

Buying/Owning Homes for Trust Beneficiaries: Legal, Tax and Practical Considerations

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Introduction

- There are three basic ways that a home can be acquired for a trust beneficiary.
 - The trust buys the home and allows the beneficiary to live in the house rent free.
 - The trust lends the money to the beneficiary who then acquires the home in his or her own name.
 - The trust makes a distribution of funds in accordance with the trust's distribution provisions, and the beneficiary then acquires the home in his or her own name.

Income Tax Issues

- Deemed Distributions to Beneficiary Living in Home Held by Trust
 - Rent free use of the home should not be treated as a distribution to the beneficiary.
 - Payment of ordinary and necessary maintenance expenses of the home probably won't be treated as a distribution to the beneficiary.
 - Payments of other expenses that are more personal to the beneficiary rather than the maintenance of a capital asset of the trust (e.g., utilities) could be treated as a distribution to the beneficiary.

Income Tax Issues

- Deduction of Interest and Expenses
 - Mortgage interest should generally be deductible by the trust, subject to the limitations that would apply to beneficiary-owned property.
 - Property taxes should generally be deductible by the trust.
 - Expenses required to preserve the home as a trust asset arguably could be deductible by the trust, but also may be viewed as nondeductible personal expenses.
 - Expenses that are more personal to the beneficiary (e.g., utilities and other expenses of the beneficiary's occupancy) presumably would not be deductible to the trust, except possibly as a distribution to the beneficiary.

Income Tax Issues

- Capital Gains
 - Sale of the home by the trust will generate a capital gain (assuming, of course, it has appreciated).
 - Sale of the home by a beneficiary would also generate a capital gain, but that gain might qualify for the \$250,000/\$500,000 exclusion for gain on the sale of a principal residence.

Income Tax Issues

- Deemed Distributions to Beneficiary Who Purchases Residence with a Loan from Trust
 - If the Trust loans money to the beneficiary so that he or she may purchase a house, and the beneficiary fails to repay the loan, the following may result:
 - A deemed distribution to the beneficiary if the trustee would otherwise have the ability to collect but does not actively pursue repayment.
 - A deemed distribution if the trustee applies amounts that would have been distributed to the beneficiary to satisfy the debt.
 - Cancellation of Debt Income to the beneficiary if the trustee determines that the loan is uncollectable and forgives the loan.

Fiduciary Duties of the Trustee

- The fiduciary duties of the trustee should not be ignored in structuring the ownership of the home.
- If the home is to be acquired by the trust, it must represent a reasonable investment of the trust considering all the usual factors under state law and the trust agreement.
 - The trust agreement will govern whether and to what extent a trustee may allow a beneficiary of the Trust to live in a house held by the Trust rent free and to what extent the Trust is allowed to loan money to a beneficiary in order to buy a home.

Fiduciary Duties of the Trustee

- Texas Trust Code, which defines the default rules if the trust agreement is silent, allows the trustee to:
 - Permit real estate held in the trust to be occupied by a beneficiary who is currently eligible to receive distributions. Texas Trust Code 113.022(1).
 - If reasonably necessary for the maintenance of a beneficiary who is currently eligible to receive trust distributions, invest in real property to be used for a home by the beneficiary. Texas Trust Code 113.022(2).

Fiduciary Duties of the Trustee

- If the beneficiary will not be paying rent, this should be considered as part of the overall appropriateness of the investment as this will obviously affect the trust's return on the investment.
- Diversification issues should be considered. Section 117.005 of the Texas Trust Code provides that the trustee shall diversify unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying. Modern trust agreements often attempt to abrogate the duty to diversify, but the duty should never be ignored.

Fiduciary Duties of the Trustee

- If the trustee lends the money to the beneficiary, the loan must be on appropriate terms with adequate security for the trust.
 - When the trust instrument permits discretionary principal distributions to the beneficiary, the Restatement gives considerable flexibility in this area. Under the Third Restatement, a loan is treated as a form of discretionary benefit, and may be made at a market rate of interest or at low or no interest; and funds may even be advanced with recourse only against the beneficiary's interest in the trust, without personal liability. See RST (THIRD) § 50 comment (d)(6).

Fiduciary Duties of the Trustee

- The loan will be part of the trust's overall investment portfolio and therefore should be appropriate as an investment under the trust agreement and state law.
- If the loan structure is employed, be sure that all parties understand that this is a real loan and that the trustee may have to foreclose on the property if the beneficiary fails to make payments. Failure to aggressively pursue such a debt could have fiduciary concerns for the trustee and income tax issues for the beneficiary.
- To this end, consider whether the trustee wishes to perfect the security interest by filing appropriate UCC statements. Such perfection is not necessary to make a valid debt, but there are certainly times when beneficiaries may have other creditor issues, and perfecting the security interest may become important.

Fiduciary Duties of the Trustee

- If the trustee makes a distribution to the beneficiary to purchase the home, the distribution must be proper under the trust agreement's standard for distributions and applicable state law.
- Distributions for the purpose of acquiring a home under the typical health, education, maintenance, and support standard are generally considered appropriate as long as the distributions and purchase are consistent with the beneficiary's accustomed standard of living. Query whether a beneficiary is entitled to a larger home as he advances in age.

Transfer Tax Issues

- Transfer Tax Consequences of Trust Ownership
 - If the trust owns the house and allows rent-free use of the house by the beneficiary, this amounts to the distribution of all trust income to the beneficiary as to that asset. Therefore, while this certainly makes sense for many trusts, trustees of those trusts that are specifically generation-skipping and GST exempt should think twice about this arrangement—particularly if there are other sources available for funding the beneficiary’s home ownership.
 - Example: Under the will of Grandfather, there is a GST exempt trust (that lasts as long as the perpetuities period allows) and a GST non-exempt trust. If a grandchild needs financial support to acquire a home, and trust ownership is determined to be the best approach, all other things being equal the GST non-exempt trust should acquire the home. The home represents an asset that can certainly appreciate in value, but its rent-free use is tantamount to the distribution of income from that asset.

Transfer Tax Issues

- Expense sharing and the cost of improvements should be carefully considered. As discussed elsewhere, typical recurring expenses of home ownership, such as property taxes, utilities, and ordinary maintenance have long been held to be the obligations of the life tenant or current beneficiary. It would be appropriate for the current beneficiary to assume those expenses (though this is not required). Those expenses associated with the protection and improvement of the investment, such as capital improvements and hazard insurance, would be the obligation of the trust or remainderman. Consequently:
 - The current beneficiary should not pay for improvements or hazard insurance, as this could be considered a contribution to the trust and result in a number of nefarious estate and gift tax issues.

Transfer Tax Issues

- The current beneficiary may assume the other recurring expenses of home ownership and should be required to do so if possible since this would, in effect, reduce the cost of the trust's investment in the asset and thereby provide additional estate and gift tax benefits to the family. (This assumes that the trust owning the house would not be included in the current beneficiary's taxable estate.)
 - Example: Grandmother creates GST exempt trust for the benefit of son and his descendants. Son needs a home, and the trust acquires it and plans to allow the son to occupy it on a rent-free basis. The trustee should agree with son that son pays (if possible) property taxes, utilities, and ordinary maintenance, while the trust pays the hazard insurance and makes any capital improvements. Of course, son does not have to pay those expenses.

Transfer Tax Issues

- Transfer Tax Considerations of Beneficiary Home Ownership.
 - Trust distribution to fund home acquisition. Of course the least favorable approach from a transfer tax standpoint is a simple distribution of income and principal to the beneficiary for the purpose of acquiring the home.
 - The distribution carries out taxable income to the beneficiary in accordance with normal rules of trust income taxation.
 - This is the simplest approach to home ownership within the family context, but also the least advantageous from an estate and gift tax standpoint.

Transfer Tax Issues

- Trust loan to beneficiary to acquire home. From a transfer tax standpoint, the effect of this is to freeze the value of the house in the trust and give the benefit or burden of the value of the home to the beneficiary. Obviously, this can be good or bad from a transfer tax (and fiduciary investment) standpoint.
 - Most loan transactions will be structured with the note bearing interest at the applicable AFR and the trust taking a security interest in the residence.
 - What interest rate will be charged? Most parties default to the applicable AFR, but this is not absolutely required in a trustee loan context.

Marital Property Issues

- Separate v. Community Property
 - General rule is a residence is separate property of a spouse if it was acquired before marriage, if it was purchased during the marriage with separate property funds, or if it was acquired by gift, devise or descent before or during the marriage. Otherwise, a residence acquired during marriage is community property.
 - Under the “inception of title” rule, the separate or community character of an asset is determined at the time the property is acquired and the status of the property never changes.

Marital Property Issues

- Example: Wife acquires residence prior to marriage. After marriage, the property remains Wife's separate property regardless of improvements or other expenses paid from community or Husband's separate funds
- Community presumption- property acquired during marriage is community property unless proven otherwise. Even if property is purchased entirely with separate property, the purchase should be carefully documented as such.
- Debt incurred during marriage—The proceeds from debt incurred during marriage are presumed to be community property unless the lender specifically agrees in writing to look solely to the separate property of a spouse for repayment.

Marital Property Issues

- Expenses of Residence Paid During Marriage
 - To the extent a mortgage on a separate property residence, or improvements to the residence are paid with community property during marriage, such payment creates a claim for reimbursement of the community estate unless it can be proven the mortgage or improvement was paid with the separate property funds of the spouse who owns the residence.
 - Example: Prior to marriage, Husband purchases “tear down” house. After marriage, the house is, in fact torn down. With the proceeds of a typical mortgage (or perhaps a loan from the trust), the couple builds a very large and expensive home, the value of which far exceeds the value of the original “tear down” house. The new home is nevertheless the separate property of the Husband, and the community estate has a claim for reimbursement against Husband’s separate property to the extent the community makes payments on the debt.

Marital Property Issues

- Owner spouse should be sure to pay the following expenses from separate property, which will otherwise create a reimbursement claim if paid from community property:
 - Improvements to the home
 - Hazard Insurance
 - Mortgage/Note

Marital Property Issues

- Property taxes can be paid from separate or community funds, without creating a reimbursement claim to the community estate. Other maintenance expenses such as utilities can also be paid from separate or community property.
- If the residence is held in Trust, the trust should bear the costs that the owner spouse would bear (mortgage, improvements, hazard insurance), leaving other expenses to the beneficiary.

Marital Property Issues

- Pros of Holding Residential Property In Trust in View of Marital Property Issues
 - No presumption of community – house was acquired by the Trust, not either party, therefore there is no presumption of community
 - Non-beneficiary spouse should not have a homestead right in the house, and thus his or her consent will not be required to sell or otherwise deal with the house (discussed in more detail below below).
 - Non-beneficiary spouse should not have any rights as surviving spouse to live in the house after the beneficiary is deceased (discussed in more detail below).

Marital Property Issues

- Potential Cons of Holding Residential Property In Trust
 - Though generally accumulated income in a third party trust will not be subject to community property claims of the non-beneficiary spouse, there are Texas cases holding that certain rights of the beneficiary spouse will support a community property claim on accumulated income, including a withdrawal right, a mandatory income interest, a general power of appointment, or other similar right to the trust principal or income.
 - In other states, the effectiveness of using a trust to hold real property as protection against the non-beneficiary spouse's divorce claim could be undermined. Some states will consider the size of a trust for the benefit of one spouse in setting alimony payments. This is not a con per se, but questions the effectiveness of holding the residence in the trust solely to avoid a marital property claim.

Marital Property Issues

- Example: Couple marries while Texas residents. Husband is the beneficiary of a trust created by his parents in Texas. Couple then moves to Massachusetts and the Trust purchases a home for the couple in which they live rent-free. Ten years later, the couple divorces, residents of Massachusetts. Massachusetts law will govern the division of the marital property, a state where all property no matter when acquired is subject to equitable division. The court will likely take the value of the house into consideration when apportioning non-trust assets, awarding the wife perhaps a greater share of assets held outside the trust and will similarly take the trust into account when awarding alimony.

Homestead Issues

- Spousal Homestead Right: Required Consents
 - In Texas, selling, mortgaging or otherwise disposing of the primary residence (the “homestead”) of a married couple requires the consent of both spouses, whether or not the property is separate or community property.
 - If a Trust created by a third party for the beneficiary holds the residence, the homestead right should not attach, and the Trustee can sell, mortgage or otherwise dispose of the residence without consent of the beneficiary’s spouse.

Homestead Issues

- The Texas Property Code specifically provides that if one spouse transfers his homestead residence to a revocable trust during marriage, that transfer must be approved of by the other spouse. Once the spouse has consented and the transfer is made, the trustee can sell or otherwise deal with the residence without the consent of the other spouse. Texas Property Code Section 41.0021(c) and (d).
- It is unclear whether the spouse's consent is required with respect to selling or mortgaging a home that was transferred to a revocable trust before the marriage, as this particular situation is not addressed in the Property Code.

Homestead Issues

- Spousal Homestead Right to Live in the Property.
 - Under the Texas Constitution and Texas Estates Code, if one spouse dies, the surviving spouse has a right to live in the couple's homestead for his or her life, whether or not the property is community or separate property.
 - This right likely applies to a residence held in a revocable trust.
 - If a Trust, other than a self-settled revocable trust, holds the property for the beneficiary, this right to live in the residence after the death of the beneficiary should not attach and the residence can be disposed of in accordance with the terms of the trust agreement.

Homestead Issues

- Property taxes
 - Texas Tax Code Section 11.13 provides for a “residence homestead” exemption that reduces the amount of property taxes that are imposed against a home. Although individual cities, counties, school districts, and other taxing authorities have some ability to vary exemptions, the residence homestead exemption is equal to 20% of a home’s value for most purposes. Texas Tax Code Section 11.13 provides additional exemptions, including a tax ceiling applicable to most school district and county taxes, for a “residence homestead” of an individual who is age 65 or older.

Homestead Issues

- Until 2013, a home owned by a trust and occupied by a beneficiary could qualify as a “residence homestead” only if the beneficiary was a trustor or the spouse of a trustor and only if the agreement, will, or court order that created the trust authorized the beneficiary to use and occupy the residence.
- Section 6 of House Bill 2913 enacted in the 2013 Regular Session amended Texas Tax Code 11.13(j), effective September 1, 2013, so that a home owned by a trust and occupied by a beneficiary (including a non-trustor beneficiary) as the beneficiary’s primary residence can now qualify as a “residence homestead” so long as the agreement, will, or court order that created the trust, or an instrument transferring property to the trust, or any other agreement that is binding on the trustee provides that the beneficiary has the right to use and occupy the residence in accordance with certain terms.

Homestead Issues

- The agreement must provide that the beneficiary has the right to use and occupy the property as the beneficiary's principal residence rent free and without charge except for taxes and other costs and expenses specified in the agreement, and such right must be granted for life, for the lesser of life or a term of years, or until the date the trust is revoked or terminated by an instrument or court order that describes the property and is recorded in the county's real property records.
- We have drafted a simple two-page agreement that has been accepted by the Dallas County Appraisal District that grants a beneficiary a right to use and occupy a residence on a year-by-year basis that automatically renews at the end of each year unless the trustee notifies the beneficiary at least 60 days before the end of the year that the agreement is terminating. The agreement also provides that it will terminate automatically upon the death of the beneficiary.

Homestead Issues

- The status of a home on January 1 determines whether the home qualifies for the “residence homestead” exemption for the calendar year. We suggest that an agreement granting a beneficiary the right to use and occupy a home be dated and signed before January 1 of the year for which the exemption is sought. If the agreement is not signed before January 1, it may be acceptable to use an effective date of January 1 or earlier if the home was actually owned by the trust and occupied by the beneficiary on or before the effective date.
- Note that qualifying as a “residence homestead” does not create a spousal homestead right that otherwise would not be there.

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