The Estate Planner

By Lewis J. Saret

Transfer of Family Homes–Part II

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This column picks up where Part I left off. Specifically, Part I discussed transfers of family homes generally and different types of taxes planners must consider when planning for the transfer of a family home, and then began to focus on different ways that family homes may be transferred and the tax and nontax issues associated with such ways. Part II will focus more heavily on different ways that family homes may be transferred and will specifically discuss the following types of transfers:

- Family Limited Partnerships (FLPs) and Family Limited Liability Companies (FLLCs)
- Gifts in trust: Qualified personal residence trusts (QPRTs)

Future columns will discuss the following types of transfers: gifts in trust, remainder purchase marital trusts, sales and bargain sales, gifts to charity and charitable remainder trusts. Future columns will also discuss practical, nontax issues associated with transfers of family homes, including agreements to clarify who will pay post-transfer maintenance costs of the home and who has access to the home, *etc.*

How to Transfer a Home

Family Limited Partnerships (FLPs) and Family Limited Liability Companies (FLLCs)

Generally

One popular technique for transferring family homes is to use a FLP or FLLC. This involves transferring the

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home to a FLP or FLLC and then transferring interests in the FLP/FLLC to the objects of the transferor's bounty. There are numerous advantages to this approach but also some disadvantages that planners must consider.

FLP/FLLC Benefits

A key benefit of using FLPs/FLLCs to transfer homes is the ability to transfer the home by using an assignment of FLP/FLLC interest rather than having to prepare a new deed to the home each time the owner desires to transfer an interest in the home. This is advantageous because an assignment of interest in a FLP/FLLC is generally easier and less expensive to prepare than a new deed. In turn, this greatly facilitates the ability to make annual exclusion gifts.

> **Example 1.** Rochester wants to transfer his home, Thornfield Hall, to his daughter, Charlotte, by using a FLLC. To do this, Rochester transfers Thornfield Hall to the Bronte FLLC in 2012 executing a deed transferring Thornfield Hall to the FLLC and in return Rochester receives a 100-percent interest in the FLLC. Rochester than transfers a one-percent interest in the Bronte FLLC to Charlotte by executing an Assignment of LLC Interest. In 2013 and subsequent years Rochester can make additional gifts of interests in the Bronte FLLC to Charlotte by executing additional Assignment of LLC Interest forms with no need for any further execution of a new deed.

A second benefit of using FLPs/FLLCs is increased asset protection for the underlying property because owners of FLLC interests will not own a direct interest in the underlying property. As a result, the underlying property should be protected from claims of creditors of the FLLC members.

> **Example 2.** Same facts as Example 1 except that in 2015 Charlotte, who is an OBGYN, is sued by one of her patients who wins a $1 million judgment against Charlotte. Here, the judgment holder, as a general rule, cannot directly reach Thornfield Hall.

In most jurisdictions, the remedy that the judgment holder can receive is a charging order, which in most jurisdictions is the sole remedy of a creditor.[1] As a general rule, when a creditor obtains a charging order, the creditor has only the rights of a transferee.[2] As a result, the court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor in respect of the partnership.[3] A charging order constitutes a lien on the judgment debtor's transferable interest.[4] The court may order a foreclosure upon the interest subject to the charging order at any time.[5] The purchaser at the foreclosure sale has the rights of a transferee.[6]

Third, the operating agreement can be drafted to address the management of the property, including co-ownership issues that would otherwise be included in a tenancy in common agreement, which is discussed below. However, unlike a tenancy in common agreement, which must generally be enforced by external action such as litigation, the terms of a FLP/FLLC operating agreement may operate automatically by adjusting the capital accounts of the FLP/FLLC members to reflect their respect contributions or lack thereof.

> **Example 3.** Paris and Nicole are sisters. Their parents have transferred Manderley, the family beach compound, to them as tenants in common, and they sign a tenant-in-common agreement upon receipt of their respective interests, which requires them to make equal contributions to maintain Manderley. Nicole makes a $50,000 contribution pursuant to the agreement in 2012 but Paris fails to do so. Here, Nicole is left with little recourse to force Paris to make her contribution other than litigation.

> **Example 4.** Same facts as Example 3 except that the parents of Paris and Nicole transfer Manderley to them *via* an FLLC, with each originally receiving a 50-percent FLLC interest. Here, when Paris fails to make her $50,000 contribution, the capital accounts of Paris and Nicole are adjusted to reflect this difference, so that Nicole's capital account is adjusted upward by $50,000 but Paris' capital account is not so adjusted, so that they are no longer 50 percent, equal, owners in the FLLC.

More important with respect to the management of the underlying property, from the perspective of clients, the management interests in the FLP/FLLC can be bifurcated from the ownership interests. Therefore, clients can transfer wealth in the form of ownership interests in the FLP/FLLC to their loved ones while retaining control.

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Example 5. Ron and Nancy have three children. They own Eldorado, a large farm in Virginia, which they want to transfer to their three children, Alfred, Betty and Charles, who are 20, 21 and 22 years old respectively. Ron and Nancy form the Eldorado FLLC, and each transfers his or her 50-percent interest in Eldorado to the FLLC in exchange for a one-percent Managing Member interest and a 49-percent nonmanaging member interest. They each then begin making gifts of the nonmanaging member interests to their three children. This allows them to shift wealth to the children while retaining control over the property.

One popular technique for transferring family homes is to use an FLP or FLLC.

Fourth, using a FLP or FLLC can result in valuation discounts for transfer tax purposes. This requires some elaboration however.

In this regard, the value of the gifted interest is arrived at by means of a two-step process. First, the underlying property of the FLP/FLLC must be valued. This requires an appraisal of the home by a competent real estate appraiser. Second, a competent business appraiser must value the interest transferred. This valuation may include valuation discounts such as minority interest discounts (sometimes referred to as discounts for lack of control), and lack of marketability discounts.[7]

The basic concept of valuation discounts is as follows. Under the Internal Revenue Code, the valuation standard for transfer tax purposes is generally the amount that a willing buyer and a willing seller would arrive at with neither being under any compulsion to buy or sell, and with both parties having reasonable knowledge of relevant facts.[8] This standard incorporates discounts for lack of control and lack of marketability, which logically would cause such a willing buyer and seller to reach a lower value than a pure pro rata interest in the underlying property.

Example 6. Same facts as Example 1 except that the value of Thornfield Hall is $30 million. The one-percent gift of the Bronte FLLC therefore represents a one-percent interest in the underlying assets, which, assuming Thornfield Hall is the sole asset, would equal $300,000. However, because the valuation standard for determining the value of the one percent FLLC interested that Rochester gifted to Charlotte is (1) not a proportionate share of the value of the underlying assets of the Bronte LLC but instead (2) the amount that a willing buyer and a willing seller would arrive at with neither being under any compulsion to buy or sell, and with both parties having reasonable knowledge of relevant facts, the value of the one percent interest is less than $300,000. Here, the value is $240,000, which happens to equal 80 percent of the value that a property share of the underlying assets of the Bronte LLC would equal. Therefore, the value reflects total valuation discounts of 20 percent.

Example 7. Same facts as Example 6 except that the Rochester has already used up his $5.12 million estate tax exemption in 2012. Therefore, the amount of the gift from Rochester to Charlotte is subject to a 35-percent federal gift tax. Here, the amount of the gift tax equals $84,000. If there were no valuation discounts and the value of the gift equaled $300,000, then the gift tax would equal $ 105,000. Therefore, the valuation discount results in gift tax savings of $21,000.

Valuation discounts or transfers of FLPs and FLLCs are a hot-button issue for the IRS because of perceived abuses by taxpayers in this area. A full discussion of valuation discounts exceeds the scope of this column. However, there are a few valuation discount issues that are particularly relevant in the context of personal residences.

One of the key valuation discount issues in this context is that the FLP/FLLC must generally have a business purposes to respected for tax purposes. An absence of such a business purpose may cause the FLP to be disregarded for tax purposes. In this context, many commentators believe that because real property, including personal residences, has significant investment value, FLPs/FLLCs should generally be respected for tax purposes as long as they are validly formed under state law.[9]

Planning Pointer. Prudent planners will take steps to ensure that the FLPs/FLLCs that are used to hold family homes are respected for tax purposes. Such steps may include the following:

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- Clearly establish and memorialize a business/non–estate tax reason for forming the FLP/FLLC. Such reasons can include asset protection, avoidance of probate, or other reasons.
- Have the grantor pay rent for the real property and its contents at fair market value.
- Where appropriate, rent out the property to third parties.

FLP/FLLC Disadvantages

Although FLPs/FLLCs provide great advantages from an estate planning standpoint, they also have certain disadvantages.

First, to be respected for tax and legal purposes, generally, it's important that clients comply with entity formalities and treat the FLP/FLLC as a separate legal entity and not part of their personal assets. As a result, this requires a substantial increase in compliance on the part of clients. In this regard, what advisors may perceive to be a minor increase in the compliance burden may be perceived by clients as a substantial increase in compliance efforts and complexity. Such additional compliance may include the following:

- Establishment of separate bank accounts for FLPs/FLLCs
- Ensuring that fair market rent is paid for the use of the property
- Separate federal and state income tax returns for FLPs/FLLCs
- Separate accounting records for FLPs/FLLCs
- Appraisals for transfers of interests in the FLP/FLLC

Second, because of the compliance requirements associated with using FLPs/FLLCs, they are inherently expensive to set up and operate. Advisors should apprise clients of the compliance requirements and an estimate of associated costs in order to manage client expectations.

Income Tax Considerations

Exclusion of Capital Gain Under Code Sec. 121. Under Code Sec. 121, taxpayers can exclude from income the first $250,000, or $500,000 in the case of joint filers, of gain on the sale or disposition of a personal residence. Most taxpayers view this as an important advantage of owning a personal residence. As a general rule, if a single-member LLC owns a personal residence and is treated as a disregarded entity under Reg. §301.7701-3, then the owner of the LLC will be treated as satisfying the ownership requirement for purposes of Code Sec. 121. However, if there is more than one owner of the LLC, then the LLC will not qualify as a disregarded entity and, therefore, the LLC will not qualify for the Code Sec. 121 capital gain exclusion.[10]

> **Example 8.** Shu Li owns her home within the Li FLLC, of which Shu is the 100-percent owner and which is treated as a disregarded entity or income tax purposes. Here, if the Li LLC sells the home and it otherwise qualifies for the Code Sec. 121 capital gain exclusion, then Shu may take advantage of this exclusion.

> **Example 9.** Same facts as Example 8 except that Shu makes a gift to her daughter, Liu, of a 50-percent interest in the Li FLLC. After the gift the LLC is neither a single-member LLC nor a disregarded entity. Therefore, the property no longer qualifies for the Code Sec. 121 exclusion.

Vacation Home Income Tax Rules. Planners should keep in mind the vacation home rules under Code Sec. 280A, which determine the treatment of expenses associated with a residence.

Code Sec. 280A provides that for homes that are rented less than 15 days during the year, rental income from such home is not included in the taxpayer's gross income but that no deductions attributable to the rental of the property are allowed.[11]

Code Sec. 280A also provides that if personal use of a vacation home exceeds the greater of (1) 14 days, or (2) 10 percent of the number of days, the property is rented to non–family members at fair market value, the property must be treated as a residence for tax purposes. If this occurs, income and expenses associated with the property are allocated according to the following rules:

- Rental income must be recognized but rent related deductions may offset such income, subject to limits of Code Sec. 280A(c)(5).
- The property owner (*i.e.,* the FLP/FLLC) may claim a depreciation deduction.
- Excess deductions may be carried forward.
- Mortgage interest and real estate taxes allocable to personal use are deductible as for residences used fully for personal use.[12]

If the residence is used solely for personal use, then the vacation home rules contained in Code Sec. 280A preclude such taxpayer from taking any business deduction for the residence.[13]

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If personal use of the residence does not exceed (1) 14 days or (2) 10 percent of the number of days that the property is rented to non–family members at fair market value, then the property can be treated as primarily a rental property.

Qualified Personal Residence Trusts (QPRTs)

Generally

A QPRT is a trust to which the grantor transfers a personal residence and retains the right to use the residence for a term of years. After that term ends, the ownership passes to the remainder beneficiaries of the QPRT, either outright or in trust for the benefit of the remainder beneficiaries.

The primary benefit of using a QPRT is that the gift tax value of the property transferred to the QPRT is the actuarial value of the remainder beneficiary's interest in the property, which is almost always lower than the current fair market value of the property. The value is determined as of the date of the contribution of the property to the trust. As long as the grantor survives the terms of the QPRT all post-gift appreciation of the property escapes taxation with respect to the grantor.[14]

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Planning Pointer. The longer the QPRT term the lower the value of the gift of the remainder interest. However, if the grantor dies before the QPRT term ends, the QPRT assets are included in his/her estate under Code Sec. 2036. Therefore, planners must balance the gift tax benefits of increasing the QPRT term against the increased mortality risk associated with increasing the QPRT term.

Planning Pointer. Sometimes planners will select a longer QPRT term and hedge against the mortality risk by purchasing life insurance on the life of the grantor.

Planning Pointer. The gift tax value may also be reduced by having the QPRT instrument provide that if the grantor dies during the QPRT term that the QPRT property reverts to the grantor's estate.[15]

Example 10. George, who is 60 years old, owns a home on Lake Michigan worth $2 million. George transfers the home to a QPRT with a 10-year term, which allows him to live in the house for 10 years. At the end of the term, the home will pass outright to George's son, Dan. Here, the amount of the gift equals $1,295,648, even though the value of the home at the time of the transfer to the QPRT is $2 million. Moreover, if the value of the home increases at the rate of four percent per year, the home will be worth $2.96 million at the end of the 10-year QPRT term. As a result, Dan will receive assets worth $2.96 million with a transfer tax cost of $1,295,648.

What Constitutes a "Personal Residence" for QPRT Purposes?

Generally. A prerequisite of creating a QPRT is that the donor must own a residence that qualifies as a "personal residence" under Treasury regulations. For this purpose, to qualify as a "personal residence" the residence must satisfy the following requirements:

- The "personal residence" must satisfy the "primary use" requirement.
- The "personal residence" must qualify as either (1) the donor's "principal residence," or (2) another residence.

Primary Use Requirement. There are two prongs to the primary use requirement. First a residence is a principal residence only if its primary use is as a residence of the donor when the donor occupies it.[16]

Second, a residence is not a principal residence if during any period that the donor does not occupy the residence its primary use is other than as a residence. As a general matter, the fact that the donor has guests that live with the donor does not cause the failure of the primary use test. In addition, if the donor leases part of his/her residence to a paying tenant this does not cause the failure o the primary use test as long as the primary use of the residence is as the donor's residence when the donor occupies the residence.[17]

Example 11. Margaret owns a home in Boca Raton, where she lives year-round. Her sister, an executive, lives with Margaret whenever she is not traveling. Here, although Margaret has a guest who lives with her in the residence, the residence still satisfies the primary use requirement.

"Principal Residence" or "Other Residence." One of the requirements for a residence to qualify as a personal residence that qualifies under Treasury regulations for a QPRT is that the personal residence must qualify as either the donor's "principal residence" or as an "other residence."[18]

The determination of whether the donor's residence is his/her "principal residence" depends on all of the facts and circumstances.[19] For this purpose, Reg. §1.121-1(b)(2) provides that the IRS may consider the following factors:

- The taxpayer's place of employment
- The principal place of abode of the taxpayer's family members
- The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration and voter registration card
- The taxpayer's mailing address for bills and correspondence
- The location of the taxpayer's banks
- The location of religious organizations and recreational clubs with which the taxpayer is affiliated

In addition to the donor's principal residence, the donor may also transfer "one other" residence to a QPRT.[20] However, in order to qualify as the "other residence," the donor must use the residence the greater of the following:

- Fourteen days during the year
- At least 10 percent of the days that the residence is rented[21]

Caution. Only two residences may be simultaneously subject to QPRTs with respect to the same donor at any one time. However, it appears that a donor can create more than two QPRTs as long as there are only two QPRTs with respect to such donor in existence at any one time.[22] In addition, if one donor has created two QPRTs that exist at any one time, one of such QPRTs must contain the donor's "principal residence."[23]

Example 14. Mollie creates two QPRTs in 2012. She puts her principal residence, located in Bethesda, Maryland, in one QPRT with a 10-year term, and her beach house, located in Rehoboth Beach, Delaware, in to another QPRT with a five-year term. Mollie has a third home, in Charlottesville, Virginia, which she would like to put into a QPRT in 2012, but she is precluded from doing so because she has already created two QPRTs, which are currently in existence. However, after one of the existing QPRTs terminates (*i.e.,* after the five-year term of the QPRT holding the Rehoboth Beach home terminates), Mollie can create another QPRT and place her Charlottesville, Virginia home into that QPRT.

Miscellaneous Technical Requirements for QPRTs. Treasury regulations set forth various technical requirements for QPRTs, some of which are discussed above. Some other technical requirements are as follows:

- Multiple QPRTs may be created to transfer interests in the same property. For purposes of the rule allowing no more than two QPRTs per donor at any one time, multiple QPRTs holding fractional interests in the same property are treated as one QPRT.[24]
- QPRTs cannot hold tangible personal property.
- The grantor must use the QPRT property as a personal residence.[25]
- The grantor cannot use the QPRT property in a trade or business unless such use is secondary to its use as a personal residence.
- The QPRT property may be rented to third parties as long as the property satisfies the Code Sec. 280A(d) residence test discussed above. However, if the grantor moves to an assisted living facility then, technically, the QPRT fails unless at all times the grantor could return to the property. Generally, this precludes any rental of the property during any period that the grantor is living in an assisted living facility.
- Other than the contributed personal residence, a QPRT may only be funded with "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)."[26]
- The grantor must have the exclusive use of the property during the trust term. However as discussed above this requirement does not preclude the grantor from inviting others to use the property and the rental of the property within certain limits.
- The grantor is responsible for the costs and maintenance of the property during the QPRT term. On the other hand, payment of expenses associated with capital improvements and payment of mortgage principal payments that constituted QPRT obligations constitute additional gifts to the QPRT, which must be valued as of the date of such contributions.
- QPRTs cannot hold cash in excess of certain limitations and any excess must be distributed.[27]

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- If the QPRT residence is sold then one of the following must occur:[28]
  - The sale proceeds must be reinvested in a replacement property within two years of the sale.
  - The sale proceeds must be distributed to the grantor.
  - The QPRT must be converted to a grantor retained annuity trust (*i.e.,* a GRAT).

ENDNOTES

[1] *See* Uniform Limited Partnership Act (2001) §703(e).

[2] *See* Uniform Limited Partnership Act (2001) §703(a).

[3] *See* Uniform Limited Partnership Act (2001) §703(a).

[4] *See* Uniform Limited Partnership Act (2001) §703(b).

[5] *See* Uniform Limited Partnership Act (2001) §703(b).

[6] *See* Uniform Limited Partnership Act (2001) §703(b).

[7] *See generally* Lewis D. Solomon and Lewis J. Saret, VALUATION OF CLOSELY HELD BUSINESSES: LEGAL AND TAX ASPECTS (1998).

[8] Rev. Rul. 59-60, 1959-1 CB 237.

[9] *See generally* Nancy G. Henderson, *Estate and Income Tax Planning for the Passage of Family Homes Using QPRTs, Split Interest Purchases, Family LLCs, Dynasty Trusts, and Other Strategies (Including a Discussion of Non-Tax Considerations),* ALI-ABA Estate Planning In Depth (June 2011), *citing A. Strangi Est.,* 115 TC 478, Dec. 54,135 (2000), *aff'd in part and remanded in part,* CA-5, 2002-2 USTC ¶60,441, 293 F3d 279 (2002), *on remand,* 85 TCM 1331, Dec. 55,160(M), TC Memo. 2003-149, *aff'd,* CA-5, 2005-2 USTC ¶60,506, 417 F3d 468 (2005); *I.F. Knight,* 115 TC 506, Dec. 54,136 (2000); *E.J. Church,* DC-TX, 2000-1 USTC ¶60,369 (2000), *aff'd,* CA-5 (unpublished opinion), 2001-2 USTC ¶60,415, 268 F3d 1063 (2001). *But see W.C. Bongard Est.,* 124 TC 95, Dec. 55,955, 124 TC 95 (2005), in which the Tax Court disregarded a validly formed limited partnership because, among other reasons, the Court determined the partnership lacked "a legitimate non-tax purpose" for its creation.

[10] Reg. §1.121-1(c)(3)(ii).

[11] Code Sec. 280A(g).

[12] Code Sec. 280A(b).

[13] Code Sec. 280A(a).

[14] *See generally* Code Sec. 2702 and regulations thereunder. Generally, under these rules the gift tax value of the gift is essentially calculated using the rules set forth under Code Sec. 7520 and the regulations thereunder as follows: value of personal residence transferred to the QPRT – actuarial value of donor's right to the exclusive use of the personal residence during the QPRT term = amount of gift for gift tax purposes.

[15] *See H.W. Smith v. Shaughnessy,* SCt, 43-1 USTC ¶10,013, 318 US 176 (1943); Reg. §25.2512-5(e).

[16] Reg. §25.2702-5(c)(2)(iii).

[17] *See* LTR 960915 (Nov. 22, 1995), LTR 9741004 (July 3, 1997), LTR 9816003 (Dec. 23, 1997), LTR 199906014 (Nov. 9, 1998), LTR 199916030 (Jan. 22, 1999).

[18] Reg. §25.2702-5(c)(2).

[19] Reg. §1.121-1(b)(1).

[20] Reg. §25.2702-5(c)(2)(i)(B).

[21] *Id.*

[22] *See generally* David A. Handler, *There's No Place Like Home—Unless You Give It Away,* 46 U. MIAMI LAW CENTER'S PHILIP A. HECKERLING INSITUTE ON ESTATE PLANNING, at ¶802.4.

[23] *Id.*

[24] Reg. §25.2702-5(a).

[25] Reg. §25.2702-5(c)(2)(iii).

[26] Reg. §25.2702-5(c)(2)(ii).

[27] Reg. §25.2702-5(c)(5)(ii)(A)(2).

[28] Reg. §25.2702-5(c)(7).

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