

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B09-PLR-112284-00
Date:
February 13, 2002

LEGEND:

Taxpayer =

Spouse =

Property =

Date 1 =

Trust =

Date 2 =

a =

b =

Date 3 =

c =

d =

Date 4 =

Replacement
Property =

e =

Date 5 =

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f =

Dear :

We received your representative's letter, dated June 8, 2000, and subsequent correspondence, requesting a ruling regarding the federal gift tax consequences of a grantor retained annuity trust. This letter responds to your request.

The facts and representations submitted are summarized as follows: Taxpayer and Spouse owned equal undivided community property interests in Property. On Date 1, Taxpayer established Trust. On Date 2, Taxpayer transferred his undivided one-half interest in Property to Trust. Trust is intended to meet the requirements of a QPRT within the meaning of § 25.2702-5(c) of the Gift Tax Regulations. At the time of the transfer, Property was valued at \$a. Taxpayer represents that this value was determined by a qualified independent appraiser. The value of the one-half interest in Property that Taxpayer transferred to Trust was \$b, or one-half the full value of the residence. Taxpayer filed a gift tax return reporting the transfer to Trust and represents that no valuation discounts were claimed on the gift tax return.

On Date 3, Taxpayer and Spouse sold Property for \$c. After paying selling expenses and the balance of a mortgage on the Property, Trust received \$d. On Date 4, Trust acquired Replacement Property. Approximately \$e was reinvested in the acquisition and rehabilitation of the Replacement Property. The Replacement Property became the personal residence of Taxpayer on Date 5.

After acquiring the Replacement Property, Trust had assets of \$f that were not reinvested in a personal residence. Pursuant to the terms of Trust, the sale proceeds that were not reinvested in a new residence ceased to be a QPRT and converted to an annuity.

Article 4.1 of Trust provides that the trust is permitted to hold, among other assets, proceeds from the sale of the residence.

Article 4.8 provides that the trustee, in his discretion, may sell the residence at any time, and may in his discretion acquire a replacement residence. In exercising his discretion, the trustee shall consider the mandatory obligations of the trustee under this instrument, the needs of the trustor, and the purposes of a QPRT. In the event of sale, the trustee shall hold the proceeds in a separate account and the trust shall cease to be a QPRT with respect to the proceeds of sale not later than the earlier of the date that is two (2) years after the date of sale, the termination of the term holder's (trustor's) interest in the trust, or the date on which a new residence is acquired by the trust.

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Article 4.11 provides that within thirty (30) days following the date on which the trust ceases to be a QPRT with respect to any assets of the trust, those trust assets shall be converted to, and held for the balance of the trust term in a separate share of the trust pursuant to the provisions of Article 6.

Article 6 of the Trust provides that in the event assets of the trust are to be held and administered as a separate share because the trust has ceased to be a QPRT with respect to those assets, the assets of the separate share shall be administered and distributed in accordance with this Article 6. It is the purpose of these provisions to accomplish a conversion to a qualified annuity interest under Treasury Reg. § 25.2702-5(c)(8), which complies with Treasury Reg. § 25.2702-3, and this article shall be construed accordingly.

Article 6.1 provides that the trustee shall distribute to the trustor from the separate account an annuity at the times and in the amounts hereafter set forth.

Article 6.2 provides that the right of the trustor to receive the annuity amount shall begin on the date of the 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 as a personal residence, as the case may be (the "cessation date"); provided however, that the trustee may defer payment of any annuity amount otherwise payable after the cessation date until the date that is thirty (30) days after the assets are converted to a qualified annuity interest (the "conversion date"). Any deferred payment must bear compound interest from the cessation date at a rate not less than the IRC § 7520 rate in effect on the cessation date. At the sole discretion of the trustee, the trustee may reduce the aggregate deferred annuity payments by the amount of income actually distributed from the trust to the trustor during the deferral period.

Article 6.3 provides that the annuity amount shall be payable to the trustor annually for each taxable year of the term. The annuity amount may be paid after the close of the taxable year, provided that the payment is made no later than the date by which the trustee is required to file the federal income tax return of the trust for the year (without regard to extensions).

Article 6.4 provides for the determination of the annuity amount. Article 6.4.1 provides that if, on the conversion date, the trust estate does not include a residence used or held for use as a personal residence of the trustor, the annuity amount shall be the amount determined by dividing the lesser of (a) the value of all interests retained by the trustor as of the date of the original transfer or transfers of the residence to the trust; or (b) the value of all the trust assets as of the conversion date; by an annuity factor determined (a) for the original trust term, and (b) using the interest rate used in valuing the trustor's interest in the trust at the time of the original transfer.

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Article 6.4.2 provides that if, on the conversion date, the trust estate includes a residence used or held for use as a personal residence of the trustor, the annuity amount shall be the amount determined under the above subparagraph 6.4.1, 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 amount (including acquisition costs) reinvested in the new residence or expended for repairs of the existing residence; and the denominator of which is the fair market value of the trust estate on the conversion date.

Article 6.5 provides that in the case of a taxable year of the trust which is for a period of less than twelve (12) months, including the taxable year in which the trust terminates, the annuity amount shall be the amount otherwise determined for the year multiplied by a fraction the numerator of which is the number of days in the taxable year of the trust and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

Article 6.6 of the trust provides that the value of the trust estate for purposes of determining the annuity amount shall be the fair market value of the assets as determined for federal tax purposes. If such value is incorrectly determined by the trustee then, within a reasonable time after the value is set for federal tax purposes, the trustee shall pay to the trustor (in the case of overvaluation), an amount equal to the difference between the amount which the trustee should have paid to the trustor and the amount actually paid to the trustor.

Article 6.7 provides that additional contributions to a separate account administered under this Article 6 shall be prohibited. In the event additional assets become subject to administration under this Article 6 after other assets are already being administered under this article, the additional assets shall be administered separately.

Article 6.8 provides that the trustee shall make no distribution to or for the benefit of any person other than the trustor during the trust term, provided, however, that this sentence shall not limit the trustee's ability to make distributions for trust expenses.

Article 6.9 provides that commutation (prepayment) of the interest of the trustor is prohibited.

Article 6.10 provides that on expiration of the trust term, the trustee shall pay to the trustor (if living, and otherwise the estate of the trustor) all remaining amounts due under the obligation to pay the annuity as set forth herein. Any amounts remaining after such payment shall be distributed in accordance with Article 5.

You have requested a ruling that, notwithstanding the appreciation in value that occurred with respect to the Property between the time Trust was funded and the date

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the Property was sold, payment of the annuity amount calculated in accordance with Article 6.4 of Trust will not result in an additional gift to the residuary beneficiaries or in any gift tax consequences to Taxpayer.

Section 2501 imposes a tax, computed as provided in § 2502, for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

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 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 the 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 shall be determined under § 7520.

Section 2702(a)(3)(A)(ii) provides that § 2702(a) shall not apply to any transfer if the transfer involves the 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 that § 2702 does not apply to a transfer in trust meeting the requirements of this section. A transfer in trust meets the requirements of this 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. A trust of which the term holder is the grantor that otherwise meets the requirements of a personal residence trust (or a qualified personal residence trust) is not a personal residence trust (or a qualified personal residence trust) if, at the time of transfer, the term holder of the trust already holds term interests in two trusts that are personal residence trusts (or qualified personal residence trusts) of which the term holder was the grantor.

Section 25.2702-5(c)(1) provides, generally, that a qualified personal residence trust is a trust meeting all the requirements of § 25.2702-5(c). 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.

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Section 25.2702-5(c)(2)(i) provides that for purposes of § 25.2702-5(c), a personal residence of a term holder is either: (A) the principal residence of the term holder (within the meaning of § 1034); (B) one other residence of the term holder (within the meaning of § 280A(d)(1) but without regard to § 280A(d)(2)); or (C) an undivided fractional interest in either.

Section 25.2702-5(c)(8)(i) provides, generally, that the governing instrument must provide that, within thirty days after the date on which the trust has ceased to be a qualified personal residence trust with respect to certain assets, either: (A) the assets be distributed outright to the term holder; (B) the assets be 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; or (C) in the trustee's sole discretion, the trustee may elect to comply with either paragraph (C)(8)(i)(A) or (B) of this section pursuant to their terms.

Section 25.2702-5(c)(8)(ii)(A) provides that for assets subject to § 25.2702-5(c)(8) to be converted to and held as a qualified annuity interest, the governing instrument must contain all provisions required by § 25.2702-3 with respect to a qualified annuity interest.

Section 25.2702-3(b) provides that an interest is a qualified annuity interest only if it meets the requirements of § 25.2702-3(b) and (d). Section 25.2702-3(b)(1)(i) provides, generally, that a qualified annuity interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually. A right of withdrawal, whether or not cumulative, is not a qualified annuity interest.

Section 25.2702-3(b)(1)(ii) provides that a fixed amount means: (A) a stated dollar amount payable periodically, but not less frequently than annually, but only to the extent the amount does not exceed 120 percent of the state dollar amount payable in the preceding year; or (B) a fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year.

Section 25.2702-3(b)(1)(iii) provides that an annuity interest does not fail to be a qualified annuity interest merely because the trust permits income in excess of the amount required to pay the annuity amount to be paid to or for the benefit of the holder of the qualified annuity interest. Nevertheless, the right to receive the excess income is not a qualified interest and is not taken into account in valuing the qualified annuity interest.

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Section 25.2702-3(b)(2) provides that if the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iii) of this chapter (relating to adjustments for any incorrect determination of the fair market value of the property in the trust).

Section 25.2702-3(b)(3) provides that the annuity amount may be payable based on either the anniversary date of the creation of the trust or the taxable year of the trust. In either situation, the annuity amount may be paid annually or more frequently, such as semi-annually, quarterly, or monthly. If the payment is made based on the anniversary date, proration of the annuity amount is required only if the last period during which the annuity is payable to the grantor is a period of less than 12 months. If the payment is made based on the taxable year, proration of the annuity amount is required only if the last period during which the annuity is payable to the grantor is a period of less than 12 months. If the payment is made based on the taxable year, proration of the annuity amount is required for each short taxable year of the trust during the grantor's term. The prorated amount is the annual annuity amount multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

Section 25.2702-3(b)(4) provides that an annuity amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days after the anniversary date. An annuity amount payable based on the taxable year of the trust may be paid after the close of the taxable year, provided the payment is made no later than the date by which the trustee is required to file the Federal income tax return of the trust for the taxable year (without regard to extensions). If the trustee reports for the taxable year pursuant to § 1.671-4(b) of this chapter, the annuity payment must be made no later than the date by which the trustee would have been required to file the Federal income tax return of the trust for the taxable year (without regard to extensions) had the trustee reported pursuant to § 1.671-4(a) of this chapter.

Section 25.2702-3(b)(5) provides that the governing instrument must prohibit additional contributions to the trust.

Section 25.2702-3(d)(1) provides, in part, that to be a qualified annuity or unitrust interest, an interest must be a qualified annuity interest in every respect or a qualified unitrust interest in every respect. To be a qualified interest, the interest must meet the definition of and function exclusively as a qualified interest from the creation of the trust.

Section 25.2702-3(d)(2) provides that the governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity or unitrust interest during the term of the qualified interest.

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Section 25.2702-3(d)(3) provides that the governing instrument must fix the term of the annuity or unitrust interest. The term must be for the life of the term holder, for a specified term of years, or for the shorter (but not the longer) of those periods. Successive term interests for the benefit of the same individual are treated as the same term interest.

Section 25.2702-3(d)(4) provides that the governing instrument must prohibit commutation (prepayment) of the interest of the term holder.

Section 25.2702-5(c)(8)(ii)(B) provides that the governing instrument must provide that the right of the term holder to receive the annuity amount begins 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 ("the cessation date"). Notwithstanding the preceding sentence, the governing instrument may provide that the trustee may defer payment of any annuity amount otherwise payable after the cessation date until the date that is 30 days after the assets are converted to a qualified annuity interest under § 25.2702-5(c)(8)(i)(B) ("the conversion date"); provided that any deferred payment must bear interest from the cessation date at a rate not less than the § 7520 rate in effect on the cessation date. The governing instrument may permit the trustee to reduce the aggregate deferred annuity payments by the amount of income actually distributed by the trust to the term holder during the deferral period.

Section 25.2702-5(c)(8)(ii)(C)(1) provides, generally, that the governing instrument must require that the annuity amount be no less than the amount determined under this paragraph (C). Section 25.2702-5(c)(8)(ii)(C)(2) provides that if, on the conversion date, the assets of the trust do not include a residence used or held for use as a personal residence, the annuity may not be less than an amount determined by dividing the lesser of the value of all interests retained by the term holder (as of the date of the original transfer or transfers) or the value of all the trust assets (as of the conversion date) by an annuity factor determined (i) for the original term of the term holder's interest; and (ii) at the rate used in valuing the retained interest at the time of the original transfer.

Section 25.2702-5(c)(8)(ii)(C)(3) provides that if, on the conversion date, the assets of the trust include a residence used or held for use as a personal residence, the annuity must not be less than the amount determined under § 25.2702-5(c)(8)(ii)(C)(2) multiplied by a fraction. The numerator of the fraction is 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 the fraction is the fair market value of the trust assets on the conversion date.

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Article 6 of Trust provides that in the event Trust ceases to be a QPRT with respect to any assets of Trust, those assets are to be held in a separate share as a qualified annuity interest. Article 6.4 provides rules for determining the annuity amount. Based on the facts submitted and representations made, we conclude that Article 6.4 of Trust satisfies the requirements of § 25.2702-5(c)(8)(ii). Therefore, payment of the annuity amount to Taxpayer, calculated in accordance with Article 6.4, will be a qualified annuity interest for purposes of § 2702(b) and will not result in an additional gift to the remainder beneficiaries or in any additional gift tax consequences to Taxpayer.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. If there is a change in material fact or law (local or federal) before the transactions considered in this ruling take effect, the ruling will have no force or effect. 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.

A copy of this letter should be attached to any gift, estate or generation-skipping transfer tax returns that you may file relating to this matter. A copy is enclosed for that purpose. Except as specifically ruled herein, we express or imply no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code. In addition, we express or imply no opinion regarding whether Trust meets the requirements for a qualified personal residence trust under § 25.2702-5(c). 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.

Pursuant to the power of attorney on file, we are sending a copy of this letter to your authorized representative.

Sincerely,

Melissa C. Liquerman

Melissa C. Liquerman
Branch Chief, Branch 9
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures

Copy for section 6110 purposes
Copy of this letter