

# Internal Revenue Service

Department of the Treasury  
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## LEGEND:

Grantor =  
Spouse =  
Residence =

Trust =  
a =  
b =  
c =  
d =  
e =  
f =

Dear :

This is in response to your August 15, 2007 letter and other correspondence requesting a ruling that Residence meets the requirements of a personal residence under § 25.2702-5(c)(2) of the Gift Tax Regulations.

The facts submitted are as follows:

Grantor and Spouse, Grantor's spouse, own Residence as tenants-in-common. Residence is the principal residence of Grantor and Spouse.

Residence consists of approximately a acres of land. Grantor and Spouse live in a single-family dwelling of approximately b square feet. The single-family dwelling is used exclusively for residential purposes. In addition to the single-family dwelling, the following structures are located on Residence: (1) a general purpose barn of approximately c square feet; (2) two closed sheds; and (3) one open shed.

Residence is in the d zone district. The d zone district is intended to preserve agricultural and wildlife lands while permitting single family residential development at a density of one dwelling unit per e acres.

It is represented that most of the lots in the vicinity of Residence contain at least e acres of land. Many of the lots in the vicinity of Residence contain a acres or more.

Grantor proposes to execute Trust, a trust intended to qualify as a Qualified Personal Residence Trust (QPRT) as described in § 25.2702-5(c). Grantor will transfer his entire interest in Residence to Trust. Article V, Section 1, of Trust provides that the QPRT term shall end on the earlier of the date f years after the creation of Trust, or the date of Grantor's death.

Article IV of Trust provides that the trustee shall hold and maintain Residence as Grantor's personal residence during the period beginning on the date of creation of Trust and continuing through the date of termination of Trust. During the QPRT term, Grantor shall have the exclusive rent-free use, possession, and enjoyment of Residence.

Article V, Section 2(a), provides that if the QPRT ends on the date f years after the creation of Trust, the trustee shall hold all of the property of Trust under the provisions of Section 3.

Article V, Section 2(b), provides that if the QPRT ends on the Grantor's date of death, the trustee shall distribute all Trust property to Grantor's estate.

Article V, Section 3(a), provides, in relevant part, that until the earlier of Grantor's death or written notification to the trustee of Grantor's decision not to rent or continue renting Residence, the trustee shall retain Residence and the Grantor shall have the option of renting Residence from the trust. The trustee's lease of Residence to Grantor shall be for a one year period, annually renewable by Grantor, for a market rent determined by an independent professional appraisal. The lease shall require that Grantor pays all maintenance and upkeep of Residence and all real property taxes on Residence.

Article V, Section 3(b), provides, in relevant part, that until the earlier of Grantor's death or written notification to the trustee of Grantor's decision not to rent or continue renting Residence, the trustee may distribute to or for the benefit of Grantor's children such amounts of the net income and principal as the trustee considers reasonable and necessary to provide for their education, support in their accustomed manner of living, and their medical, dental, hospital, and nursing expenses and expenses of invalidism.

Article V, Section 3(c), provides, in relevant part, that upon the earlier of Grantor's death or written notification to the trustee of Grantor's decision not to rent or

continue renting Residence, the trustee shall distribute the remaining Trust property in equal shares, with one equal share distributed to each of Grantor's then-living children, and one equal share being distributed to the estate of each of Grantor's children who is not then living and who is survived by one or more then-living descendants, to be held and administered as part of that estate.

Article VII, Section 6, provides, in relevant part, that any net income of the QPRT during the QPRT term shall be distributed to Grantor, not less frequently than annually.

Grantor represents that the value of the interest retained by Grantor exceeds 5 percent of the value of the property transferred to Trust.

You have requested the following rulings:

1. Residence qualifies as a personal residence under § 25.2702-5(c)(2).
2. Trust, while operated as a QPRT or a GRAT, will be treated as a grantor trust under § 671.
3. Grantor's interest in Residence will not be included in his gross estate under §§ 2033, 2035, 2036, 2038, or 2041 if he survives the term of the trust and continues to live on Residence pursuant to a lease agreement requiring the payment of fair market rent.

## LAW AND ANALYSIS

### Ruling 1

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

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

Section 2702(a)(3)(A)(ii) provides that § 2702(a) shall not apply to any 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) provides, in part, that § 2702 does not apply to a transfer in trust meeting the requirements of that section. A transfer in trust meets the

requirements of the section only if the trust is a personal residence trust as defined in § 25.2702-5(b). A trust meeting the requirements of a "qualified personal residence trust" as defined in § 25.2702-5(c) is treated as a personal residence trust.

Section 25.2702-5(c)(1) provides that for purposes of § 2702(a)(3)(A)(ii), a qualified personal residence trust is a trust meeting all the requirements of the section. 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)(5) provides that, in general, except as otherwise provided in §§ 25.2702-5(c)(5)(ii) and (c)(8), the governing instrument of a qualified personal residence trust 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 § 25.2702-5(c)(7)(i)) as a personal residence of the term holder. 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)(2)(i) provides that a personal residence of a term holder is either the principal residence of the term holder (within the meaning of § 1034), one other residence of the term holder (within the meaning of § 280A(d)(1) but without regard to § 280A(d)(2)), or 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).

Section 25.2702-5(c)(2)(iii) provides that a residence is a personal residence only if its primary use is as a residence of the term holder when occupied by the term holder. A residence is not used primarily as a residence if it is used to provide transient lodging and substantial services in connection with the provision of lodging (e.g., a hotel or a bed and breakfast). A residence is not a personal residence if, during any period not occupied by the term holder, its primary use is other than as a residence.

In this case, based on the facts submitted and the representations made, the size of Residence is comparable to that of other properties in the vicinity of Residence used for residential purposes. Accordingly, we conclude that Residence qualifies as a personal residence under § 25.2702-5(c)(2).

Section 4.01(52) of Rev. Proc. 2008-3, 2008-1 I.R.B. 110, 118, provides that rulings will not ordinarily be issued on whether a trust with one term holder satisfies the requirements of § 2702(a)(3)(A) and § 25.2702-5(c) to be a QPRT. Rev. Proc. 2003-42, 2003-1 C.B. 993, provides sample trust provisions for QPRTs. By following the sample

trust provisions, taxpayers can be assured that the Service will recognize a trust as meeting all of the requirements of § 2702(a)(3)(A) and § 25.2702-5(c) if the trust (1) operates consistently with the terms of the trust instrument and (2) is a valid trust under local law.

### Ruling 2

Section 671 provides that where it is specified in subpart E of part I of subchapter J of chapter 1 that the grantor or another person shall be treated as the owner of any portion of a trust, there shall be included in computing the taxable income and credits of that person those items of income, deduction, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account in computing taxable income or credits against the tax of an individual.

Sections 673 through 678 specify the circumstances under which the grantor or a person other than the grantor is treated as the owner of a portion of a trust.

Section 673 provides that the grantor is treated as the owner of any portion of a trust in which the grantor has a reversionary interest in either the corpus or the income, if, as of the inception of that portion of the trust, the value of such interest exceeds five percent of the value of such portion. Section 673(c) provides that for purposes of section 673(a), the value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion in favor of the grantor.

Section 677(a) provides that the grantor is treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed or accumulated for future distribution to the grantor.

Section 1.671-3(a) of the Income Tax Regulations provides that when a grantor or other person is treated under subpart E (section 671 and following) as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. For example, if a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), the grantor takes into account in computing the grantor's income tax liability all items of income, deduction, and credit (including capital gains and losses) to which the grantor would have been entitled had the trust not been in existence during the period the grantor is treated as the owner.

Section 1.671-3(b)(3) provides that if a grantor or another person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus. Both ordinary income and other income allocable to corpus are included by reason of an interest in or a power over both ordinary income and corpus, or an interest in or power over corpus alone that does not

come within the provisions of § 1.671-3(b)(2). For example, if a grantor is treated under § 673 as the owner of a portion of a trust by reason of a reversionary interest in corpus, both ordinary income and other income allocable to corpus are included in the portion.

Under the terms of Trust, Grantor is entitled to the income of Trust. Thus, Grantor will be considered the owner of the income of Trust under § 677. Additionally, if the Grantor dies during the f year term, Trust assets will revert to Grantor's estate. Therefore, Grantor retains a reversionary interest in the corpus of Trust.

If the present value of Grantor's reversionary interest has a value in excess of 5 percent of the trust fund upon creation (determined under § 7520), Grantor will be treated as the owner of both the income and the corpus of Trust for federal income taxes under § 673 during the f year term. Accordingly, Grantor will include in his federal income tax return all items of income, deduction, and credit against tax with respect to Trust under § 671. This includes deductions for mortgage interest, taxes, and other deductions applicable to the Residence during the Trust term without regard to whether Taxpayer or Trust makes the actual payments.

### Ruling 3

Section 2033 provides that the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2035(a) provides that (1) if the decedent transferred an interest in or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and (2) the value of such property (or interest therein) would have been included in the decedent's gross estate under § 2036, 2037, 2038, or 2042 if the transferred interest or relinquished power had been retained by the decedent on the date of death, then the value of the gross estate includes the value of any property (or interest therein) that would have been so included.

Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, in which the decedent has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death, (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income from the property.

Section 2038(a)(1) provides that the value of the gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for adequate and full consideration

in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death.

Section 2041(a)(2) provides that the value of the gross estate shall include the value of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by disposition which is of such a nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§ 2035 to 2038.

Section 2041(b)(1) provides that for purposes of § 2041(a), the term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, except if such power is limited by an ascertainable standard relating to the health, education, support or maintenance of the decedent.

Section 2041(b)(2) provides that the lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power, shall be considered a release of such power, but only to the extent such lapse exceeds the greater of \$5,000 or 5 percent of the aggregate value of the assets subject to the power.

In Estate of McNichol v. Commissioner, 265 F.2d 667 (3d Cir. 1959), cert. denied, 361 U.S. 829 (1960), the court held that "enjoyment" as used in the predecessor statute to § 2036 is not a term of art, but is synonymous with substantial present economic benefit. In McNichol, the decedent purportedly conveyed income-producing real estate to his children 9 years before his death. Pursuant to an oral understanding with his children, the decedent continued to receive the rents from the properties until his death. The court held that the properties were includible in his gross estate under the predecessor to § 2036.

In Rev. Rul. 70-155, 1970-1 C.B. 189, a parent continued to live rent-free in a residence that he had transferred to his son and daughter-in-law in accordance with an understanding by all parties that the father would retain use of the residence. The ruling states that the donor's continued occupancy of a transferred residence rent free until death is as much an economic benefit as if the donor had rented the property and obtained the income therefrom. Accordingly, the donor's continued rent-free occupancy until death pursuant to the understanding resulted in inclusion of the property under § 2036.

In Estate of Barlow v. Commissioner, 55 T.C. 666 (1971), acq., 1972-2 C.B. 1,

the decedent and his spouse transferred a farm to their children and contemporaneously leased the property from the children at fair market value rent. The decedent and his spouse were legally obligated as tenants to pay this rent and the children were entitled, as landlords, to terminate the lease and remove the decedent and his spouse from the property if the rent was not paid. After two years, the family agreed that, because of certain medical problems, the decedent need not continue to pay the rent. The decedent occupied the property rent-free until his death four years later. Because the decedent was obligated to pay fair market value rent from the date of the transfer and there was no express or implied agreement at the date of the transfer that the decedent could continue to occupy the premises whether or not rent was paid, the court held that the property was not includible in the decedent's gross estate under § 2036. Compare, Estate of Maxwell v. Commissioner, 3 F.3d 591, 594 (1993), *aff'g* 98 T.C. 594 (1992), where the Circuit Court agreed with the Tax Court that such an implied agreement did exist at the date of transfer and therefore the residence was includible under § 2036.

In the present case, Grantor proposes to transfer his entire interest in Residence to Trust for a f year term. If Grantor survives the f year term, Residence will remain in Trust. If pursuant to a lease agreement Grantor pays fair market value rental, and assuming there is no express or implied understanding that Grantor may retain use or possession of Residence whether or not rent is paid, Grantor's continued use or possession of Residence will not result in the inclusion of Residence in Grantor's gross estate under §§ 2033, 2035, 2036, 2038, or 2041.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, we express no opinion as to whether any valuation discount used in determining the fair market value, for gift tax purposes, of Grantor's interest in Residence is appropriate.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.



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

Sincerely,

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George Masnik  
Chief, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure:

Copy of letter for section 6110 purposes

cc: