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Department of the Treasury

**P.O. Box 7604
Ben Franklin Station
Washington, DC 20044**

Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:4 - PLR-115426-98

Date: November 30, 1998

Re:

LEGEND: Trustor 1 -
 Trustor 2 -
 Trust 1 -

 Trust 2 -

 Residence -

 x -
 y -
 z -

This is in response to your letter dated July 17, 1998, in which you request rulings on behalf of Trustors 1 and 2 concerning the application of § 2702 of the Internal Revenue Code to Trusts 1 and 2. This letter responds to your request.

The facts and representations submitted are summarized as follows: Trustors, husband and wife, each own a one-half community property interest in Residence. The Residence consists of approximately x acres of land. Improvements on the property include a main house, a carport, a pier and boat dock, and a small guesthouse. A footpath along the coastline connects the main house and the guesthouse, and it also provides both houses with access to the boat dock.

Trustors use Residence approximately half of the year as a vacation home for themselves, their family, and their guests. The main house consisting of approximately y square feet is used exclusively by Trustors and their family. The guesthouse is z square feet and is used by Trustors for their guests and as a

housekeeper's cabin. All other improvements, as well as any unimproved land, are used by Trustors, their family, and their guests for various recreational or residential purposes.

Trustors propose to transfer their respective one-half community interest in Residence to two separate trusts, Trust 1 and Trust 2 (the Trusts), the terms of which are intended to satisfy the requirements of § 25.2702-5(c) of the Gift Tax Regulations. Trustors will serve as trustees of their respective Trusts. The Trusts, pursuant to Article 10, will be irrevocable. The terms of Trust 1 and Trust 2 are identical except for the beneficiaries.

Article 2, Paragraph 2.2 of the Trusts provide that the Trusts will terminate upon the "Termination Date," which is the earlier of: (i) the date that is fifteen years after the date of the Trust Agreement, and (2) the date of the Trustor's death. Upon termination, the Trust corpus is to be held in further trust as provided in Article 6.

Article 2, Paragraph 2.3 of the Trusts provide that for purposes of the Trusts, the term "residence" shall mean the interest in the personal residence originally purchased by or transferred to the Trusts and any replacement or successor personal residence purchased by the trustees pursuant to the provisions of the Trust Agreements.

Article 2, Paragraph 2.4 provides that Trustor's interest in the Trust can not be commuted.

Under Article 3, Paragraph 3.1, the Trustor shall have the right, free of any charge, to the use, occupancy, and possession of the interest in the Residence held by the Trust during the term of the Trust.

Article 3, Paragraph 3.2 directs the trustee to distribute the entire net income of the Trust to or for the benefit of Trustor at regular, convenient intervals, but at least annually.

Article 3, Paragraph 3.9 states that the Trustor is the sole beneficiary of the Trust, and that no distributions of income or principal are to be made to or for the benefit of any person other than the Trustor prior to the expiration of the retained term interest.

Article 3, Paragraph 3.3 provides that in addition to holding the interest in Residence, the Trust may hold cash for the following purposes, provided such cash is held in a separate account and in an amount which, when added to the cash already in the account for such purposes, does not exceed the amount required:

(A) for payment of Trust expenses (including mortgage payments) already incurred or reasonably expected to be paid by the Trust within six months from the date the addition is made;

(B) for improvements to the Residence to be paid for by the Trust within six months from the date the addition is made;

(C) for purchase by the Trust of the initial Residence, within three months of the date the Trust is created, provided that no addition may be made for this purpose, and the Trust may not hold any such addition, unless the trustee has previously entered into a contract to purchase that Residence; and

(D) for purchase by the Trust of a personal residence to replace the Residence within three months of the date the addition is made, provided that no addition may be made for this purpose, and the Trust may not hold any such addition, unless the trustee has previously entered into a contract to purchase that residence.

Article 3, Paragraph 3.4 states that the trustee shall distribute, not less frequently than quarter-annually, any amounts held by the Trust for the payment of expenses that are in excess of the amounts permitted by Article 3, Paragraph 3.3 and § 25.2702-5(c)(5)(ii)(A)(1).

Article 3, Paragraph 3.6 states that improvements to the Residence may be added to and held by the trustee as part of the Trust, provided that the Residence, as improved, meets the requirements of a personal residence as set forth in § 25.2702-5(c).

Article 3, Paragraph 3.7 states that the trustee may sell the Residence and hold the proceeds from the sale in a separate account for a period not to exceed two years from the date of sale. The trustee may use such proceeds to purchase another residence, to be used as a successor personal residence of the Trustor, which successor residence (if any) shall thereafter be held under the terms of the Trust for the benefit of the Trustor as provided in the Trust Agreement.

Under Article 3, Paragraph 3.8, the trustee may hold one or more policies of insurance on the Residence. The trustee may hold, in a separate account, proceeds of insurance paid to the Trust as a result of damage to or destruction of the Residence. For purposes of this paragraph, amounts received as a result of the involuntary conversion of the Residence (within the meaning of § 1033) shall be treated as proceeds of insurance. The

trustee may expend all such amounts for the purchase, construction, reconstruction, and/or repair of a personal residence for the Trustor. Any such amounts shall not be subject to the provisions of Article 3, Paragraphs 3.3 and 3.4.

Article 4, Paragraph 4.1 states that if, during the Trust term, the Trust ceases to be a qualified personal residence trust with respect to some or all of the trust assets, then within thirty days after the date on which the Trust ceases to be a qualified personal residence trust with respect to such assets, the trustee shall convert such assets to a qualified annuity interest and hold such assets in a separate trust pursuant to the terms and conditions of Article 5.

Article 4, Paragraph 4.2 describes the circumstances in which the Trust shall cease to be a qualified personal residence trust. If the Residence held in the Trust ceases to be used or held for use as a personal residence of the Trustor within the meaning of § 25.2702-5(c)(7)(i), then the Trust will cease to be a qualified personal residence trust. If the Residence is sold, then the Trust will cease to be a qualified personal residence trust with respect to all proceeds from the sale held by the trustee on the "Cessation Date," which is the earliest to occur of the following: (A) the date that is two years after the date of such sale; (B) the date on which a new Residence is acquired by the Trust; or (C) the Termination Date. If damage or destruction renders the Residence unusable as a residence, then Trust will cease to be a qualified personal residence trust on the earlier to occur of the following: (A) the date that is two years after the date of such damage or destruction, or (B) the Termination Date, unless, prior to such earlier date, (1) replacement of or repairs to the Residence are completed, or (2) a new Residence is acquired by the Trust. If proceeds of insurance (including amounts received because of any involuntary conversion referred to in Article 3, Paragraph 3.8) are received and held by the trustee as a result of the damage to or destruction of the Residence, then the Trust will cease to be a qualified personal residence trust with respect to all such proceeds held by the trustee on the earliest to occur of the following: (A) the date that is two years after the date of the damage, destruction or involuntary conversion of the Residence; (B) the date on which replacement of or repairs to the Residence are completed; (C) the date on which a new Residence is acquired by Trust; or (D) the Termination Date.

Article 4, Paragraph 4.3 states that notwithstanding the foregoing provisions of Article 4, cessation of Trust as a qualified personal residence trust shall be deemed to occur only if it is deemed to occur under § 25.2702-5(c), and only such portion of the Trust assets as is required by § 25.2702-5(c)(8)(i) to be converted shall be so converted.

Article 5 states that any property that is converted to a qualified annuity interest pursuant to the provisions of Article 4 shall be distributed to the person(s) and/or institution hereinafter named or appointed as hereinafter provided to act as Trustee of the Qualified Annuity Interest Trust, and shall be administered by such person(s) and/or institution as hereinafter provided in a single, separate trust for the primary benefit of Trustor for the balance of the Trust term.

Article 5, Paragraph 5.1 states that the right of the Trustor to receive the annuity amount shall begin on the date of sale of the Residence, the date of damage to or destruction of the Residence, or the date on which the Residence ceases to be used or held for use as a personal residence, as the case may be.

Article 5, Paragraph 5.2 states that the trustee may defer payment of any annuity amount otherwise payable after the Cessation Date until the date that is thirty days after the assets are converted to a qualified annuity interest pursuant to Article 4; provided, however, that any deferred payment shall bear compound interest from the Cessation Date at a rate equal to the deferred annuity payments by the amount of income actually distributed by the trustee to the Trustor during the deferral period.

Article 5, Paragraph 5.3 describes how the annuity amount is determined. If, on the conversion date, the assets of the Trust do not include a residence used or held for use as a personal residence by the Trustor, the annuity shall be an amount determined by dividing the lessor of: (A) the value of all interests retained by the Trustor (as of the date of the original transfer or transfers), or (B) the value of all the Trust assets (as of the conversion date) by an annuity factor determined for the original term of Trustor's interest, at the rate used in valuing the retained interest at the time of the original transfer to the qualified personal residence trust. If, on the conversion date, the assets of Trust include a residence used or held for use as a personal residence by the Trustor, the annuity shall be the amount determined as if the assets of Trust do not include a residence, multiplied by a fraction, the numerator of which shall be the excess of the fair market value of the Trust assets on the conversion date over the fair market value of the assets as to which the Trust continues as a qualified personal residence trust, and the denominator of which shall be the fair market value of the Trust assets on the conversion date.

Article 5, Paragraph 5.4 provides that the annuity amount shall be paid to or for the benefit of the Trustor for each taxable year of the Trust commencing on the cessation date and until the Termination Date of the Trust under Article 2, Paragraph 2.2. Each such payment shall be made not later than

sixty-five days after the close of the taxable year to which it applies. Payment shall be made from income, and to the extent that income is not sufficient, from principal. Any income of Trust for a taxable year in excess of the annuity amount shall be added to principal.

Article 9, Paragraph 9.2.1 prohibits the trustee from selling or transferring the Residence, directly or indirectly, to the Trustor or the Trustor's spouse, or an entity controlled by the Trustor or the Trustor's spouse, or a grantor trust of the Trustor or the Trustor's spouse within the meaning of § 25.2702-5(c)(9), but subject in all events to the exceptions contained in that section.

You have requested the following rulings:

(1) The interest in Residence that each of the Taxpayers proposes to transfer to Trust 1 and Trust 2 will meet the requirements of a personal residence under § 2702(a)(3)(A) of the Code and § 25.2702-5(c)(2) of the Gift Tax Regulations.

(2) Trust 1 and Trust 2 meet the requirements of a qualified personal residence trust 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 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)) is 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 an exception to § 2702(a)(2) if such transfer involves the transfer of an interest in trust and the property transferred consists of a residence to be used as a personal residence by persons holding term interests in such trust.

Section 25.2702-5(a) of the Gift Tax Regulations provides, in part, that a transfer in trust meeting the requirements of a "qualified personal residence trust" as defined in § 25.2702-5(c) will be treated as satisfying the requirements of § 2702(a)(3)(A)(ii).

Section 25.2702-5(c)(1) provides that, in order to qualify as a qualified personal residence trust, the provisions of the

governing instrument must satisfy all the requirements of a qualified personal residence trust throughout the term of the trust.

Section 25.2702-5(c)(2)(i) provides that a personal residence of a term holder is either the personal 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). 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, in general, the governing instrument of a qualified personal residence trust 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)(i) provides that, in general, 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 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)(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 qualified personal residence trust 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 the governing instrument must provide that, within 30 days after the date on which the trust ceases to be a qualified personal residence trust with respect to certain assets, the assets must be either distributed outright to the term holder, or 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. If the assets are 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 generally 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 during which the trust is a grantor trust (under § 671, et. seq.).

Based on the information submitted and the representations made, we conclude that: (1) Residence, as described above, constitutes a personal residence under § 2702(a)(3)(A)(ii) and § 25.2702-5(c)(2); and (2) Trust 1 and Trust 2 meet the requirements of a qualified personal residence trust under § 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(j)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

Assistant Chief Counsel
(Passthroughs and Special
Industries)

By _____
George Masnik

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Chief, Branch 4

Enclosure

Copy for 6110 purposes