

## Part IV. Items of General Interest

### Notice of Proposed Rulemaking and Notice of Public Hearing

#### Sale of Residence from Qualified Personal Residence Trust

PS-4-96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains a proposed regulation permitting the reformation of a personal residence trust or a qualified personal residence trust in order to comply with the applicable requirements for such trusts. The proposed regulation also clarifies that the governing instruments of such trusts must prohibit the sale of a residence held in the trust to the grantor of the trust, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse. The proposed regulation will affect trusts created after the proposed effective date.

DATES: Written comments and outlines of oral comments to be presented at the public hearing scheduled for July 24, 1996, must be received by July 15, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (PS-4-96), Room 5228, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (PS-4-96), Courier's Desk Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224. The public hearing will be held in the IRS auditorium, Seventh Floor, 7400 Corridor, Internal Revenue Building, 1111 Constitution Avenue NW., Washington DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Dale Carlton, (202) 622-3090; concerning submissions and the hearing, Evangelista Lee, (202) 622-7180 (not toll-free numbers).

### SUPPLEMENTARY INFORMATION:

#### *Paperwork Reduction Act*

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507).

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by June 15, 1996.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collection of information is in §25.2702-5. This information is required by the IRS to ensure compliance with the regulatory requirements. The likely respondents are individuals or households. Responses to the collection of information are required to obtain favorable gift tax treatment.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual reporting/recordkeeping burden: 625 hours.

The estimated annual burden per respondent varies from 3 hours to 3.25 hours depending on individual circumstances with an estimated average of 3.1 hours.

Estimated number of respondents: 200

Estimated annual frequency of responses: 2

#### *Background*

This document proposes to amend the Gift Tax Regulations (26 CFR

part 25) under section 2702 relating to "personal residence trusts" and "qualified personal residence trusts."

Section 2702(a) provides special valuation rules for determining the value of a gift when a transfer is made 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 section 2702(a)(2)(A), the value of any retained interest that is not a "qualified interest" is treated as zero. Therefore, the value of the gift is equal to the full value of the property at the time of the transfer. In contrast, the value of a retained interest that is a qualified interest is determined under the valuation tables prescribed pursuant to section 7520. Section 2702(b) provides that a qualified interest means an annuity interest, a unitrust interest, or a remainder interest after either an annuity or unitrust interest.

Congress recognized that many people desire to maintain the family ownership of their home and pass ownership on to future generations, while retaining its use for a period of time. The annuity and unitrust requirements are not, however, conducive to the transfer of a residence. Accordingly, section 2702(a)(3)(A)(ii) provides an exception to the annuity and unitrust requirements. Under this limited exception, the grantor's retained interest need not be in one of these forms, but rather can take the form of a right to the use and occupancy of the residence. Because this is an exception to the general rule of section 2702, a grantor may take into account not only the value of the retained interest, but also any contingent reversionary interest, in determining the amount of the gift to the remainderman.

The requirements of section 2702(a)(3)(A)(ii) are satisfied by a personal residence trust and a qualified personal residence trust as set forth in the regulations. The governing instruments of these trusts must prohibit the trust from holding, for the original duration of the term interest, assets other than one residence to be used or held for the use as a personal residence of the term holder. In addition, a qualified personal residence trust can hold limited amounts of cash for certain specified purposes such as the payment of operating expenses and expenses for the improvement or replacement of the

residence, and the trustee is permitted to sell the residence during the original duration of the term interest, if certain requirements are satisfied.

If the trust does not qualify as a personal residence trust or a qualified personal residence trust, the grantor's retained interest is valued at zero under section 2702. This is the result even where the lack of compliance with the requirements in the regulations is the result of error or poor advice. As most errors are discovered at the time the gift tax return is prepared, the proposed regulation permits reformation of the trust to be commenced up to 90 days after the gift tax return is due. A properly reformed trust will be treated as satisfying the regulatory requirements.

Questions have arisen as to whether it is permissible for the grantor to place a personal residence in trust, obtain all the tax benefits of a qualified personal residence trust and then purchase the residence from the trust. For example, in a transaction described by one commentator as the "bait and switch," the grantor places the residence in trust with the intention of purchasing the residence from the trust just prior to the expiration of the grantor's retained term so that cash or other assets pass to the remaindermen in place of the residence.

The Treasury Department and the IRS have previously stated the view that Congress intended the personal residence trust exception to enable transferors to pass the family home to younger members of the family. Preamble to TD 8395, 1992-1 C.B. 316, at 319. Using the "bait and switch" technique, however, the personal residence trust exception could be used to facilitate the transfer of the grantor's other assets to future generations. The residence would merely serve as a temporary "stand-in" to avoid the annuity and unitrust requirements of section 2702. The proposed regulations clarify that the sale of the residence to the grantor by the trustee of the personal residence trust or qualified personal residence trust is not consistent with Congress' intent in enacting section 2702.

#### *Explanation of Provisions*

The proposed regulation provides that a trust that does not comply with one or more of the regulatory re-

quirements for qualification as a personal residence trust or a qualified personal residence trust, will be treated as satisfying those requirements if the trust is reformed by judicial reformation (or nonjudicial reformation if effective under state law) to comply with the requirements. The reformation must be commenced within 90 days of the due date (including extensions) for filing the gift tax return reporting the transfer of the residence, and must be completed within a reasonable time after commencement. If the reformation is not completed by the due date (including extensions) for filing the gift tax return, the grantor or grantor's spouse must attach a statement to the gift tax return stating that the reformation has been commenced, or will be commenced within the 90-day period.

The proposed regulation also requires that, in order to qualify as a personal residence trust or a qualified personal residence trust, the trust's 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. A sale or transfer to another grantor trust of the grantor or the grantor's spouse is considered a sale or transfer to the grantor or the grantor's spouse. For these purposes, the term *grantor trust* is a trust treated as owned by the grantor or the grantor's spouse within the meaning of sections 671-677. The term *control* is defined in §25.2701-2(b)(5)(ii) and (iii).

#### *Proposed Effective Date*

The amendments to §§25.2702-5(b) and (c) are proposed to be effective for trusts created after May 16, 1996. Thus, a trust created after this date will not satisfy the requirements of a personal residence trust or a qualified personal residence trust if the trust document does not comply with the regulations, as amended. Such a trust would be eligible for reformation under the proposed regulation.

Notwithstanding the proposed effective date, if the IRS examines a pre-effective date trust and finds it inconsistent with the purposes of section 2702 or the regulations thereunder, the IRS, by using established legal doctrines such as the substance over form doctrine, may treat the trust as not

qualifying under section 2702. Thus, for example, if the grantor actually purchases the residence from the trust pursuant to a right or option to purchase that is stated in the trust instrument or a collateral document, the IRS may not treat the trust as a qualified personal residence trust.

#### *Special Analyses*

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### *Comments and Public Hearing*

Before this proposed regulation is adopted as a final regulation, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing has been scheduled for July 24, 1996, at 10 a.m. in the auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by July 15, 1996 and an outline of the topics to be discussed and the time to be devoted to each topic. A period of 10 minutes will be allotted each person for making comments.

An agenda showing the scheduling of speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

*Drafting Information*

The principal author of this regulation is Dale Carlton, Office of the Assistant Chief Counsel (Passthroughs and Special Industries). However, personnel from other offices of the IRS and Treasury Department participated in their development.

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*Proposed Amendment to the Regulations*

Accordingly, 26 CFR part 25 is proposed to be amended as follows:

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Paragraph 1. The authority citation for part 25 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 25.2702-5 is amended as follows:

1. Paragraph (a) is redesignated as paragraph (a)(1) and paragraph (a)(2) is added.

2. In paragraph (b)(1), four new sentences are added after the third sentence.

3. Paragraph (c)(5)(ii)(C) is revised.

4. Paragraph (c)(9) is added.

The additions and revisions read as follows:

§25.2702-5. *Personal residence trusts.*

(a)(1) *In general* \* \* \*

(2) *Modification of trust.* A trust that does not comply with one or more of the regulatory requirements under paragraph (b) or (c) of this section will, nonetheless, be treated as satisfying these requirements if the trust is modified, by judicial reformation (or nonjudicial reformation if effective under state law), to comply with the requirements. The reformation must be commenced within 90 days after the due date (including extensions) for the filing of the gift tax return reporting the transfer of the residence under section 6075 and must be completed within a reasonable time after commencement. If the reformation is not completed by the due date (including extensions) for filing the gift tax return,

the grantor or grantor's spouse must attach a statement to the gift tax return stating that the reformation has been commenced or will be commenced within the 90-day period.

(b) \* \* \* (1) \* \* \* In addition, the trust does not meet the requirements of this section unless the governing instrument prohibits 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, at any time after the original term interest during which the trust is a grantor trust. For purposes of the preceding sentence, a sale or transfer to another grantor trust of the grantor or the grantor's spouse is considered a sale or transfer to the grantor or the grantor's spouse. For purposes of this section, a *grantor trust* is a trust treated as owned by the grantor or the grantor's spouse within the meaning of sections 671-677. The term *control* is defined in §25.2701-2(b)(5)(ii) and (iii). \* \* \*

\* \* \* \* \*

(c) \* \* \*

(5) \* \* \*

(ii) \* \* \*

(C) *Sale proceeds* The governing instrument may permit the sale of the residence (except as set forth in paragraph (c)(9) of this section) and may permit the trust to hold proceeds from the sale of the residence, in a separate account.

\* \* \* \* \*

(9) *Sale of residence to grantor, grantor's spouse, or entity controlled by grantor or grantor's spouse.* 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 original term interest of the trust, or at any time after the original term interest that the trust is a grantor trust. For purposes of the preceding sentence, a sale or transfer to another grantor trust of the grantor or the grantor's spouse is considered a sale or transfer to the grantor or the grantor's spouse. For purposes of this section, a *grantor trust* is a trust treated as owned by the grantor or the grantor's spouse within the meaning of sections 671-677. The

term *control* is defined in §25.2701-2(b)(5)(ii) and (iii).

\* \* \* \* \*

Par. 3. Section 25.2702-7 is amended as follows:

1. The first sentence of this section is revised; and

2. A new sentence is added at the end of the section, to read as follows:

§25.2702-7 *Effective date* .s

Except as provided in this section, §§25.2702-1 through 25.2702-6 are effective as of January 28, 1992. \* \* \* The fourth through seventh sentences of §25.2702-5(b)(1) and §25.2702-5(c)(9) are effective with respect to trusts created after May 16, 1996.

Margaret Milner Richardson,  
*Commissioner of Internal Revenue.*

(Filed by the Office of the Federal Register on April 15, 1996, 8:45 a.m., and published in the issue of the Federal Register for April 16, 1996, 61 F.R. 16623)