vancouver, Canada (co-presenter) (September 28, 2007)

Testimony before Department of the Treasury Regarding Proposed Regulations Under Internal Revenue Code Section 2053, Washington D.C. (August 6, 2007)

Written Comments to Proposed Regulations Under Internal Revenue Code Section 2053, submitted to the Department of the Treasury by the American Bar Association Taxation Section (July 24, 2007)

The Inheritance Trust: Multi-Generational Planning from the Bottom Up, Advanced Estate Planning and Probate Course, San Antonio, Texas (June 6, 2007)

Recent Developments in Estate Planning, Meeting of ABA Taxation Section, Estate and Gift Taxes Committee, Washington, D.C. (co-presenter) (May 11, 2007)

Missouri Uniform Trust Code: One Year Later, Missouri Bar Association Annual Estate and Trust Institute (October 1, 2005)

An Overview of the Missouri Uniform Trust Code, Bar Association of Metropolitan St. Louis CLE seminar (co-presenter) (September 1, 2004)

Personal Asset Protection and Estate Planning, Forum for St. Louis physicians (May 1, 2004)

The Benefits of Combining Family Trusts with Limited Partnership or Limited Liability Companies, Co-authored with Steven B. Gorin, E-Dirt (2001, Vol. II, Issue 3)

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TABLE OF CONTENTS

Page No.

I. INTRODUCTION 1

II. ASSISTING CHILD IN ACQUISITION OF RESIDENCE 1
- A. Cash Gift 1
- B. Loans 1
- C. Planning with Existing Loan Obligations 2
- D. Outright Gift of Residence 3
- E. Gift of Residence to Trust 4

III. CO-OWNERSHIP OF REAL PROPERTY 7
- A. Introduction. 7
- B. Rights of Co-Tenants 7
- C. Joint Purchase of Residence from Third Party 7
- D. Gift of Fractional Interest in Residence 7
- E. Co-Ownership Agreement 8

IV. WEALTH TRANSFER PLANNING WITH A RESIDENCE 9
- A. Introduction 9
- B. Qualified Personal Residence Trusts 9
- C. Split-Purchase QPRT 15
- D. Transfer of Residence with Lease-Back 18

V. MARITAL PROPERTY ISSUES 26
- A. Homestead Rights of Surviving Spouse 26
- B. Co-Ownership of Residence Between Separate and Community Estates 26
- C. Reimbursement Issues 26
- D. Premarital Agreements 27

VI. BENEFITS OF TRUST OWNERSHIP 28
- A. Revocable Trust Ownership to Avoid Probate 28
- B. Creditor and Spousal Protection 28
- C. Preserve Legacy Property for Multiple Generations 29
- D. Trust Owned Property and Ad Valorem Exemption 29

HOME SWEET HOME: PLANNING ISSUES FOR RESIDENCES

I. INTRODUCTION

Residential real estate often represents the centerpiece of the personal and financial life of the property's owner and his or her family. The purchase, sale and financing of a residence can present estate planning issues and opportunities. This paper analyzes the estate planning issues that arise when a client wishes to assist his or her child (or other family member) in the acquisition of a residence. It also discusses potential wealth transfer strategies that may facilitate the use of interests in a residence to minimize transfer tax liability. Finally, it discusses some miscellaneous issues that arise when a trust owns an interest in a residence.

II. ASSISTING CHILD IN ACQUISITION OF RESIDENCE

Consider the following fact pattern. Bob and Jane Smith have an adult son, David. David has recently married, and he and his wife, Betty, have identified a perfect house for their first home, which the seller has agreed sell to David and Betty for $250,000. David and Betty have both started their careers, which provide them with $120,000 per year of gross income. However, they have little savings, and Betty's student loan balance is approximately $100,000. Lenders have been reluctant to loan David and Betty funds to purchase the residence, because of the lack of available cash for a down-payment and Betty's student loan debt. Bob and Jane have expressed a willingness to assist David and Betty with the home purchase.

A. Cash Gift

1. Bob and Jane could give David cash to assist with the purchase of the residence. For federal gift tax purposes, a taxpayer may give up to $13,000 per year to any individual without any gift tax consequences (or $26,000 if the taxpayer and his or her spouse elect to "gift-split").

2. Bob and Jane could give David and Betty $52,000 without gift tax consequences, assuming they have made no other gifts to them during the year. David and Betty could then use that $52,000 as a down-payment on their new residence.

3. Bob and Jane could give cash in excess of the annual gift tax exclusion, including up to the entire purchase price. A gift in excess of the annual gift tax exclusion will utilize a portion of Bob's and Jane's lifetime gift tax exemptions and must be reported on a United States Gift (and Generation-Skipping Transfer) Tax Return, IRS Form 709.

4. Before the passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRA"), each taxpayer had a $1,000,000 lifetime gift tax exemption. However, the TRA increased the lifetime gift tax exemption to $5,000,000 for 2011, which will be indexed for inflation in 2012. Absent additional legislation, the lifetime gift tax exemption will revert to $1,000,000 on January 1, 2013.

B. Loans

1. While cash gifts may enable a child to purchase a residence, cash gifts may be inappropriate or insufficient. In our example, even with the $52,000 cash gift as a down-payment, David and Betty may face difficulty obtaining an affordable loan, because of Betty's significant student loan debt. Alternatively, David and Betty may be

unwilling to give cash, out of concern that they may need the funds in the future. In these situations, a loan by the parent to the child may be an effective tool to assist with the acquisition of the residence.

2. The loan should be evidenced by a written promissory note from the child and, if appropriate, the child's spouse. The note should describe the term of the loan, the interest rate, the payment terms, and whether or not it is secured.

a. Term of Loan. The note should either state a fixed maturity date (a term loan) or that the obligation is payable on demand of the lender (a demand loan). Typically, a term loan is preferable because it locks in a current interest rate and is simpler to administer.

b. Interest Rate. A term loan should require interest at no less than the applicable federal rate (AFR) for the month and year of the loan. For example, the AFRs for February 2012, with annual compounding, are 0.19% (term of less than three years), 1.12% (term of three to nine years) and 2.58% (term of greater than nine years). A demand loan should require an interest rate no less than the short-term AFR for each month for which the interest is accrued, compounded semi-annually.

c. Interest Payments. The note typically should require interest be paid at least annually, with principal payable at the end of the term. While accrual of interest at the AFR should not cause any gift tax issues, the accrual may implicate the original issue discount (OID) rules that may require recognition of the accrued interest before it is paid. The interest paid to the parent will be taxable as interest income and, if secured by a mortgage, should be deductible by the child as deductible mortgage interest. Alternatively, the note might require fully amortized payments of principal and interest, similar to what a third-party lender would require.

d. Principal Prepayment. The note may allow the borrower to prepay any portion of the loan, without penalty.

e. Security. The note should be secured by a deed of trust on the child's residence. This provides two important benefits. First, the child is entitled to a mortgage interest income tax deduction for interest paid only if the note is secured. Second, the deed of trust provides the lender (the parents in this case) with collateral if the child defaults.

f. Subordinate to Institutional Lender. If the child borrows funds from parents and a lending institution, the lending institution likely will require the parents' loan be subordinate to the lending institution's loan.

g. Community Property vs. Separate Property. A loan to a married borrower during the borrower's marriage is presumed to be an obligation of the community estate unless the loan documents list one spouse as the sole borrower and agree to look solely to that spouse's separate property to satisfy the loan obligations.

C. Planning with Existing Loan Obligations

1. Generally. The current low interest rate environment and the increased lifetime gift tax exemption for 2011 and 2012 may offer an opportunity to ease a child's financial obligations with respect to an existing note without paying transfer tax.

2. Refinancing Loan. The lender in most family loan situations selects the minimum interest rate necessary (i.e., the AFR) to avoid the imputed interest rules of Code section 7872. If the AFRs have declined

since the date of the original note, the parties may refinance the loan at the lower current AFR. Most practitioners believe that no gift occurs when the note is renegotiated at a lower interest rate, even if no additional consideration is provided for the refinance. However, to mitigate the risk that a refinancing for no consideration could be a taxable gift, the debtor could provide some consideration for reducing the interest rate, such as paying a portion of the principal or shortening the note term.

3. Forgive Existing Loan.

a. Generally. The increase in the federal lifetime gift tax exemption to $5,000,000 for 2011 and 2012 may enable clients who previously loaned money to their children to forgive the loans without incurring transfer tax. The Internal Revenue Service ("Service") takes the position that if the parties originally intended that the loan would be forgiven, then the loan is treated as a gift of the loaned funds on the date of the loan. However, the Service may be hard-pressed to argue successfully that the parties originally intended to forgive a loan made prior to the enactment of the TRA, since the motivation for the loan forgiveness stems from a fact (i.e., the increased gift tax exemption) that was unknown at the time of the original loan.

b. Gift Tax Consequences. The donor will have made a taxable gift equal to the unpaid principal plus accrued interest to the date of the gift, unless the donor establishes a lower value.

c. Income Tax Consequences. The donor will recognize taxable interest income on the amount of accrued interest forgiven, but the donee should not have discharge of indebtedness income because of the loan forgiveness. The donee will be entitled to a mortgage interest deduction for the forgiven interest, as long as the donee otherwise qualifies for the deduction (i.e., the loan was secured).

D. Outright Gift of Residence

1. Generally. Bob and Jane could simply purchase a new residence for David and Betty. If Bob and Jane already own the residence that David and Betty want to use, Bob and Jane could give that residence to them.

2. Benefits. This approach is simple and potentially can be achieved without incurring gift tax, particularly given the increased lifetime gift tax exemption for 2011 and 2012.

a. A portion of the gift should qualify for the gift tax annual exclusion for gifts by Bob and Jane to David and Betty, taking into consideration any prior gifts to them during the year.

b. The excess amount would utilize a portion of Bob and Jane's lifetime gift tax exemptions and would only result in out-of-pocket gift tax if it exceeded Bob and Jane's combined lifetime gift tax exemption.

3. Income Tax Considerations. David and Betty would have an income tax basis in the residence equal to Bob and Jane's income tax basis, except if that basis, as adjusted, exceeds fair market value of the residence on the date of the gift, then for purposes of determining loss, the basis shall equal fair market value at the time of the gift. If Bob and Jane pay gift tax to transfer the residence to David and Betty, David and Betty could increase their income tax basis in the property by that gift tax paid, provided that such increase cannot cause the basis to exceed the fair market value of the property at the time of the gift.

E. Gift of Residence to Trust

1. Generally. Bob and Jane may consider creating an irrevocable trust for the benefit of David and giving the property to that trust.

a. Distributions. The trust could authorize distributions to David, Betty and David's descendants for their health, education, maintenance and support.

b. Protection if David and Betty Divorce. The trust could provide that if David and Betty divorce, Betty is no longer a permissible beneficiary of the trust. As a result, unlike an outright gift to David and Betty, a gift of a residence to a properly structured irrevocable trust would not provide Betty with an interest in the residence should David and Betty divorce.

c. Gift Tax Annual Exclusion. Normally, gifts to a trust are ineligible for the gift tax annual exclusion, because they do not qualify as gifts of a present interest. However, for more than forty years, taxpayers have qualified gifts to trusts for the gift tax annual exclusion by giving trust beneficiaries a right to withdraw a certain amount of property given to the trust (capped at the gift tax annual exclusion) for a limited time period (typically 30 days after notifying the beneficiary of the gift to the trust). These withdrawal rights are commonly referred to as "*Crummey* withdrawal rights" based on the court case upon which the technique is based. This typically requires that written notice be sent to the beneficiaries with the *Crummey* withdrawal right within a reasonable period of time after the gift.

d. Withdrawal Rights for David, Betty and Descendants. The trust could grant David, Betty and their descendants (if they had any descendants) *Crummey* withdrawal rights over all contributions to the trust. This should allow gifts to the trust to take advantage of Bob and Jane's annual exclusion gifting capacity for gifts to David, Betty and their descendants, thereby minimizing the amount of lifetime gift tax exemption used to fund the trust.

e. GST Allocation. Bob and Jane could allocate GST exemption to the trust on their Forms 709 in amounts equal to their gifts to the trust. This should allow the trust assets to pass to the descendants of David and Betty free of transfer taxes.

(i) For GST planning, the trust's *Crummey* powers should be structured as "hanging powers". With a hanging power, each donee's withdrawal right lapses each year only to the extent that the lapse would not constitute a release of a general power of appointment, with the unlapsed withdrawal rights continuing in existence until they lapse over time.

(ii) The hanging power should prevent the donee of a withdrawal right from being a deemed donor to the trust for estate and GST tax purposes.

(iii) As with any potential GST planning, practitioners should evaluate whether a trust funded with a residence and, potentially, cash for expenses, is an efficient use of a client's GST exemption.

f. Cash Flow for Expenses. The difficulty with this approach is how to pay for expenses (including taxes and insurance), repairs and improvements to the residence without jeopardizing the tax and non-tax benefits of the trust.

(i) David and Betty should not pay for these costs directly, because such payments would be deemed gifts by them to the trust. This could expose the trust assets to their

creditors and may subject the trust assets to estate tax at their deaths.

(ii) Bob and Jane could make additional gifts to the trust of cash to facilitate the payment of expenses. Again, these gifts could be subject to *Crummey* withdrawal rights and, if desired, Bob and Jane could allocate GST exemption to the trusts for these gifts.

(iii) Bob and Jane could implement other estate planning strategies with the trust that could provide the trust with future cash flow.

i. Bob and Jane could give and, potentially, sell assets to the trust that either currently produce income or may experience a liquidity event in the near term.

ii. Bob and Jane could designate the trust as the remainder beneficiary of one or more grantor retained annuity trusts ("GRATs") that are funded with assets that could provide future cash flow.

g. Creditor/Marital Property Issues. Under Texas law, the failure to exercise such a withdrawal right should not cause the beneficiary to be treated as a settlor of the trust. This treatment should prevent the withdrawal right from impairing the protection of a spendthrift clause.

h. Grantor Trust. Bob and Jane could each create a separate trust for the primary benefit of David, fund his or her trust with the grantor's separate property, and structure the trust as a grantor trust for federal income tax as to the trust's grantor.

i. For example, each trust could give its grantor the power to substitute assets with trust property of an equivalent value. The Service has ruled that such a "swap power" should not cause estate tax inclusion in the grantor's estate.

ii. Grantor trust status is particularly useful if Bob and Jane later decide to sell assets to the trust. Transactions between an individual and a grantor trust as to such individual are considered non-recognition events for income tax purposes.

iii. Additionally, the Service has ruled that the payment of income tax pursuant to the grantor trust rules is not a taxable gift to the trust by the grantor paying the income tax.

iv. There is some uncertainty as to whether a trust structured as a grantor trust for income tax purposes as to the trust's original grantor qualifies for that income tax treatment if the trust also grants *Crummey* withdrawal rights. A *Crummey* withdrawal right would appear to cause a trust to be at least partially a grantor trust as to the withdrawal right holder under Code section 678(a). Code section 678(b) states that a grantor trust power in the original trust's grantor trumps a beneficiary's grantor trust power under Code section 678, but only if the 678 power is a "power over income". It may be argued that the 678(b) exception would not apply to a *Crummey* power, since a *Crummey* power applies to corpus and not income. The Service has issued numerous private letter rulings in which it has held that a trust qualifies as a grantor trust as to its original grantor, notwithstanding the presence of *Crummey* withdrawal rights. However, keep in mind that private letter rulings are only binding on the Service for the taxpayer who obtained the ruling.

i. Distribution Structure. The trust instrument should clearly indicate that the beneficiary may use the trust-owned residence, rent-free. A provision authorizing the trustee to distribute income

and principal for the beneficiary's maintenance and support may be sufficient, even without specific authorization in the trust instrument that the beneficiary may use a trust-owned residence, rent free. However, what if the trust instrument provides that the trustee must consider the beneficiary's other assets before making distributions to or for the beneficiary? If the beneficiary already has sufficient assets for maintenance and support, this limitation on considering other assets could prevent the trustee from allowing the beneficiary to use the trust owned residence, rent-free.

j. Income Tax Issues.

(i) Generally. A taxpayer may exclude up to $250,000 of gain on the sale or exchange of the taxpayer's principal residence ($500,000 if the taxpayer is married and files jointly) so long as taxpayer has owned and used the residence as taxpayer's principal residence for periods aggregating at least two years over the five year period preceding the sale of the property. Such preferential capital gains treatment is available only if the taxpayer has not previously sold a principal residence within the previous two years.

(ii) Grantor Trusts. If a residence is owned by a trust, for the period that a taxpayer is treated under Code sections 671 through 679 as the owner of the trust or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the two year ownership requirement, and the sale or exchange by the trust will be treated as if made by the taxpayer.

i. Traditional Grantor Trust. With a trust that is a grantor trust as to the original settlor, the gain exclusion rules will not likely apply, given that the settlor will likely not satisfy the usage requirements, even though the settlor is treated as the owner for income tax purposes, unless the settlor's usage of the residence prior to contribution to the trust would be sufficient to satisfy the usage requirements.

ii. 678 Trust. A grantor trust under Code section 678 could satisfy both the ownership and usage requirements for the favorable capital gain treatment on the sale of a principal residence, provided the distribution structure of the trust allows the beneficiary to use the residence. A 678 trust is a trust that is a grantor trust with respect to the beneficiary of the trust. Section 678 treatment is typically obtained by creating a trust, funding it with a gift of $5,000 or less and granting the beneficiary a *Crummey* withdrawal right over the initial contribution. If the beneficiary allows that withdrawal right to lapse, the beneficiary should be treated as the owner for income tax purposes under Code section 678 but such lapse should not be a taxable gift under Code section 2514.

(iii) Taxable Trusts. A taxable trust (i.e., a trust that is not a grantor trust for income tax purposes) cannot take advantage of the preferential capital gains treatment for a sale of a principal residence.

k. Ad Valorem Tax. Keep in mind that the beneficiaries of the trust will not be able to claim the homestead exemption from ad valorem tax. Also, the ad valorem tax is the obligation of the trust itself, even if the trust is a grantor trust for federal income tax purposes. Any payment of such tax by the grantor would be a taxable gift to the trust.

l. Homestead Creditor Protection. The trust agreement should authorize the primary beneficiaries of the use (David and, potentially, Betty) to use the residence rent-free. This should enable them to obtain the constitutional homestead creditor protection

benefits for the residence. See VI.B.1.e.i, *infra.*

III. CO-OWNERSHIP OF REAL PROPERTY

A. Introduction.

1. Consider the following variation from the original fact pattern. Assume Bob and Jane currently own or are willing to purchase a residence in which David and Betty will reside.

2. As discussed earlier, Bob and Jane could give the residence to David and Betty. This approach is simple, and potentially can be achieved without incurring gift tax, particularly given the increased lifetime gift tax exemption for 2011 and 2012. However, Bob and Jane may wish to utilize their increased lifetime gift tax exemptions in other ways.

3. Bob and Jane could own the residence but allow David and Betty to occupy the residence, rent-rent. Unfortunately, the rent-free use of a residence may constitute a taxable gift equal to the fair rental value of the residence.

4. Bob and Jane could own the residence and charge David and Betty rent to occupy the residence. This approach is inefficient from an income tax standpoint. Specifically, David parents would recognize taxable income on the rent paid, but David and Betty would not receive an income tax deduction for the rental payments.

5. Joint ownership of the residence by David, Betty and David's parents could prevent the additional tax consequences caused by the rental (or rent-free use) of the residence by David and Betty.

B. Rights of Co-Tenants

1. Texas and many other states provide that co-tenants of real estate have equal rights to possession. Therefore, even if the child owns a relatively small interest in the residence with the parent, the child's use of the residence generally should not be deemed a gift by the parent to the child. This feature of co-tenancy provides potential estate planning opportunities.

C. Joint Purchase of Residence from Third Party

1. David, Betty and David's parents could jointly purchase a residence from a third party. Each party would provide consideration equal to their respective percentage ownership in the residence. As co-tenants, David and Betty could occupy the residence rent-free, without such rent-free possession resulting in a taxable gift to them by Bob and Jane. However, see discussion of apportionment of expenses in III.E.3, below.

D. Gift of Fractional Interest in Residence

1. If Bob and Jane already own a residence, they could give a fractional interest in the residence to David and Betty. Bob and Jane will have made a taxable gift equal to the fair market value of the fractional interest on the date of transfer.

2. The fair market value of the fractional interest should be determined by an appraisal. Typically, a fair market value appraisal of a fractional interest in real property will take into account valuation discounts. The range of discount varies (as well as the manner in which such discounts are determined), but case law has typically upheld discounts of approximately 20%.

3. To illustrate the leverage, assume that Bob and Jane wish to transfer a 50% interest

in their $1,000,000 residence to David and Betty. If a 20% valuation discount applies to the valuation of the 50% interest, Bob and Jane will make a $400,000 gift to David and Betty (which represents a $100,000 reduction in value from a pro rata portion of the value of 100% of the residence).

4. Alternatively, Bob and Jane could give fractional interests to a trust for David, Betty and their descendants. See II.E for a discussion of issues applicable to gifts to trusts.

E. Co-Ownership Agreement

1. Generally. The owners in any co-tenancy arrangement should execute a co-ownership agreement that sets forth the obligations of the owners with respect to the residence.

2. Equal Rights to Possession. The agreement should reiterate that, consistent with Texas law, each owner has equal rights to possession of the residence.

3. Apportion Expenses. The agreement should address how expenses, insurance and property taxes will be apportioned among the owners. Generally, all such expenses should be apportioned between the parties in proportion to their respective ownership interests in the residence. Such apportionment should negate any possible argument by the Service that the payment by one owner of expenses constitutes a taxable gift to the other owners. Note, however, that any expenses that are unique to a particular owner (namely, the owner occupying the residence) should be paid solely by that owner.

4. Restrictions on Transfer.

a. Generally. The agreement can restrict the ability of a co-owner to transfer his or her interest in the residence during life or at death. For example, it could provide that any transfer of an interest in the residence other than to certain "permissible transferees" requires the consent of all owners.

b. Annual Exclusion Impact. If one of the co-tenants intends to make gifts of fractional interests in the residence after the execution of the co-ownership agreement, the donor's counsel should consider the impact that such transfer restrictions may have on the ability of the donor to qualify the gifts for the gift tax annual exclusion as a present interest. In recent cases, courts have been more restrictive in granting annual exclusion treatment for interests in closely-held entities. Arguably, a fractional interest in real estate subject to a co-tenancy agreement bears some semblance to an interest in a closely held entity – at least with respect to transfer restrictions – although the ability of the co-tenant to use the residence should be sufficient to distinguish it from an entity interest. To address this concern, consider making the transfer subject to a 30 day put right by the donee, in which the donee can compel the donor to purchase the interest for cash equal to the fair market value of the interest transferred.

5. Desire to Sell. The sale of 100% of the residence to a third party requires the consent of all of the owners. However, if desired, the co-ownership agreement could address the situation of one co-owner wanting to sell when the other owner does not. For example, the agreement could state that if one party ("selling party") wants to sell to a third party buyer, the selling party will obtain an appraisal of the residence. The other owner ("non-selling party") could have the option to either buy the selling party's interest or sell his interest to selling party at a pro rata portion of the lesser of the appraised value or the third party offer. If

the non-selling party fails to exercise this option, the parties would agree to sell the residence to the third party buyer.

6. Purchase at Death. The agreement could provide that upon the death of a co-owner, the surviving co-owners could have a right or obligation to purchase the deceased owner's interest for its fair market value.

7. Mandatory Purchase Upon Divorce. If one of the co-owners divorces from another co-owner, the agreement could grant one spouse the right to purchase the other spouse's interest, or compel one spouse to sell his or her interest to the other spouse or the other co-owners.

8. Restrictions on Use. If desired, the agreement could restrict the ability of the owners to (i) allow pets in the residence, (ii) smoke in the residence, (iii) operate a business in the residence, (iv) sublease the residence, (v) allow visitors to remain in the residence beyond a certain number of days, or (v) make any repairs or improvements without consent of the other owners.

9. Dispute Resolution. Generally, the owners should use their best efforts to resolve disputes informally between themselves. However, the agreement could set forth a more formal procedure for resolving disputes if informal efforts fail, such as mandatory participation in mediation or even binding arbitration.

IV. WEALTH TRANSFER PLANNING WITH A RESIDENCE

A. Introduction

1. Residential real estate frequently makes up a sizeable portion of a client's estate and, therefore, would generate a sizeable portion of any estate tax due at the client's death. The client may wish to preserve a residence for the use and enjoyment of the client's family for multiple generations. This section of the paper analyzes various planning opportunities that may allow a client to transfer an interest in a residence on a tax-advantaged basis.

2. The discussion below relates specifically to techniques dealing with an interest in a residence. In evaluating a client's overall estate plan, practitioners must consider whether a residence is the most efficient asset with which to achieve a tax-advantaged wealth shift. For example, the appreciation potential of the residence, as compared to appreciation potential of a client's other assets, may dictate the implementation of planning with the client's non-residential assets. Additionally, certain techniques (namely a QPRT and SP-QPRT, discussed below) are less efficient from a wealth transfer standpoint when interest rates are low.

B. Qualified Personal Residence Trusts

1. Generally. The purpose of a qualified personal residence trust ("QPRT") is to reduce the upfront gift tax value of a gift of an interest in a personal residence, while allowing the donor to retain the exclusive use of the residence for a fixed period of years. With this technique, a client transfers a "personal residence" to the QPRT and retains the exclusive right to use the residence for a fixed period of years. The transfer of the residence to the QPRT constitutes a taxable gift by the client at the creation of the QPRT equal to the actuarial value of the remainder interest in the QPRT. The value of the gift is based on three factors: (1) the fair market value of the residence, (2) the age of the donor, and (3) the Code section 7520 interest rate at the time of the gift (which equals 120% of the mid-term term AFR). If the donor survives the end of the fixed term, the residence

passes to the designated remainder beneficiaries with no additional gift tax consequences. If the donor does not survive the term, the QPRT property is included in the donor's gross estate for federal estate tax purposes.

2. Example. A 60-year old client transfers a residence valued at $1,000,000 to a 20-year QPRT at a time when the Section 7520 rate is 3.0%. Under those assumptions, the client will be deemed to have made a $321,220 taxable gift to the remainder beneficiaries of the QPRT. If the client survives the 20-year term, the residence will pass to the remainder beneficiaries of the QPRT (the client's children, for example) without any additional gift tax consequences. If the Section 7520 rate were 5.0% rather than 3.0%, then the client's gift upon creation of the QPRT would be reduced from $321,220 to $218,660.

3. Meaning of Personal Residence. A QPRT may only be funded with a personal residence of the term holder. A personal residence means (a) the principal residence of the term holder, (b) one other residence of the term holder within the meaning of Code section 280A(d)(1) but without regard to Code section 280A(d)(2), or (c) an undivided fractional interest in either (a) or (b). The residence may be subject to a mortgage. It may include appurtenant structures used by the term holder for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location). It does not include any personal property. Its primary use must be as a residence of the term holder when occupied by the term holder. A residence will not qualify as a personal residence if it is used to provide transient lodging and substantial services are provided in connection with lodging (e.g., a hotel or a bed and breakfast). A residence is not a personal residence if, during any period not occupied by the term holder, its primary use is other than as a residence.

4. Governing Instrument Requirements. A trust qualifies as a QPRT only if the trust instrument meets certain requirements of the Treasury Regulations, which provisions must by their terms continue in effect during the existence of any term interest in the trust.

a. Income. The governing instrument must require that any income of the trust be distributed to the term holder not less frequently than annually.

b. Distributions to Others. The governing instrument must prohibit distributions of corpus to any beneficiary other than the term holder prior to the expiration of the retained term interest.

c. Assets of QPRT.

(i) Generally. Except as described below, the governing instrument must prohibit the trust from holding, for the entire term of the trust, any asset other than one personal residence to be used or held for use as a personal residence of the term holder.

(ii) Cash. The governing instrument may allow the trust to hold cash in a separate account, in an amount which, when added to the cash already held in the account for such purposes, does not exceed the amount required:

- for payment of trust expenses (including mortgage payments) already incurred or reasonably expected to be paid by the trust within six months from the date the addition is made;

- for improvements to the residence to be paid by the trust within six months from the date the addition is made;

- for purchase by the trust of the initial residence, within three months of the date the trust is created, provided that no addition may be made for this purpose, and the trust may not hold any such addition, unless the trustee has previously entered into a contract to purchase that residence; and

- for purchase by the trust of a residence to replace another residence, within three months of the date the addition is made, provided that no addition may be made for this purpose, and the trust may not hold any such addition, unless the trustee has previously entered into a contract to purchase that residence.

If the governing instrument permits additions of cash as described above, it must require that the trustee determine, not less frequently than quarterly, the amounts held by the trust for payment of expenses in excess of the amounts permitted and must require that those amounts be distributed immediately thereafter to the term holder. Additionally, the governing instrument must require, upon termination of the term holder's interest in the trust, any permissible cash held by the trust that is not used to pay trust expenses due and payable on the date of termination (including expenses directly related to termination) be distributed outright to the term holder within thirty days of termination.

d. Improvements. The governing instrument may permit improvements to the residence to be added to the trust and may permit the trust to hold such improvements, provided that the residence, as improved, meets the requirements of a personal residence. However, keep in mind that the amount contributed to or on behalf of the trust for the payment of such improvements will constitute an additional taxable gift by the donor that is computed at the time of the gift, reduced by the value of the donor's retained interest under the QPRT. A similar rule applies with other cash contributions to the QPRT.

e. Sale Proceeds. The governing instrument may permit the sale of the residence (except to certain impermissible persons discussed in IV.B.4.l., below) and may permit the trust to hold proceeds from the sale of the residence, in a separate account.

f. Insurance and Insurance Proceeds. The governing instrument may permit the trust to hold one or more insurance policies on the residence and may hold, in a separate account, proceeds of insurance payable to the trust because of damage to or destruction of the residence.

g. Commutation. The governing instrument must prohibit commutation (prepayment) of the term holder's interest.

h. Cessation of Use as Personal Residence. The governing instrument must provide that a trust ceases 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 held for use as a personal residence of the term holder so long as the residence 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.

i. Sale of Personal Residence. The governing instrument must provide that the trust ceases to be a QPRT upon sale of the residence if the governing instrument does not permit the trust to hold proceeds of sale

of the residence. If the governing instrument permits the trust to hold proceeds of sale, it must provide that the trust ceases to be a QPRT with respect to all proceeds of sale held by the trust not later than the earlier of (A) the date that is two years after the date of sale, (B) termination of the term holder's interest in the trust, or (C) the date on which a new residence is acquired by the trust.

j. Damage/Destruction of Personal Residence. The governing instrument must provide that, if damage or destruction renders the residence unusable as a residence, the trust ceases to be a QPRT on the date that is two years after the date of damage or destruction (or the date of termination of the term holder's interest in the trust, if earlier) unless, prior to such date, replacement of or repairs to the residence are completed or a new residence is acquired by the trust. Note that if the governing instrument allows the trust to hold insurance proceeds received because of damage to or destruction of the residence, the governing instrument must contain provisions similar to those described above in the case of a QPRT that is permitted to hold proceeds of sale.

k. Disposition of Assets Upon Cessation as QPRT. The governing instrument must provide that, within 30 days after the date on which the trust has ceased to be a QPRT with respect to certain assets:

- the assets be distributed outright to the term holder,
- the assets be converted to and held for the balance of the term holder's term in a separate share of the trust meeting the requirements of a qualified annuity interest (i.e., in a GRAT), or
- the trustee, in its sole discretion, elects to comply with either of the above two options.

l. Certain Sale Prohibitions. The governing instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse during the retained term interest of the trust, or at any time after the expiration of the retained term interest that the trust is a grantor trust. A sale or transfer to another grantor trust of the grantor or the grantor's spouse is considered a sale or transfer to the grantor or the grantor's spouse; however, a distribution (for no consideration) upon or after the expiration of the retained term interest to another grantor trust of the grantor or the grantor's spouse pursuant to the express terms of the trust will not be considered a sale or transfer to the grantor or the grantor's spouse if such other grantor trust prohibits the sale or transfer of the residence to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse. These restrictions do not apply if the grantor dies prior to the expiration of the retained term interest and the residence is distributed (for no consideration) to any person (including the grantor's estate) pursuant to the express terms of the trust or pursuant to the exercise of a power retained by the grantor under the terms of the trust. Additionally, these restrictions do not apply to an outright distribution (for no consideration) of the residence to the grantor's spouse after the expiration of the retained trust term pursuant to the express terms of the trust.

5. Payment of Expenses, Repairs and Maintenance. The term interest holder may pay all property taxes, general repairs, maintenance and utilities on the residence. Insurance and improvements should be

apportioned between the life tenant and remainder beneficiary according to their actuarial interests.

6. Income Tax Issues.

a. During QPRT Term. During the QPRT term, the trust will be treated as a grantor trust as to the term holder with respect to the income. If the term holder has a reversionary interest if he or she dies before the end of the QPRT term, the trust will in most cases be treated as a grantor trust as to the term holder with respect to the corpus as well.

b. Expiration of QPRT Term. To facilitate future planning opportunities, client should consider structuring the remainder beneficiary as a grantor trust for income tax purposes. Practitioners routinely cause grantor trust status with a traditional "intentionally defective grantor trust" by giving the grantor a power to substitute assets with property of equivalent value. However, a traditional swap power would seem to violate the QPRT requirement that the governing instrument prohibit sales to the grantor, the grantor's spouse, or an entity controlled by the grantor after the term interest ends if the remainder beneficiary is a grantor trust. As a result, other grantor trust provisions of the Code should be implicated to cause grantor trust status, other than the swap power. For example, a power of an unrelated third party to add charitable beneficiaries should cause grantor trust status without implicating the sale prohibition described above.

7. Lease at End of Term.

a. Clients frequently want to continue using the residence as a personal residence at the end of the QPRT term. To avoid inclusion of the residence under Code section 2036, the term holder and the remainder beneficiary should enter into a lease that commences upon termination of the QPRT term. The lease should charge fair market rental to the term holder and should otherwise contain terms that are consistent with an arm's length arrangement.

b. This rental arrangement provides a number of benefits. First, it allows the client to continue using the residence without causing the residence to be included in the client's gross estate under Code section 2036. Second, the rental payments provide the remainder beneficiary with additional cash without any additional taxable gifts, although the remainder beneficiary will recognize taxable income on the rent unless the remainder beneficiary is a grantor trust as to the term holder.

c. The right to lease the residence may be expressly set forth in the trust agreement creating the QPRT. The grantor could even execute a lease prior to the end of the QPRT term, or even contemporaneously with the creation of the QPRT, that gives the grantor the right to continue to occupy the residence and prescribes the rental payments.

8. Trustee of QPRT. Careful practitioners must be mindful that designating the grantor as trustee of the QPRT may cause unintended transfer tax consequences, unless proper drafting steps are taken. For example, if the grantor is the trustee of the QPRT and, as trustee, may sell the residence and decide whether to reinvest the sales proceeds in another residence, the grantor effectively has the power to reacquire the trust property simply by selling the residence and refusing to reinvest the proceeds in another residence. Even if the governing instrument requires a reinvestment of sales proceeds, the grantor (as trustee) may have a power to recover the trust property if the residence is destroyed

by fire or other casualty or if the grantor ceases to use the property as a residence.

a. Potential Tax Issues. At least two potential transfer tax issues may arise as a result of the above trust structure. First, if the grantor serves as trustee and has discretion to sell and whether to reinvest the sales proceeds in another residence, the grantor's gift to the QPRT may be incomplete until the grantor's power ends. Second, the grantor's retained power to reacquire the trust property may constitute a general power of appointment, the lapse of which at the termination of the QPRT results in a taxable transfer.

b. Planning Alternatives. To minimize the risk of the above transfer tax issues, the trust instrument should contain certain safeguards if the grantor will serve as trustee (or has the power to remove the trustee without cause and appointment himself or someone related or subordinate to himself as trustee within the meaning of Code section 672(c)):

(i) The trust instrument should not allow the trustee to elect between distribution of trust assets to the grantor or conversion to a GRAT, if the trust ceases to be a QPRT. Instead, it should mandate that the trust assets will be transferred to a GRAT if the trust ceases to be a QPRT.

(ii) The trust instrument should require the remainder beneficiary to consent to a sale of the residence.

(iii) The trust instrument should require the trustee to reinvest the proceeds of a sale (or insurance proceeds received because of destruction of the residence) in a new residence. Alternatively, the trust instrument could require the trustee to reinvest such cash in a new residence, unless the remainder beneficiary consents to an alternate arrangement.

These issues would not apply if the trust instrument designates a third party trustee and restricts the grantor's ability to remove and replace the trustee so that the trustee's powers are not attributable to the grantor.

9. Discounted QPRT Funding. Married clients can enhance the potential gift tax benefits of a QPRT by partitioning a residence and giving their undivided fractional interests in the residence to separate QPRTs.

a. Benefits. This technique should further reduce the value of the taxable gift upon creation of the QPRTs by taking advantage of the discounted values attributable to fractional interests in real estate.

b. Example. Client and his spouse each contribute a 50% interest in a $1,000,000 residence to separate 20-year QPRTs. The client and his spouse are both age 60 and the Section 7520 rate is 3.0%. The fair market value of the 50% interest in the residence must be determined by a qualified appraisal. If each 50% interest in the residence were valued by applying a 20% valuation discount and, therefore, is worth $400,000, each spouse would make a taxable gift of $128,488 (for a combined gift of $256,976). This reduces the taxable gift from $321,220 (if one QPRT is funded with a $1,000,000 residence) to $256,976 (if two QPRTs are each funded with a 50% interest in that same residence), a difference of $64,244.

10. Multiple QPRTS. Treasury regulations only allow a taxpayer to establish QPRTs for his or her principal residence and one other residence. If structured appropriately, however, married taxpayers with a primary residence and more than one vacation residence actually may transfer three residences to QPRTs and still comply with the applicable Treasury regulations. Specifically, the couple would transfer 50%

interests in their primary residence to separate QPRTs. Each spouse would exchange his or her interest in one vacation residence for the other spouse's interest in the other vacation residence, so that each spouse owns one vacation residence as his or her separate property. Each spouse would then transfer that spouse's vacation residence to a separate QPRT.

11. Usefulness of QPRTs in Current Low Interest Environment.

a. Generally. The 7520 rate is at an all-time low (1.4% for February, 2012). As discussed earlier, the effectiveness of the wealth shift from a QPRT is less when the 7520 rate is lower. Therefore, it stands to reason that a gift of a residence to a QPRT is typically not an efficient leveraged gifting strategy when interest rates are low.

b. Impact of Depreciated Value. Combined with currently low interests, our economy has witnessed a tremendous depreciation in the value of real estate. For example, consider a residence that has a current value of $1,000,000 that a 60 year old taxpayer wants to contribute to a 10 year QPRT. At February's 7520 rate of 1.4%, taxpayer would make a taxable gift of $743,030 to fund the QPRT with this property. However, what if this property's value is currently depressed by approximately 35%? If the property's value rebounded to $1,350,000 over two years, taxpayer would incur approximately the same taxable gift if he funded the QPRT two years later (when taxpayer is age 62) at a value of $1,350,000 if the 7520 rate was 4.2% (which would produce a taxable gift of $742,230). The "leverage" of the taxable gift versus the value of the residence is clearly more significant when interest rates are higher. Nevertheless, in appropriate circumstances, the depressed value of real estate could still make a QPRT a viable planning opportunity, even in a low interest rate environment. If a taxpayer elects to defer implementing a QPRT until interest rates rise, an increase in the value of the property over that time could negate the benefits of waiting. Additionally, the actuarial probability that the taxpayer will survive the QPRT term necessarily decreases if taxpayer waits for two years before funding the trust.

12. Pre-97 QPRTs. As discussed earlier, the QPRT trust instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse during the retained term interest of the trust. This requirement was established by 1997 treasury regulations. Query: does this apply to a pre-1997 QPRT? If not, then shortly before the expiration of the QPRT term, the settlor of the pre-1997 QPRT could purchase the residence back from the QPRT. This would allow cash to go into the QPRT (and ultimately to the remainder beneficiaries) and the residence to return to settlor. It would alleviate the need to paid rent at the end of the QPRT term and would allow the residence to obtain a new income tax basis at settlor's death.

C. Split-Purchase QPRT

1. Downsides to QPRT. While a QPRT offers a number of potential benefits, it is deficient in a number of respects. First, it requires an upfront taxable gift, which may be significant depending on the value of the residence, the age of the donor and the term of the trust. Second, a QPRT does not allow taxpayers to utilize their GST exemptions efficiently so that the residence can pass tax-free for multiple generations. Third, the residence is included in donor's gross estate for federal estate tax purposes, if the donor dies before the QPRT term ends, meaning

the donor has not accomplished any transfer tax savings if he or she dies prematurely. Fourth, the donor must pay rent to the remainder beneficiaries if he or she wishes to use the residence at the expiration of the QPRT term. As discussed earlier, this rental payment, while potentially useful as a transfer tax planning strategy, can be administratively burdensome and potentially cause adverse income tax consequences. Also, if the donor is relatively cash poor, the rental obligation can actually impose some financial hardship on the donor.

2. SP-QPRT as Alternative. The "split-purchase qualified personal residence trust" ("SP-QPRT") provides clients with a residence planning alternative that addresses a number of the short-comings of the traditional QPRT. First, a SP-QPRT allows the client to retain the rent-free use of the residence for the client's lifetime. When the client dies, the residence should not be included in client's gross estate for federal estate tax purposes. Instead, it will be distributed to the remainder beneficiaries of the SP-QPRT free of estate (and potentially) GST tax.

3. Rulings. The Service has issued five private letter rulings on the SP-QPRT technique, two of which were obtained by the author's law firm. In all four rulings, the Service ruled favorably on most aspects of the transaction but refused to rule on the applicability of Code section 2036 to the transaction.

4. Structure.

a. Acquisition. The remainder beneficiaries of the SP-QPRT acquire their interest in the residence by purchase rather than by gift. If a client owns a residence that he wants to contribute to a SP-QPRT, the client would transfer the residence to the SP-QPRT and the remainder beneficiaries would pay the client an amount equal to the actuarial value of the remainder interest in the SP-QPRT. Alternatively, the client and remainder beneficiary can jointly acquire a new residence by contributing cash to the SP-QPRT according to their actuarial interests in the SP-QPRT. The trust would purchase the residence in the name of the SP-QPRT.

5. Income Tax Issues.

a. New Residence. The joint purchase of a newly acquired residence by the client and the remainder beneficiaries should not be an income tax event, in the same way that a purchase of a residence by an individual is not an income tax event to the purchasing individual.

b. Existing Residence.

(i) Generally. If client contributes an existing residence to the SP-QPRT, this may be an income tax recognition event. In this case, this transaction should be treated like a sale of a remainder interest in the residence by client to the remainder beneficiaries. As a result, the client would recognize capital gain equal to the amount contributed by the remainder beneficiaries minus the product of the client's basis in the residence and the remainder factor used to determine the remainder beneficiary's contribution to the SP-QPRT.

(ii) Principal Residence Gain Exclusion. Generally, a taxpayer can exclude up to $250,000 of gain from the sale of a principal residence ($500,000 for a married couple). However, if a taxpayer funds a SP-QPRT with taxpayer's principal residence, the taxpayer cannot exclude such gain as a sale of a principal residence unless the remainder beneficiary is unrelated to the client (unlikely, given the estate planning nature of the transaction) and the taxpayer

affirmatively elects for the principal residence exclusion to apply to the sale of the remainder interest.

(iii) Grantor Trust. No income taxable event should occur if the remainder beneficiary is a grantor trust with respect to client.

6. Lifetime Interest. The SP-QPRT typically lasts for the client's lifetime. As a result, the client can occupy the residence for his lifetime, without any obligation to pay rent.

7. Immediate Estate Tax Savings. The assets of the SP-QPRT should not be included in client's estate for federal estate tax purposes, regardless of when the client dies. In contrast, with a traditional QPRT, the donor achieves estate tax savings only if he or she outlives the QPRT term.

8. No Taxable Gift. The creation and funding of a SP-QPRT does not require a taxable gift, since the remainder beneficiaries acquire their interest by paying fair market value for their actuarial interest in the residence.

9. Payment of Expenses, Repairs and Maintenance. The life tenant should pay all property taxes, general repairs, maintenance and utilities on the residence. Insurance and improvements should be apportioned between the life tenant and remainder beneficiary according to their actuarial interests.

10. Tool to Provide Client with Liquidity. The SP-QPRT technique also offers clients an opportunity to exchange an illiquid residence for liquid assets. For example, a client may have implemented effective wealth transfer planning for the benefit of his descendants, creating a trust that now holds significant liquid wealth. Client's existing assets cannot satisfy his liquidity needs. If the existing trust and client participate in a SP-QPRT, client will receive liquid assets equal to the value of the remainder interest in the SP-QPRT, and the trust will receive a remainder interest in the residence. The trustee of the existing trust should consider whether the proposed transaction would violate the trustee's fiduciary duties to the trust beneficiaries, before implementing the transaction.

11. GST Exemption Planning.

a. The assets of a traditional QPRT are included in the donor's estate for estate tax purposes if he fails to survive the trust term. As a result, a donor to a traditional QPRT cannot effectively allocate his GST exemption to the trust until the expiration of the QPRT term, because the QPRT is subject to an estate tax inclusion period ("ETIP") until the QPRT term ends. When the QPRT term ends (and the ETIP expires), the donor would have to allocate GST exemption equal to the value of the residence at that time in order allow the residence to pass free of GST tax. This approach does not provide any opportunity to leverage GST exemption.

b. In contrast, a SP-QPRT can allow for the leveraging of GST exemption. Specifically, the residence should pass free of all transfer taxes for multiple generations if a GST exempt trust serves as the remainder beneficiary of the SP-QPRT.

12. Risks. While the potential benefits of the SP-QPRT can be significant, the transaction is not completely free of tax risk.

a. Based on Letter Rulings. The SP-QPRT technique is based on four different private letter rulings. Only the taxpayer obtaining the private letter ruling may rely on it. If a client wishes to attain some added

certainty to the transaction, he or she should consider seeking a private letter ruling before implementing the transaction.

b. Section 2036 Concerns.

(i) Rulings Silent. All of the letter rulings on SP-QPRTs have refused to opine on whether Code section 2036 would cause the trust property to be included in the donor's estate for federal estate tax purposes.

(ii) Some Favorable Case Law. The Fifth Circuit Court of Appeals held that a sale of a remainder interest does not result in estate tax inclusion as long as the remainder interest is acquired for consideration equal to its actuarial value. The Third and Ninth Circuit Courts of Appeals have adopted a similar approach. In contrast, the Tenth Circuit Court of Appeals and the Federal Circuit Court of Appeals held that Code section 2036 applied, unless the donee paid consideration equal to the value of the entire property (not just the value of the remainder interest).

(iii) Executor's Domicile. While the donor may reside within the jurisdiction of a federal circuit with favorable precedent (such as the Fifth Circuit), practitioners should keep in mind that the executor's domicile (and not the donor's) dictates the applicable appellate court jurisdiction for an estate tax case.

c. Requires Existing Trust or Credit Worthy Individual. The remainder beneficiary of a SP-QPRT must have sufficient assets, independent of the life tenant, to participate in the transaction. Moreover, client should not fund a trust with the express purpose of acquiring a remainder interest in the SP-QPRT. Otherwise, the IRS might assert that the step-transaction doctrine should collapse the funding of the remainder trust and the acquisition of the remainder interest as a gift of a remainder interest by the client.

D. Transfer of Residence with Lease-Back

1. Introduction.

a. Both the QPRT and SP-QPRT have certain drawbacks as a wealth transfer technique. The traditional QPRT requires an up-front taxable gift and does not allow the donor to leverage his GST exemption. While the SP-QPRT allows for GST planning if the remainder beneficiary is a GST exempt trust, that remainder trust must be an existing trust with old and cold funds. Both the QPRT and SP-QPRT contain limitations on the ability of the trust to hold assets other than a personal residence and also prevent the sale of the residence to the grantor, the grantor's spouse or a grantor trust of either of them while the QPRT or remainder trust of the QPRT is a grantor trust. Finally, both techniques use the Code section 7520 rate as the basis for the various actuarial assumptions, as opposed to a lower rate (such as the short or mid-term AFR).

b. Experienced estate planning practitioners have implemented installment sales to irrevocable grantor trusts with a variety of assets, such as closely held stock, limited partnership interests, and LLC membership interests. Similarly, courts and the Service have held that a donor to a QPRT can lease the residence from the remainder beneficiaries as long as the terms of the lease reflect fair market rental. Can the limitations of the QPRT and SP-QPRT be overcome by combining these two time-tested estate planning techniques: i.e., a sale of the residence to an irrevocable grantor trust, combined with a lease of the residence from the trust by the grantor? This section of the paper discusses the possible mechanics of a sale/lease-back transaction

as well as the potential risks associated with the technique.

2. Basic Concept.

a. Existing Residence. Consider the following fact pattern. Bob Smith owns a residence with a fair market value of $2,000,000.

b. Irrevocable Grantor Trust. Bob Smith creates an irrevocable trust for Bob's descendants. The trust is a grantor trust for income tax purposes with respect to Bob, because Bob retains the power over the trust to substitute property with trust property of equivalent value.

c. Initial Funding of Trust. Bob funds the trust with a gift of cash or securities. Bob will report the gift on his Form 709 and allocate GST exemption to the trust equal to the amount of the gift. The amount of the gift should be no less than 10% of the fair market value of the property to be sold to the trust.

d. Sale of Residence for Note. Bob sells his residence to the trust for fair market value (determined to be $2,000,000). In exchange, the trust gives Bob a promissory note, with a face amount of $2,000,000, interest payable annually at the mid-term AFR (assumed for this example to be 2.44), the principal payable in 9 years, and no penalty for prepayment of the note.

e. Lease. Bob and the trust enter into a lease of the residence, under which Bob agrees to pay fair market rental (determined to be $100,000 per year for year 1) to the trust. The lease is renewable on a year to year basis, with each subsequent year's rent to be equal to fair market rental at that time. For illustration purposes, assume that rent increases 4% per year. Assume the lease is structured as a triple-net-lease, meaning that Bob would be responsible for taxes and insurance on the residence.

f. Possible Use of Entity. To further leverage the transaction, some practitioners have suggested the creation of a single member limited liability company to own the residence, a lease of the residence between the sole member and the LLC, and then a gift and sale to the trust of LLC membership interests that could be subject to valuation discounts. Generally, an interest in an entity such as an LLC will be valued by applying larger valuation discounts than would apply to a fractional interest in real estate.

3. Economics.

a. Generally. With any wealth transfer strategy, the ultimate driver of whether the transaction produces results depends on the economics of the transaction. In this case, unless the trust sells the residence to a third party, the ability of the trust to repay the note will depend on the following factors: (1) the value of the initial gift to the trust, (2) the rental income received and (3) the annual investment return on the non-real estate assets (i.e., the initial gift and the trust's net income). In each of the following examples, assume that the trust makes annual interest payments on the note and a balloon payment of principal at the end of the term.

b. Sale of Residence to Trust. If the trust generates a 5% annual return on its non-real estate assets, Bob would have to fund the trust with an initial gift of approximately $811,000 (assuming a 5% total annual return on the non-real estate assets) to produce enough liquidity in the trust to pay off the note at the end of the nine-year note term. If the non-real estate assets produced an 8% total annual return, the trust would need an

initial gift of approximately $586,000 to pay off the note at the end of the term.

c. Sell Separate 50% Fractional Interests.

(i) Bob and his wife, Jane, could each create separate grantor trusts for their children. Each would sell a 50% fractional interest in the residence to the trust that grantor created. If each fractional interest were appraised by applying a 20% discount, the purchase price for each trust would be $800,000 ($1,600,000 between the two trusts), a difference of $400,000 from the undiscounted value. Bob and Jane would lease his or her trust's interest in the residence from the trust they created for a combined rent between the trusts of $100,000 ($50,000 per trust).

(ii) Each of Bob and Jane would have to fund his or her trust with an initial gift of approximately $242,000, or $484,000 between the two trusts, (assuming a 5% total annual return on the non-real estate assets) to produce enough liquidity in the trust to pay off the $800,000 notes. If the non-real estate assets produced an 8% total annual return, the trusts would require an initial gift of approximately $162,500 per trust ($325,000 between the trusts) to pay off the notes at the end of the term.

d. Contribute Residence to Entity and Sell Entity Interests.

(i) Gift and Sell Interests in Entity. Assume that Bob contributes the residence to a single member LLC. Bob gives cash to his grantor trust and sells a 99% interest in the LLC to the trust for its appraised value in exchange for a note. Assuming a 35% discount off of net asset value, the value of the 99% LLC interest would be $1,287,000. Assume the same terms on the promissory note as in the prior examples (2.44% interest rate, interest payable annually, nine-year term, balloon payment of principal, and no-penalty for prepayment).

(ii) Lease with Entity. In this example, Bob would lease the residence from the LLC rather than from the trust. Because the only members of the LLC would be Bob and a grantor trust as to Bob, the LLC should be treated as a disregarded entity for federal income tax purposes. Therefore, rent paid to the LLC by Bob should not be taxable income to the LLC's members.

(iii) Distributions from LLC. Assume that the LLC distributes 95% of all of its income. Thus, of each $100,000 lease payment, $94,050 would be distributed to the trust ($100,000 x 95% x 99%).

(iv) Economics. Bob would have to fund his trust with an initial gift of approximately $277,000 (assuming a 5% total annual return on the non-real estate assets) to produce enough liquidity in the trust to pay off the $1,287,000 note. If the non-real estate assets produced an 8% total annual return, the trusts would require an initial gift of approximately $163,000 to pay off the notes at the end of the term.

4. Income Tax Issues.

a. While Trust is Grantor Trust. The sale of the residence to the trust should be a non-recognition event for income tax purposes (i.e., no gain or loss recognized on the sale). The trust takes the same income tax basis in the residence as Bob had at the time of the transfer. Interest payments by the trust to Bob will not be taxable income to Bob or deductible by the trust. The rent paid by Bob to the trust will not be taxable income to the trust.

b. Note Outstanding at Bob's Death. A taxable event may occur if Bob dies before the note is repaid in full. This could result

in one of three potential tax consequences: (1) immediate recognition of gain recognition by Bob's estate at his death, (2) deferral of gain recognition until the obligation is satisfied after Bob's death with the recipient of installment payments treating the payments as income in respect of a decedent, or (3) no recognition of capital gain by Bob's estate or by recipient of note payment as IRD and future interest payments to Bob's estate treated as taxable interest income. Although commentators have debated these income tax issues for many years, it appears that the prevailing view is that death not a recognition event for income tax purposes.

5. Gift Tax Issues.

a. Seed Gift to Fund Trust. Bob's initial gift to the trust, must be reported on Bob's Form 709. No tax should be incurred so long as Bob has remaining lifetime gift tax exclusion equal to the value of the gift.

b. No Gift Tax on Sale. The sale should not be treated as a taxable gift, because the trust paid Bob an amount equal to the fair market value of the residence. Bob should consider disclosing the sale transaction on his Form 709 and reporting it as a non-gift transaction, in order to start the statute of limitations on the Service to assert that the sale constitutes a taxable gift.

c. Preferable to Have Third Party Trustee. If possible, the trust should designate someone other than Bob as the initial trustee for purposes of implementing the sale transaction. A third party trustee is not required for recognition of the transaction as a sale, but it does add a layer of objectivity to the transaction that may be beneficial if the transaction is audited.

d. Potential Issues With Transfers of Entity.

(i) Generally. As with the creation of any entity followed by a subsequent transfer of interests in the entity, there is some risk that the discounts claimed will be reduced or eliminated if challenged by the IRS.

(ii) Section 2703. In particular, practitioners should be mindful of the potential application of Code section 2703 to an LLC funded solely with a personal residence. For example, in *Fisher v. United States*, taxpayers made gifts of membership interests in an LLC, the primary asset of which was undeveloped real estate. The court held that the transfer restrictions in the LLC's operating agreement should be disregarded under Code section 2703, because the taxpayers failed to demonstrate that the LLC was a bona fide business arrangement. It reasoned that under the exception to Code section 2703, any restriction at issue must foster active involvement in the business. The Court concluded that the LLC was nothing more than an asset container and, therefore, not a bona fide business.

(iii) Indirect Gift. If client intends to contribute the residence to an LLC, client should wait a period of time before transferring LLC interests to the irrevocable grantor trust. In recent years, the Service has achieved some success in arguing that the funding of an entity promptly followed by gifts of interests in that entity should be recharacterized as indirect gifts of interests in the underlying property of the entity. Some cases have required only a short period of time between funding of the entity and transfer of entity interests. While no specific period of delay is definitely "safe," common sense dictates that the level of safety increases as the delay between funding and transfer of entity interests increases.

6. Estate Tax Issues.

a. Desired Result. The assets of the trust should be exempt from estate tax at Bob's death as long as Bob does not retain any power that would otherwise cause estate tax inclusion. If Bob dies before the note is fully paid, the note will be included in Bob's estate and subject to estate tax based on its fair market value, taking into consideration the remaining principal balance on the note as well as other factors (which value may be subject to discounts for transfer tax purposes).

b. 2036 Risk. Code section 2036(a)(1) states that the value of a decedent's gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), under which he has retained the possession or enjoyment of the property for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death.

(i) Express Agreement to Retain Rent-Free Use. Clearly, an express agreement that allows decedent to continue to use the property, rent-free, for as long as the decedent desires would cause estate tax inclusion. For example, in *Tehan v. Commissioner*, decedent made gifts of fractional interests in his residence to his children over a period of years, divesting himself completely of legal title to the property prior to his death. Prior to the initial transfer, the decedent and the children executed a written agreement that stated that decedent could occupy the residence, rent-free, for as long as his desired. Decedent was the sole occupant of the property until his death, and he paid all taxes and expenses for the property. Not surprisingly, the Tax Court held that Code section 2036 caused estate tax inclusion of the entire property, because of the express agreement that granted decedent the rent-free use of the property for a period that did not end until his death

(ii) Implied Agreement to Retain Rent-Free Use. Code section 2036 also applies if the decedent transfers legal title of the property to a third party but, pursuant to an implied agreement, retains the rent-free use of the property for a period that does not end prior to decedent's death.

i. Guynn v. United States. Decedent purchased a house in the town where decedent's daughter lived. The daughter selected the house but the decedent paid the purchase price. Decedent did not record the initial deed that named decedent as the owner of the property. Instead, a few months after the initial purchase, decedent, joined by the former owners, deeded the property to decedent's daughter. This second deed was recorded, and decedent reported the gift of the home to the daughter on her Form 709. The decedent was the only occupant of the property from the date of the initial purchase until her death. During this time, she paid all expenses for the property and did not pay any rent to her daughter. In reversing the district court, the Fourth Circuit Court of Appeals held that Code section 2036 caused the inclusion of the property in decedent's estate at death, because of an implied agreement between decedent and daughter that decedent would occupy the property, rent free, until the decedent's death. It reasoned that both decedent and her daughter expected decedent to live in the property indefinitely. The daughter even testified that the parties assumed that decedent would live in the property until her death.

ii. Estate of Van v. Commissioner. Decedent lived in a residence purchased by a man whom she was dating. Out of a

concern that decedent might raise a palimony claim, the owner of the residence obtained a release of any palimony claim by decedent. In exchange for the release, he sold decedent the residence for a cash down payment and a secured promissory note. Decedent's daughter and son-in-law provided decedent with the cash for the down payment and for the payments on the note. Soon after this purchase, the decedent conveyed title to the residence to herself and two grandchildren. Five years later, the grandchildren reconveyed their interests back to decedent. Three years later, decedent transferred title to her daughter and two grandchildren and died approximately one year after that final transfer. Decedent lived in the residence, rent free, from the initial purchase date to her date of death. The Tax Court held that even though decedent transferred title to the residence prior to her death, decedent retained possession or enjoyment under Code section 2036 because she lived in the property, rent-free, up until her death.

(iii) No Inclusion with Agreement to Pay Fair Market Value. Code section 2036(a) should not apply if a taxpayer transfers property and then leases the property back in a fair rental arrangement.

i. Estate of Barlow v. Commissioner. In *Barlow,* husband and wife transferred farm property, by gift, to their children and immediately leased the property back from the children for rent that was customarily paid by tenant farmers in the region. The lease continued until the parents were deceased and thereafter until all crops then in growing condition on the property had been harvested. The lease mandated that husband and wife pay the ad valorem and other taxes on the property, with those payments deducted from the next rental. The children could terminate the lease if rental was not paid within 30 days after it became due. During the first two years of the lease, husband and wife created trust accounts for each child (naming husband as trustee) and deposited funds into those individual trusts accounts for the rent due to such child. Husband and wife deducted the amounts of these payments as farm rental, and one or more of the children reported the funds deposited as taxable income. In year three, rental payments were withheld due to various family difficulties, with the understanding that the back rent would be repaid when circumstances improved. Four years elapsed without payment of additional rent, and husband died before any back rent was paid. Following husband's death, the children filed claims against his estate for back due rent. The Tax Court held that Code section 2036(a) did not cause inclusion of the property in husband's estate. It reasoned that while the unanticipated financial difficulties of the family prevented the terms of the lease from being followed to perfection, the intent of the transaction was not to grant husband a retained interest for less than full and adequate consideration.

ii. Estate of Riese v. Commissioner. In *Riese*, decedent contributed a residence to a three year QPRT. The trust agreement provided that at the end of the QPRT term, the property would be divided in equal shares among trusts for the taxpayer's children. During the planning process, decedent's counsel advised decedent that she would need to pay fair market rental upon termination of the QPRT if she wanted to continue living there. Shortly before termination of the QPRT, decedent's lawyer advised decedent's daughter that the rental amount could be determined and paid at the end of the calendar year in which the QPRT terminated. For six months after termination of the QPRT, decedent continued to live in the residence and paid all taxes, insurance, upkeep and maintenance on the property. However, she died before the first year's

rent was determined or a lease agreement executed. Following the decedent's death (six months after expiration of QPRT term), her executors determined the appropriate back-rent due and paid it to the trusts for the children. The Tax Court held that Code section 2036 did not cause estate tax inclusion, because the evidence showed that the parties (decedent and remainder beneficiaries) had always agreed that she would pay fair rental value to occupy the residence following termination of the QPRT term, and that unfortunate circumstances led to the failure to execute the necessary lease agreement and determine the appropriate rent before decedent's death. While practitioners should not rely on receiving the surprisingly favorable treatment received in *Riese*, they should take notice of the importance of demonstrating clear intent of a desire for a fair market rental arrangement.

iii. Determination of Fair Market Rental. Clients should consult with real estate brokers in the area in which the property is located in order to establish a fair market rental. This rental should be re-determined on a basis that is typical in similar arrangement on an arm's-length basis.

(iv) Step Transaction Doctrine.

i. In recent years, the Service has achieved some success in the courts by asserting the application of the step transaction doctrine in the transfer tax context. The step transaction doctrine treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result. If an interrelated series of steps is taken pursuant to a plan to achieve an intended result, the tax consequences will be determined considering all of the steps as an integrated whole.

ii. It is conceivable that with a sale of a residence followed by an immediate lease-back by the seller, the Service might argue that all of the steps should be collapsed into a single transfer of the residence with a retained interest by the transferor. On its face, the sale-leaseback transaction with a personal residence seems to have a circular flow of assets that might encourage the application of the step transaction doctrine: (1) property sold to the trust for a note, (2) seller leases the residence from the trust, (3) seller pays rent to the trust, and (4) the trust uses the rent to make note payments to seller. No income tax liability occurs from the rent payments or the note payments because the trust is a grantor trust as to the seller. The end result is that seller continues to occupy the residence, and cash simply moves back and forth to the seller without income tax consequences. The risk would seem to be further heighted, if the residence is contributed to a single member LLC and then membership interests in the LLC are sold to the trust. In short, while a properly structured sale-leaseback may potentially provide an effective wealth transfer strategy, practitioners should proceed with caution in light of the Service's focus on the step transaction doctrine.

(v) Section 2036; Impact of Consideration from Installment Sale.

i. Issue. What is included in client's gross estate if Code section 2036 applies to the transaction? Ideally, the consideration received from the purchase would significantly reduce the amount ultimately included under Code section 2036. However, as discussed below, this may not be the case.

ii. Subtraction Method. If a transfer to a trust implicated by Code section 2036 is made for consideration but is not a bona fide sale for an adequate and full consideration in money or money's worth, the value included in the transferor's gross estate equals the excess of the fair market value as of transferor's death of the property otherwise included under Code section 2036, minus the value of the consideration received by the decedent. The consideration is valued as of the date of the sale. As a result, if the residence has appreciated significantly from the date of sale to the decedent's date of death, all of that appreciation would be included under Code section 2036.

iii. Implicate Subtraction Method – Appraisal Wrong. If Code section 2036 applies, the subtraction method could be implicated in one of two ways. First, the Service could argue that the purchase price for the residence was less than fair market value at the time of the sale. Under the subtraction method, the amount by which the consideration is less than adequate and full consideration is immaterial – if it is less than full and adequate consideration at all, then it is a transfer for less than full and adequate consideration.

iv. Implicate Subtraction Method – Step Transaction. Second, even if the purchase price accurately reflects fair market value, the subtraction method could still be implicated if the initial gift to the trust and the sale transaction are collapsed into a single transaction (i.e., a transfer of property for less than full and adequate consideration). To avoid this particular risk, it is imperative to allow some time to elapse between the initial gift to the trust and the subsequent sale to the trust.

v. Implicate Subtraction Method – Note Undervalued. Third, even if the face amount of the note equals the fair market value of the residence, such note may not be valued, for gift tax purposes, as equal to the purchase price. This problem could occur if, for example, the note charged interest at less than the AFR.

7. GST Tax Issues.

a. Allocate GST Exemption to Gift. Bob will allocate GST exemption to the trust on a timely filed Form 709 in an amount equal to the initial gift to the trust. If Bob makes additional gifts to the trust, he would need to allocate GST exemption to those gifts as well. By allocating GST exemption to all of Bob's gifts to the trust, Bob can ensure that the trust has a zero inclusion ratio for GST tax purposes and, therefore, the trust assets can pass free of transfer tax for multiple generations.

b. Elect "GST Trust" Treatment. Bob should elect to treat the trust as a "GST Trust" for all purposes on his Form 709 reporting the initial $200,000 gift. Thus, if the Service recharacterized the sale as a partial gift to the trust, this GST election would cause a deemed allocation of GST exemption by the donor to the trust equal to the portion of the purchase price that is characterized as a gift. However, as discussed below, the allocation of GST exemption may be partially or completely ineffective if Code section 2036 applies to the transaction.

c. Problem if Code Section 2036 Applies. If an individual transfers property to a trust during his or her life and the value of such property would be includible in such person's gross estate if he or she died immediately after making the transfer, the allocation of GST exemption to such property cannot be made before the close of the ETIP. Upon the close of the ETIP, the taxpayer may allocate GST exemption to the property, but must do so based on the

property's value at the close of the ETIP. Thus, if Code section 2036 applies, the client has estate tax inclusion and does not have a completely GST exempt trust.

V. MARITAL PROPERTY ISSUES

A. Homestead Rights of Surviving Spouse.

1. Texas law provides that a surviving spouse may continue to occupy the marital homestead for his or her life. The survivor's right continues so long as the surviving spouse occupies the residence as his or her homestead or otherwise abandons the right. The surviving spouse's homestead applies regardless of whether the homestead was the deceased spouse's separate property or even if the decedent's will devises the property to someone other than the surviving spouse.

2. While the right attaches, the beneficial owner of the property may not sell or partition the property.

3. The surviving spouse's homestead right is in the nature of a life estate, subject to divestment if the surviving spouse abandons the property. As a result, the surviving spouse must pay for the expenses, care, repair and property taxes associated with the property. Generally, homeowner's insurance is the obligation of the remainder beneficiary.

4. Although a spouse may waive his or her homestead right, the intent to waive the right must be expressly made or inferred from intentional conduct that is inconsistent with an intent to claim the right. A waiver of the homestead right must be shown by proof of clear, unequivocal, and decisive acts showing an intent to waive the right.

B. Co-Ownership of Residence Between Separate and Community Estates

If the spouses' community estate and one spouse's separate estate each have an ownership in the residence, their respective ownership interests will be determined by the rule of inception of title.

C. Reimbursement Issues

1. When funds of one marital property character (separate or community) are used for the benefit a residence with a different marital property character, the contributing marital estate may have a claim for reimbursement against the other estate.

2. A reimbursement claim may include:

a. payment by one marital estate of the unsecured liabilities of another marital estate;

b. the reduction of the principal amount of a debt secured by a lien on the property owned before marriage, to the extent the debt existed at the time of marriage;

c. the reduction of the principal amount of a debt secured by a lien on property received by a spouse by gift, devise, or descent during a marriage, to the extent the debt existed at the time the property was received;

d. the reduction of the principal amount of that part of a debt, including a home equity loan:

(i) incurred during a marriage;

(ii) secured by a lien on property; and

(iii) incurred for the acquisition of, or for capital improvements to, property;

e. the reduction of the principal amount of that part of a debt:

(i) incurred during a marriage;

(ii) secured by a lien on property owned by a spouse;

(iii) for which the creditor agreed to look for repayment solely to the separate marital estate of the spouse on whose property the lien attached; and

(iv) incurred for the acquisition of, or for capital improvements to, property;

f. the refinancing of the principal amount of a loan described above, to the extent the refinancing reduces that principal amount in a manner described above;

g. capital improvements to property other than by incurring debt; and

h. the reduction by the community property estate of an unsecured debt incurred by the separate estate of one of the spouses.

3. When resolving a claim for reimbursement, the court shall use equitable principles, including the principle that claims for reimbursement may be offset against each other if the court determines it to be appropriate.

4. Benefits for the use and enjoyment of property may be offset against a claim for reimbursement for expenditures to benefit a marital estate, except that the separate estate of a spouse may not claim an offset for use and enjoyment of a primary or secondary residence owned wholly or partly by the separate estate against contributions made by the community estate to the separate estate. The party seeking an offset to a reimbursement claim bears the burden of proof as to that offset.

5. Reimbursement for funds expended by a marital estate for improvements to another marital estate shall be measured by the enhancement in value to the benefited marital estate.

D. Premarital Agreements

1. Generally. Spouses can address a number of issues associated with a residence by executing a premarital agreement. Under Texas law, a premarital agreement must be in writing and signed by both parties. The agreement is enforceable without consideration. A premarital agreement is not enforceable if the party against whom enforcement is requested proves that:

a. the party is not signing the agreement voluntary; or

b. the agreement was unconscionable when it was signed and, before signing the agreement, that party:

(i) was not provided with a fair and reasonable disclosure of the property or financial obligations of the other party;

(ii) did not voluntarily and expressly waive, in writing, any right to disclosure of the property or financial obligations of the other party beyond the disclosure provided; and

(iii) did not have, or reasonably could not have had, adequate knowledge of the property or financial obligations of the other party.

2. Common Residence Issues Covered in Premarital Agreement. A premarital agreement can address, among other items, certain issues associated with a residence:

a. If desired, the parties can waive a surviving spouse's homestead rights.

b. The agreement can address co-ownership of a residence and set forth procedures for when the statutory reimbursement scheme would apply to payments associated with the residence.

c. The agreement can provide who receives the residence upon the dissolution of the marriage by death or divorce.

d. If the parties intend to use one spouse's existing residence as their marital domicile, the agreement can provide that the parties will agree to convert such property to community property following the marriage. This can be a particularly effective incentive to convince a reluctant spouse-to-be to agree to execute a premarital agreement.

VI. BENEFITS OF TRUST OWNERSHIP

A. Revocable Trust Ownership to Avoid Probate

1. Texas. Texas allows the independent administration of probate estates. As a result, probate avoidance may not always be a significant incentive for clients to retitle a personal residence into his or her revocable trust.

2. Out of State Properties. The use of trust ownership to avoid probate can be useful for out-of-state vacation homes. Ancillary probate proceedings can often be burdensome and require the retention of probate counsel in multiple jurisdictions. These issues can be avoided by re-titling the vacation residence into the owner's revocable trust.

B. Creditor and Spousal Protection

1. Constitutional Homestead Protection

a. Generally. Texas law exempts a “homestead” from seizure for the claims of creditors except for encumbrances properly fixed on homestead property. This exemption also applies to the homestead claimant's proceeds of a sale of a homestead for six months after the date of sale.

b. Definition of Homestead. A homestead can be either “urban” or "rural." An urban homestead consists of not more than ten acres used as a home or as both a home and a business, and may be in one or more contiguous lots, together with any improvements on the lots. A rural homestead is property, including improvements, used as a home that consists of not more than 200 acres, in the case of a family, or 100 acres, in the case of an individual not otherwise entitled to a homestead exemption.

c. Homestead in Qualifying Trust. Property owned through a “qualifying trust” will qualify as a homestead of the settlor or beneficiary if the property would otherwise qualify as a homestead for such settlor or beneficiary if he or she owned the property outright. A "qualifying trust" means an express trust in which the instrument or court order creating the trust grants the settlor or beneficiary the right to:

i. revoke the trust without the consent of another person;

ii. exercise an inter vivos general power of appointment over the property that qualifies for the homestead exemption; or

iii. use and occupy the residential property as his or her principal residence at no cost to such person, other than payment of taxes and other costs and expenses specified in the trust instrument (i) for the life of the settlor or beneficiary; (ii) for the shorter of the life of the settlor or beneficiary or a term of years specified in the instrument or court order; or (iii) until

the date the trust is revoked or terminated by an instrument or court order recorded in the real property records of the county in which the property is located and that describes the property with sufficient certainty to identify the property.

d. Revocable Trust While Settlor Living. Some clients may elect to transfer title to their principal residence to a revocable trust during life in order to avoid probate. Because the settlor would typically retain the right to revoke the trust during lifetime without consent of any other party, a revocable trust should be a "qualifying trust" without any additional language.

e. Irrevocable Trust.

i. Constitutional Protection. For a residence owned by an irrevocable trust to qualify for the state constitutional homestead exemption, the trust instrument must authorize the beneficiary to use and occupy the property as his or her principal residence, rent-free.

ii. Spendthrift Trust. Even if the trust fails to qualify for constitutional homestead protection, the trust can be structured to protect the trust assets (including the residence) from the creditors of a beneficiary. This can be achieved by including a spendthrift clause and limiting the ability of the beneficiary, while serving as trustee, from making distributions to himself (other than for his health, education, maintenance and support) or in discharge of his legal obligations.

C. Preserve Legacy Property for Multiple Generations

1. GST Exempt Trust. Property owned by a properly structured irrevocable trust can be preserved for use by multiple generations without reduction for transfer tax, if the trust has a zero inclusion ratio for GST purposes.

2. Distribution Proceeds. Care should be taken to ensure that the trust beneficiaries may use the residence, rent-free, pursuant to the trust agreement.

3. Fund for Expenses. It is important for a trust that owns a residence to have sufficient liquid funds with which to pay taxes, insurance, expenses and repairs. For example, an individual who intends to leave the residence at his death to a GST exempt trust should also include a bequest of cash or marketable securities to that trust sufficient to pay taxes and expenses over time.

D. Trust Owned Property and Ad Valorem Exemption

1. Generally. Individuals may own all or a portion of their residence in a trust. For example, an individual may transfer her residence to a revocable trust during her lifetime for probate avoidance and privacy purposes. Additionally, a deceased spouse may leave her share of the couple's principal residence to a bypass trust, in order to take advantage of the deceased spouse's applicable exclusion amount from federal estate taxes. While trust ownership can offer a number of benefits, care should be taken in drafting the trust instrument to ensure qualification for the residence homestead exemption from ad valorem tax, particularly for taxpayers over age 65.

2. Definition of Residence Homestead. A residence homestead means a structure or a separately secured and occupied portion of a structure (together with the land, not to exceed 20 acres, and improvements used in the residential occupancy of the structure, if the structure and the land and improvements have identical ownership). The residence can be owned directly by one or more

individuals or through a beneficial interest in a qualifying trust. It must be designed or adapted for human residence and actually occupied as the principal residence of an owner or, for property owned through a beneficial interest in a qualifying trust, by a settlor of the trust who qualifies for the exemption.

3. Importance for Age 65 and Older. The residence homestead exemption from ad valorem tax is particularly important for individuals who are age 65 or older. For such individuals, the school taxes for his or her residence will not increase above the amount assessed at the time he or she attains the age 65 exemption for the property, so long as the individual continues to occupy the property as his or her principal residence.

4. Available for Surviving Spouse. The surviving spouse of an individual who qualifies for the 65 and older exemption from ad valorem tax is entitled to an exemption for the same property from the same taxing unit in an amount equal to that for which the deceased spouse qualified if: (1) the deceased spouse died in a year in which the deceased spouse qualified for the exemption; (2) the surviving spouse was 55 or older when the deceased spouse died; and (3) the property was the residence homestead of the surviving spouse when the deceased spouse died and remains the residence homestead of the surviving spouse.

5. Residence Homestead in Qualifying Trust. Certain individuals may take advantage of the residence homestead exemption from ad valorem tax for a residence owned in a "qualifying trust". To meet the definition of qualifying trust, the trust instrument or court order creating the trust must grant the settlor of the trust (or the beneficiary if the trust is created by court order) the right to use and occupy the property as his or her principal residence rent free and without charge except for taxes and other costs and expenses specified in the instrument or court order. This right must last (i) for the shorter of the life of the individual or a term of years specified in the instrument or court order; or (iii) until the trust is revoked or terminated by an instrument or court order recorded in the real property records of the county in which the property is located and that describes the property with sufficient certainty to identify the property.

6. Generally, the exemption is not available to a beneficiary of a trust, unless (1) the trust was created by a court for the benefit of that beneficiary or (2) in the case of the 65 and older exemption, the beneficiary is a surviving spouse of the settlor and would otherwise qualify for the exemption if he or she received the property outright from his or her deceased spouse.

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