INCOME TAX IMPLICATIONS OF PUTTING TITLE TO A PERSONAL RESIDENCE INTO A TRUST

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Practitioners are generally aware of the administration issues that may arise in connection with a trust and find them an acceptable tradeoff for the estate planning benefits of the trust vehicle. The phenomenal increase in home values, however, has led to more and more estate plans that have the family residence put in trust. The unique nature of the asset may lead to unique problems, such as whether the trustee or the beneficiary pays for the plumber.

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Over the past quarter-century, home prices in the U.S. generally have soared.[1] And although home prices in some areas of the U.S. have dipped during the past year,[2] many economists believe that home prices in the U.S. will rebound and continue to grow in the years to come. A home has thus become and will likely remain one of the most valuable assets in a taxpayer's financial portfolio. Because of a home's financial stature, taxpayers are being ever more circumspect about how they handle this prized asset for estate planning purposes.

A growing and widespread trend is that taxpayers are placing title to their homes into trusts. There are several reasons for this phenomenon. First, the applicable exclusion amount for federal estate tax purposes has risen to $2 million.[3] Thus, to fully use this exclusion, many taxpayers have had to stretch to find assets that can be used to fund their "bypass trusts" (i.e., those trusts that absorb the unused applicable exclusion amount). Second, taxpayers are using trusts to safeguard against forced home sales if the need for Medicaid-provided nursing home care for their loved ones arises. Third, in situations such as multiple successive marriages and civil unions between nontraditional couples, a trust can provide a living arrangement for a loved one during his or her life but then, in accordance with its terms, pass title to the family (often, children from a prior marriage or other chosen beneficiaries) of one of the parties.

The easy part of this arrangement is placing title to a home into a trust. More difficult and challenging, however, are the diverse income tax implications concomitant with title ownership held by a trust.[4]

TYPES OF TRUSTS

Before delving into the income tax implications associated with trust ownership of homes, we explore the various forms of trusts that are suitable for this arrangement. Essentially, three kinds of trusts are appropriate receptacles to hold title to a taxpayer's home:

1. Qualified terminable interest property (QTIP) trusts.
2. Bypass trusts.
3. Life estate trusts.

QTIP trusts are those trusts that qualify for the unlimited marital estate tax deduction.[5] For an estate executor to elect QTIP status for a trust, the trust must contain special features, such as requiring that the surviving spouse receive a lifetime income interest, granting the surviving spouse the right to make nonproductive property productive, and limiting the power of the trustee so that distributions may be made only to the surviving spouse during the surviving spouse's lifetime. On the death of the surviving spouse, the aggregate value of any assets held in a QTIP trust is included in the surviving spouse's gross estate for federal estate tax purposes.[6]

Bypass trusts serve an entirely different tax purpose from QTIP trusts. Taxpayers use these trusts to capitalize on their unused applicable exclusion amounts. Unlike a QTIP trust, the terms of these trusts have virtually no restrictions other than prohibiting the surviving spouse from having unfettered control or rights to the assets of such a trust.[7] The testator may mandate income distributions or permit income to be accumulated; discretionary principal distributions can be made to a surviving spouse or anyone else; and trust beneficiaries can have lifetime and testamentary special powers of appointment over the trust's assets. The terms of such trusts are specifically designed to avoid causing inclusion of the trust assets for federal estate tax purposes in the estate of the surviving spouse, who is usually the primary beneficiary of such a trust.

Aside from the salient fact that title to the real property is held by a trustee (rather than a different kind of arrangement whereby a settlor drafts a real estate deed the terms of which provide a beneficiary with a life estate), a *life estate trust* is a unique trust arrangement.[8] It can have features that would qualify it for the unlimited marital deduction; alternatively, it can have features that would enable it to serve as a bypass trust.

Such trusts provide lifetime benefits for a named beneficiary, often the decedent's surviving spouse. The terms of these trusts often grant useful choices to the designated beneficiary. For example, beneficiaries of life estate trusts are often given the right to instruct the trustee to sell the home owned by the trust and reinvest the proceeds in a new home or in income-producing property, the resulting income flow from which would be payable to the designated beneficiary.

There are distinctions between the types of trusts just mentioned and a qualified personal residence trust (QPRT).[9] A QPRT is established during a settlor's lifetime, generally for a term of years, and is specifically designed to save the settlor transfer taxes (i.e., only the actuarial value of the remainder interest is subject to gift tax). If the settlor survives the trust's term, the value of the home is removed from the settlor's taxable estate. Aside from the estate tax savings motive associated with a QPRT and its inter vivos nature, what truly distinguishes QPRTs from the trusts described in this analysis is the fact that QPRTs are classified for income tax purposes as grantor trusts.[10] This means that their existence is generally ignored for income tax purposes, thereby mooting virtually all of the income tax issues discussed herein, which pertain to nongrantor trusts.[11]

Putting a home in trust can solve estate planning issues where there are multiple successive marriages or nontraditional couples.

The particular form of trust that taxpayers choose for holding title to their homes depends on their tax and nontax objectives. Where taxpayers have fully used their applicable exclusion amounts or have other assets that they believe will appreciate more rapidly in value than their homes (making such other highly appreciating assets more attractive candidates to fund the bypass trust), a taxpayer's executor may elect to have title to the decedent's home pass to a QTIP trust. Where taxpayers have not fully used their applicable exclusion amounts, placing title to a home in a bypass trust is an obvious choice. Finally, some taxpayers choose to put title to their homes into a life estate trust because it offers them psychological comfort that they have provided flexibility and a lifestyle arrangement for the balance of the trust beneficiary's life span.

To meet any of the foregoing estate planning objectives, it is essential that title to the home be handled correctly during the initial estate planning stage. This means that if title is currently held jointly by a taxpayer and the spouse (or another person) with the right of survivorship, the taxpayer's testamentary planning through the will may prove ineffectual because title will automatically pass to the taxpayer's joint tenant if the taxpayer is survived by such person. Therefore, if the taxpayer's intent is to fund a QTIP, bypass, or life estate trust with the home, it is imperative that the title to the home be held in the taxpayer's name or, depending on other factors (e.g., the value of the other assets owned by taxpayer), as a tenant-in-common with another person so that at least a portion of the property

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1 See News Release, Office of Federal Housing Enterprise Oversight, "OFHEO House Price Index Shows Deceleration in Fourth Quarter; U.S. House Prices Show Annual Rise of 11 Percent" (3/1/05), available at www.ofheo.gov/media/pdf/4q04hpi.pdf (showing home price percentage changes since 1980).

2 Leonhardt and Bajaj, "Drop Foreseen in Median Price of Homes in U.S.," New York Times, 8/26/07, page A1; Hagerty, Karp, and Whitehouse, "Economists See Housing Slump Enduring Longer," Wall St. J., 6/9/07, page A1.

3 Section 2010.

4 Other issues, such as title insurance, property taxes (e.g., loss of abatements available to the elderly when a trust owns the property), liability and casualty insurance, also can be complicated by trust ownership but are beyond the scope of this article.

5 Section 2056(b)(7). If the surviving spouse is a noncitizen, a special variant of a QTIP trust, known as a qualified domestic trust (QDOT), must be used. See Section 2056(d)(2)(A).

6 Section 2044.

7 Manning, Rosenbloom, and Slotkin, *Manning on Estate Planning* (Practising Law Institute, 6th ed., 2006), ch. 3.

8 Casner and Pennell, 4 *Estate Planning* (Aspen, 5th ed., 1988), § 13.13.12 through .14.

9 See generally Section 2702(a)(3)(A)(ii).

10 Section 671 *et seq.*

11 Inter vivos QTIP trusts also are classified as grantor trusts and, therefore, are not dealt with in this article.

passes pursuant to the testamentary documents.[12]

Another consideration is that the different types of trusts that may be used to hold title to a home ordinarily can be established during life or on a settlor's death. For tax purposes, the main difference between the two kinds of transfers (i.e., inter vivos and testamentary) is that a lifetime transfer generates a potential gift tax if its value exceeds the unused portion of the settlor's lifetime gift exemption,[13] while a testamentary transfer generates a potential estate tax if its value exceeds the applicable exclusion amount.[14] (Other differences between inter vivos and testamentary transfers will be highlighted below.)

INCOME TAX IMPLICATIONS OF TRUST OWNERSHIP

While the form of trust chosen and the timing of its establishment are often important issues for estate planning purposes, the income tax implications associated with lifetime and testamentary forms of trust are often quite similar.

Home ownership by an individual taxpayer gives rise to several important tax consequences. Having a trust own title to a home on behalf of a beneficiary engenders an additional dimension of complexity with respect to such consequences. These consequences will vary over a trust's life cycle—inception, administration during the trust term, and termination.

To meet the taxpayer's estate planning objectives, it is essential that title to the home be handled correctly during the initial planning stage.

Trust Inception

At death, a taxpayer can fund a testamentary trust with title to the taxpayer's home.[15] If this is the strategy chosen, the decedent's estate will have a tax basis in the home equal to FMV as of the date of death.[16] During the estate administration process, an estate's executor may not deduct as administration expenses for income tax purposes amounts expended in maintaining a personal residence; courts have ruled that such expenses are nondeductible personal living expenses.[17]

At the time the estate funds the trust, special rules under Subpart J come into play. If the terms of the testamentary instrument direct that title to a particular house pass into trust, no distributable net income (DNI) will flow to the receiving trust.[18] If, however, the terms of the testamentary instrument are silent and title to the decedent's home passes into trust, the estate will be deemed to be making a distribution equal to the lesser of (1) the tax basis of the home or (2) the FMV of the property.[19] This dollar figure must be taken into account for trust deduction and beneficiary inclusion purposes (capped by the estate's DNI allocable to such distribution).[20] In the absence of a special income recognition election,[21] the receiving trust takes a carryover tax basis in the transferred property.[22]

Administration During the Trust Term

Once a trust owns title to the home, the trustee or the trust beneficiary will have certain duties and responsibilities depending on the terms of the trust. In particular, a trust's terms should spell out who is responsible for the payment of real estate taxes, mortgage payments (including payments of interest and principal), and maintenance expenses.

Consider the implications if the terms of a particular trust declare that the trust's beneficiary is responsible for real estate taxes, mortgage interest indebtedness, and maintenance expenses. Although the taxpayer-beneficiary is not the direct title owner, courts have held that a beneficiary can deduct any real estate taxes paid even if the taxpayer is not the owner of the property.[23] Consistent with this approach, Reg. 1.163-1(b) provides similar treatment for mortgage interest payments, namely, such payments are deductible if paid by the taxpayer and if the taxpayer "is the legal or equitable owner, even though the taxpayer is not directly liable upon

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12 Taxpayers must weigh the potential benefits of funding the optimal trust for estate planning purposes with the possible loss of a measure of asset protection. This may occur, for example, if the title to the house is transferred to a spouse with greater creditor risk, or the protection of a tenancy by the entireties (the value of which varies depending on state law) is changed for another form of title in order to facilitate funding a bypass trust.

13 Currently, $1 million; see Section 2505(a)(1).

14 As noted in the text, currently $2 million (less amounts used during life); see note 3, *supra*.

15 Alternatively, during a taxpayer's lifetime, an irrevocable trust can be funded with title to that person's home. If this is done, the taxpayer will have made a taxable gift equal to the home's FMV; see Section 2512. The gift will qualify for the gift tax marital deduction only if the trust's terms meet the criteria of a marital trust and the donor makes a qualifying QTIP election (Section 2523(f)). If a QTIP election is not made, the taxpayer will either owe gift tax or will use a portion or all of the taxpayer's applicable exclusion amount; see Section 2505(a).

16 Under Section 2032, of course, the decedent's executor may be able to use the estate tax alternate valuation date. If the lifetime gift approach is employed, the trust would have a carryover basis. See Section 1015.

17 See, e.g., Estate of Fuller, 9 TC 1069 (1947), *aff'd per cur.* 171 F.2d 704, 37 AFTR 685 (CA-3, 1948), *cert. den.* But see Horrmann, 17 TC 903 (1951) (if no beneficiary resides at the home, the estate would be entitled to deduct general maintenance expenses under Section 212(2)).

18 Section 663.

19 Section 643(e)(2).

20 Sections 651, 652, 661, and 662.

21 See Section 643(e)(3) (permitting the distributing entity to elect to recognize gain). Barring extenuating circumstances, most practitioners choose not to accelerate taxable gains.

22 Section 643(e)(1) (although the estate would receive a new tax basis equal to FMV under Section 1014).

23 See, e.g., Movius, 22 TC 391 (1954) (estate beneficiaries allowed to deduct real estate taxes they paid notwithstanding the fact that legal title to such property was held in the name of decedent's estate).

24 See, e.g., Trans, TCM 1999-233 (taxpayers who resided in the residence and made mortgage payments were allowed to deduct interest payments even though title to the property was held by a relative); Uslu, TCM 1997-551 (same).

the bond or note secured by such mortgage."[24]

To date, no court has ruled directly on the issue of whether a trust beneficiary is an "equitable owner" of mortgaged property, but analogous case law appears promising.[25] Any expenses the taxpayer beneficiary incurs in maintaining the residence, however, would probably constitute nondeductible personal expenses under Section 262.

Suppose that the terms of the trust reflect that the trustee rather than the trust beneficiary will be the responsible party for real estate taxes, interest indebtedness, and maintenance expenses. Here, the Code, the courts, and the IRS seem to provide that the trust may deduct the real estate taxes, interest expenses, and maintenance payments it incurs in preserving the home in question, and that these payments do not constitute income to the trust beneficiary.[26] Nevertheless, where the maintenance and/or utility expenses directly benefit one or more trust beneficiaries (e.g., lawn service fees and plumbing bills), such expenditures are likely to be held to be tantamount to nondeductible personal expenses.[27] Consistent therewith, at least one court has questioned the wisdom of allowing such deductions without requiring the trust beneficiaries to include an amount equivalent to such deductions in income.[28]

During the term of a trust, a final issue that may arise is the tax consequence associated with making an improvement, say, purchasing a new roof for a home the title to which is held by a trust. If the trustee funds the improvement with assets from the trust, the event should largely be inconsequential; the improvement

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[25] See, e.g., Belden, TCM 1995-360 (taxpayer who had an occupancy agreement and was responsible for all the expenses associated with the upkeep of a residence had shifted sufficient burdens and benefits of ownership to enable him to have equitable title to the property).

[26] See, e.g., Plant, 30 BTA 133 (1934), *acq., aff'd* 76 F.2d 8, 15 AFTR 376 (CA-2, 1935); Ltr. Rul. 8341005. See also Carson, 317 F.2d 370, 11 AFTR2d 1471 (Ct. Cl., 1963) (holding that there was a lack of evidence to establish that a portion of the estate's income was distributed to the taxpayer in connection with the trust's incurring home maintenance expenses). As to the interest deduction, see Section 163(h)(4)(D) (providing that interest paid or accrued by a trust or estate on a residence held by either is qualified residence interest if the residence is the principal or secondary residence of a beneficiary who has a present or residuary interest in the trust or estate).

[27] See, e.g., Alfred I. DuPont Testamentary Trust, 514 F.2d 917, 36 AFTR2d 75-5130 (CA-5, 1975) (disallowing maintenance expenses incurred in connection with the upkeep of trust beneficiary's home).

[28] See Moreell, 221 F. Supp. 864, 12 AFTR2d 5777 (DC Pa., 1963) (holding that the trust should deduct as trust distributions the greater of (1) the imputed fair market rental value of such property or (2) the aggregate amount of annual real estate taxes, mortgage interest indebtedness payments, and maintenance payments, limited to the trust's DNI; correspondingly, the greater of these deemed "distributions" would be taxable to the trust's beneficiary to the extent of the trust's DNI).

will simply constitute part of the trust's corpus. In contrast, if the trust beneficiary funds the improvement, the consequences will vary based on what kind of trust is in place. For a QTIP or life estate trust, because the trust beneficiary has retained what amounts to a life estate in the improvement, the FMV of such improvement (or a proportionate share of the value of the home) should be included in the trust beneficiary's gross estate.[29] For a bypass trust, depending on its terms (e.g., right to trust income),[30] the trust beneficiary has likely made a taxable gift equal to the FMV of the improvement.[31] These inclusion results might be avoided by having the trust beneficiary lend money to the trust so that the trust can make the improvements.

Trust Termination

Trusts that hold title to a home usually undergo a fundamental change if the trustee sells the home that funds the trust or when the trust beneficiary dies.

Where the trustee sells the home, several tax consequences emerge. First, the limited exclusion from income for home sales under Section 121 does not apply (unless the trust is treated as a grantor trust).[32] This means that the trust may experience a significant capital gain, none of which can be excluded from gross income, as may be the case if the home is owned by an individual.[33]

Second, where a trust beneficiary desires to own title to the home directly and therefore buys title to the home at FMV from the trust, any loss the trust may experience is disallowed.[34] Finally, in many locations a house sale might entail the imposition of a local realty transfer tax.

When the beneficiary dies, the trust—whether a QTIP, bypass, or life estate trust—usually terminates. The distribution from the trust containing title to the home is not ordinarily in and of itself a taxable event (except perhaps for certain local transfer taxes or property tax reappraisal purposes). The trust remainder beneficiaries, however, may recognize taxable income equal to the tax basis the trustee has in the home,[35] but such amount is ordinarily limited to the trust beneficiary's pro rata share of the trust's DNI.[36] Furthermore, the remainder beneficiaries will normally have a carryover tax basis in the home.[37]

PLANNING

Due to the complexities associated with a trust's holding title to a personal residence, some practitioners resolutely look to use other assets for trust funding purposes. As part of their strategic plan, they therefore instruct a decedent's executor to sell, and the trust's putative life beneficiary to purchase, title to the home from the decedent's estate (assuming the terms of the estate/trust permit such a transaction), thereby mooting all the issues raised in this analysis.

Nevertheless, other practitioners recognize that there are sometimes no viable alternatives to having a trust hold title to a home or that the situation, if properly handled, can prove manageable. In the latter instance, in drafting trust terms associated with trust ownership of title to a home, practitioners should be mindful of the income tax consequences enumerated herein, proceed with caution, and offer clarity wherever possible.

One item of critical concern is whether the trustee or the trust beneficiary will be responsible for the payment of real estate taxes, mortgage interest indebtedness, and maintenance expenses. In light of the importance of this question, nothing should be left open to doubt—the document's drafter should specify the duties and responsibilities of each party.

Another item that the drafter should detail is the role, if any, the trust beneficiary will have during the administration of the trust. Often, a settlor who establishes a trust grants the trust beneficiary little voice in managing the affairs of the trust. Where the settlor of the trust wants the trust to hold title to a home, however, the settlor may consider according the trust beneficiary a different role.

A trust's terms should spell out who is responsible for the payment of real estate taxes, mortgage interest and principal, and maintenance expenses.

In particular, the trust settlor may want to grant the beneficiary a meaningful voice in the affairs of the trust so the trust beneficiary does not feel imprisoned in a particular home. For example, the trust settlor may provide the trust beneficiary with rights to instruct the trustee to sell one home and purchase title to a new residence or, alternatively, to use the sale proceeds to make another investment.

The vesting of this right in the trust beneficiary should not cause concern about the trust's value being included in the estate of the beneficiary. Indeed, the trust beneficiary could also be a co-trustee of the

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29 Section 2036(a).

30 For example, if the trust beneficiary holds a special power of appointment, the gift will be deemed incomplete. See generally Reg. 25.2511-2(b) (if the transferor of property reserves any power over the disposition of the property, the gift may be wholly incomplete).

31 See Section 2702(a)(2) (if, for the benefit of a family member, a taxpayer transfers an interest into trust that is not qualified, the value of the taxpayer's retained interest in such trust is deemed to be zero for gift tax valuation purposes).

32 Reg. 1.121-1(c)(3). Two authors, however, have suggested transforming irrevocable trusts into grantor trusts; were this strategy followed, it possibly would permit the use of the Section 121 exclusion. See Gans and Blattmachr, "Supercharged Credit Shelter Trust," 21 Probate & Property 52 (July/August 2007).

33 See, e.g., Ltr. Rul. 200104005 (a home owned by an irrevocable trust did not qualify for the Section 121 exclusion even though the surviving spouse had resided in the home for 30 years and had a right to direct its sale).

34 Sections 267(b)(6) and (b)(13).

35 Section 643(e)(2).

36 Section 662(a).

37 Section 643(e)(1).

Practice Notes

One item of critical concern is whether the trustee or the trust beneficiary will be responsible for the payment of real estate taxes, mortgage interest indebtedness, and maintenance expenses. In light of the importance of this question, nothing should be left open to doubt—the document's drafter should specify the duties and responsibilities of each party.

trust as long as the beneficiary is prohibited from making discretionary distributions (other than pursuant to an ascertainable standard) in his or her own favor[38] or from having the power to remove and replace the trustee with a new trustee who is not a related or subordinate party under Section 672(c).[39]

A problem that may arise during the administration of a trust holding title to a home may be one of liquidity. Consider the practical reality if the trust's only asset is a home and consider further the consequences if expenses arise (e.g., the roof of the home needs to be replaced) that are not the responsibility of the trust beneficiary. In such a situation, the only recourse for the trustee would be to borrow against the equity of the home a sum sufficient to cover the repair costs plus an additional amount to cover the interest charges on the loan until the trust term ends and the residence is sold.

Where the trust is expected to be in existence for a long period because of the relative youth of the life beneficiary, the trustee may be put into a precarious financial position. One way to avoid this result is to place title to the home into a larger QTIP or bypass trust. The trustee then would have access to other trust assets, which might enable the trustee to pay expenses related to holding title to the house.

Consider, too, the complex issues that may arise if a trust has multiple beneficiaries and the trustee's retaining title to a home might appear inappropriate as time passes. For example, suppose a trust settlor designates his spouse and children as equal trust beneficiaries of, say, the bypass trust. While the settlor's children are minors and continue to reside in the house, the trustee can retain home ownership without violating his duty of impartiality to the trust beneficiaries. Consider what happens when the settlor's children attain majority age and move to new abodes while the spouse continues in residence. In this situation (i.e., where a trust has multiple beneficiaries and only one asset that inures solely to the benefit of one of them), it seems apparent that the trustee should consider selling the residence (perhaps to the surviving spouse) and investing the proceeds in a fashion that permits the trustee to treat all trust beneficiaries equally.

A final issue to consider is that the requirements of the Prudent Investor Act, as enacted in many states, may make it inappropriate for the fiduciary to hold a house unless the governing trust terms permit the house to be so held.

CONCLUSION

Many practitioners know that trust ownership of decedents' homes has become an increasingly common feature of estate planning and the estate administration process. Many fewer practitioners, however, are familiar with the income tax consequences associated with these arrangements. Although some aspects of this area of the law are fairly straightforward and readily distillable, other aspects are more complex and contain challenging issues. By taking the time to plan and prepare a trust that meets the needs and wishes of a client, practitioners can empower their clients with the ability to provide trust beneficiaries with a "Home Sweet Home."

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38 Section 2041(a)(2).

39 Rev. Rul. 95-58, 1995-2 CB 191.