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RESIDENCE AS QTIP

— by Neil E. Harl*

The concept of qualified terminable interest property or QTIP,¹ which has been available since 1982, has enjoyed much greater use than originally anticipated by many planners.² While most farm and ranch property poses few problems in funding, a marital deduction with a QTIP election funded with the residence or residence part of the form requires special care.³

Basic QTIP requirements

An election may be made by the personal representative of the estate to treat life estates passing to a surviving spouse as eligible for the marital deduction.⁴ To be eligible, the spouse must receive a qualifying income interest for life which requires that both of the following conditions be met —

- The spouse must be entitled to all of the income from the entire interest, or all of the income from a specific part of the interest, payable annually or more frequently, for a period measured solely by the spouse's life.⁵

- There must not be a power in any person to appoint any part of the property subject to the qualifying income interest to any person other than the spouse during the spouse's life.⁶

The first of the two basic requirements has posed the major obstacle for residences and the residence part of farms. The critical question is what interest in a residence is the equivalent of receiving all of the income from the property.

Electing QTIP for residence

A devise of the personal residence or residence part of a farm or ranch may pose problems of eligibility.

- A residence may not be eligible for QTIP treatment if the spouse's right of occupancy of the residence would terminate upon abandonment of the residence.⁷

- If the surviving spouse's right to the residence is dependent upon continuing occupancy, the property may not be eligible as QTIP.⁸ Similarly, an interest of a surviving spouse in a residence may not be eligible for a QTIP election if the surviving spouse would lose the

interest by moving to a new residence.⁹ Even a provision that would result in loss of the interest in a residence for failure to occupy the residence for some stated time period may cost the estate the QTIP election.¹⁰

- In the event the residence is to be sold if the surviving spouse vacates the residence and the proceeds are to pass to someone else, the property is not eligible QTIP.¹¹ However, to the extent the proceeds of sale are to be held for the spouse for life the property may be eligible for the election.¹²

- Indeed, any conveyance less than the equivalent of a life estate under state law is not eligible for QTIP.¹² However, a bequest of "full and exclusive" use of a lake home provided "substantially that degree" of beneficial enjoyment of a life estate, was not subordinated to the rights of anyone else and was deemed eligible as QTIP.¹³

- Similarly, a surviving spouse's right to occupy a residence "for as long as he desires" entitled the estate to QTIP treatment.¹⁴

In conclusion

Special care is needed in planning for a QTIP election where a residence or residence part of a farm is involved. Attention should be given to any language appended to the devise of the residence to the surviving spouse. Any significant diminution of the spouse's interest from a traditional life estate could cost the estate QTIP treatment as to the residence.

FOOTNOTES

- ¹ See I.R.C. § 2056(b)(7).
- ² See generally 5 Harl, *Agricultural Law* § 44.04[6][b] (1993); Harl, *Agricultural Law Manual* § 5.04[3][b][ii] (1993).
- ³ See, e.g., *Est. of Peacock v. U.S.*, 90-2 U.S. Tax Cas. (CCH) ¶ 60,051 (11th Cir. 1990).
- ⁴ I.R.C. § 2056(b)(7). *Est. of Higgins v. Comm'r*, 91 T.C. 61 (1988), *aff'd*, 897 F.2d 856 (6th Cir. 1990) (QTIP election not allowed where no election made on estate return nor did return identify QTIP property); *Spohn Estate v. U.S.*, 90-2 U.S. Tax Cas. (CCH) ¶ 60,027 (N.D. Ind. 1990) (no clear and unequivocal communication of intent to elect QTIP treatment).
- ⁵ See, e.g., *Ellingson v. Comm'r*, 92-1 U.S. Tax Cas. (CCH) ¶ 60,101 (9th Cir. 1992) (QTIP treatment allowed for family farm property even though trader could accumulate income; however, despite accumulation provision, trader actually

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possessed no power to accumulate income because of pressure of adverse death tax consequences if QTIP not available).

- 6 I.R.C. § 2056(b)(7)(B)(ii). See *Est. of Boydston v. Comm'r*, T.C. Memo. 1984-312, *aff'd without pub. op.*, 774 F.2d 1173 (9th Cir. 1985) (spouse's life estate interest in trust not eligible for marital deduction as qualified terminable interest property because spouse did not have power over corpus).
- 7 *Est. of Kyle v. Comm'r*, 94 T.C. 829 (1990).
- 8 Ltr. Rul. 9229004, March 31, 1992 (surviving spouse to receive decedent's home "subject...to the condition of his occupancy...." not a qualifying income interest for life because surviving spouse could neither convey residence nor obtain rent from it); Ltr. Rul. 8651002, Aug. 12, 1986 (devise of right of occupancy in decedent's residence to surviving spouse not

eligible QTIP because interest based on occupancy and not life of surviving spouse).

- 9 Ltr. Rul. 8736004, May 22, 1987.
- 10 Ltr. Rul. 8742001, June 30, 1987 (failure to live in residence for at least one month in any calendar year).
- 11 Ltr. Rul. 8843004, July 27, 1988 (proceeds of sale to be distributed to decedent's child).
- 12 Ltr. Rul. 9040001, July 8, 1990 (50 percent of proceeds held in trust for spouse for life produced QTIP as to 50 percent).
- 13 Ltr. Rul. 9033004, no date given.
- 14 Ltr. Rul. 9126020, March 20, 1991.
- 15 *Est. of Peacock v. U.S.*, 90-2 U.S. Tax Cas. (CCH) ¶ 60,051 (11th Cir. 1990).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

FENCE. An owner of a large tract of farm land sold the northern half to the defendants and the southern half to the parents of the plaintiffs. The tracts were separated by a fence which meandered back and forth over the true boundary. Both parties testified that they did not consider the fence as the true boundary. The plaintiffs used the disputed property as pasture land, first as tenants of their parents and as full owners. The defendants used the disputed property as a trash dump and as a drain point for a sewer line. The court held that the plaintiffs' title to the disputed property could not be acquired by adverse possession through mutual recognition of the fence as the boundary because neither party ever considered the fence as the true boundary. In addition, the plaintiffs did not have exclusive possession of the disputed property because both parties made continuous use of the property. **Thornburg v. Haeker**, 502 N.W.2d 434 (Neb. 1993).

BANKRUPTCY

GENERAL

DISCHARGE-ALM § 13.03[6].* The debtor entered into a series of contracts for the sale and purchase of a horse and its foals in order to create a tax shelter for the plaintiffs. The plaintiffs paid \$15,000 to the debtor as "interest" on a promissory note given for the horse and claimed the payment as a deduction on the 1982 federal tax return. The deduction was disallowed by the IRS which considered the transactions as shams. The plaintiffs sought to have their claims against the debtor declared nondischargeable for misrepresentation and fraud. The court held that the claims were dischargeable because the plaintiffs did not rely on the representations of the debtor as to the tax deductibility of the interest payments since the plaintiffs knew that the transactions would not produce bona fide tax deductions. **In re Farley**, 156 B.R. 486 (Bankr. W.D. Pa. 1993).

EXEMPTIONS-ALM § 13.03[3]*

AVOIDABLE LIENS. The debtors claimed a homestead exemption for the equity remaining after a mortgage. The debtors sought to avoid a pre-petition judgment lien against the homestead as impairing their exemption. The court held

that because the judgment lien exceeded the debtors' exemption amount, the lien was completely avoided. **In re Osborne**, 156 B.R. 188 (Bankr. W.D. Va. 1993).

The debtor claimed a homestead exemption. The homestead was subject to four liens in the following priority order: (1) a judgment lien, (2) a creditor's judgment lien, (3) an unavoidable federal tax lien, and (4) a county tax lien. The debtor sought avoidance of the second lien as impairing the homestead exemption. The creditor argued that because the amount of the first two liens did not exceed the fair market value of the house less the exemption amount, the liens did not impair the exemption but that the later liens were the ones which impaired the exemption. The court held that the priority of the liens did not affect the impairment issue and allowed avoidance of the second lien. **In re Bradshaw**, 156 B.R. 239 (Bankr. S.D. Ind. 1993).

The debtor claimed a homestead exemption and sought to avoid a judgment lien against the house. The Bankruptcy Court had avoided the entire \$92,000 lien, although the exemption amount was only \$12,000. The creditor argued that the house was already exempt from the lien under Utah law; therefore, no impairment existed. The appellate court reversed, holding that the homestead exemption was not impaired because the lien could not affect the homestead exemption under state law. In addition, the court held that the entire lien could not be avoided but that the lien could have been avoided only to the extent of the impaired exemption amount. **In re Sanders**, 156 B.R. 667 (D. Utah 1993).

HOMESTEAD. The debtor filed a declaration of homestead post-petition and sought avoidance of judgment liens impairing the exemption. The debtor vacated the property the day after filing the homestead declaration and applied for court approval of the sale of the property. The court held that the post-petition declaration of homestead and sale of the property did not affect the debtor's right to the exemption; however, the court ordered a hearing as to whether the declaration of homestead was truthful in that the debtor's actions were contrary to the declaration that the debtor intended to use the property as a residence. **In re Zohner**, 156 B.R. 288 (Bankr. D. Nev. 1993).

More than three years before filing for Chapter 7, the debtor disposed of several non-exempt assets and used the