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HIGHLIGHTS

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without the making of a claim for it, or (2) if collection has not been made, is to be abated.

No relief for estate. The estate argued that the amount of the deficiency in the prior decision was disallowed when that decision was reversed, vacated, and remanded by the Fifth Circuit. The Tax Court disagreed. It said that the statutory language provides for abatement and refund of the "amount of the deficiency determined" by the Tax Court that has been "disallowed in whole or in part by the court of review," regardless of whether the taxpayer files a claim for relief. The Tax Court held, however, that where the court of review reverses and remands but does not indicate that any ascertainable "amount" of the previously determined deficiency has been precluded, the court of review has not "disallowed in whole or in part" the "amount of the deficiency determined by the Tax Court."

The Tax Court noted that the Fifth Circuit made no finding regarding the correct value of the Exxon claim, nor did it preclude an ultimate finding of value by the Tax Court that would result in the same deficiency amount contained in the original decision. The Tax Court stressed that the Fifth Circuit simply held that post-death events, such as the settlement of the Exxon claim, should not be considered in making the valuation determination. It remanded the case with instructions to make the valuation based on facts that existed on the date of Algerine's death. Thus, the amount of the prior deficiency determination was not disallowed in whole or in part.

observation: After the Tax Court redetermines a deficiency and the taxpayer decides to appeal, the taxpayer can post a bond to stay collection or pay the deficiency. In light of the result in the present Tax Court decision, one may question the wisdom of paying in cash rather than using a bond to stay collection. But the bond route doesn't stop the running of interest whereas cash payment does.

Practice Alert: The Treasury Department Proposals to Change Qualified Personal Residence Trusts (QPRTs)

Wendell R. Bird

The General Explanations of the Administration's Revenue Proposals, issued by the Department of the Treasury in 1998, 1999, and 2000 included a proposal to "repeal the personal residence exception of section 2702(a)(3)(A)(ii)." The proposed effective date of the proposals was the date of enactment of tax amendments.

This proposed repeal would subject qualified personal residence trusts (QPRTs) to the special valuation rules of Code Sec. 2702 and effectively eliminate family QPRTs. The value of the transferred interest would be the entire fair market value, unless the QPRT took the form of a grantor retained annuity trust (GRAT) or grantor retained unitrust (GRUT), which realistically would not work.

QPRTs and other personal residence trusts (PRTs) are widely used to reduce transfer taxes for estates that exceed the unified credit or exemption equivalent. Curtailing these techniques would have major implications for charitable donations.

observation: The Chairman of the House Ways and Means Committee has reiterated his desire to abolish estate and gift taxes, not to expand them. The Republicans controlling the House and Senate have reiterated their opposition to tax increases, which the Administration proposals would constitute.

Example of the economic effects of a QPRT. Parent, age 65, owns a home that has a current appraised value of $500,000. If Parent establishes a QPRT for a 10-year term, with the remainder then going to the children, Parent reports a gift of $189,645 to the children (the income interest and reversionary interest are worth $310,355). If Parent instead chooses a 15-year term, the gift is $104,340 to the children (the income interest and reversionary interest are worth $395,660). Parent files a gift tax return, and uses $189,645 or $104,340 of unified credit equivalent, and does not pay any gift tax. (At the time of writing, the 120% midterm adjusted federal rate is 7.2%.)

If Parent survives the 10- or 15-year term, the $500,000 house plus all appreciation is out of Parent's taxable estate. If appreciation is $500,000, Parent has removed $1 million from his or her taxable estate at a discounted value of $189,645 or $104,340—at a discount of 79% or 88%. If Parent does not live the full 10- or 15-year term, the house remains in his or her taxable estate, and the amount of unified credit that was used is restored.

Evaluation of the Administration proposals for QPRTs and PRTs. The proposal to "repeal the personal residence exception of section 2702(a)(3)(A)(ii)" would effectively mean that the value of a family gift of a remainder interest in a residence would be the entire fair market value. The proposal provides that "[i]f a residence is used to fund a GRAT or a GRUT, the trust would be required to pay out the required annuity or unitrust amount[;] other-

Wendell R. Bird, J.D., the senior attorney at Bird & Associates, P.C., is a former editor of the Yale Law Journal, and the author of numerous articles and book chapters on tax law.

wise the grantor's retained interest would be valued at zero for gift tax purposes." However, funding a GRAT or a GRUT with a residence would not be economically possible, because the GRAT or GRUT payment would have to be made each year, and the money could only come from the residence owner paying rent to himself during the QPRT term, selling the residence for cash, or prefunding the trust upon setting it up to be able to make payments. The first two sources of funds would not make economic sense, and the third source would be inconsistent with the requirements for a QPRT (allowing only six months of expenses). Thus, the Administration proposal effectively is to cause "the grantor's retained interest [to] be valued at zero for gift tax purposes."

A remainder in the future is not worth current value. In the example above, the Administration proposal would treat the gift today of a $500,000 residence, to be delivered in 15 years, to be worth $500,000. That contradicts common sense and economics teaching about present value and future value. A gift today of $500,000, to be delivered in 15 years, is worth considerably less than $500,000. A cash gift of $123,652 today will grow over 15 years, at the interest rate used for QPRTs, to be worth $500,000. A residence given in trust today, not to be delivered for 15 years when it will be worth $500,000, is only worth $123,652. The Administration proposal discriminates against QPRTs as compared to gifts of cash or securities.

GRATs and GRITs (including QPRTs) should be treated equally. A GRAT or GRUT that pays income from $500,000 for 15 years and delivers the remainder at the end of the 15-year period has a present value of the remainder of much less than $500,000. Under the Administration proposal, a QPRT that allows use of a $500,000 house for 15 years and then delivers the house in 15 years, would have a present value of the remainder of $500,000. This does not equalize QPRTs and GRATs, but discriminates against them. The donor receives income from the GRAT, and use value from a QPRT of the same value, yet the taxable gift is very low for the GRAT and a full $500,000 for the QPRT.

The Administration proposal gives as its first of two reasons for change: "Because the exemption under Code Sec. 2702 completely removes personal residence trusts from section 2702, such trusts receive more favorable gift tax treatment than that given to the statutorily authorized GRATs and GRUTs. Specifically, when valuing the gift made to the remainderman in a PRT, the value of any reversionary interest in the grantor can be taken into account, and such value reduces the amount of the taxable gift. In contrast, even if the grantor has a reversionary interest in a GRAT or a GRUT, section 2702 prohibits the actuarial value of that interest from being taken into account in valuing the gift."[2]

However, by denying not just the retained reversionary value, but also the retained usage value of the residence in computing the remainder value that is given, the proposal goes far beyond equalizing GRATs and QPRTs. Thus, the proposal is disingenuous. In the example given above of a 15-year QPRT, the $395,660 retained interest would be valued at $0 by the Administration proposal, even though it consists of a retained usage value of $276,735, in addition to the retained reversionary value of $118,925.

Use value from free rent. The Administration proposal gives as its second reason for valuing the remainder at current value, and the life estate at $0, that: "Experience has shown that the use value of the residence retained by the grantor is a poor substitute for an annuity or unitrust interest. In the personal residence trust, the grantor ordinarily remains responsible for the insurance, maintenance and property taxes on the residence. Therefore, the true rental value of the house should be less than fair market rent. In these circumstances, the actuarial tables overstate the value of the grantor's retained interest in the house."[3]

However, the proposal goes far beyond correcting an overstatement of true rental value, when it changes rental value to $0 and a remainder 15 years away to $500,000 now. The true rental value of a house is clearly more than $0, as evidenced by the lease payments made by millions of Americans for houses and apartments. The true rental value is clearly more than the sum of insurance, maintenance, and property taxes, because landlords universally charge more to cover their costs of debt or time value of money and to provide a profit. If use value is a "poor substitute," a $0 value is an indefensible substitute. If actuarial tables "overstate the value," they should be corrected rather than ignored, and it should not be assumed that the rental value is $0 and that future value is present value. Alternatively, the QPRT regulations could be modified to provide that grantors must treat payments for insurance, maintenance, and property taxes as gifts, though, in fact, payments for those items are normally made by tenants in the form of higher rent.

ENDNOTES

[1] Department of the Treasury, General Explanations of the Administration's Revenue Proposals 131 (Feb. 2000).

[2] Department of the Treasury, General Explanations of the Administration's Revenue Proposals 131 (Feb. 1998).

[3] *Id.*