

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Refer Reply To:
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Date:

November 30, 1999

Re: Ruling under § 2702 of the Internal Revenue Code

Legend:

Taxpayer:

Spouse:

Trustee:

Ranch:

date 1:

date 2:

a:

b:

Dear _____ :

We received your letter dated May 17, 1999, in which you request several rulings on behalf of taxpayers concerning the application of § 2702 of the Internal Revenue Code. This letter is in response to your request.

The represented facts are as follows: On date 1, Taxpayer and Spouse purchased an a acre tract of land. Taxpayer and Spouse built a house, garage and caretakers quarters on a. On date 2, Taxpayer and Spouse acquired a b acre tract of land adjacent a. Together the a and b tracts of land make up the Ranch. Taxpayer and Spouse own the Ranch as tenants in common.

Taxpayer and Spouse use the Ranch as a vacation home exclusively for residential purposes. Taxpayer and Spouse represent that they have no intention at

this time of selling any portion of the Ranch. In addition, Taxpayer and Spouse represent that the property is not used for any business purpose. Taxpayer and Spouse also represent that they receive no rent from any guests or family members who may use the Ranch. Generally, Taxpayer and Spouse are present when guests use the Ranch.

Taxpayer and Spouse each propose to create an irrevocable trust and transfer their individual interests in the Ranch to their respective trusts. These Trusts are intended to satisfy the requirements of a Qualified Personal Residence Trust (QPRT) under Treas. Reg. § 25.2702-5(c). Taxpayer and Spouse expect that the Ranch will be held for family residential purposes at the expiration of the QPRT. The terms of the Trusts for Taxpayer and Spouse are identical.

Paragraph A of Article First of the proposed irrevocable Trusts provides that the Trusts will hold an interest in real property constituting the personal residence of the Grantors (Taxpayer and Spouse). The Grantors will have the right, rent free, to the use, possession and enjoyment of the Ranch, as a personal residence. The Grantors will pay all carrying costs associated with the Ranch held in the trust from time to time and properly chargeable to Grantor's interest hereunder, and may at Grantor's election pay all other costs associated with the Ranch, including costs of extraordinary repairs and improvements. The Trustee of the Trusts shall have no responsibility for the payment of costs associated with the Ranch except to the extent funds available therefor are held by the Trustee in a separate account pursuant to Article Fourth(D) hereof. The Trustee is to pay over or apply any net income of each Trust at the end of each calendar year to or for the benefit of the Grantors. During the term of the Trusts under this Article First, the Trustees shall not pay over or apply any portion of the income or principal of the trust estate to or for the benefit of any person other than the Grantor; provided, however, that this sentence shall not be construed to prevent the payment by the Trustee of expenses properly chargeable to the trust estate.

Paragraph A of Article First further provides that the Trusts held under this Article First shall terminate upon the first to occur of 1) the death of the Grantor of the Trust or 2) the expiration of a term of 8 years from the date of this Agreement (the "Fixed Term"), and the Trustee shall thereupon dispose of the principal of the trust estate, as it is then constituted, pursuant to the provisions of Article Second.

Paragraph B of Article First provides that during the term of the Trusts under this Article First, the Trustees may sell the personal residence then held in the Trusts at the request of the Grantors and use the proceeds of any such sale to acquire a successor personal residence satisfactory to the Grantors, which shall thereafter be held hereunder for the benefit of the Grantors as provided above, subject, however, to the provisions of paragraph D of this Article First.

Paragraph C of Article First provides that if cash is held by the Trustee pursuant

to Article Fourth (D)(1)(a) hereof, the Trustee shall determine, at the end of each calendar quarter, whether the amounts held by the trust for the payment of expenses are in excess of the amounts permitted by Article Fourth (D)(1)(a) and § 25.2702-5(c)(5)(ii)(A)(1) of the Special Valuation Rules and shall distribute immediately to the Grantor any amounts in excess of the amounts so permitted.

Paragraph D of Article First states that notwithstanding the foregoing provisions, if during the Fixed Term, the Trusts held under this Article First ceases to be a Qualified Personal Residence Trust (QPRT), with respect to some or all of the trust assets, then within thirty (30) days after the date on which the Trusts have ceased to be a QPRT with respect to such assets, the Trustee shall convert and hold such assets in a separate trust pursuant to the terms and conditions of Article Third.

Paragraph A of Article Second provides that if the Grantor dies prior to the expiration of the Fixed Term, then upon the Grantor's death the trust estate, as it is then constituted, shall be transferred, conveyed and paid over to the Grantor's estate to be disposed of by the Grantor's Executors or personal representatives as provided in Grantor's Last Will and Testament.

Paragraph B(1) and (2) of Article Second provides that if the Grantor survives the Fixed Term, the trust estate, as it is then constituted, shall be disposed of as follows: (1) Any amounts of cash held by the Trustee pursuant to Article Fourth(D)(1)(a) in excess of the amounts used to pay trust expenses due and payable on the date of termination of the Fixed Term (including expenses related to termination) shall be distributed to the Grantor within thirty (30) days of the expiration of the Fixed Term. (2) The principal of the trust estate, as it is then constituted, shall continue to be held by the Trustee, who shall pay over or apply the net income and the principal, to such extent, in such amounts and proportions, at such time or times as the Trustee, in the exercise of absolute discretion, shall determine, to or for the benefit of such one or more of the Grantor's descendants who are living at the time of payment in such shares as the Trustee may determine in the exercise of absolute discretion. Any net income not so paid over or applied shall be accumulated and added to the principal of the trust estate at least annually and thereafter, held, administered and disposed of as a part thereof.

Paragraph B(3) of Article Second provides that the Trustee is authorized, in the exercise of sole and absolute discretion, to hold and maintain any residential real property, or any interest therein, at any time forming a part of the Trust estate under this paragraph B of Article Second, and to permit the Grantor's descendants living from time to time, to occupy and to use any such residence, either rent free or upon such terms and conditions as the Trustee shall, in the exercise of sole and absolute discretion, deem appropriate.

Paragraph B(4) of Article Second provides that upon the death of the survivor of the Grantor and the Grantor's spouse, this Trust shall terminate and the principal of the

Trust estate, as it is then constituted, shall be transferred, conveyed and paid over to such of the Grantor's descendants who are then living, per stirpes, or, if none, to the descendants of the Grantor's parents who are then living, per stirpes, such beneficiaries to take any interest in real property received hereunder as tenants in common.

Paragraph A of Article Third provides, in part, that all property directed to be held in a separate Trust pursuant to the terms and conditions of this Article Third shall be held by the Trustee, who shall pay to the Grantor in each taxable year of the trust held under this Article Third the amount (the "annuity amount") determined under paragraph B of this Article Third. Paragraph A of Article Third further provides that the Trustee shall not pay over or apply any portion of the income or principal of the Trust estate to or for the benefit of any person other than the Grantor; provided, however, that this sentence shall not be construed to prevent the payment by the Trustee of expenses properly chargeable to the Trust estate.

Paragraph B of Article Third provides that the annuity amount shall be the amount determined under § 25.2702-5(c)(8)(ii)(C) as follows: 1) If, on the conversion date, the assets of the Trusts held under this Article Third do not include a residence used or held for use as a personal residence, the annuity amount shall be an amount determined by dividing the lesser of: a) the value of all interests retained by the Grantors (as of the date of the original transfer or transfers to the Trusts held under Article First); or b) the value of all the trust assets (as of the conversion date), by an annuity factor determined i) for the original term of the Trusts held under Article First and ii) using the rate used in valuing the retained interest at the time of the original transfer to the Trusts held under Article First. 2) If, on the conversion date, the assets of the Trusts include a residence used or held for use as a personal residence, the annuity amount shall be the amount determined under subparagraph 1 of this paragraph B multiplied by a fraction, a) the numerator of which is the excess of i) the fair market value of all the trust assets on the conversion date over ii) the fair market value of the assets as to which the Trust continues as a QPRT and b) the denominator of which is the fair market value of all the Trust assets on the conversion date. Paragraph C of Article Third provides that for purposes of determining the annuity amount, the value of the trust assets will be their fair market value for Federal gift tax purposes.

Paragraph A of Article Fourth provides that it is the Grantors' intention by this Agreement to create a QPRT within the meaning of § 2702(a) of the Code and § 25.2702-5(c) of the Income Tax Regulations. Accordingly, the provisions of this Agreement shall be construed and the trusts created hereunder shall be administered solely in accordance with said intention and in a manner consistent with that section of the Code and those treasury regulations and with any successor section or regulations and any revenue rulings, revenue procedures, notices or other administrative pronouncements that may be issued thereunder by the Internal Revenue Service. Should the provisions of the Agreement be inconsistent or in conflict with such section,

regulations, any successor section or regulations, or any revenue rulings, notices or other administrative pronouncements, in effect or issued from time to time, then such section, regulations, successor section or regulations, or rulings, notices or administrative pronouncements shall be deemed to override and supercede the provisions which are set forth herein.

Paragraph B of Article Fourth provides that except as otherwise provided in paragraph D of Article Fourth, during the Fixed Term created under Article FIRST, the Trustee is prohibited from holding any asset in that trust other than one residence (or an undivided fractional interest in one residence) to be used or held for use (withing the meaning of § 25.2702-5(c)(7)(i)) as a personal residence by the Grantor.

Paragraph E of Article Fourth provides that the interest of the Grantor in any trust created hereunder shall not be commuted.

Paragraph F of Article Fourth provides that the Trustee is prohibited from selling or transferring any personal residence referred to in Article FIRST, directly or indirectly, to the Grantor, the Grantor's Spouse, or an entity controlled by the Grantor or the Grantor's Spouse during the Fixed Term created under Article FIRST, or during any time after the Fixed Term during which time the Trust is treated as owned by the Grantor or the Grantor's Spouse within the meaning of §§ 671 to 677 of the Code, if doing so would cause the Trust to cease to qualify as a QPRT under § 25.2702-5 of the Income Tax Regulations.

You have requested the following rulings:

1. The Ranch that Taxpayer and Spouse propose to transfer to the Trusts satisfies the requirements of § 2702(a)(3)(A)(ii) and § 25.2702-5(c)(2).
2. The trust agreements satisfy the requirements of a QPRT under § 25.2702-5(c).

Section 2702(a)(1) provides that 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 the transfer), the value of any interest in the trust retained by the transferor or any applicable family member (as defined in § 2701(e)(2)) will be determined as provided in § 2702(a)(2).

Section 2702(a)(2) provides that the value of any retained interest which is not a qualified interest will be treated as being zero. The value of any retained interest which is a qualified interest will be determined under § 7520.

Section 2702(a)(3)(A)(ii) provides an exception to § 2702(a)(2) 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 term interests in such trust.

Section 25.2702-5(a)(1) of the Gift Tax Regulations provides, in part, that § 2702 does not apply to a transfer in trust meeting the requirements of this section. A trust meeting the requirements of a QPRT (as defined in § 25.2702-5(c)) is treated as a personal residence trust.

Section 25.2702-5(c)(1) provides that a QPRT is a trust meeting all the requirements of § 25.2702-5(c). These requirements must be met by provisions in the governing instrument, and these governing instrument provisions must by their terms continue in effect during the existence of any term interest in the trust.

Section 25.2702-5(c)(2)(i) provides that for the purposes of § 25.2702-5(c), a personal residence of a term holder is either--(A) The principal residence of the term holder (within the meaning of § 1034); (B) One other residence of the term holder (within the meaning of § 280A(d)(1) but without regard to § 280A(d)(2)); or (C) An undivided fractional interest in either.

Section 25.2702-5(c)(2)(ii) provides that a personal residence may include appurtenant structures used by the term holder for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location). The fact that a residence is subject to a mortgage does not affect its status as a personal residence. The term personal residence does not include any personal property (e.g., household furnishings).

Section 25.2702-5(c)(3) provides that the governing instrument must require that any income of the trust be distributed to the term holder not less frequently than annually.

Section 25.2702-5(c)(4) provides that the governing instrument must prohibit distributions of corpus to any beneficiary other than the transferor prior to the expiration of the retained term interest.

Section 25.2702-5(c)(5) provides that, in general, except as otherwise provided in paragraphs (c)(5)(ii) and (c)(8) of this section, the governing instrument of a QPRT must prohibit the trust from holding, for the entire term of the trust, any asset other than one residence to be used or held for use (within the meaning of paragraph (c)(7)(i) of this section) as a personal residence of the term holder (the "residence"). Under § 25.2702-5(c)(5)(ii), the trust may hold certain assets listed in that section in addition to the personal residence.

Section 25.2702-5(c)(6) provides that the governing instrument must prohibit commutation (prepayment) of the term holder's interest.

Section 25.2702-5(c)(7)(i) provides that the governing instrument must provide that a trust ceases to be a QPRT if the residence ceases to be used or held for use as a personal residence of the term holder. A residence is held for use as a personal residence of the term holder so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence.

Section 25.2702-5(c)(8) provides that, (i) The governing instrument must provide that, within 30 days after the date on which the trust has ceased to be a QPRT with respect to certain assets, either, (A) The assets be distributed outright to the term holder; (B) The assets be converted to and held for the balance of the term holder's term in a separate share of the trust meeting the requirements of a qualified annuity interest; or (C) In the trustee's sole discretion, the trustee may elect to comply with either paragraph (C)(8)(i)(A) or (B) of this section pursuant to their terms. (ii)(A) For assets subject to this paragraph (c)(8) to be converted to and held as a qualified annuity interest, the governing instrument must contain all the provisions required by § 25.2702-3 with respect to a qualified annuity interest.

Section 25.2702-5(c)(9) provides that the governing instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse during the retained term interest of the trust or at any time after the retained term interest that the trust is a grantor trust.

Based on the information submitted and the representations made, we conclude that the Ranch, as described above, constitutes a personal residence of Taxpayer and Spouse within the meaning of § 2702(a)(3)(A)(ii) and § 25.2702-5(c)(2). Because the Trusts contain all the provisions required under § 25.2702-5(c) and § 25.2702-3, we conclude that each trust constitutes a qualified personal residence trust within the meaning of section 25.2702-5(c).

Except as ruled above, we express or imply no opinion concerning the federal tax consequences of this transaction under the cited provisions of the Code or any other provision of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

Christine E. Ellison
Branch Chief, Branch 7
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)