

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Refer Reply To:
CC:DOM:P&SI:4- PLR-110780-98
Date:
May 10, 1999

Re:
Legend

Taxpayer A =

Taxpayer B =

A =

B =

Property =

Foundation =

Trust =

This responds to your letter dated April 21, 1999, and prior correspondence, in which you request rulings on behalf of Taxpayers that the proposed trusts, holding property as described below, will be qualified personal residence trusts (QPRTs) satisfying the requirements of § 25.2702-5(c) of the Gift Tax Regulations, and that the property placed in the trusts will not be includible in each Taxpayer's gross estate under § 2036 of the Internal Revenue Code if the Taxpayers survive the terms of the trusts.

You represent the facts to be as follows: Taxpayer A and Taxpayer B (together "Taxpayers") are married and reside in State. Taxpayers currently own Property as tenants-by-the-entirety. Property is residential property and is equivalent in size to the other residential properties in the area. Taxpayers use Property exclusively as a

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vacation residence between November and April of each year. Property has never been rented and no other individuals have the right to use or occupy Property.

Taxpayers propose to convert ownership in Property from tenants-by-the-entirety to tenants-in-common. Taxpayer A and Taxpayer B propose to establish separate irrevocable trusts and transfer his or her interest in Property to the trust. The terms of the proposed trusts are identical and are intended to satisfy the requirements for QPRTs under § 25.2702-5(c).

Article FOURTH (A) of each trust provides that the trust will terminate at the earliest to occur of (1) the date 20 years from the date of execution of the trust agreement, (2) the date of death of the settlor of the trust agreement, and (3) the date that the trust ceases to own a personal residence as defined in § 25.2702-5(c)(2). Under Article FOURTH (H)(1), if the trust terminates at the expiration of the 20-year term, the assets will be retained in further trust, Trust, under the terms of Article SIXTH.

Under Article FOURTH (H)(2), if the trust terminates as a result of the settlor's death, the trust assets will be distributed to his or her estate.

Article FOURTH (C) of each proposed trust instrument requires the trustees to distribute all of the net income of the trust to the settlor on a quarter-annual or more frequent basis. Article FOURTH (G) prohibits distributions of principal during the term of the QPRT to any person other than the settlor of the trust.

Article FOURTH (E) provides that the trust may hold cash in a separate account for the payment of (1) expenses of the trust (including mortgage) already incurred or reasonably expected to be paid within 6 months from the date of contribution of such cash, (2) improvements to Property to be paid within 6 months from the date of contribution of such cash, provided Property remains a personal residence, and (3) the purchase of a replacement personal residence that the trustees have contracted to purchase and that is to be acquired within 3 months after the cash is contributed to the trust. Any cash in excess of the amount necessary for these purposes must be distributed to the settlor on at least a quarter-annual basis.

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Article FOURTH (I) provides that the interest of the settlor shall not be subject to commutation.

Article FOURTH (D) provides that in the event Property is sold or disposed of by the trustees, the trustees may use the net proceeds to acquire a property that constitutes a personal residence as defined in § 25.2702-5(c)(2). If the trustees receive any insurance proceeds as a result of any damage or destruction to Property that renders Property unusable as a residence, the trustees may use such insurance proceeds to repair or rebuild Property. Any such acquisition, repair or rebuilding must be done within 24 months (but not later than the date for termination) of the date of sale, damage or destruction of Property.

Article FOURTH (H) and Article FIFTH provide that if the trust terminates as a result of the trust ceasing to own a personal residence and the trustees (1) do not intend to replace or repair the personal residence, (2) do not replace or repair the personal residence within 24 months after the trust ceases to own a personal residence, or (3) replace or repair the personal residence for a cost less than the net proceeds received for the personal residence, then within 30 days after the trust terminates, the balance of the trust assets will be converted into a qualified annuity interest as defined under §§ 25.2702-3(b) and (d) for the benefit of the settlor.

Article FIFTH (B) provides that the annuity amount shall begin on the earliest date that any personal residence owned by the trust is sold, damaged or destroyed or ceases to be held as a personal residence. The annuity amount will be the smallest amount required under § 25.2702-5(c)(8)(ii)(C). Article FIFTH (G) provides that if trust terminates as a result of reaching the twentieth anniversary of its execution, and at that time trust is a qualified annuity trust, the remaining principal shall be paid to the settlor's living issue per stirpes. If there are no issue of settlor living on the twentieth anniversary, the remaining principal shall be paid to the settlor's spouse, and if the settlor's spouse is not living, the corpus shall be paid to Foundation.

Under Article FOURTH (J) the trustees shall not sell or transfer Property, directly or indirectly, to the settlor, the settlor's spouse, or an entity controlled by the settlor or the settlor's spouse during the term interest of the trust, or at any time after the original term of this trust that any trust held under this trust agreement is a grantor trust under §§ 671 through 677 of the Code. For purposes of the preceding sentence, a sale or transfer to another grantor trust of the settlor or the settlor's spouse is considered a sale or transfer to the settlor or the settlor's spouse. The term "control" is defined in § 25.2701-2(b)(5)(ii) and (iii).

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If Trust is established under Article SIXTH at the expiration of the 20-year term, Article SIXTH (B) provides that, if one or more of the settlor's issue (including grandchildren and more remote descendants) are then living, the trustees of Trust have the sole discretion to distribute income or principal to any one or more of settlor's issue. Article SIXTH (D) provides that if there are no issue of the settlor then living, the trustees have the sole discretion to distribute income or principal to any one or more members of a class consisting of the issue of the settlor's parent. However, under Article SIXTH as proposed, the settlor will be excluded as a potential beneficiary of any trust created under Article SIXTH. In the case of Taxpayer A, parent is identified as A. In the case of Taxpayer B, parent is identified as B. Article SIXTH (A) provides that Trust terminates upon the death of the survivor of Taxpayer A and Taxpayer B. Article SIXTH (E) provides that upon termination of Trust, the remaining trust assets are to be distributed to settlor's then living issue, per stirpes. If there are no issue of settlor then living, trust assets will be distributed to Foundation.

Taxpayers also propose to enter into an agreement granting them the option to lease Property. Under the terms of this agreement, if either or both Taxpayers survive the 20-year trust term, the survivor or survivors will have the right to lease Property at fair market value as determined every year. If either Taxpayer fails to pay the fair market value rent, then the owner of Property will have the right to evict Taxpayer or Taxpayers.

Taxpayers have requested the following rulings:

1. The provisions of the trust agreements satisfy the requirements of § 25.2702-5(c) and the Taxpayers' transfers qualify under § 2702(a)(3)(A)(ii).
2. The execution of the option for lease of Property held by the QPRTs, which provides for the payment of fair market rent, does not cause each trust agreement to fail to satisfy the requirements of § 25.2702-5(c).
3. If either or both of Taxpayers survive the 20-year term and continue to reside or otherwise use Property until the death of the survivor of them pursuant to a lease requiring the payment of fair market value rent, the interests in Property that the Taxpayers transfer to their respective trusts will not be includible in their respective gross estates under § 2036.

ISSUES 1 and 2 (Qualified Personal Residence Trusts)

Section 2702(a) provides special valuation rules for determining the value of a transfer for gift tax purposes where a donor transfers property in trust to or for the benefit of a member of the donor's family, and the donor retains an interest in the trust. Under § 2702(a)(2), the value of any retained interest that is not a "qualified interest" is treated as being zero and the value of any retained interest that is a qualified interest is

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determined under § 7520. Section 2702(a)(3)(A)(ii) provides that § 2702 shall not apply to a transfer if it involves the transfer of an interest in trust, all the property of which consists of a residence to be used as a personal residence by persons holding term interests in the trust.

Under § 2702(b)(1), a qualified interest includes an interest that consists of the right to receive fixed amounts payable not less frequently than annually.

Section 25.2702-2(a)(5) defines a qualified interest as a qualified annuity interest. Section 25.2702-2(a)(6) provides that a qualified annuity interest is an interest that meets all of the requirements of § 25.2702-3(b) and (d).

Section 25.2702-5(a) provides that a qualified personal residence trust (QPRT) as defined in § 25.2702-5(c) is treated as a personal residence trust satisfying the requirements of § 2702(a)(3)(A)(ii). Section 25.2702-5(c) provides that a qualified personal residence trust must meet all the requirements set forth in § 25.2702-5(c) and that those requirements must be satisfied in provisions in the governing instrument and must continue in effect during 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 principle 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. 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 the personal residence of the term holder only if its primary use is as a residence of the term holder when occupied by the term holder.

Based on the above, we conclude:

1. The terms of each trust agreement satisfy the requirements for a QPRT as set forth in § 25.2702-5(c) as well as the requirements for a qualified annuity interest as set forth in § 25.2702-3(b) and (d). Therefore, Taxpayers' transfers of their interests in Property to the proposed trusts qualify under the exception in § 2702(a)(3)(A)(ii).

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2. The execution of the option to lease Property after the 20-year term for fair market rental will not cause the trust agreements to fail to satisfy the requirements of § 25.2702-5(c).

ISSUE 4 (Includibility in gross estate)

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 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.

In Estate of McNichol v. Commissioner, 265 F.2d 667 (3d Cir. 1959), cert. den. 361 U.S. 829 (1960), the court held that "enjoyment" as used in the death tax statute 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

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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.

In the present case, Taxpayer A and Taxpayer B each propose to transfer their respective interest in Property to two separate irrevocable trusts for a 20-year term. If either or both Taxpayers survive the 20-year term and Property passes in further trust to Trust, Taxpayer A and Taxpayer B represent that they will pay the fair market value rental for the period of time for which they have use or possession of Property. If Taxpayer A and Taxpayer B pay fair market value rental, and assuming there is no express or implied understanding that Taxpayer A and Taxpayer B may retain use or possession of Property whether or not rent is paid, Taxpayer A's and Taxpayer B's continued use or possession of Property will not result in the inclusion of the interests in Property that the Taxpayers transfer to their respective trusts in Taxpayers' respective gross estates under § 2036(a). However, this ruling under § 2036 regarding the estate tax consequences if either Taxpayer survives the 20-year term of the QPRT is conditioned on Article SIXTH of each trust expressly excluding the settlor as a potential beneficiary of any trust created under Article SIXTH.

Except as we have specifically ruled herein, we express no opinion under the cited provisions or under any other provision of the Code.

This ruling is based on the facts and applicable law in effect on the date of this letter. If there is a change in material fact or law (local or Federal) before the transactions considered in the ruling take effect, the ruling will have no force or effect. If the taxpayer is in doubt whether there has been a change in material fact or law, a request for reconsideration of this ruling should be submitted to this office.

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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 _____
George L. Masnik
Chief, Branch 4

Enclosure
Copy for § 6110 purposes