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HEADLINE: Transferring the Family Home: Gift Tax Implications

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BODY:

AN explanation of how to apply IRC @ 7520 to determine the actuarial value of the donor's life estate for gift tax purposes when transferring a remainder interest in the family home and retaining a life estate, was discussed in a previous article. n1

n1 "Transferring the Family Home and Retaining a Life Estate," *NYLJ*, April, 24, 1997, page 1, column 1.

But left open was the question of the application of IRC @ 2702, which would make the value of the retained interest zero under certain circumstances, thus making the whole value of the gift taxable for gift tax purposes.

Assume that a mother, perhaps as an asset protection measure, plans to gift her remainder interest in her primary residence to her child and has retained a life estate.

The intent of the Special Valuation Statutes found in the IRC @@ 2701-2704 is to correct certain abuses perceived by the IRS resulting from partially completed transfers among family members which artificially depress the value of the gift, while, in fact, the donor retains substantial control.

The statute at issue here, @ 2702(a), provides as follows:

(1) In General -- Solely for purposes of determining -- whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member [as defined in @ 2701(e)(2)] shall be determined as provided in paragraph (2).

(2) Valuation of Retained Interest --

(A) In General -- The value of any retained interest shall be treated as being zero.

(B) Valuation of Qualified Interest -- The value of any retained interest which is a qualified interest shall be determined under @ 7520.

The transfer of an interest in property with respect to which there is one or more term interests shall be treated as a "transfer of an interest in a trust." [IRC @ 2702(c)(1)] A "term interest" is defined as "(A) a life interest in property, or (B) an interest in property for a term of years." [IRC @ 2702(c) (3)]. Thus, transfer of a remainder interest in real estate, while retaining a life estate, is encompassed in the Statute. The statute's focus is on valuing the retained interest and then determining the value of the interest transferred.

The statute only applies to transfers to a "member of the family." The term member of the family means, with respect to any individual "(A) such individual's spouse; (B) any ancestor or lineal descendant of such individual or such individual's spouse; (C) any brother or sister of the individual, and (D) any spouse of any individual described in subparagraph (B) or (C)." [IRC @ 2704(c)(2)] For example, transfers to one's child, parent, sibling or the spouse of any of these individuals, are included. A transfer to one's nephew is excluded.

The statute only applies if the interest retained is retained by the donor or by an "applicable family member," defined as "(A) the transferor's spouse; (B) an ancestor of the transferor or the transferor's spouse and (C) the spouse of any such ancestor." [IRC @ 2701(e)(2)]

Incomplete Transfers

The statute, however, does not apply to transfers which are "incomplete" for gift tax purposes. Section 2702(3)(B) provides: (B) "Incomplete Gift. -- For purposes of subparagraph (A), the term "incomplete gift" means any transfer which would not be treated as a gift whether or not consideration was received for such transfer."

The fact that a transfer may be incomplete because of certain retained interests, such as a retained power of appointment or a retained life estate, does not mean that the gift is incomplete for gift tax purposes. When one transfers a remainder interest and retains a life estate, a complete gift has been made and the statute is potentially applicable.

Transfer of Remainder

Regulation @ 25.2702-2(d) illustrates: "Example 4. A transfers property to an irrevocable trust, under which the income is to be paid to A for life. Upon termination of the trust, the trust corpus is to be distributed to A's child. A also retains certain powers over principal that cause the transfer to be wholly incomplete for federal gift tax purposes. Section 2702 does not apply because no portion of the transfer would be treated as a complete gift."

Transfer of Remainder

Do not be confused by the above example, which speaks of a "trust." Since a conveyance of an interest in property with respect to which there is one or more term interests shall be treated as a transfer of an interest in a trust, a conveyance of a remainder estate in real property with a retained interest, in which the donor retains certain powers of appointment with respect to the remainder, e.g. to appoint the remainder to other than the present grantee, is clearly within the purview of the example.

There is an additional exception to the statute: "This subsection shall not apply to any transfer -- if such transfer involves the transfer of an interest in trust all the property in which consists of a residence to be used as a personal residence by persons holding terms interests in such trust . . ." [IRC @ 2702(3)(A)(ii)]

Life interest in property may be a "term interest." In setting forth its "personal residence" exception, the statute appears to exclude from its purview a transfer of a remainder interest in the primary residence. It creates this exception by referring back, somewhat awkwardly, to its own definition of a conveyance into a "trust."

In short, the statute appears to provide that the transfer of a remainder interest in a personal residence to proscribed family members allows the grantor to value the retained interest in accordance with IRC @ 7520, the actuarial valuation statute.

CCH's explanation to the Regulations @ 25.2702-7, prior to a recent amendment, Aug. 20, 1996, Pub. L. No. 104-188, 110 Stat. 1755, squarely supported this interpretation: "Trusts and term interests -- Code @ 2702 provides rules to determine whether and in what amount the transfer of an interest in trust to a member of the transferor's family constitutes a gift. Generally, under these rules the retained or income interest is valued at zero unless the interest consists of the right to receive fixed payments or a fixed percentage of the trust property, payable at least annually . . . However, it should be noted that these valuation rules do not apply with respect to an incomplete transfer nor to a transfer of an interest in a personal residence that is inhabited by the holder of the term interest." (CCH Explanation to Regulations @ 2702-7)

Qualified Interests

The Regulations, which generally are designed to implement and expound, give an example of an incomplete gift, but do not address the personal residence exception otherwise. Reg. 25.2702-5 provides that the statute considers a conveyance into a Personal Residence Trust and a Qualified Personal Residence Trust, as a conveyance of a qualified interest.

The former is a true trust for a term of years which holds as its major asset the grantor's personal residence. The latter is a true trust for a term of years which may hold the principal residence; one other residence or an individual interest in either and some appurtenant structures and adjacent land not in excess of that which is reasonably appropriate for residential purposes.

IRC @ 7520 is applicable to determining the value of the gift of these "qualified interests." The grantor who outlives the term has irrevocably parted with his retained interest. The date of death market value of the whole property need not be reported on the estate tax return as part of the of the taxable estate, as there is no retained interest.

The date of the gift value, determined in accordance with IRC @ 7520, is reported as a completed gift on the estate tax return and gift tax paid is applied as a credit to the enhanced estate tax resulting from the inclusion of the gift in the estate.

The grantor who dies before the expiration of the term is back in the same position as if he had not created the trust and the date of death value of the gift is reported on schedule "G", pursuant to IRC @ 2036(a).

Of course, the concern here does not involve the application of @ 2036(a). It is understood that section applies and the value of the fee interest is pulled back into the estate for estate tax purposes whenever there is a retained interest. Regrettably, the Regulations do not give an example which squarely fits the simple facts: Mother transfers a remainder interest in the family home to her child and retains life estate.

Oddly, authority for either position, (i.e. the statute does not apply to gratuitous transfers of a remainder interest in one's primary residence, or the exception only applies to a qualified transfer in accordance with the Regulations) is scarce. Nor can guidance be found in the legislative history.

On June 19, 1997, the U.S. Court of Appeals for the Fifth Circuit, decided [*Wheeler v. United States*, \(116 F3d 749\)](#). The executor of the estate had not included any portion of the value of the decedent's ranch in his estate, because decedent had sold, some years prior to his death, the remainder interest in the ranch to his adopted sons for the actuarial market value of the remainder interest at the time of sale. The decedent had taken back a mortgage and actual payments had been made on the mortgage.

The Internal Revenue Service determined that, pursuant to IRC @ 2036 (a), the gross estate included the difference between the date of death value of the fee interest in the ranch and the consideration paid by the sons. The district court agreed with the IRS and the circuit court reversed. The issue was whether the sale of the actuarial value of the remainder interest determined in accordance with IRC @ 2512, constituted "adequate and full consideration" pursuant to @ 2036(a).

In its opinion, the circuit panel touched upon @ 2702, stating, in a footnote: "Although the Special Valuation rules do not apply where the holder of a life or term interest uses the property as his personal residence, IRC @ 2702(a)(3)(A)(ii), the Treasury Regulations provide that the personal residence exception applies only where the residence is placed in an irrevocable trust, 26 CFR @ 25.2702-5(b) 1996. ([116 F3d 749, 1996](#), supra).

The panel commented that the Regulation was "strengthened" by a new clause added to @ 2702, on

Aug. 20, 1996 (Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755).

The additional clause provides that the statute shall not apply . . . to the extent that regulations provide that such transfer is not inconsistent with the purposes of this section." Section 2702(a)(3)(A)(iii).

In short, the *Wheeler* court did not consider a gift transfer of a term remainder interest in a personal residence to proscribed family members, as excluded from the Special Valuation statute, unless such transfer was "qualified" pursuant to the Regulations.

Interestingly, CCH has changed its commentary and now provides: "Personal residence exception. A second important exception is made for the personal residence of the grantor." [Code @ 2702(a)(3)(A)(iii) and Reg. @ 25.2702-5]. This exception gives rise to a planning tool called a qualified personal residence trust (QPRT).

It would seem that caution now requires the application of @ 2702 to determine the value of the retained interest when the donor makes a gift of the remainder interest to proscribed family members in his primary residence and retains a life estate. Underpayment may have expensive consequences.

In view of the exclusion for up to \$ 250,000 available on the New York State estate tax return, an exclusion not available on the gift tax return, the application of IRC @ 2702 may be a deterrent for the client with modest resources, who wishes to make a gift of a remainder interest in his primary residence.