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Neil Harl

Iowa State University, harl@iastate.edu

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REACQUIRING THE RESIDENCE FROM A GRIT

— by Neil E. Harl*

The Grantor Retained Income Trust (GRIT) has been used only rarely in farm and ranch estate planning, partly because of uncertainties associated with how death would impact the arrangement. What use has been made of GRITS has often involved the residence.2

Typical GRIT

Under a typical GRIT, the transferor establishes the trust arrangement under which the transferor uses the property for a period of years with the property then distributed to the beneficiaries of the trust. The presence of the retained interest diminishes the value of the remainder interest which is a gift to the trust beneficiaries. For residences, it is a particularly appealing way to transfer value to family members at a reduced cost in terms of estate and gift tax.

Example: X, a taxpayer age 65, transfers a residence valued at $100,000 to a trust with the transferor's children as beneficiaries and retains the right to use the residence for five years. The retained right is valued, under the actuarial tables, at approximately 36 percent of the value of the residence or $36,000. The gift would be approximately $64,000 which would come out of the unified credit. The federal gift tax annual exclusion would not be available inasmuch as the gift is a future interest.

Even if during the period of the five year retained interest, the residence were to increase to $125,000, the residence would pass to the beneficiaries of the trust, at no additional tax cost. The property would be in the hands of the children at a cost of approximately $64,000 of the unified credit.

Problems with a GRIT

There are several potential problems with a GRIT. These problems are the reason why the GRIT has not been more widely used.

• If the transferor dies before the end of the period of retained use of the residence, the value of the residence itself is included in the transferor's gross estate at its date of death value (or as of the alternate valuation date).5

• In the event the transferor dies after the end of the period of retained use of the residence, the amount of the gift (approximately $64,000), would be added back into the estate as a taxable gift, not the value of the residence at death.

• The transferor would lose the right to occupy the residence at the end of the period of retained use. Would that mean that the transferor must move out of the residence? Not necessarily. The transferor would have several options.

Lease arrangement. The grantor could enter into a lease arrangement with the holder or holders of the remainder interest, after the end of the term interest, for a fair and customary rental. In settings where parents had gifted farmland and then rented it back, it has been clear that the rental arrangement should be at a fair rental and should reflect the type of rental arrangements common in the community. Even at that, the value of such leasebacks has sometimes been included in the donor-lesssee's gross estate.

Life estate for spouse. The transferor could grant the spouse a life estate to follow the retained income interest. This strategy would, of course, accomplish nothing if the spouse dies first.

Repurchase the residence. Another strategy would be for the transferor, before the retained interest term ends, to repurchase the personal residence from the trust for fair market value. It has been believed, based upon a 1985 IRS ruling, that the repurchase could be accomplished without recognizing any income tax liability if the grantor is treated as the owner of the entire trust for federal income tax purposes. In a 1994 private letter ruling, IRS affirmed the position taken in the 1985 ruling in holding that there was no recognized gain on the transfer of S corporation stock from a trust to the grantor in payment of an annuity or on substitution by the grantor of cash or other property of equal value. A 1995 ruling has also indicated that IRS feels comfortable with the position taken in the 1985 ruling. So, if the residence trust is a grantor trust for income tax purposes, no income tax consequences should ensue from the repurchase of the residence. This also enables cash or other property to pass to the remainder holders which may be a further plus from an estate planning perspective. Of course, the residence is then subject to inclusion in the estate of the original transferor.
Qualified personal residence trust (QPRT)

A qualified personal residence trust (QPRT) offers additional flexibility. A QPRT is similar to personal residence trusts with the same definition of personal residence.

A QPRT is permitted to hold assets other than the personal residence for certain time periods — (1) cash needed for payment of trust expenses, including mortgage payments, incurred or reasonably expected to be paid within six months from the date the cash is contributed to the trust; (2) amounts for improvements to be paid within six months from the date of contribution to the trust; (3) amounts for purchase of an initial residence within three months of the date of the contribution if the trustee has previously entered into a contract for the purchase; and (4) amounts for purchase of a replacement residence within three months from the date of the contribution provided the trustee has previously entered into a contract for the purchase. Any excess cash must be distributed to the term holder on a quarterly basis and, on termination of the term interest, must be distributed to the term holder within 30 days.18 A QPRT is also permitted to hold improvements to the residence, proceeds from sale of the residence and insurance policies and insurance proceeds payable as a result of damage to the residence.

FOOTNOTES
4 Id.
5 Id.
7 I.R.C. § 2001(b).
8 Ltr. Rul. 9425028, March 28, 1994 (provision permitting grantors to rent residence from remainder beneficiaries for fair market value rent or to purchase residence for fair market price after termination of trust (30 years)); Ltr. Rul. 9349014, September 4, 1992 (grantor would be required to pay "fair market value rent" after termination of 10-year term of trust to avoid being included in grantor's gross estate as rent-free occupancy; result not affected by female "friend" who also resided in residence).
10 See Estate of Nicol v. Comm'r, 56 T.C. 179 (1971) (farmland rented to daughter and son-in-law under five year crop share lease included in donor-lessee's gross estate).
12 Id.
15 Treas. Reg. § 25.2702-5(e). See Ltr. Rul. 9340009, June 29, 1993 (taxpayer could occupy residence rent-free for five years; if death occurs during that period, assets distributed to estate); Ltr. Rul. 9402011, October 8, 1993 (taxpayer could occupy residence as personal residence for three years; if death occurs during that time, assets distributed to revocable living trust or estate).
17 Treas. Reg. § 25.2702-5(c)(5).
18 Id.

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY
GENERAL-ALM § 13.03.*

DISCHARGE. The debtor was an officer, director and 50 percent shareholder of a corporation which was licensed under the Perishable Agricultural Commodities Act (PACA). The corporation purchased, but did not pay for, produce from a creditor. The creditor claimed that the debtor was liable for payment for the produce and that the debt was nondischargeable because of defalcation as a fiduciary by the debtor since the debtor failed to preserve the PACA trust to pay for the produce. The Bankruptcy Court held that for the nondischarge of a debt for defalcation as a fiduciary in a trust, an express or constructive trust must exist between the debtor and creditor. The Bankruptcy Court held that an express or constructive trust was not created by PACA because (1) no identifiable trust res existed since PACA allows trust assets to be commingled with the produce buyer’s other assets, (2) PACA does not impose fiduciary obligations on produce buyers, and (3) the PACA trust provisions act as a super lien on the produce buyer’s assets. The Bankruptcy Court also noted that an issue of fact remained as to whether the creditor complied with the PACA notice procedures and as to whether the sales involved contained payment provisions of 30 days or less and were, therefore, protected by PACA. The District Court reversed on the discharge issue, holding that a PACA trust does satisfy the three requirements identified by the Bankruptcy Court. The District Court noted that the trust res need not be separate from other assets, but the res needed to be identifiable. In re Snyder, 184 B.R. 473 (D. Md. 1995), aff’,g, 171 B.R. 532 (Bankr. D. Md. 1994).

PREFERENTIAL TRANSFERS. The debtor was involved in an automobile accident and the debtor filed a declaration of homestead for the debtor’s residence ten days later. A personal injury lawsuit was subsequently filed

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.