

**Internal Revenue Service**

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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-105196-98

Date: January 22, 1999

LEGEND:

Taxpayer =

Property =

Trust =

State =

X =

Dear :

This is in response to your letter dated January 4, 1998, and prior correspondence in which you requested rulings concerning a qualified personal residence trust. Specifically, you have requested the following rulings:

1. During the trust term, Taxpayer will be treated as the owner of the income and corpus of Trust for federal income tax purposes and therefore will be entitled to deductions for mortgage interest, taxes, and other deductions applicable to Property during the trust term without regard to whether Taxpayer makes the payments directly or Trust makes the payments.

2. Property, including improvements, is not in excess of that which is reasonably appropriate for residential purposes within the meaning of § 25.2702-5(c)(2)(ii) of the Gift Tax Regulations.

3. Leasing the caretaker residence and occupancy during the trust term by lessee of the caretaker residence will not cause Property to fail to qualify as a personal residence under § 2702(a)(3)(A)(ii) of the Internal Revenue Code or § 25.2702-5(c)(2)(iii).

4. Trust's provisions satisfy the requirements of § 25.2702-5(c) and Taxpayer's transfer qualifies as a transfer to a qualified

personal residence trust (QPRT).

5. If any of the assets of Trust are converted to a qualified annuity interest, Taxpayer's retained interest will be a qualified interest under § 2702(b) and the value of that interest will be determined under § 7520.

6. A rental agreement to rent the residence after the expiration of the trust term between Taxpayer and her children will not disqualify Trust from being a Qualified Personal Residence Trust.

7. The rental agreement will not result in the inclusion of Property in Taxpayer's gross estate under § 2036.

8. Taxpayer's transfer of the contingent remainder interest in trust is a completed gift for gift tax purposes, the value of which is equal to the fair market value of Property transferred to Trust minus (a) the present value of Taxpayer's retained income interest in Property determined under § 7520 and (b) Taxpayer's retained contingent reversion in Property determined under § 7520.

The facts and representations submitted are summarized as follows. Taxpayer owns fee simple title to Property located in State. Property consists of one parcel on the local tax map and is assessed as one parcel for property tax purposes. Property is improved by a large single family dwelling, a swimming pool, a caretaker residence, a garage, a small barn or stable, and a fenced pasture. Property is similar in size to nearby properties used for residential purposes. Taxpayer uses the main house as a personal residence and has done so for over X years. The caretaker residence is leased to an unrelated third party, at fair market value, on a month to month basis. No services are provided by the taxpayer in connection with the leased premises other than ordinary maintenance. No commercial activity is conducted on Property.

Taxpayer proposes to transfer Property, with improvements, to a Qualified Personal Residence Trust (QPRT). Prior to transferring Property to Trust, Taxpayer will donate a permanent conservation easement on the property to State Environmental Trust. The easement would preclude division and development of the entire parcel.

During the term of Trust, Taxpayer will be entitled to the exclusive occupancy of the residence, and to the income from Property (subject to the rights of the lessee of the caretaker residence). All the income of Trust must be distributed to Taxpayer annually. The trust document prohibits distribution of corpus to anyone other than Taxpayer. In addition, Taxpayer is

prohibited from directly or indirectly reacquiring Property.

Other than Property, Trust will hold no assets other than amounts permitted under § 25.2702-5(c)(5). Trust provides that Taxpayer's interest in Trust may not be commuted.

Trust will terminate at the earliest of 20 years from the date it is established or the date of Taxpayer's death, or the date Trust ceases to be a QPRT.

If Trust terminates at the end of the 20-year term, within 30 days of the expiration of the term, the trustee shall distribute to Taxpayer any cash held by the trustee for purposes authorized by the Treasury Regulations to the extent the cash is not used to pay expenses incurred in terminating Trust. If at the end of the 20-year term, Trust holds a personal residence as described in § 25.2702-5(c)(2) of the Treasury Regulations, the trustee shall transfer title to the personal residence in equal shares to the then living descendants of Taxpayer, per stirpes, as tenants in common.

If Taxpayer dies before the 20-year term expires, within 30 days of Taxpayer's death, the trustee shall distribute to the personal representative of Taxpayer's estate any cash held by the trustee for purposes authorized by the Treasury Regulations. The trustee shall then distribute the remaining Trust assets to or for the benefit of such person or persons, or institution or institutions, including Taxpayer's estate, Taxpayer's creditors, or the creditors of Taxpayer's estate, in such amounts and proportions, and for such estates, and upon such terms, trusts, conditions, and limitations as Taxpayer shall direct and appoint by Taxpayer's Last Will and Testament. The trust agreement provides that if Taxpayer fails to exercise the general power of appointment, or if the exercise thereof is ineffective or invalid, or if Taxpayer should only partially exercise the power of appointment, or if the exercise would be partially ineffective or invalid, then when the trust term ends upon Taxpayer's death, the undistributed and unappointed assets pass to or for the benefit of Taxpayer's descendants, per stirpes.

If Trust ceases to be a QPRT with respect to any assets held in Trust, within 30 days after the cessation date, the trustee must convert those assets to a qualified annuity trust. Trust must function as a qualified annuity trust from the conversion date until the termination of Trust as specified in § 25.2702-5(c)(8)(ii).

In addition to the proposed trust agreement, Taxpayer intends to enter into an agreement with the beneficiaries to rent the residence after the term of the trust expires. Taxpayer will

rent the residence at fair market rental value.

#### ISSUE 1: GRANTOR TRUST RULING

Section 671 provides that if the grantor or another person is treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, 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 the taxable income or credits against the tax of an individual.

Section 1.671-3(a) of the Income Tax Regulations provides that when under subpart E (§ 671 et seq.) a grantor or another person is treated as the owner of any portion of a trust, there are included in computing his personal income 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 the 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 that the grantor is treated as the owner.

Section 1.671-3(b)(3) provides that both ordinary income and other income allocable to corpus are treated as owned by the grantor where the grantor has 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 (i.e., an interest in or power over corpus alone that does not come within the provisions of § 1.671-3(b)(2)), both ordinary income and other income allocable to corpus are included in the portion.

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 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.

In this case, during the trust term, Taxpayer is entitled to the income of Trust. Thus, Taxpayer will be considered the owner of the income of Trust under § 677. If Taxpayer dies prior to the expiration of the trust term, the entire Trust will be included in Taxpayer's gross estate and distributed according to Taxpayer's exercise of a general testamentary power of appointment or, in default of the power, to Taxpayer's descendants, per stirpes. Therefore, Taxpayer retains a reversionary interest in the corpus of the proposed Trust.

If the present value of Taxpayer's reversionary interest on the date of the transfer (determined under § 7520) exceeds five percent of the value of the Trust corpus on the date of the transfer, then Taxpayer, the grantor of the Trust, will be considered the owner of both the income and the corpus of the Trust for federal income tax purposes under § 673 during the 20-year term. Accordingly, Taxpayer will include in her federal income tax return all items of income, deduction, and credit against tax with respect to the Trust under § 671 that Taxpayer would take into account in computing her taxable income or credits against tax were the Trust not in existence. This includes deductions for mortgage interest, taxes, and other deductions applicable to the Residence during the Trust term without regard to whether Taxpayer or the Trust makes the actual payments.

#### ISSUES 2 - 6: QUALIFIED PERSONAL RESIDENCE TRUST RULINGS

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)) 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) 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). Section 25.2702-5(b)(1) provides that a personal residence trust is a trust the governing instrument of which prohibits the trust from holding any asset other than one residence to be used as the personal residence of the term holder. 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)(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). 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)(2)(iii) provides that the principal residence of the term holder will not fail to meet this requirement merely because a portion of the residence is used in an activity meeting the requirements of § 280A(c)(1) or (4), (relating to the deductibility of expenses related to certain uses in a trade or business of the taxpayer), provided that such use is secondary to use of the residence as a residence. 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).

In this case, Property has been used as a residence for more

than X years. Further, Property is comparable in size to other adjoining and nearby residential properties. Based on the facts submitted and the representations made, we conclude that:

-- property, including improvements, is not in excess of that which is reasonably appropriate for residential purposes within the meaning of § 20.2702-5(c)(2)(ii);

-- leasing the caretaker residence and occupancy during the trust term by lessee of the caretaker residence will not cause Property to fail to qualify as a personal residence under § 2702(a)(3)(A)(ii) or 25.2702-5(c)(2)(iii);

-- Trust's provisions satisfy the requirements of § 25.2702-5(c), and Taxpayer's transfer qualifies as a transfer to a QPRT;

-- if any of the assets of Trust are converted to a qualified annuity interest, Taxpayer's retained interest will be a qualified interest under § 2702(b) and the value of that interest will be determined under § 7520.

In addition, we conclude that the rental agreement which will allow Taxpayer to lease the residence after the expiration of Trust (by paying fair market rental value) will not affect the status of the personal residence trust for purposes of § 25.2702.

#### ISSUE 7: ESTATE TAX RULING

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the decedent's interest therein at the time of his death. Section 2033 applies generally to property that is owned outright by the decedent and that may be passed by the decedent's will to the beneficiaries of the probate estate. The section does not apply to property interests that are extinguished at death.

Section 2036 provides that the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has made a transfer by trust or otherwise under which the decedent has retained for his life, or for a period that does not in fact end before his death, (1) the possession or enjoyment of, or the right to income from the property, or (2) the right, either alone or in conjunction with any person to designate the person who shall possess or enjoy the property, or the income from the property.

Rev. Rul. 70-155, 1970-1 C.B. 189, holds that the value of a residence occupied rent free by a donor after he transferred title to his son and daughter-in-law, pursuant to an express or

implied understanding by all the parties, is includible in the donor's gross estate under § 2036(a)(1).

In this case, Taxpayer intends to enter into an agreement with her children to lease the property at fair market rental value after the trust term expires. The fact that Taxpayer rents the property from her children after the trust term expires will not cause the property to be included in her estate under § 2036.

#### ISSUE 8: GIFT TAX RULING

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual.

Section 2511(a) provides that the gift tax imposed by § 2501 applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.2511-2(b) states that, as to any property or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or the benefit of another, the gift is complete.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift is considered the amount of the gift.

Section 25.2512-5(d)(2) provides that, when the donor transfers property in trust or otherwise and retains an interest therein, generally, the value of the gift is the value of the property transferred less the value of the donor's retained interest. However, if the donor transfers property after October 8, 1990, to or for the benefit of a member of the donor's family, the value of the gift is the value of the property transferred less the value of donor's retained interest as determined under § 2702.

Section 2702(a) provides that the value of an interest in trust retained by the transferor shall be determined under § 7520 if the retained interest is a qualified interest as defined in § 2702(b) or shall be zero if the retained interest is not a qualified interest. However, § 2702(a)(3) provides that § 2702(a) does not apply in the case of a transfer in trust which meets the requirements for a qualified personal residence trust.

Therefore, based on the facts submitted and the



representations made, we conclude that if Taxpayer properly executes the proposed Trust, Taxpayer's transfer of the contingent remainder interest in Trust will be a completed gift for gift tax purposes, the value of which will be equal to the fair market value of Property transferred minus (a) the present value of Taxpayer's retained income interest in Property determined under § 7520 and (b) the present value of Taxpayer's retained contingent reversion in Property determined under § 7520.

A copy of this letter should be attached to any gift, estate or generation-skipping transfer tax returns that you may file relating to these matters. No opinion is expressed regarding the tax treatment of these transactions under any other provision of the Code or regulations.

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,

Assistant Chief Counsel  
(Passthroughs and Special  
Industries)

By \_\_\_\_\_  
Katherine A. Mellody  
Assistant to the Chief  
Branch 4