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HOLDING PERSONAL RESIDENCES IN TRUSTS

By Julius H. Giarmarco, J.D., LL.M.

There are a number of reasons to title a personal residence in a revocable living trust. First, because of the higher estate tax exemption ($2,000,000 in 2008 and $3,500,000 in 2009), a married couple's residence may be needed to fund a credit shelter trust (in order not to "waste" either spouse's exemption). Second, in a second marriage, placing a personal residence in a QTIP trust allows the surviving spouse to live in the residence for life, while assuring the deceased spouse that the residence will pass (at the surviving spouse's death) to the deceased's children from a prior marriage (or other desired heirs). Third, Michigan's new estate recovery law for Medicaid-provided nursing home care applies only to probate assets. Assets held in trust are expressly not reachable. Fourth, for unmarried and same-sex couples, placing a residence in trust (for the life of the surviving partner) may be desirable so that the deceased partner can determine where the residence will pass at the surviving partner's death.

While it is relatively easy to transfer a residence to a living trust, the income tax consequences to the beneficiaries (when the grantor dies and the trust becomes irrevocable) can be complicated. Following are some of the income tax issues:

1. The trust will have a tax basis in the residence equal to its FMV on the date of the grantor's death (or the alternate valuation date). IRC Sections 1014 and 2032.

2. If the trust agreement provides that the beneficiary is responsible for mortgage interest, then the beneficiary should be able to deduct the interest payments. See Treas. Reg. 1.163-1(b).

3. If the trust agreement provides that the beneficiary is responsible for real estate taxes, the Tax Court has held that the beneficiary can deduct those taxes. See *Mouius*, 22 TC 391 (1954).

4. If the trust agreement requires that the trustee (rather than the trust beneficiary) pay mortgage interest and real estate taxes, then the trust can deduct such expenses.

5. What about the maintenance expenses? If the trust is responsible for maintenance, there is authority for allowing the trust to deduct expenses it incurs in preserving the residence (see *Plant*, 76 F2d 8 (CA2, 1935), but at least one court has ruled that such expenditures were nondeductible personal expenses. See *Alfred I. DuPont Testamentary Trust*, 514 F2d 917 (CA-5, 1975). If the beneficiary is responsible for maintenance, such expenditures would probably constitute nondeductible personal expenses under IRC Section 262.

6. If the trustee sells the residence, the limited exclusion from capital gain under IRC Section 121 will not apply (unless the trust is a grantor trust).

7. If the beneficiary purchases the residence from the trust at FMV, any loss the trust may incur will not be deductible. IRC Sections 267(b)(6) and (b)(13).

8. Upon the life beneficiary's death, the remainder beneficiaries may have to recognize taxable income equal to the trust's tax basis in the residence, but only up to their pro rata share of the trust's distributable net income (DNI). IRC Sections 643(e)(2) and 662(a).

9. The remainder beneficiaries' basis in the residence will be the trust's basis (i.e., carryover basis). IRC Section 643(e)(1).

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Apart from the income tax consequences, placing a residence in trust may also, upon the grantor's death, "uncap" the property for Michigan real estate tax purposes. Unless the trust beneficiary will be the grantor's spouse alone, uncapping will occur upon the grantor's death. Thus, if, upon the grantor's death, the residence is transferred to the typical credit shelter trust that has multiple beneficiaries, an uncapping will occur. However, if the residence is further allocated to a sub-trust of that same credit shelter trust, and the sole beneficiary of the sub-trust is the grantor's spouse, an uncapping will be deferred until the spouse's death.

Assuming the residence will be placed in trust, the trust drafter should expressly state in the trust agreement whether the beneficiary or the trustee will be responsible for interest, taxes and maintenance. If the trustee will be responsible for such expenses, then additional assets should be available in trust to pay such expenses. Another drafting issue is whether the beneficiary should have the power to direct the trustee to sell the residence and to use the sale proceeds to purchase a replacement residence. A third issue is whether the beneficiary should also be named as a co-trustee or have the right to remove and replace trustees. Finally, if the residence could pass to a credit shelter trust, the sub-trust provision mentioned above should be included in the trust agreement. In closing, with careful planning, the tax and non-tax objectives of both the grantor and the beneficiary can be satisfied when a personal residence is placed in trust.

TRANSFERRING CUSTODIAL ACCOUNTS TO A SECTION 529 PLAN

By Julius H. Giarmarco, J.D., LL.M.

Section 529 Savings Accounts ("529 Plans") have become the vehicle of choice to set aside funds for a child's or grandchild's college education. Among the advantages of 529 Plans are: (1) front-loading of contributions (the tax law treats a lump sum contribution as an annual $12,000 [or $24,000 for spouses] gift over five years); (2) tax deferred growth; (3) tax-free (federal) withdrawals if used to pay qualified education expenses (tuition, books, supplies, room and board, computer equipment and internet service at virtually any accredited college or university); and (4) a possible state income tax deduction for contributions.

Prior to 529 Plans, many parents and grandparents used Uniform Gift to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA) accounts to save for college expenses. Now that these have been eclipsed by the federal tax-free benefits of 529 Plans, should the custodian of an UGMA or an UTMA account transfer the account to a 529 Plan?

The short answer is "yes". Most (but not all) 529 Plans accept funds from existing UGMA or UTMA accounts. Transferring funds from an UGMA or an UTMA account will provide tax-deferred potential growth and federal tax-free withdrawals for qualified education expenses. Moreover, tax-deferred accounts benefit even more from the power of compounding, which means the funds in a 529 Plan will grow faster than funds in an UGMA or an UTMA account, since both of them are taxable.

There are several factors to consider transferring an UGMA or an UTMA account to a 529 Plan:

- **529 Plans only accept cash.**

  Therefore, the investments in the UGMA or UTMA account must be sold and taxes paid on any gains. On the other hand, if there is little or no gain (or if there are losses) then income taxes should not be a barrier. But if there is only a year or two before college, there may not be enough time for the advantages to make an impact.

- **The custodian does not gain control over the account.**

  The funds are still considered an irrevocable gift to the minor, and he/she will have full access to the funds in the 529 Plan upon attaining the age of majority (generally 18 or 21, depending on state law). As such, the custodian cannot change the beneficiary of the 529 Plan.

- **529 Plan assets may only be withdrawn federally tax-free if used for qualified education expenses.**

  Funds withdrawn from a 529 Plan that are not used for qualified education expenses are potentially subject to income taxes and an additional 10% tax penalty. Therefore, the custodian should be confident that the minor plans to attend college.

Finally, the custodian should consider setting up a new 529 Plan instead of adding to an existing 529 Plan. The reason is that some states will subject 529 Plans to the rules of the originating UGMA or UTMA account. Thus, the ability to change the beneficiaries of an existing 529 Plan that receives UGMA or UTMA funds may be lost. Using a new 529 Plan to receive UGMA or UTMA funds will preserve the ability to change beneficiaries of the existing 529 Plan. In summary, depending on the facts and circumstances, transferring an UGMA or an UTMA account to a 529 Plan can be a smart financial move.

GIFT-SPLITTING TO ILIT WHERE THE GRANTOR'S SPOUSE IS A BENEFICIARY

By Julius H. Giarmarco, J.D., LL.M.

IRC Section 2513 allows a married couple to treat gifts made by one spouse (the donor spouse) as if each spouse made one-half of the gift. Split-gifts allow the use of both spouses' $12,000 annual gift tax exclusion and $1,000,000 lifetime gift tax exemption. The split-gift rules applicable to transfers to trusts where the non-donor spouse is a beneficiary are complex. This article will examine those rules in the context of gifts to irrevocable life insurance trusts (ILITs).

In order to split gifts, both spouses must be U.S. citizens or residents; they must be married at the time the gift is made must not be remarried during the remainder of the calendar year of the gift; they must consent to treat the transfer as a split-gift on the gift tax return (Form 709); the split-gift election must apply to *all* gifts made by *either* spouse during the year; and the gift must be made to a third party – a direct or indirect gift to the non-donor spouse will not qualify for split-gift treatment. Transfers to an ILIT of which the non-donor spouse is a beneficiary may be considered "indirect" gifts. If they are, gift-splitting will not be available. Therefore, whether such transfers will qualify for gift- splitting depends upon the ILIT's terms.

Let us analyze a common situation. Husband creates an ILIT to own a policy on his life. Upon husband's death, his wife will receive income and principal as needed upon terms similar to those found in a credit shelter trust. Upon the wife's death, the remaining trust property will pass – estate tax free – to their children (either outright or in further trust). If the husband dies within three years of transferring an existing policy to the ILIT, then the trust property will pass to his living trust (or to a "contingent QTIP" trust to be established by the ILIT) where it will qualify for the unlimited martial deduction. During the husband's lifetime, the trustee can use trust income (if any) and principal (i.e., the policy's cash surrender value) for the benefit of the wife and/or children. Finally, the children (and possibly the wife) are given *Crummey* powers.

Transfers Subject to Crummey Powers.

Treas. Reg. 25.2513-1(b)(4) provides that where the non-donor spouse is one of several trust beneficiaries, transfers to that trust qualify for split-gift treatment only if the interest transferred to the third parties (i.e., the children) is ascertainable and therefore severable from the interest transferred to the non-donor spouse. If it is, the portion of the transfer allocated to the children will qualify for split-gift treatment and the portion allocated to the non-donor spouse will not.

For example, if the non-donor spouse is given the power to withdraw $5,000 and each child the power to withdraw (up to) $24,000, the interest of the children should be ascertainable and severable from the interest of the non-donor spouse. Therefore, the gift to the children (up to the withdrawable amount) should qualify for split-gift treatment. The gift to the non-donor spouse will not. This result is supported by several private letter rulings, the latest of which is PLR 200130030.

However, the IRS recently issued PLR 200616022 which adopts a different analysis. In that PLR, the non-donor spouse did not have a *Crummey* power and appeared to have had no interest in the trust other than as the beneficiary of a contingent QTIP trust. Departing from its previous rulings, the IRS did not conclude that the gifts to the grantor's children (who had *Crummey* powers) automatically qualified for gift-splitting. Instead, the IRS reviewed the trust agreement to determine whether the interest of the non-donor spouse was severable from the interest of the children. The IRS determined that the transfers to the trust were eligible for gift-splitting to the extent that they exceeded the actuarial value of the non-donor spouse's trust interest. Although the IRS did

not calculate the amount eligible for gift-splitting, presumably it was less than the entire amount transferred. The IRS reached a similar result in PLR 200422051. In neither PLR did the IRS indicate that it was departing from its prior position. Thus, it is unclear whether the IRS's failure to follow the prior rulings was inadvertent or signals a change in its position.

Transfers in Excess of Crummey Powers.

What if the transfers to the trust exceed the withdrawal powers (or the trust does not contain withdrawal powers)? From the numerous cases, published rulings and private rulings addressing this issue, a two-part test to determine whether or not the non-donor spouse's interest is severable and ascertainable has emerged. See Rev. Rule. 56-439, *Robertson*, 26 TC 246 (1956); *Kass*, TC Memo 1957-227; *Falk*, TC Memo 1965-22; *Wang*, TC Memo 1972 -143; PLR 199903040; and PLR 200345038.

The first part is whether the trust's distribution provisions are sufficiently limited to measure the trustee's power to distribute income and principal to the non-donor spouse. For example, if the distribution is limited to an ascertainable standard (i.e., health, education, maintenance and support), then it is capable of measurement. The second part is whether the non-donor spouse's other resources and standard of living make the likelihood that the trustee will actually distribute income or principal to the non-donor spouse so remote as to be negligible. The greater such outside resources are, the less likely a trust distribution will be necessary.

Calculating the Non-Donor Spouse's Interest. Assuming that it is necessary to determine the value of the non-donor spouse's interest, (so that the balance of the transfer qualifies for gift-splitting), how is the calculation made? Unfortunately, no guidance was given by the cases and rulings cited above. All of the cases cited either found that the entire transfer qualified for gift-splitting (because the spouse's interest was negligible), or that no part of the transfer qualified for gift-splitting (because the non-donor spouse's interest was not sufficiently limited). Thus, there was no need to do a calculation. While some of the PLRs did determine that the non-donor spouse's interest was sufficiently limited and thus severable, they declined to determine the amount. Thus, unless the likelihood of the trustee distributing property to the non-donor spouse is so remote as to be negligible, prudence dictates that an actuary be hired to determine the value of the non-donor spouse's interest.

Drafting Ideas. The best way to assure the availability of gift-splitting is to exclude the non-donor spouse as a beneficiary of the trust. If that is not acceptable to the donor spouse, then do not give the non-donor spouse a *Crummey* power, and limit the gifts to the trust so that they do not exceed the third-party beneficiaries' (i.e., the children's) *Crummey* powers. In that case, hopefully the IRS position in PLR 200130030 (and its earlier rulings) will prevail over its more recent position in PLRs 200616022 and 200422051.

If the non-donor spouse is a beneficiary and the transfers exceed the withdrawal rights of the other beneficiaries, then limit the distributions (to the non-donor spouse) to an ascertainable standard (i.e., health, education, maintenance and support). Stay away from distributions for "care", "general welfare", etc. In addition, it is important that the non-donor spouse have control of other resources. If both of these requirements are met, then the trustee will likely not need to make distributions to the non-donor spouse, making the non-donor spouse's interest negligible and the entire value of all transfers to the trust eligible for gift-splitting.

