Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
October 26, 1999

Re:

Legend

Taxpayer -
Father -
Community -
Parcel A -

Dear :

This is in response to your letter dated , , and prior correspondence in which you requested rulings concerning the transfer of property to a proposed qualified personal residence trust.

Taxpayer and Taxpayer's spouse own a fee simple title to Parcel A, located in Community, which they acquired in 1965. Parcel A is approximately 14.3 acres and includes a house and barn that occupy approximately 2.5 acres of the total acres. The remaining acreage in Parcel A is farmland that is leased to a tenant farmer in exchange for nominal rent and a percentage of the profits. The house on Parcel A is the permanent residence of Taxpayer and Taxpayer's spouse and the barn is used for storage of household items and some farming equipment.

Taxpayer proposes to create an irrevocable trust that is intended to satisfy the requirements of a qualified personal residence trust (QPRT) under § 25.2702-5(c) of the Gift Tax Regulations. Prior to creating the trust, Taxpayer and Taxpayer's spouse will sever Parcel A into two parcels. One parcel will consist of the 2.5 acre plot (Subplot A) that includes the residence and barn and the other parcel will consist of the remaining 11.8 acre plot that is currently leased for farming use. The Taxpayer's spouse will then transfer by gift her entire interest in Subplot A to Taxpayer. Taxpayer will transfer Subplot A to the trust.

Under the terms of the proposed trust, Taxpayer's spouse will serve as trustee. The trust will terminate upon the earlier of 15 years or the Taxpayer's death. During the term of the trust, Taxpayer will have use of the residence on the property and the trustee will pay Taxpayer all of the trust income, at least annually. Distributions of principal during the term of the trust to anyone other than Taxpayer will be prohibited. Taxpayer will pay all expenses of the property. In addition, the trust will include the following provisions:

1. The trust shall not hold any property other than a single residence for use as a personal residence by Taxpayer, except for other property that is permitted under §§ 25.2702-5(c)(5)(ii) and (c)(8).

2. Improvements may be made to the property provided the residence, as improved, satisfies the requirements of a personal residence under § 25.2702-5(c)(2).

3. Any additions of cash will be held in a separate account and will be subject to the provisions of § 25.2702-5(c)(5)(ii)(A)(1) and (2).

4. Proceeds from the sale of the residence will be held in a separate account as provided by § 25.2702-5(c)(5)(ii)(C) and insurance policies on the residence and proceeds of insurance for damage to or destruction of the residence (and amounts receivable upon an involuntary conversion as provided in § 1033) will also be held in a separate account.

5. The trust will cease to be a qualified personal residence trust if the residence ceases to be used or held for use as a personal residence by Taxpayer, or, as to proceeds of sale or insurance proceeds, if such proceeds are held in trust longer than provided under § 25.2702-5(c)(7)(ii).

6. The trust may not be commuted (prepaid).

7. If damage or destruction renders the residence not usable as a residence, § 25.2702-5(c)(7)(iii) will apply.

8. If the trust ceases to be a qualified personal residence trust as to any property, that property shall, within 30 days, be held in a separate share and the Taxpayer's interest shall be converted into a qualified annuity interest, as defined in § 25.2702-3. The requirements for a qualified annuity interest as described in § 25.2702-3 are made a part of the trust instrument by incorporation. The annuity amount shall be the smallest

fixed payment permitted under § 25.2702-5(c)(8) for the balance of the term. The commencement date of the qualified annuity interest shall be determined in accordance with § 25.2702-5(c)(8)(ii)(B).

9. The trustee may not sell or otherwise transfer the residence in a manner that conflicts with § 25.2702-5(c)(9).

If Taxpayer dies before the expiration of the 15 year term, the trust principal will be distributed to Taxpayer's estate. If the 15 year term expires before the Taxpayer's death, the trust assets will be held in a separate trust (family trust). During this period, Taxpayer's spouse may occupy the residence, if owned by the family trust. Upon the death of Taxpayer's spouse or, in the event that the spouse no longer wishes to reside in the residence, the Taxpayer may lease the residence at a fair market value.

Under the terms of the proposed trust, Taxpayer may appoint a successor trustee (other than Taxpayer or Taxpayer's spouse) to serve in place of any trustee who may resign or, for any other reason, may no longer be acting as trustee. Taxpayer may also remove a trustee of the proposed trust or any trust created under the proposed trust and appoint a successor trustee who is not related or subordinate to the Taxpayer or the Taxpayer's spouse within the meaning of § 672(c) of the Internal Revenue Code. Under the terms of the family trust, the trustee has discretion to apply the income and principal for the benefit of Taxpayer's spouse and Taxpayer's issue. However, the proposed trust also provides that any person serving as trustee to whom or for whose benefit a discretionary payment of income or principal may be made may not participate in any decision involving the exercise of the discretionary power in his or her own favor or the exercise of the power in favor of any person the trustee is obligated to support or maintain.

Upon the death of the last to die of Taxpayer and Taxpayer's spouse, the family trust assets will be divided equally among the Taxpayer's issue, per stirpes, and held in separate trusts for their benefit. The trustee will have discretion to distribute income and principal to the Taxpayer's children and their issue during the term of each trust. Upon the death of a child of the Taxpayer, that child's trust will terminate and be distributed pursuant to the terms of a testamentary nongeneral power of appointment exercised by the respective Taxpayer's child.

You have requested the following rulings:

(1) The 2.5 acre portion (Subplot A) of Parcel A that includes the current residence and barn, which Taxpayer will transfer to the proposed trust, meets the requirements of a personal residence, as defined in § 25.2702-5(c)(2).

(2) The proposed trust meets the requirements of a qualified personal residence trust under § 25.2702-5(c), and therefore, the transfer will qualify for the exception to § 2702(a) that is provided in § 2702(a)(3)(A)(ii).

Law and Analysis

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) 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.).

In this case, the structures on Subplot A of Parcel A are used for residential purposes. Severance of Subplot A from the remaining portion of Parcel A (the acreage rented to the tenant farmer) is essential for the qualification of Subplot A as a personal

residence. Consequently, we conclude that Subplot A of Parcel A, the 2.5 acre plot that includes the current residence and barn as described above, constitutes a personal residence within the meaning of § 25.2702-5(c)(2).

Based on the information submitted and the representations made, we conclude that, if Subplot A is severed from Parcel A and then transferred to the proposed trust, as proposed, the trust will meet the requirements for a qualified personal residence trust under § 25.2702-5(c) and therefore, the transfer to the trust will qualify for the exception to § 2702(a) that is provided in § 2702(a)(3)(A)(ii).

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.

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 the 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.

Except as specifically set forth above, no opinion is expressed concerning the Federal tax consequences of the facts described above under the cited provisions or any other provision of the Code.

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

Sincerely,

Assistant Chief Counsel
(Passthroughs and Special
Industries)

By James F. Hogan
James Hogan
Acting Assistant to the Branch Chief
Branch 4

Enclosure
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