

KEEPING THE VACATION PROPERTY IN THE FAMILY¹

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I. ANSWERING THE QUESTION “WHY?”

Why do clients often place so much more importance on keeping vacation property in the family than they do for the family’s primary residence? What unique challenges will a lawyer face in applying various legal techniques to transfer ownership? What challenges should a lawyer anticipate in addressing use, maintenance, repairs, taxes, and other financial and operational concerns? These questions arise because vacation properties are different—they often produce no income and may, in spite of the tendency to increase in value, present more of a liability to the junior generation than the senior generation may imagine. This outline focuses on appropriate alternatives to ownership, transfer, and operation of family vacation properties and the approach to documenting solutions.

A. Family Emotional Connections

In our busy society, such time often presents an opportunity for family reconnection with a corresponding disconnection from the busy daily activities of life. Time spent in the vacation home builds strong memories leading to emotional ties to the property not usually associated with other vacation spots such as hotels, rented condos, or timeshares. Because most vacation properties are situated in desirable locations such as coastal, mountain, or resort areas, visits to the property strengthen positive associations simply based upon the beauty of the surroundings. Children and grandchildren often form lasting memories based upon their individual and collective experiences while vacationing on the property.

B. Unique Financial Considerations

1. Unique Investment. Vacation property values can represent a sizable percentage of a family’s estate. Vacation properties often appreciate, frequently faster and more significantly than other residential property in urban or suburban settings. Notwithstanding the significant value associated with vacation property, such assets tend to be illiquid and nonincome-producing. These factors pose challenges for both the senior and junior generations. For the senior generation holding the asset at death, inclusion can generate a substantial estate tax liability without liquidity to pay such taxes. For the junior generation, inheriting a valuable vacation property can become more of a liability than a benefit due to the expense of deferred maintenance and decorating, property taxes, insurance premiums, and frustrations associated with the management of access and use by other family members. The ability of members of the next generation to satisfy these financial and management requirements can vary significantly from ease to great difficulty.

2. Purchase Prohibitively Expensive. The junior generation, although interested in owning desirable vacation property, often cannot afford a purchase of such property until later in life when their finances are more established. In order to provide the opportunity to own and

use a vacation property while the grandchildren are growing, the senior generation may feel motivated to share the use and transfer the ownership of the property to the next generation to allow them to experience the same benefits of the family vacation home for their children that their own children experienced. Transfers of ownership during life or at death from the senior generation to the junior generation can enable the opportunity for ownership without the financial strain of a purchase.

3. Retirement. The senior generation may wish to spend retirement years in the family vacation home. Often located in resort communities, amenities such as golf courses, tennis courts, restaurants, and other facilities contribute to a desirable lifestyle. As the senior generation ages, health conditions may limit their use of such facilities. As time progresses, the incentive to transfer the property increases. The financial ability to maintain the lifestyle may also decline, providing an incentive to sell the property or to transfer the property to the junior generation who could assume the burdens of ownership.

C. Unique Strategies

These unique emotional and financial characteristics can be addressed through open communications with each generation regarding expectations, desired outcomes, and abilities to meet the financial demands of ownership. The lawyer can open the door by raising the issues with her client, assisting in surveying the parties, and summarizing needs and desired outcomes.

II. OBJECTIVES

A. Termination of Use by Senior Generation

1. Lifetime Transfers of Entire Interest. Occasionally, the senior generation will terminate their lifetime use by a lifetime transfer of their entire interest in the property to the next generation.

a. Sale. A cash, installment, or bargain sale or private annuity all offer a means to transfer the property at relatively low capital gain rates during lifetime. Long term capital gains on a sale of Oregon vacation property by Oregonians would generally be taxed at a combined federal and state effective tax rate of 22.65% (15% federal plus 9% state with the state rate reduced by 15% due to the deduction of state income taxes on the federal return).¹

b. Gift. A gift of the entire interest would generate federal gift tax if the fair market value of the property exceeds the available annual gift tax exclusions of \$12,000 per donee² and lifetime applicable exclusion amount of \$1,000,000³ less the amounts of previously taxable gifts.⁴ Oregon does not impose a gift tax on lifetime transfers. Since

¹IRC §1(h)(1)(C) and ORS 316.037.

²IRC §2503(b).

³IRC §2505(a)(1).

⁴IRC §2505(a)(2).

Oregon imposes no gift tax, a lifetime transfer of up to \$1,000,000 (assuming no previously taxable federal gifts) will be free of federal gift tax and will remove the asset from the Oregon estate for inheritance tax purposes, potentially saving almost \$100,000 of Oregon inheritance tax.⁵ A lifetime gift may be advisable for the senior generation whose gross estate equaled \$2,000,000 as their estate would be exempt from federal estate tax in 2006 but would be subject to Oregon inheritance tax due to the lower state exemption.⁶ A cautionary word, however, as to the continued use thereafter by the senior generation without payment of fair rental value. Such use raises the risk of inclusion of the fair market value of the property at death in the estate of the senior generation because of the retained use and enjoyment without fair rental payments.⁷

2. Transfer at Death. If the senior generation wishes to retain ownership throughout their lifetime but plans to transfer ownership at their death, the fair market value of the property will be included in their gross estates, subject to estate and inheritance taxes if the value of all property together with the amount of adjusted taxable gifts exceeds the federal exemption.⁸ Currently, the federal exemption is \$2,000,000. Although the current federal exemption of \$2,000,000 will change,⁹ the Oregon inheritance tax for the state exemption remains at \$1,000,000.¹⁰ If the federal and state death tax exemptions exceed the value of the decedent's gross estate, a transfer at death will avoid death tax and for income tax purposes can benefit the beneficiaries due to the step up in basis to fair market value at death.¹¹

B. Continued Use and Control

In my experience, the senior generation wishes to use and enjoy the vacation property throughout their lives while utilizing tax advantaged techniques for transferring the property to their children and grandchildren. Because they view their own use as primary, they wish to control access and use of the property for as long as those considerations matter to them. The appropriateness of a particular transfer technique should be examined and weighed against their objectives and priorities. Each technique illustrated below offers benefits and risks to be considered and communicated to the client.

⁵ORS 118.010(2) and IRC Section 2011 as amended and in effect on December 31, 2000.

⁶IRC §2010, which provides a \$2,000,000 exemption in 2006, while ORS 118.160 exempts estates from filing if the gross estate is less than \$1,000,000.

⁷IRC §2036(a)(1).

⁸IRC §2001.

⁹IRC §2010(c).

¹⁰ORS 118.160(1)(b)(D).

¹¹IRC §1014(a)(1).

III. TRANSFER TECHNIQUES

A. Lifetime Annual Exclusion Gifts (Using a Tenancy in Common Approach)

1. **Facts.** The Smiths desire to gradually transfer ownership of their beach cabin by gift to their two children and four grandchildren. They are each 70 years old. They would like to transfer all of their ownership by the time they reach 80. They anticipate that they will occupy the property for the summer months with weekend visits to the beach throughout the year. They expect their use to decline as they reach 80. They have made no other taxable gifts during life.

2. **Lifetime Exclusion Gifts Using Fractional Interests—Tenancy in Common Ownership.** The Smiths could simply transfer fractional interests each year to their children and grandchildren by deed. The resulting ownership with the family would create a tenancy in common.¹²

a. **Gifts to Minors.** In Oregon, a deed of an interest in real property to a minor¹³ may be accomplished in a variety of methods, as follows.

i. **Gifts to Minors Under ORS 126.805 to 126.886.** A deed of a partial interest in real property may be made by the transferor to an adult other than the transferor or the beneficiary or in the name of a trust company¹⁴ if the deed contains language substantially as follows:

(A) “As custodian for _____ (name of beneficiary) under the Oregon Uniform Transfers to Minors Act,” or

(B) If the transfer will be delayed until a time after the beneficiary turns 21 but before age 25, “As custodian for _____ (name of beneficiary) under the Oregon Uniform Transfers to Minors Act until the beneficiary attains the age of _____ years.”¹⁵

ii. **Transfer by Custodian.** A custodian must transfer the property to the beneficiary upon the earlier of the beneficiary’s:

(A) Twenty-first birthday if the gift was irrevocable and not delayed until age 25,¹⁶

(B) Eighteenth birthday if the transfer was in the absence of a will or under a will or trust that did not contain an authorization to transfer to a custodian,¹⁷ or

¹²ORS 93.180 creates a presumption in favor of tenancy in common ownership absent indications to the contrary.

¹³ORS 126.805(11): “Minor” means any person who has not attained the age of 21 years. This applies to gifts of custodial property to custodians for minors. ORS 109.520 and 106.010. Note, however, that the Oregon Uniform Transfers to Minors Act permits transfers to custodians at any time before the beneficiary turns 25. ORS 126.836(2).

¹⁴ORS 126.832(1)(e).

¹⁵ORS 126.832(3)(a) and (b).

¹⁶ORS 126.869(1).

¹⁷ORS 126.869(2).

(C) The beneficiary's death.¹⁸

b. Gift Tax Annual Exclusions. The Smiths could gift substantial portions of their property annually using annual gift tax exclusions. Each of the Smiths can give \$12,000 per year to each of their children and grandchildren for a total to each donee of \$24,000. With six donees, the annual gift tax free transfer can total \$144,000 (\$24,000 × 6). If only one of the Smiths owns the property, they can elect to split the gifts taking advantage of the annual exclusion for the nonowner spouse as well.¹⁹ Over the ten-year span of expected ownership and use, the Smiths could transfer \$1,444,000 (\$144,000 × 10), assuming no appreciation in the asset or change in the amount of the annual exclusion. Taxpayers have successfully justified valuation discounts for gifts of tenancy in common interests.²⁰ Assuming a discount, for example, of 20%, the annual gifting technique accelerates the transfer process. Using the same facts of this example and applying the 20% discount, the Smiths can give \$15,000 per year to each of their children and grandchildren for a total to each donee of \$30,000 (\$15,000 × 2 × 80% = \$24,000). With six donees, the annual gift tax free transfer can total \$180,000 (\$30,000 × 6 × 80%). With discounting, the ten-year span shortens to eight years for the same value (\$1,444,000 ÷ \$180,000), assuming no appreciation in the asset or change in the amount of the annual exclusion.

c. Tenancy in Common Agreement. As discussed later in this outline, economic and management issues arise when multiple parties own vacation property, regardless of the form of ownership. These issues are also addressed in parts VI. and VII., below, and in a sample tenancy in common agreement included as Appendix A.

d. Tax Issues and Risks in the Tenancy in Common Transfer Technique

i. Present Interest Gift. An annual exclusion gift only qualifies if it is a gift of a present interest.²¹ As long as the donee has unrestricted right to the immediate use, possession, or enjoyment of the property or the income from the property, the gift of a tenancy in common interest should qualify as a present interest.²² Oregon law also grants the tenants the right to partition and to sell the property.²³

¹⁸ORS 126.869(3).

¹⁹IRC §2513.

²⁰*LeFrak v. Com'r.*, T.C. Memo 1993-526 (20% minority interest in commercial real estate and 10% lack-of-marketability discounts); *Shephard v. Com'r.*, 115 T.C. 376 (2000) (15% discount for undivided one-half interest in timberland); *Estate of Stevens*, T.C. Memo 2000-53 (25% discount for undivided one-half interest in commercial real estate); TAM 9336002 (discount limited to costs of partitioning property), *but see Estate of Cervin v. Comm'r.*, 68 T.C.M. (CCH) 115(1994), where the court permitted a 20% discount (5% plus half of the cost to partition the property where one-half interest valued).

²¹IRC §2503(B)(1), Reg. §25.2503-3(b).

²²Reg. §25.2503-3(b); PLR 8906026 and PLR 9323030.

²³ORS 105.205 et seq.

However, since courts have denied present gift status to gifts of limited partnership interests where a general partner holds too much control over distributions and where limited partners lacked any right to withdraw capital or assign their interests, one needs to be careful in drafting a tenancy in common agreement that limits use, possession, or enjoyment too restrictively.²⁴ Lifetime gifts outside of a trust within the annual exclusion (in the form of direct skips) are not subject to the GST tax.²⁵

ii. Gifts to Minors. While gifts to minors using Oregon's Uniform Transfer to Minor's Act (the "Act") permits placement of the title in a custodian until the minor is age 25, the Internal Revenue Code limits the maximum age for present interest treatment for purposes of the annual exclusion to age 21.²⁶ Therefore, it would be necessary to limit the age in the transfer document under the Act to age 21 to avoid the loss of the annual exclusion if qualification for that exclusion is intended.

iii. Risk of Inclusion in Senior Generation's Estate for Death Tax Purposes. If the senior generation uses the property more than their proportionate share, there is a risk of inclusion of a greater proportionate share of the property at their death. If the senior generation retains a right of possession or enjoyment, including the right to income or the right to designate the persons who would possess or enjoy such property or income, or if the transferor retains the power to alter, amend, revoke, or terminate a transfer, the IRS may attempt to include the entire fair market value of the vacation property in their estate at date of death.²⁷ To protect against this risk, the tenancy in common agreement can provide that all cotenants' use is proportional to their interests, or to the extent that use exceeds proportional ownership that fair rental value will be paid to the other cotenants.

iv. Basis. A disadvantage of this gifting technique results from the donees acquiring a carryover basis from the donors. When the children and grandchildren sell the property, their gain may be greater than if they had inherited the property with the stepped-up basis at death of the parents/grandparents.²⁸

B. Qualified Real Property Trusts ("QPRTs")

1. Facts. Mrs. Johnson, a widow in her 70s, spends the summer months in her Broken Top home in Bend, Oregon. She invites her only child, Megan, her husband Michael, and their children, who live in Portland, to spend several long weekends and summer vacation weeks with her. Mrs. Johnson anticipates that she will likely move to

²⁴TAM 9751003; *Hackl v. Comm'r*, 118 T.C. 279 (Mar. 27, 2002), *aff'd* 335 F.3d 664 (7th Cir. 2003).

²⁵IRC §§2612(c)(1) and 2642(c)(1).

²⁶IRC §2503(c).

²⁷IRC §§2036(a)(1) and (2) and 2038.

²⁸IRC §1014.

an assisted living center sometime in five to seven years and would no longer wish to retain ownership. Megan and Michael have often expressed interest in Mrs. Johnson retaining the property for their future ownership as they would use the property year-round for recreation. Mrs. Johnson's attorney explained the benefits of using a QPRT to transfer ownership to her daughter.

2. QPRT Technique. Mrs. Johnson executes a trust for a term of seven years and deeds ownership of the property to herself as trustee. She retains the right to live and occupy the home for the term of the trust. During this time, Mrs. Johnson continues to pay the taxes, insurance, and maintenance. Upon termination of the trust, she executes a deed from the trust to her daughter. Mrs. Johnson's attorney modified a draft of her QPRT, starting with the form provided by the Internal Revenue Service.²⁹

3. Tax Consequences to Mrs. Johnson. Mrs. Johnson has gifted her residence to a grantor trust in which she retains a "qualified interest," i.e., a residence to be used as a personal residence.³⁰ She is entitled to all of the income and deductions of the trust as if she owned the home outright.³¹ She has made a gift of the home to her daughter on a leveraged basis because the value of the gift of the home is substantially reduced to a present interest due to the delayed distribution of the property to her daughter.³² Although the gift fails to qualify for the annual exclusion, as the gift is a future, not present, interest gift, her gift can be offset by the \$1,000,000 exemption equivalent. She will have also effectively removed all of the appreciation on the Broken Top home during the seven-year term of the trust as well. By way of illustration:

Fair market value of home	\$1,000,000
Value of retained interest	541,900
Gift: present value of remainder	458,100
Less: lifetime gift tax exclusion	<u>– 458,100</u>
Net gift:	\$ 0
Property value after seven years (6% after tax)	\$1,503,630
Potential death tax saved (combined 50%)	\$ 522,767 ³³

4. Risks and Disadvantages. Unless Mrs. Johnson outlives the term of the trust, her estate will include the value of the home at her death.³⁴ Therefore, it would be best to set the term of the trust well within her life expectancy to take advantage of this leveraged gift. If she dies before the seven-year term ends at a time when the property had

²⁹ See Revenue Procedure 2003-42, June 9, 2003, and Appendix B.

³⁰ IRC §2702(a)(3)(A) and Regs. §25-2702-5(c).

³¹ IRC §671 et seq. (grantor trust rules).

³² IRC §§2072(a)(2)(B) and 7520.

³³ NumberCruncher calculations.

³⁴ IRC §2036(a)(1) and (2).

appreciated to \$1,500,000, her estate and inheritance taxes on this asset would total approximately \$750,000. Also, if she outlives the terms of the trust and wishes to use the home, she must pay a fair market value rent to her daughter for the use. The payment of rent by Mrs. Johnson, although taxed to her daughter as income, does reduce Mrs. Johnson's taxable estate.

C. Transfers in Trust

1. Facts. The Marshalls wish to transfer ownership of their Black Butte home to their children and grandchildren. However, because of uncertainties regarding the stability of the marriage of their daughter Jessica, they want to protect the ownership and use of the property in the event of her divorce as well as protect against other potential creditor claims that might affect the multiple owners. They are familiar with trusts, having set up a revocable living trust and irrevocable life insurance trust. They wish to establish a trust for their vacation property for the benefit of the family.

2. Alternate Trust Techniques

a. Revocable Living Trust. Should the Marshalls want to "try this arrangement on for size," so to speak, they might establish a revocable living trust that include terms and conditions regarding management, use, transfer, and the like. Because the Marshalls serve as trustees, they can control all aspects of the property. Since the trust is revocable, they can amend the trust to adjust to circumstances that they experience in the management and use of the home. At the death of the survivor, the trust becomes irrevocable and continues for the benefit of children and grandchildren. The terms and conditions for management and use of the home as documented in the trust language would have been established during their lifetime and may now be accepted more readily by the beneficiaries. I have found greater acceptance of management provisions by the junior generation if they have had an opportunity to live with the terms and to voice changes as needed. Additional assets can be added to the trust during lifetime or at death for a source of funds for maintenance, repair, and operations.

b. Irrevocable Living Trust. Should the Marshalls wish to utilize lifetime annual exclusions and applicable gift tax credit, an irrevocable trust offers an opportunity to do so while providing for the management and use of the property. The Marshalls may designate their issue, as well as the spouses of their issue, as trust beneficiaries. They may grant powers of appointment to certain beneficiaries that permit the addition of other beneficiaries.

3. Tax Consequences

a. Revocable Living Trust. The tax consequences for the Marshalls and their issue are the same as if the Marshalls died owning the property outright (see part II.A.2., above).

b. Irrevocable Living Trust. The tax consequences for the Marshalls and their issue are the same (except for GST issues—see

below) as if the Marshalls transferred the entire property outright (see part II.A.1., above), including the risk of inclusion in the Marshalls' gross estates if they fail to pay fair market rent for the right to use the property after transfer to the trust. The Marshalls as settlors should not act as trustee of the trust. The trust can be designed to qualify for annual exclusions provided it offers the beneficiaries a present right to withdraw contributions. Note, however, that gifts qualifying for the annual exclusion under IRC 2503(b) do not automatically (without careful drafting) qualify for exemption from the GST tax³⁵).

4. Risks and Disadvantages

a. Revocable Living Trust. Few disadvantages apply to this form of trust, as the settlors may change the terms to fit the circumstances. The main disadvantage is that the settlors have not utilized leveraged gifting techniques. The disadvantages arise when the trust becomes irrevocable (see paragraph b., below).

b. Irrevocable Living Trust. The language of the trust document controls and can be difficult to modify to adjust to changing circumstances. Under Oregon's Uniform Trust Code, the trust may be modified during the settlor's life with the consent of the settlor and all of the beneficiaries even if the modification or termination is inconsistent with a material purpose of the trust.³⁶ After the settlor's death, the trustee and all of the beneficiaries may modify the trust provided the court finds that the modification is not inconsistent with a material purpose of the trust.³⁷ A termination requires the court to find that the continuance of the trust is not necessary to achieve any material purpose of the trust.³⁸ A termination may be more difficult than a modification because a spendthrift clause is considered a material purpose of the trust.³⁹ Duration of trusts will be limited by the rule against perpetuities. Trustees are fiduciaries. To the extent that family members serve as trustees, they run the risk of charges of violating the duties of loyalty⁴⁰ and impartiality⁴¹ to other beneficiaries if they favor themselves individually as to use, assessments, or other operational considerations over other trust beneficiaries. If the settlor serves as trustee or appoints a third-party trustee while reserving a right to appoint a successor trustee including herself, and the trustee holds any §§2036–2038 powers, the settlor runs the risk of inclusion of the property in their estates. Also,

³⁵A gift in trust equal to the annual exclusion is not automatically exempt from GST tax even with Crummey powers (IRC 2642(c)(2)). *See also* IRC §2632(c), where the GST exemption is automatically allocated to such gifts unless elected out of such treatment on a timely filed gift tax return.

³⁶ORS 130.200(1). This is a nonjudicial modification.

³⁷ORS 130.200(2). This requires judicial involvement to modify.

³⁸ORS 130.200(2).

³⁹ORS 130.200(2) and (3).

⁴⁰ORS 130.655.

⁴¹ORS 130.660.

generation-skipping transfer tax exemption allocation strategies should be considered for lifetime gifts into irrevocable trusts.⁴²

D. Limited Liability Companies

1. Facts. The Trumps operate many of their real estate holdings in the form of limited liability companies (“LLCs”). They have discussed using this form of entity for owing and transferring interests in their Gearhart beachfront property to their children and grandchildren. They wish to use the property but want to reduce their estate taxes while protecting the property from claims from sons and daughters-in-law and third-party creditors.

2. Technique. The Trumps form an LLC entitled “The Trump Family LLC” and deed the property to the entity. Mr. and Mrs. Trump each receive a 50% member interest in the LLC. In addition, they transfer cash to the property sufficient to establish an endowment fund to generate income for maintenance and repair of the property. They execute a written operating agreement that restricts transfer of ownership interests other than to “permitted transferees” at death (defined as lineal descendants and trusts for spouses whose interests are held in trust for life, remainder to lineal descendants). The operating agreement includes other provisions governing the ownership, use, and operation of the entity and the property. The Trumps later transfer membership interests in the LLC to their children and grandchildren. Their attorney explains that the LLC can provide a measure of protection against creditor claims.⁴³ Creditors who successfully attach the membership interest of the debtor become mere assignees unless the members vote them into membership. As assignees, the creditor is entitled to distributions when and as made.⁴⁴ The deferral of distributions can be frustrating enough to creditors to nudge them into a significantly reduced settlement.⁴⁵ The Trump Family LLC can be established to have a perpetual existence, unlike trusts in Oregon (as opposed to states where the rule against perpetuities has been abolished). Also, the operating agreement can be more easily amended by the members without resorting to court approval as may be required in a trust after the settlor’s death.

3. Tax Consequences

a. To the Senior Trumps. The senior Trumps have formed and funded an entity on a tax-free basis.⁴⁶ The LLC will receive the

⁴²IRC §§2632 and 2642.

⁴³ORS 63.165 and 63.175.

⁴⁴ORS 63.249(3).

⁴⁵*But see Movitz v. Fiesta Invs., LLC (In re Ehmann)*, 319 B.R. 200, 206 (Bankr. D. Ariz. 2005), where the federal bankruptcy court in Arizona allowed a trustee in bankruptcy to dissolve and liquidate an LLC to satisfy creditors (case discussed in Steve Leimberg’s Asset Protection Planning Email Newsletter—Archive Message #81, April 24, 2006, online at <http://leimbergservices.com>).

⁴⁶IRC §721(a).

Trumps' carryover basis in the contributed property.⁴⁷ The Trumps' basis in the membership interests will equal their basis in the contributed property.⁴⁸ The transfer of membership interests to their children and grandchildren can qualify for annual exclusion gifts,⁴⁹ as well as for lifetime applicable exemption equivalent gifts (up to \$1,000,000 each for a total of \$2,000,000 for Mr. and Mrs. Trump). GST exemptions can be allocated to the gifts to grandchildren if the gift value exceeds the annual exclusion.⁵⁰ As an added advantage, the gifts of minority interests in the LLC can qualify for valuation discounts due to lack of marketability and absence of control. These discounts can reduce the value of the gift by 25% to 40% or more. The retention of equal membership interests by the senior Trumps also provides the advantage of potential valuation discounts for estate and inheritance tax purposes at each of their deaths due to the lack of marketability and lack of control (each owns a 50% interest upon formation of the LLC). The discount at death would not otherwise be available for outright ownership of the Gearhart home for the husband and wife.⁵¹

b. To the Junior Trumps. The junior Trumps (children and grandchildren) receive a minority interest in the LLC. To the extent that the LLC generates income or loss (unless specially allocated to the member providing the capital contribution), the junior Trumps share in such items to the extent of the pro rata membership interest in the LLC.

4. Risks and Disadvantages

a. To the Senior Trumps. The IRS may choose to include the entire value of the underlying property held by the LLC in their gross estates at their deaths depending upon the structure of the LLC and the degree of retained control. If the Trumps retain unrestricted access and use of the property, the IRS may argue that the entire underlying value of the vacation property held by the LLC should be included in their estate by arguing that the senior Trumps retained too much power over the possession or enjoyment of, or the right to the income from, the property.⁵² If the Trumps act as managers and retain powers that are exercisable by them alone or in conjunction with others to control the right to designate the persons who shall possess or enjoy the property or the income therefrom to include the value of the underlying assets in their estates (the "swing vote problem"), the Service may attempt to in-

⁴⁷IRC §723.

⁴⁸IRC §722.

⁴⁹PLR 9131006, PLR 8611004, and TAM 199944003, which held the gifts to be present interests; *but see Hackl v. Comm'r, supra*, where the rights of the donee partners were too limited rendering the gifts ineligible for the annual exclusion due to failure to qualify as present interest gifts.

⁵⁰IRC §2631(c). The GST exemption equals the applicable exclusion under IRC §2010(c)—currently \$2,000,000 for each of the Trumps.

⁵¹Numerous cases provide support for minority and lack of marketability discounts, the discussion of which is beyond the scope of this outline.

⁵²IRC §2036(a)(1).

clude the entire value of the underlying asset.⁵³ Nevertheless, if properly structured, these risks can be minimized or eliminated. Also, the transfer of the vacation home to the LLC will preclude the senior Trumps from claiming exemptions from capital gains for sale of a principal residence if their ownership and use would otherwise qualify them for this exclusion equal to \$500,000 as a married couple.⁵⁴ An annoying disadvantage for some families using LLCs can be the added legal and accounting burdens and expenses associated with annual corporate office filings and tax reporting.

b. To the Junior Trumps. Mostly, the risks associated with the senior Trumps become risks assumed by the junior Trumps as their estates grow and become more exposed to death taxes. Operational integrity and attention to detail can reduce these risks.

IV. ADEQUATE DISCLOSURE RULES FOR GIFT TAX RETURNS

A. Running of the Statute

To begin the running of the three-year statute of limitations, a gift must be adequately disclosed on Form 709, U.S. Gift Tax (and Generation-Skipping Transfer) Tax Return.⁵⁵

B. Adequate Disclosure

Whether or not one chooses to file a gift tax return depends upon the chosen strategy (aggressive discounting of valuations, electing out of automatic GST exemptions, etc.). Although beyond the scope of this outline, adequate disclosure includes the following:

1. A description of the transferred property and any consideration received by the donor,
2. The identity of, and relationship between, the donor and each donee,
3. If the property is transferred in trust, the trust's EIN and a brief description of the terms of the trust (or a copy of the trust), and
4. Either a qualified appraisal or a detailed description of the method used to determine the fair market value of the gift.⁵⁶

V. FOREST SERVICE RECREATION RESIDENCE PROGRAM

Cabins situated within USDA national forest land require special consideration, as cabins on these sites are leased from the Forest Service under a permit system.⁵⁷ Although frequently referred to as "99-year leases," the maximum lease term is actually 20 years, while leases for new sites cannot exceed 10 years. All existing leases will terminate in 2008, which establishes a common expiration date for all permits. It is

⁵³IRC §2036(a)(2).

⁵⁴IRC §121.

⁵⁵IRC §6501(c)(9).

⁵⁶Instructions, Form 709, page 4; *see also* Regs. §301.6501(c)-1(e) and (f).

⁵⁷Marieb, Carolyn Donohoe, "Borrowed Time," *Homes & Gardens of the Northwest*, *The Oregonian*, May 4, 2006.

reasonable to assume that the Forest Service will extend the leases for an additional 10 years. The Forest Service charges an annual fee for the use of the land. These fees have increased significantly in the last few years. The Cabin User Fee Fairness Act of 2000 (CUFFA)⁵⁸ and rules promulgated thereunder charge the Forest Service with responsibility to update their procedures and approaches to managing these cabins. Changes in ownership require approval by the Forest Service Special Use Administrator before a new permit is issued. Before proceeding with any of the transfer techniques discussed in this outline, be sure to check with the local Forest Service office to determine if authorized. The rules preclude the use of many of them.

VI. DEVELOPMENT OF THE APPLICABLE OPERATING AGREEMENT—GENERAL COMMENTS

I have attached a sample tenancy in common agreement that can be used as a reference point in addressing many of the operational issues associated with vacation properties owned by multiple parties. It is not intended as the final word on how to manage such issues but does represent an evolving arrangement with which I have almost 15 years of experience.⁵⁹

A. Decision-Making Regarding Management and Governance

The senior generation's decision-making process has usually settled into an informal but effective pattern. The husband/wife team utilize the vacation property at will, share the same priorities regarding repair and maintenance, and include maintenance and repair costs as a part of their budget. Unless a formal decision-making process has been adopted during their ownership involving the next generation (infrequently done), the transfer of ownership to the next generation (usually at death of the surviving parent) imposes the burden of all of the financial and administrative decisions on siblings, nieces, and nephews, who may be unaccustomed to working together. The necessity of coordinating decisions without an established process can lead to squabbles, disagreements, and estrangement among the family. To avoid that situation, a written and binding agreement should address governance, administrative, and financial issues.

B. Timing of Implementation of the Agreement

Family members who adopt an agreement during the period of senior generation ownership and shared use with the junior generation are more likely to accept and continue the terms of governance and financial contribution once the senior generation is no longer involved in ownership or use of the property.

⁵⁸ See also *The Forest Service Manual*, online at <http://www.fs.fed.us/im/directives/dughtml/fsm.html>; 16 USC ch. 81, User Fees Under Forest System Recreation Residence Program.

⁵⁹ See Appendix B, Sample Tenancy in Common Agreement.

C. Form of Agreement

Management issues can be included in the applicable written agreement for whichever entity or structure is used (operating agreement for LLC, tenancy in common agreement, trust, etc.).

**VII. SPECIFIC ISSUES TO ADDRESS IN DRAFTING
THE APPLICABLE AGREEMENT**

A. Parties to the Agreement

Who should sign the agreement—owners or owners and users? The junior generation will more likely “buy into” the agreement if they are parties during the period of senior ownership and junior use.

B. Use

Who is entitled to use the property and how should it be used?

1. Owners only?
2. Extended family?
3. Friends?
4. Must an owner be present during any period of use?
5. Can ex-spouses own an interest? Can they use the property with lineal descendants of owners (children and grandchildren)?
6. What is the primary use of the property? Rental or personal?
7. Are areas of exclusive use reserved or set aside for specific owners (i.e., certain rooms, storage areas, locked closets, etc.)?
8. If rented, will rent be pooled into a common account or allocated to owners renting out their allocated time?
9. Should a minimum rental rate be established for weekend or week-long use?
10. How will the right to use the vacation property be determined?
 - a. Rotation?
 - b. Percentage?
 - c. Specific blocks of the calendar for individual owners?
11. How will prime time (holidays, spring and summer vacations, winter skiing season, etc.) be allocated?

C. Maintenance and Management of Financial Matters

1. Challenging. Next to the issue of use, financial issues are often the most vexing challenge to the junior generation.

2. Common Account. A common checking account should be established and funded to provide for both predictable and unpredictable expenses. The questions of who signs on the account, who reconciles the statement, and what limits are placed on the dollar amount of expenditures need to be spelled out in the agreement.

3. Reserves and Assessments. For both known and unexpected expenses, an initial and periodically scheduled capital contribution from each owner may be advisable to fund and maintain the

reserves in sufficient amount to pay the expenses in a timely manner. If deposits are to be made monthly, establishing an automatic debit to each owner's personal accounts and crediting to the common house account can save a great deal of trouble in meeting financial obligations. Known expenditures include property taxes, insurance premiums, association dues, utilities, routine maintenance and repairs, and replacement of furniture and fixtures and equipment. "Unplanned" expenses include homeowners' assessments for community improvements (golf course, pool, or other facility updates if in a resort community or homeowners' association with such amenities, roof repair, exterior painting and the like). Provisions for failure to timely deposit funds should be addressed as well. Establishing an expectation of the need to vote for an increase in contributions to the reserve account in the agreement (on a simple majority vote) may assist in addressing increasing costs over time.

4. Annual or Periodic Reports. Depending upon the form of ownership, an annual report may be necessary for distributing information for income tax purposes. This report should contain a simple financial statement and receipts and disbursements accounting, preferably in a format that reports the income, deposits, and expenses in categories useful for income tax reporting. Quicken and other vendors provide simple financial accounting packages that will organize and maintain reports.

5. Limits on Individual Purchases. A dollar limit on items that could be purchased for the home and paid for by the common account without a vote of the co-owners can be useful. For example, a \$100 to \$200 amount for decor items and the like with an annual limit per member can go a long ways to providing some sense of individuality for the home.

6. Allocation of Certain Expenses. The agreement should consider whether specific expenses incurred by an owner such as personal telephone calls should be allocated to and paid by the party incurring the charge. To avoid disproportionate expenditures by owners who cannot utilize the property, also consider allocating utility, firewood, or other monthly expenditures periodically (at least annually) based upon percentage of usage or other reasonable basis.

VIII. PRACTICAL DRAFTING—SAMPLE AGREEMENTS AND CHECKLISTS

- A. Appendix A—Sample Tenancy in Common Agreement for Vacation Property.⁶⁰
- B. Appendix B—Sample QPRT, Rev. Proc. 2003-42, June 9, 2003.
- C. In summary, a well-drafted document governing the key issues of use of the property and financial matters is a good accompaniment to whichever entity is chosen as the vehicle to own, manage, and transfer the family vacation property.

⁶⁰The author also acknowledges the work of his partner James F. Ambrose in assisting in the initial drafting process of this agreement a dozen years ago.

APPENDIX A—SAMPLE TENANCY IN COMMON AGREEMENT

Tenancy-in-Common Agreement

THIS AGREEMENT effective on the 1st day of June, 200_, by and among _____, husband and wife (“the _____”), _____, husband and wife (“the _____”), _____, husband and wife (“the _____”) and _____, husband and wife (“the _____”).

RECITALS

The Parties own a residence property and related improvements located at _____ County, Oregon which has a legal description of _____ County, Oregon (hereinafter referred to as the “Property”).

The title to said Property has been acquired by the _____ as to an undivided ____% interest, by the _____ as to an undivided ____% interest, by the _____ as to an undivided ____% interest, and by the _____ as to an undivided ____% interest as tenants in common among each married couple as to each couple.

The Parties desire to execute an agreement to define their respective rights, duties, liabilities, and responsibilities to the ownership, development, management, and occupancy of the Property and to each other.

NOW, THEREFORE, in consideration of the mutual benefits to be derived herefrom, and further in consideration of mutual promises given herein, the Parties agree as follows:

1. Status. The Parties are tenants in common in the ownership, development, management, and occupancy of the Property. The purpose of the tenancy in common shall be for the investment of capital and not for the active conduct of a business. Except as provided herein, the relationship between the Tenants shall not be expanded to include any other Tenant, property, or activity without the written consent of all Tenants. As used herein, the following terms shall have the following meanings:

- a. “Tenant” shall mean and refer to each individual who is a signatory to this Agreement.
- b. “Party” shall mean and refer to a married couple, each individual of which is a Tenant.
- c. “Tenants” or “Parties” shall mean and refer to all Tenants collectively.

2. Assumed Name. The business of the cotenancy shall be conducted under the name _____. An application for registration of the assumed business name shall be filed with the State of Oregon.

3. Ownership Interest and Capital. Upon the inception of this Tenancy-in-Common Agreement, the names of the Parties and Tenants and their percentage undivided interests in the Property are as follows:

- a. _____, husband and wife, an undivided _____% interest held as community property.
- b. _____, husband and wife, an undivided _____% interest.
- c. _____, husband and wife, an undivided _____% interest.
- d. _____, husband and wife, an undivided _____% interest.

The beginning capital of the tenancy in common is being contributed and is owned by the above-named Parties in the percentages set forth. The initial capital is comprised of the unencumbered ownership of the Property.

4. Increase of Capital. At such times as additional capital shall be required or deemed desirable, for purpose of preserving the Property, additional capital shall be provided by the Parties, in the relative percentages as set forth in paragraph 3, unless they specifically agree otherwise.

5. Bank. The bank account shall be established at _____ at a Portland, Oregon branch. It may be changed to any other bank upon the unanimous agreement of the Parties without need for a written amendment to this Tenancy-in-Common Agreement.

6. Banking Transactions. All cash, checks, or money equivalents received by, or on behalf of, the tenancy in common shall promptly be deposited to the credit of the tenancy in common in the bank designated by the Tenants for the account of the tenancy in common. The bank account shall be established with all Parties as signatories on the account with no need for a second signature for any withdrawal. However, the structure of the bank account in regard to the signatories on the account shall not be determinative of the rights of the various Parties with regard to expenditures. Such rights shall be governed by paragraph 10 of this agreement.

7. Meetings. The tenancy in common shall operate on a calendar year from January 1 to December 31. An annual meeting shall be held within the month of December of each year. It is hereby acknowledged that the _____ reside in _____, while all other Tenants reside in _____. Accordingly, such meetings may be held telephonically, by email, or by other unanimously agreed-to means. Additional meetings may be called by any of the Tenants, in which case the meeting must be preceded by written notice to all Parties and such notice must be not less than 10 or more than 30 days in advance of the meeting.

8. Books and Records. The Tenants shall designate one of their members from time to time who shall maintain complete and accurate records of all tenancy-in-common business, and these records shall be open to inspection by any of the Tenants at all reasonable times. _____ shall be designated initially for this purpose. At least quarterly, a summary report shall be prepared showing income and expenses. At the end of each fiscal year, an account of the tenancy in common's affairs shall be furnished to each Tenant, together with such appropriate information as shall be required by each Tenant for income tax purposes.

9. Management. Each Tenant shall have a voice in the management of the tenancy-in-common Property. There shall be considered 100 votes in accordance with the 100% interest in the tenancy in common, and each Party shall have the votes relative to its percentage interest in the Property. Each Party (which consists of husband and wife) shall vote its interest as a block. In the absence of one Tenant of a Party, the Tenant present shall have the authority to vote for such Party

unless such absent Tenant has notified all of the Tenants in writing that the Tenant present shall not have such authority. Any Party may give its proxy in writing to another Party to be voted in its place. All decisions regarding the business of the tenancy in common shall be by a simple majority vote of the interests in the Property, except as otherwise provided herein.

10. Improvement, Maintenance, and Insurance of the Property. The Property shall be maintained in first-class condition, insured for the full replacement value thereof, including appropriate endorsement for public liability coverage commensurate with the potential exposure of the Tenants in Common.

Upon the commencement of this tenancy in common, there shall be established a reserve account equal to two months of anticipated expenses, to be contributed by each of the Parties in their relative percentages. The purpose of this contribution is to provide sufficient funds to pay for anticipated expenses such as _____ for removal for fire safety, clearing needles from the property, acquiring supplies for the house, partial funding for property taxes due each November 15th, and any other unanticipated expense. Upon inception, therefore, a monthly reserve shall be equal to the amount of \$2,000. Thereafter, beginning _____ and on the first of each month thereafter until adjusted by a vote of the Parties, each Party shall contribute a monthly sum as follows:

_____	\$ 250
_____	\$ 260
_____	\$ 245
_____	\$ 245
Monthly Total	\$1,000

The Parties agree that each will cause the above sums, as adjusted from time to time by agreement of the Parties, to be automatically debited on the first of each month from the Party's personal checking account and automatically credited to the general bank account of the tenancy in common established pursuant to paragraph 6 of this agreement. Such expenses include expenses for the reserve for taxes and payments for utilities, association dues, maintenance, and improvements. Each month thereafter, each of the Parties shall advance, relative to its percentage interests, monies to a common fund as required to pay for the cost of improvements, furniture and furnishings, maintenance, insurance, taxes, operation of the Property, including interest on principal on the mortgage thereof, utility expenses, and other reasonable expenses necessary for the maintenance of the Property.

Any improvement or purchase less than \$100 may be made by any Party without the consent of the other Parties, and such Parties shall be reimbursed out of the common fund of the tenancy in common. Notwithstanding the above, no one Party may obligate the tenancy in common for more than \$200 during any single calendar year without the approval of 75% of the interests of the tenancy in common. Any expenditure for an improvement in excess of \$100 but less than \$250 will only be made or reimbursed to the Party spending the funds upon the vote of a majority of the interests in the Property. Any expenditure in excess of \$250 will require the consent of at least 75% of the interests in the tenancy in common. An increase in the monthly reserves from the present level of \$1,000 will require a simple majority vote.

11. Personal and Commercial Use. It is acknowledged and understood by all the Parties hereto that the intent behind the Parties acquisition of the Property shall be primarily for the personal, noncommercial use of the Tenants. The Parties acknowledge that valuable benefits accrue to

each of the Parties, and the Parties will make and adjust rules and regulations regarding the use and enjoyment of the Property. Such rules will cast equal burden and benefit on the Parties. Under no circumstances will any Party use the Property so as to deprive the other Parties of their respective and similar use. Under no circumstances will the tenancy in common or any of the Parties hereto be deemed liable or responsible for the torts of any of the Parties committed on or in connection with the Property. None of the Parties shall presume to act as the agent or representative of the other Parties, beyond the specific authority contained in this agreement or the regulations and rules adopted for the Property. The Parties are not general partners, and their relationship extends only to the Property.

Notwithstanding the intent of Parties that the Property is primarily for their personal use, it is acknowledged and understood that Tenants may permit, within the limitations of further specified rules and regulations to be promulgated, individuals other than themselves to use the Property. Such third parties will sometimes be charged rent and sometimes will not be charged rent. Relative to such third-party use of the Property, it is agreed that rental of the Property to third parties for purposes of obtaining rental income shall be ancillary rather than a primary goal of the tenancy. The rental rate to be charged to third parties shall be set by the agreement of at least a vote of 75% of the interests in the Property and shall initially be set at \$1,000 per week (or if rented on a daily basis, \$150 per night for Monday through Thursday nights and \$175 per night for Friday, Saturday, and Sunday nights). These rates can be changed by the vote of 75% of interests without necessitating a written amendment to this Agreement. Third-party rental income will be placed in the common fund to be used as all other monies in the common fund are used.

Such revenues shall operate to reduce proportionately the funds and additional capital needed from the Parties. An accounting of such revenues shall be provided for periodically by the Tenant in charge of finances. The Parties also agree that from time to time third parties, such as family or friends of the Parties hereto, or business associates or contacts of the Parties hereto, may be granted permission by one or more of the Parties to use the Property on a rent-free basis. Such rent-free use is intended to allow the Parties to use the Property in a courtesy fashion, and the Party extending such courtesy to the third party shall be considered to have personally used the Property during that period of time when the third party is occupying the Property rent-free. Nevertheless, the Party permitting such use shall be responsible for arranging post-use cleaning service.

12. Personal Use Allocation and Nonproportional Expenses. At the annual meeting each year, the Parties shall determine an allocation of personal use by weeks for the upcoming calendar year. Each Party shall pick on rotating basis which weeks it wishes to reserve for its personal use. Each week shall be deemed to run from Friday at noon to the following Friday at noon.

The year shall be divided initially into twelve holiday weeks, which include the following:

- a. Martin Luther King's Birthday;
- b. President's Day;
- c. Spring break (as determined by the Portland Public Schools schedule);
- d. Easter;
- e. Memorial Day;

- f. Fourth of July;
- g. Labor Day;
- h. Columbus Day;
- i. Thanksgiving;
- j. Christmas;
- k. New Year's Day; and
- l. Wild card week.

The balance of the year represents 40 weeks and shall be allocated after the initial twelve holiday weeks have been selected. The wild card week can be any week of the year other than those holiday weeks listed.

The selection process shall operate in the following fashion for the holiday weeks:

- a. Each Party is entitled to three choices among the 12 holiday weeks;
- b. The Tenants will rotate who gets the first choice each year, with each Party moving down one position and the Party in fourth position moving to first position in the subsequent year. For example, in 2007, the _____ get first selection, the _____ get second selection, the _____ get third selection, and the _____ get fourth selection. The above twelve holiday weeks need not be picked in chronological or any other particular order.

For the balance of the 40 weeks, the procedure is to repeat the selection process that was done for the 12 holidays three times, thus selecting 36 weeks. The final four weeks would be allocated as follows: first selection to the Party with the first selection that year, the second selection to the Party with the second selection that year, the third selection to the Party with the third selection that year, and the fourth selection to the Party with the fourth selection that year. The Tenants will rotate selection position corresponding to the rotation order above in paragraph b.

At the annual meeting in December of each year, there will be adjustments made to the weekly stays, which normally run from Friday at noon to the following Friday at noon. These adjustments are to be made in light of the Thanksgiving holiday, in which it is anticipated that the week would flow from the Wednesday at noon preceding Thanksgiving Day to the following Wednesday, and that the following week would be a long week. Also, holiday weeks for Christmas, New Year's Day, and the Fourth of July may be adjusted, depending on the day of the week in which the holiday falls.

It is also acknowledged and understood that whether the Property be used for personal use or for commercial rental use, to the extent practicable any smoking or housing of pets on the Property shall be absolutely prohibited. Any guests shall be told emphatically not to smoke in the house and not to bring pets. The purpose of this provision is to respect the health of Tenants with severe allergies and their rights under this agreement.

While each Party will be assigned at the annual meeting to a specified number of weeks and particular dates, it is the obligation of each of the Parties to advise the Party so designated to be in charge of scheduling (initially _____) of its intended use or nonuse of the Property during the period specified. The purpose of this requirement is to maximize the personal use by all Parties of the Property, to keep the availability of it known to all Parties, and to prevent accidental overlapping use resulting from lack of communication. To the extent one Party wishes to use it on the spur of the moment (either for its own personal use or for a favor or courtesy to some individual or family) on a week that is not designated as its own, communication is necessary at least with the individual in charge of scheduling and the Party who is scheduled for that week. As a courtesy, a confirming email to all Parties will be appreciated to avoid conflicts in use. While it is not the obligation of any one Party to unilaterally give up its use for a week it had selected regardless of whether it intended to use the Property, neither is it the intent that all Tenants strictly feel obliged to trade weeks each time a request is made to use or rent the Property in a week that was not originally selected by the one wanting to make such use of the property or wanting to rent it out for such week. Rather, the intent and the goal of the Parties is to first and foremost maximize each Party's personal use of the Property (and thus not always require a trade-off when there is a vacant week) and then secondly to increase the availability of the Property for family or friends who wish to use and/or rent the Property so long as it doesn't conflict with the reasonable personal use of another Party.

Periodically, but no less frequently than annually, the Tenant in charge of handling the books and records shall total the variable costs that have been incurred in connection with the use of the Property and not otherwise specifically allocated to a Tenant in common (e.g., long-distance telephone calls of one of the Tenants). These variable costs do not include fixed charges unrelated to the actual use of the Property, i.e., property taxes, base telephone charge, base cable charge, association dues, and base utility charges. Rather, it is intended to reflect the incremental costs of utilities, wood, and other services. The total variable cost for the period in question shall be aggregated, and a reasonable charge shall be assessed based on the number of days use of the Property was actually made. Days of use shall relate to nights a Tenant or renter stays in the house. To the extent the days constituted a use by a renter, those charges shall be considered an offset against the rental income. To the extent that such charges are attributable to personal use, which includes the use by family or friends of a Party on a nonrental basis, those charges will be charged back against the said Party, who shall be obligated to contribute additional monies to the common fund to so reimburse the tenancy in common (or receive less of a credit for excesses in the reserve account).

13. Lien for Failure to Pay Expenses. In the event any Tenant fails or refuses at anytime to pay when due its share of the periodic expenses required hereunder, which failure continues for a period of ten days after receipt of written notice thereof from any other Tenant, then the Tenant or Tenants paying the periodic expense allocable to the defaulting Tenant shall have a lien on the interest in the Property of the Party of which the defaulting individual is a Tenant for the amount of such expenses, which amount shall bear interest at the lesser of three percent (3%) above the prime rate as published by Bank of _____ or twelve percent (12%) per annum until paid; provided, however, if there be a bona fide dispute as to the existence of such default or of the amount due and all undisputed amounts are paid, there shall be no right to place a lien on such Party's interest in the Property until such dispute is settled by final arbitration or mutual agreement. The lien (but not the interest bearing indebtedness) provided for in this paragraph shall only be effective when filed for record by the Tenant or Tenants paying the periodic expense as a claim of lien against the default Tenant in the lien records of Deschutes County, Oregon, signed and verified, which shall contain at least:

- a. A statement of the unpaid amount of expenses;
- b. A legal description sufficient for identification of the interest in the Property of the defaulting Tenant that is the subject of the lien;
- c. The name and address of the owner or reputed owner of the interest in the Property that is the subject of the lien; and
- d. The name and address of the Tenant or Tenants paying the periodic expense.

The lien, when so established against the interest in the Property described in the lien, shall be prior and superior to any right, title, interest, lien, or claim that may be or has been acquired or attached to such interest in the Property after the time of filing the lien. The lien shall be for the use and benefit of the Tenant or Tenants paying the periodic expense allocable to the defaulting Tenant and may be enforced and foreclosed in a suitor action brought in any court of competent jurisdiction; provided, however, such enforcement and/or foreclosure shall not be commenced unless: (a) the amount of such lien(s) filed pursuant to this Paragraph shall be in a total amount in excess of \$1,000, and (b) such lien(s) shall have appeared of record for a period of not less than one year.

Notwithstanding the above, at the sole discretion of the nondefaulting Parties to this agreement, a default on the part of one Party shall operate to give rise to an option on the part of the nondefaulting Parties to purchase the defaulting Party's interest in the Property in accordance with the procedure set forth in paragraphs 15 and 19. If the nondefaulting Party or Parties elect to exercise their option under this subparagraph, that shall operate to result in a purchase of the defaulting Tenant's entire interest in the Property. This is in contrast to the filing of the lien and the foreclosure on the lien, which would merely operate to decrease the Party's percentage interest in the Property. For purposes of foreclosing on the lien, and solely for that purpose, the fair market value of the Property shall be deemed to equal the original purchase price, plus closing costs of the Property. That value, for this sole purpose, shall be deemed to remain constant through the term of this Tenancy-in-Common Agreement.

14. Restriction on Members. Except as otherwise provided herein, no Tenant, without the consent of all the other Tenants, shall:

- a. Sell, assign, mortgage, grant a security interest in, or pledge its interest in the tenancy in common, either voluntarily or involuntarily, with or without consideration;
- b. Borrow or lend money on behalf of the tenancy in common or purchase any property or security on behalf of the tenancy in common;
- c. Assign, pledge, transfer, compromise, or release any claim of the tenancy in common except for full payment, or consent to the arbitration of any of its disputes or controversies;
- d. Use the name, credit, or property of the tenancy in common for any purpose other than a tenancy in common purpose; or
- e. Perform any act detrimental to the tenancy-in-common purpose or that would make it impossible to carry on that purpose.

Any action in contravention of this paragraph shall be void and without effect vis-à-vis any third party's interest in the property.

15. Sale of an Interest. Except as provided in paragraph 16, dealing with the death of a Party, and paragraph 17, dealing with the dissolution of marriage of a Party, this paragraph shall govern the sale and transfer of any interest in the Property.

a. If a Party should desire to dispose of its interest, then it shall first offer, in writing, to sell its interest to the other Parties pro rata at the price determined in accordance with the provisions of paragraph 19. Each of the remaining Parties shall have the initial right to purchase such portion of the interest as its own interest in the tenancy in common at such date shall bear to the total tenancy-in-common interest, excluding the interest of the selling Party. After the value has been determined, the other Parties shall have thirty (30) days in which to elect or not to elect to purchase such share, and if they elect to purchase, they shall give written notice to the selling Party within the thirty (30) day period. The purchase shall thereupon be consummated for cash, or at the option of the purchasing Parties, on the basis of equal annual installments over a period of two (2) years, the first payment due within sixty (60) days of the election of the purchasing properties, with interest at a rate equal to the interest rate for mortgage home loans being charged by the Bank of _____ with eighty percent (80%) financing and paying two points as a loan fee, on the date the election to purchase is received by the selling Party, such interest to be paid semiannually on the deferred balance of the purchase price. From and after the date of payment to the selling Party, whether for cash for such purchase or the first installment payment, the selling Party shall terminate its interest in and not participate further in the tenancy in common.

b. If any such other Party does not purchase its full proportionate share of the interest being sold, then the balance may be purchased by the other Parties equally. If only one other Party desires to purchase the share of the withdrawing Party, it may elect to do so by following the procedure established by subparagraph a., above, but if the entire interest of the selling Party is not so purchased, then no portion of the selling Party's interest can be purchased by any Party without the consent of the selling Party.

c. If the remaining Parties or Party elect not to purchase (on an all-or-nothing basis), the selling Party may sell its interest to any other person acceptable to the remaining Parties; provided, however, that the remaining Parties accept the new buyer within sixty (60) days of the receipt of a signed earnest money agreement. The nonselling Parties are allowed collectively two vetoes or refusals to accept proposed buyers. If the remaining Parties have vetoed two separate bona fide proposed buyers, then the remaining Parties shall once again have the option of buying the Property pursuant to subparagraph a. of this paragraph 15. Failure to exercise this option results in the selling Party having the right to find a new buyer under the same procedure, but the remaining Parties have no veto power with respect to this third proposed buyer. If at the expiration of such sixty (60) day period set forth above, the new buyer has not been rejected by the remaining Parties, the seller shall be free to sell to the new buyer. A sale by a Party must be for the same or a greater price than that for which the share was offered to the remaining Party or Parties. If such price is reduced, then the share shall again be offered to the remaining Parties, pursuant to subparagraph a. of this Paragraph 15, and they shall have another thirty (30) day period in which to consider purchasing at such reduced price.

d. The Parties do not anticipate mortgaging the Property unless unanimously agreed to by all Parties.

e. The Parties agree that the maximum number of owners shall be limited to the current number of four interests and that the interests shall not be further subdivided nor transferred to an entity such as a trust, corporation, limited liability company, limited partnership, or the like without the unanimous consent of all Parties. Consent may be withheld for any or no reason. The purpose of this provision is to prevent the ownership of the Property from becoming more like a “time-share” property and to keep the administrative burden of accounting, scheduling use, shopping trips for supplies, and other tasks to no more than the level at which they currently exist.

16. Death of a Tenant.

a. Upon the death of a Tenant of one of the Parties during the term of this Agreement, the surviving Tenant of the Party shall automatically succeed to the interest in the Property of the deceased Tenant.

b. In the event a surviving Tenant elects not to continue as a Party to this Tenancy-in-Common Agreement, or in the event both Tenants of a single Party have died, the other Parties shall have the option to purchase such tenancy-in-common interest, whether from the personal representative of the deceased or the surviving Tenant who takes title by inheritance or survivorship or otherwise. The price and terms of the purchase shall be determined pursuant to the provisions of paragraphs 15 and 19. Notification by the other Parties of a desire to exercise their option (which shall be exercised on an all-or-nothing basis), shall be made to the surviving Party or to the Party’s personal representative within thirty (30) days after receiving notice from either the survivor (of an election not to continue as a Party to the tenancy in common) or from the personal representative (as to the death of both spouses that constitute a single Party).

c. In the event the surviving Parties do not exercise their option to purchase the deceased Party’s interest or the interest of the surviving Tenant if one of the spouses died, then the surviving Tenant or the personal representative is allowed to place the decedent’s interest up for sale in a fashion similar to that set forth in paragraph 15. In such case, the provisions of paragraph 15 relating to sales to third parties shall apply, except to the extent that the surviving Parties, while having a right of first refusal (i.e., the right to match any purchase price proposed to be accepted), the remaining Parties shall not have the right to veto any bona fide proposed purchaser.

17. Dissolution of Marriage. In the event of the dissolution of the marriage of a husband and wife who are a Party hereto, only one, but not both, of the Tenants of that Party should continue in the tenancy in common. The name of the Tenant to continue in the tenancy in common shall be furnished in writing signed by both the ex-husband and the ex-wife to the other Tenants. In the event of a dissolution where the husband and wife cannot agree on which Tenant shall continue in the tenancy in common, and such disagreement continues until the judgment ordering the dissolution becomes final, then within ten days thereafter the Tenants of the Party dissolving their marriage shall offer their interest in the Property for sale to the remaining Parties not involved in the divorce in a fashion as set forth in paragraphs 15 and 19 hereof. In the event the remaining Parties do not exercise their option to purchase said interest, then the interest of the divorced couple shall be divided in half and remain with each, in which case all of the provisions of this agreement with regard to contributions to capital, voting and personal use, etc., shall be modified accordingly.

18. Foreclosure. If any Tenant is the subject of any proceeding to foreclose on its interest in the tenancy-in-common or the Property, other than as provided in Paragraph 13, and such action is not dismissed within 90 days after filing, the Party of which the individual is a Tenant shall

thereupon offer its interest in the Property for sale to the other Parties as described in paragraphs 15 and 19 hereof.

19. Purchase Price. For purposes of this agreement and pursuant to the provisions of paragraphs 15, 16, 17, and 18, the purchase price for any interest in the Property to be offered for sale hereunder is intended to be the appraised fair market value thereof, without any discount for any type of minority interest in the Property.

Any Party who wishes to voluntarily sell the Property is entitled to set the price at whatever said Party determines to be the appropriate value. In such event, the remaining Parties that have an option to purchase (as opposed to mere right of first refusal) can contest the setting of the valuation. In such case, there shall then be an appraisal made with respect to the Property. Such appraisal shall be made by a qualified and certified residential appraiser located in the Black Butte/Sisters/Bend area. The cost of said appraisal shall be borne one-half by the selling Party and one-half by the remaining Parties. If the Parties cannot agree upon a single appraiser, then each Party, i.e., the selling Party and the remaining Parties, shall each retain an appraiser, and the appraised price shall be considered the average of the two appraisals. In this case, each appraisal must be done by a qualified and certified residential appraiser located in the Black Butte/Sisters/Bend area. Each shall bear the cost of its own appraiser.

20. Alteration or Amendment. This agreement may be altered, amended, or terminated by the unanimous written consent of all the Tenants.

21. Termination of Agreement. This agreement shall continue on in effect unless otherwise provided for by the unanimous consent of the Parties or the Property is sold, whichever occurs first. In the event of an ultimate sale of the Property, all proceeds from the sale shall be distributed to the Parties in their respective percentage interests.

22. Arbitration and Costs. In the event any dispute arises regarding the subject matter of this Agreement or its interpretation, the controversy shall be settled by arbitration in Portland, Oregon, and by utilizing the Arbitration Services of Portland, Inc. ("ASPI"), following the procedures set forth by ASPI at the time of the arbitration. The decision of the arbitrator shall be final and binding for all purposes. Pursuant thereto, the prevailing Party shall be entitled to attorney fees and costs if such are incurred, but only at the discretion of the arbitrator.

23. Notices. All notices shall be made in writing and shall be given by regular mail, postage prepaid, addressed to each of the Tenants at the Tenants' permanent address, or such other address as a Tenant may hereinafter designate in writing, delivered to the other Tenants. Notice shall be deemed given as of the date of the postmark.

24. Binding Effect. This agreement shall be binding upon and shall inure to the benefit of each of the Tenants and their respective heirs, executors, administrators, legal representatives, successors, and assigns.

25. Severability. If any term or provision of this agreement shall to any extent be invalid or unenforceable, the remainder of this agreement shall not be affected thereby, and each term or provision of this agreement shall be valid and enforceable to the fullest extent permitted by law.

26. Governing Law. This agreement shall be subject to, and governed by, the laws of the state of Oregon.

IN WITNESS WHEREOF, the Tenants have executed this Agreement effective on the day and year hereinabove written.

Date: _____

Date: _____

Date: _____

Date: _____

Date: _____

Date: _____

Date: _____

Date: _____

APPENDIX B—REV. PROC. 2003-42, SAMPLE QPRT AGREEMENT

Part III

Administrative, Procedural and Miscellaneous

26 CFR 601.201: Rulings and determination letters.
(Also Part I, § 2702; 25.2702-5.)

Rev. Proc. 2003-42

SECTION 1. PURPOSE

This revenue procedure contains an annotated sample declaration of trust and alternate provisions that meet the requirements under § 2702(a)(3)(A) of the Internal Revenue Code and § 25.2702-5(c) of the Gift Tax Regulations for a qualified personal residence trust (QPRT) with one term holder.

SECTION 2. BACKGROUND

Section 2702(a) provides special rules for the valuation for gift tax purposes of a transfer of an interest in a trust to or for the benefit of a member of the transferor's family if the transferor (or an applicable family member) retains an interest in the trust. Under § 2702(a)(2)(A), the value of any retained interest that is not a qualified interest (as defined in § 2702(b)) is treated as zero unless the transfer is described in § 2702(a)(3). Section 2702(a)(3)(A) and § 25.2702-5(a)(1) provide that § 2702(a) does not apply to a transfer to a personal residence trust; that is, a 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. Although there are differences between a personal residence trust created under the statute and a QPRT created under the regulations, under § 25.2702-5(a), a trust meeting the requirements of a QPRT will be treated as a personal residence trust. Section 25.2702-5(c) contains the requirements that must be met by a trust in order to qualify as a QPRT. This revenue procedure provides a sample declaration of trust, as well as additional guidance in the form of annotations and alternative provisions.

SECTION 3. SCOPE AND OBJECTIVE

Section 4 of this revenue procedure provides a sample declaration of trust for a QPRT with one transferor for a term equal to the lesser of the life of the term holder or a term of years. Section 5 provides annotations to the provisions in the sample trust. Section 6 provides samples of certain alternate provisions concerning: (.01) additions to

the trust to purchase a personal residence, and (.02) disposition of trust assets on cessation of its qualification as a QPRT.

The Internal Revenue Service will recognize a trust as a QPRT meeting all of the requirements of § 2702(a)(3)(A) and § 25.2702-5(c) if (i) the trust instrument is substantially similar to the sample in section 4 of this revenue procedure or if the trust agreement properly integrates one or more alternate provisions from section 6 of this revenue procedure into a document substantially similar to the sample in section 4, and (ii) the trust operates in a manner consistent with the terms of the trust instrument and is a valid trust under applicable local law. A trust instrument that contains substantive provisions in addition to those provided in section 4 of this revenue procedure (other than properly integrated alternate provisions from section 6 of this revenue procedure or provisions necessary to establish a valid trust under applicable local law), or that omits any of the provisions of section 4 of this revenue procedure (unless an alternative provision from section 6 of this revenue procedure is properly integrated), will not necessarily be disqualified, but will not be assured of qualification under the provisions of this revenue procedure. The Service generally will not issue a letter ruling on whether a trust with one term holder qualifies as a QPRT. The Service, however, will generally issue a letter ruling on the effect of substantive trust provisions, other than those contained in sections 4 and 6 of this revenue procedure, on the qualification of a trust as a QPRT.

SECTION 4. SAMPLE QUALIFIED PERSONAL RESIDENCE TRUST - ONE TERM HOLDER

This trust agreement is made this ____ day of _____, 20 ____, by and between, _____, (hereinafter “the Transferor”), and _____, (hereinafter “the Trustee”), hereby creating the _____ Trust.

ARTICLE I. RETAINED INTEREST AND IRREVOCABILITY

A. Retained Interest. The Transferor intends to establish a qualified personal residence trust within the meaning of Rev. Proc. 2003-42, § 2702(a)(3)(A) of the Internal Revenue Code (hereinafter “the Code”), and § 25.2702-5(c) of the Gift Tax Regulations (hereinafter “the regulations”). Accordingly, the Transferor retains no right, title, or interest in any trust asset except as specifically provided in this trust instrument.

B. Irrevocable. This trust is irrevocable and therefore may not be modified, amended, or revoked by the Transferor or any other person. Notwithstanding the preceding sentence, however, the Trustee shall have the power, acting alone, to amend the trust to the extent provided in § 25.2702-5(a)(2) of the regulations (or any subsequent regulation or statute) in any manner required for the sole purpose of ensuring that the trust qualifies as a qualified personal residence trust for purposes of § 2702(a)(3)(A) of the Code and § 25.2702-5(c) of the regulations (including with respect to the grantor retained annuity trust (“GRAT”) administered under Article III, the

qualification of the annuity interest under § 2702(b)(1) of the Code and § 25.2702-3 of the regulations).

ARTICLE II. QUALIFIED PERSONAL RESIDENCE TRUST

A. Funding of the Qualified Personal Residence Trust ("QPRT").

(1) Residence. The Transferor transfers and assigns to the Trustee all of the Transferor's interests in and rights to certain real property, including all improvements thereon and appurtenances thereto, known as _____ [legal description and/or address] _____, _____ [city] _____, _____ [state] _____. This property, or any property acquired as a replacement, will hereinafter be referred to as the "Residence." The Trustee accepts the Residence and agrees to hold, manage, and distribute the Residence and any other trust property under the terms set forth in this instrument.

(2) Assets of Trust. Except as provided in Paragraphs A(3), B(6), and D of this Article II, the Trustee is prohibited from holding, at any time during the term of the QPRT, any property other than (a) an interest in one (and only one) Residence that meets the requirements of a personal residence of the Transferor as set forth in § 25.2702-5(c)(2) of the regulations, and (b) policies of insurance on the Residence.

(3) Additions to QPRT. From time to time, the Trustee may accept an addition of cash to the QPRT in an amount which, when added to any cash already held, does not exceed the amount reasonably required for: (a) the payment of QPRT expenses (including without limitation mortgage payments) already incurred or reasonably expected to be paid by the trust within 6 months after the date the addition is made; (b) the cost of improvements to the Residence to be paid by the trust within 6 months after the date the addition is made; and (c) the purchase by the trust of a replacement Residence within 3 months after the date the addition is made, provided that no addition may be made, or held by the Trustee, for the purchase of a replacement Residence unless the Trustee has, prior to receipt of the addition, entered into a contract to purchase that Residence. The Trustee shall hold the additions of cash received in accordance with this paragraph in a separate account.

B. Administration of Trust.

(1) Use and Management of Residence. The Trustee shall hold and maintain the Residence as a personal residence of the Transferor during the period beginning on the date of creation of the trust and continuing through the date of termination of the

trust (hereinafter “the term of the QPRT”). During the term of the QPRT, the Transferor shall have the exclusive rent-free use, possession, and enjoyment of the Residence.

(2) Payment of Expenses. The Transferor shall be responsible for the payment of all costs associated with the Residence, including but not limited to mortgage payments, property taxes, utilities, repairs, maintenance, and insurance. The Trustee’s responsibility for the maintenance of the Residence and for other costs associated with the Residence is limited to the extent of any trust income and additions of cash for that purpose received by the Trustee in accordance with this Article II. If the Trustee has insufficient funds to pay these costs and expenses, the Trustee shall notify the Transferor, who shall be responsible for the unpaid balance of these costs and expenses. In addition, the Trustee from time to time may make improvements to the Residence, but the Trustee’s authority and responsibility to do so is limited to the extent of any trust income, insurance proceeds, and additions of cash for that purpose received by the Trustee in accordance with this Article II.

(3) Distributions of Cash to Transferor. Any net income of the QPRT shall be distributed to the Transferor, not less frequently than annually. In addition, the Trustee shall determine, not less frequently than quarterly, whether the cash held by the QPRT exceeds the amount permitted to be held by the Trustee and shall immediately distribute the excess, if any, to the Transferor. Within 30 days of the date of the termination of the QPRT, the Trustee shall distribute outright to the Transferor (or to the estate of the Transferor, as the case may be), any amounts held by the QPRT pursuant to Paragraph A(3) of this Article II that are not used to pay QPRT expenses due and payable on the date of termination (including expenses directly related to the termination of the QPRT).

(4) Reinvestment of Trust Assets. Except as provided in Paragraph B(5) of this Article II, the Trustee may sell the Residence from time to time upon terms and conditions the Trustee deems appropriate. The Trustee may disburse from time to time any part or all of the amounts described in Paragraph A(1) and A(3) above and Paragraph B(6) below, including all income and capital gains thereon, as the Trustee deems appropriate for the purchase or construction of a replacement Residence to be owned by the trust or for the reconstruction or repair of the Residence. These disbursements shall be made, and any reconstruction and repairs shall be completed, within the time periods necessary to allow this trust to continue to qualify as a QPRT, but the Trustee shall not be held liable for any failure in this regard unless the Trustee has acted (or failed to act) through willful default or gross negligence.

(5) Prohibition on Sale of Residence to Transferor or Related Parties. The Trustee is prohibited from selling or transferring (as defined in § 25.2702-5(c)(9) of the

regulations) the Residence, directly or indirectly, to the Transferor, the Transferor's spouse, or an entity controlled by the Transferor or the Transferor's spouse during the retained term interest of the QPRT, or at any time after the termination of the retained term interest in the QPRT while the trust is treated as owned in whole or in part by the Transferor or the Transferor's spouse under §§ 671 through 678 of the Code.

(6) Receipt of Proceeds With Respect to Residence. If the Residence is sold, the Trustee shall hold the proceeds of the sale (along with any income accrued thereon) in a separate account. If the Residence is damaged, destroyed, or involuntarily converted within the meaning of § 1033 of the Code, the Trustee shall hold any proceeds payable as a result thereof (consisting either of insurance proceeds in the case of damage or destruction to the Residence or the proceeds payable upon involuntary conversion) in a separate account. The proceeds (and any interest thereon) so received shall be held, administered, and distributed by the Trustee as provided in this Article II.

(7) Commutation of Interests. The Transferor's interest in the QPRT may not be sold, commuted, or prepaid by any person.

(8) Prohibited Distributions. Except to the extent provided in Paragraph D below, the Trustee may not make any distribution of income or principal from the QPRT to or for the benefit of any person other than the Transferor prior to the termination of the QPRT.

C. Termination of Trust. The trust's date of termination shall be the earlier of [date], or the date of the Transferor's death. Except as otherwise provided in Paragraph D below, the Trustee shall distribute the trust property at the end of the term of the QPRT as provided in this Paragraph C. If the date of termination is [date], the Trustee shall distribute all of the property of the trust (other than any amounts due the Transferor pursuant to this trust instrument) to [designate transferees - if more than one, specify shares]. If the date of termination is the earlier death of the Transferor, the Trustee shall distribute all trust property (other than any amounts due the Transferor's estate pursuant to this trust instrument) to [designate transferees - if more than one, specify shares].

D. Cessation of Qualification as a Personal Residence Trust.

(1) Cessation Date.

(a) The trust shall cease to be a QPRT on the date on which the Residence ceases to be used or held for use as a personal residence of the Transferor within the

meaning of § 25.2702-5(c)(7) of the regulations (other than for reasons described in Paragraphs D(1)(b) or D(1)(c) below).

(b) In the event of a sale of the Residence, the trust shall cease to be a QPRT on the first to occur of the following: (i) the date which is 2 years after the date of sale; (ii) the date of termination as determined in Paragraph C above; or (iii) the date on which a replacement Residence is acquired by the Trustee. If the first to occur is the acquisition of a replacement Residence by the Trustee, then the QPRT shall continue with respect to that replacement Residence, and the trust shall cease to be a QPRT only to the extent of any sale proceeds then held by the Trustee and not used for the purchase of the replacement Residence.

(c) If the Residence is damaged or destroyed, thus making it unusable as a personal residence, the trust shall cease to be a QPRT on the first to occur of the following dates: (i) the date that is 2 years after the date of damage or destruction; (ii) the date of termination as determined in Paragraph C above; or (iii) replacement of or repairs to the Residence are completed or a new Residence is acquired by the Trustee. If the first to occur is the completion of the replacement or repair (or the acquisition of a new Residence), then the QPRT shall continue with respect to the repaired Residence or the new Residence, and the trust shall cease to be a QPRT only to the extent of any insurance proceeds then held by the Trustee and not used for the replacement or repair of the Residence (or the purchase of the new Residence).

(2) Distribution on Cessation. Within 30 days after the date on which the trust ceases to be a QPRT with respect to any of its assets, and after satisfying the provisions of Paragraph B(3) of this Article II, the Trustee shall distribute the trust assets with respect to which the trust has ceased to qualify as a QPRT to a separate share of this trust to be referred to and administered as a GRAT in accordance with Article III below. That GRAT shall continue until the date of termination as defined in Paragraph C above.

(3) Multiple GRATs. Because it may be possible to have more than one cessation of qualification during the term of the QPRT, the Trustee shall create and fund a separate GRAT for each cessation and each GRAT shall be administered as a separate share of the trust in accordance with Article III below.

ARTICLE III. GRANTOR RETAINED ANNUITY TRUST

Each GRAT administered as a separate share under this Article III (each of which is referred to as “the GRAT” with regard to that separate share) is intended to provide for the payment of a qualified annuity interest as defined in § 25.2702-3 of the

regulations for the benefit of the Transferor. No amount shall be paid before the termination of this trust other than to or for the Transferor's benefit.

A. Right to Receive Annuity. In each taxable year of the GRAT, beginning with the year beginning on the cessation date (as defined below), the Trustee shall pay to the Transferor an annuity, the amount of which shall be determined in accordance with Paragraph D of this Article III. The right of the Transferor to receive the annuity amount begins on the cessation date.

B. Cessation Date. The cessation date is the date on which the Residence ceases to be used or held for use as a personal residence of the Transferor, the date of sale of the Residence, or the date of damage to or destruction of the Residence that renders the Residence unusable as a residence, as the case may be.

C. Payment of Annuity. The annuity amount shall be paid in equal [insert monthly, quarterly, semi-annual or annual] installments. The annuity amount shall be paid first from the net income of the GRAT and, to the extent net income is not sufficient, from principal. The Trustee may defer payment of any annuity amount otherwise payable after the cessation date until the date that is 30 days after the date that the assets are converted to a GRAT as provided in this trust instrument. Any deferred payment of the annuity amount shall bear interest for the period of deferral, compounded annually, at a rate not less than the rate prescribed in § 7520 of the Code in effect on the cessation date. The Trustee shall reduce the aggregate deferred annuity payments by the amount of income actually distributed to the Transferor during the deferral period.

D. Computation of Annuity Amount.

The amount of the annuity payable to the Transferor shall be determined as follows.

(1) If, on the date that any property of the trust is converted from the QPRT to a GRAT (hereinafter the "conversion date"), the assets of the trust do not include a Residence used or held for use as a personal residence of the Transferor, the annuity shall be the amount determined by dividing the lesser of (a) the value of the interest retained by the Transferor (as of the date of the original transfer) or (b) the value of all the trust assets (as of the conversion date) by the annuity factor determined (i) for the original term of the Transferor's interest and (ii) at the rate used in valuing the retained interest at the time of the original transfer to the QPRT.

(2) If, on the conversion date, the assets of the trust include a Residence used or held for use as a personal residence of the Transferor, the annuity shall be the amount determined under subparagraph (1) of this Paragraph D multiplied by a fraction. The numerator of the fraction is the excess of the fair market value of the assets of the trust on the conversion date over the fair market value of the assets as to which the trust continues as a QPRT, and the denominator of the fraction is the fair market value of the trust assets on the conversion date.

(3) In computing the annuity amount for any second or subsequent GRAT to be administered under this Article III, the Trustee shall make appropriate adjustments to the formulas above in this paragraph D that are consistent with the applicable provisions of the Code and the regulations thereunder and with the Transferor's intent to maintain qualification of each of the trust shares hereunder as a QPRT or a GRAT.

(4) If there is an error in the determination of the annuity amount, then, within a reasonable period after the error is discovered, the difference between the annuity amount payable and the amounts actually paid shall be paid to or for the use of the Transferor by the Trustee in the event of an underpayment, or shall be repaid by the Transferor to the Trustee in the event of an overpayment.

E. Proration. Notwithstanding the preceding paragraphs of this Article III, in determining the annuity amount for a short taxable year, the Trustee shall prorate the annuity amount on a daily basis. In determining the annuity amount for the taxable year of the termination of the GRAT, the Trustee shall prorate the annuity amount for the final period of the annuity interest on a daily basis.

F. Additional Contributions Prohibited. No additional contributions shall be made to the GRAT after its creation.

G. Termination of GRAT. The GRAT shall continue through the date of termination of the QPRT, as defined in Paragraph C of Article II, and shall then terminate. Upon termination of the GRAT, the Trustee shall distribute all of the trust property in the manner described in Paragraph C of Article II as if the GRAT property had been part of the QPRT disposed of under that provision.

H. No Commutation. The Transferor's interest in the annuity amount may not be sold, commuted, or prepaid by any person.

ARTICLE IV. GENERAL PROVISIONS

A. Taxable Year. The taxable year of the trust shall be the calendar year.

B. Governing Law. The operation of the trust shall be governed by the laws of the state of [state]. The Trustee, however, shall not have or exercise any power or discretion granted under applicable law that would prevent: (1) the QPRT administered under Article II above from meeting the requirements for a qualified personal residence trust under § 2702(a)(3)(A) of the Code and § 25.2702-5(c) of the regulations; or (2) the Transferor's interest in any GRAT administered under Article III above from meeting the requirements for a qualified annuity interest under § 25.2702-3 of the regulations.

SECTION 5. ANNOTATIONS REGARDING SAMPLE QUALIFIED PERSONAL RESIDENCE TRUST

.01 Annotations for Introductory Paragraph and Article I, Retained Interest and Irrevocability.

(1) Qualification as a QPRT. In order to qualify as a QPRT, the governing instrument must contain all the provisions required under the regulations, and these provisions must by their terms continue in effect during the existence of any term interest in the trust. Section 25.2702-5(c)(1).

(2) Appointment of Trustee. Alternative or successor trustees may be designated in the trust instrument.

(3) Limited Power of Amendment. A QPRT must be irrevocable. However, modification of a trust by judicial reformation (or nonjudicial reformation if effective under state law) to comply with the requirements of § 25.2702-5(c) will be effective for purposes of § 2702, provided the reformation is commenced within 90 days after the due date (including extension) for the filing of the gift tax return reporting the transfer of the residence under § 6075 and is completed within a reasonable time after commencement. Section 25.2702-5(a)(2).

.02 Annotations for Article II, Qualified Personal Residence Trust

(1) Requirement that QPRT Must be Funded With a Personal Residence (Article II, Paragraph A(1)). The QPRT must be funded with a residence that qualifies as a personal residence of the term holder during the term of the QPRT. A personal residence of a term holder is: (A) the principal residence of the term holder (as that term is defined in § 25.2702-5(c)(2)(i)(A)); (B) one other residence of the term holder (within the meaning of § 25.2702-5(c)(2)(i)(B)); or (C) an undivided fractional interest in a residence described in either (A) or (B). Section 25.2702-5(c)(2)(i). 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, for example, household furnishings. Section 25.2702-5(c)(2)(ii). A residence is a personal residence only if its primary use is as a residence of the term holder when occupied by the term holder. The principal residence of the term holder will not fail to meet the requirements of the preceding sentence merely because a portion of the residence is used in an activity meeting the requirements of § 280A(c)(1) or (4) (relating to deductibility of expenses related to certain uses), 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 are provided in connection with the provision of lodging, for example, a hotel or a bed and breakfast. A residence is not a personal residence if, during any period not occupied by the term holder, its primary use is other than as a residence. Section 25.2702-5(c)(2)(iii).

(2) Assets other than personal residence (Article II, Paragraph A(3)). This is an optional provision that, if included in the trust instrument, permits the trustee to accept additions of cash to the trust for the purposes set forth in Paragraph A(3) of Article II. A provision in the trust instrument that permits these additions is not required in order to qualify the trust as a QPRT. Section 25.2702-5(c)(5)(ii)(A). In addition, the trust instrument may permit improvements to the residence to be added to the trust and may permit the trust to hold such improvements, provided the residence, as improved, meets the requirements of a personal residence. Section 25.2702-5(c)(5)(ii)(B).

(3) Authority to Sell or Repair Residence (Article II, Paragraph B(4)). The provisions of Paragraph B(4) are optional. If the trustee is given the authority to sell the personal residence but not to reinvest the proceeds in a replacement personal residence, the trust ceases to be a QPRT upon the sale of the residence.

(4) Prohibition on Sale of Residence to Transferor or Related Person (Article II, Paragraph B(5)). The governing instrument must prohibit the trust from selling or transferring the residence directly or indirectly to the transferor, the transferor’s spouse, or an entity controlled by the transferor or the transferor’s spouse during the retained term interest in the trust or at any time after the expiration of that interest when the trust is a grantor trust. For these purposes: (A) a sale or transfer to another grantor trust of the transferor or the transferor’s spouse is considered a sale or transfer to the transferor or the transferor’s spouse; and (B) a “grantor trust” is a trust that is treated as owned in whole or in part by the transferor or the transferor’s spouse pursuant to §§ 671 through 678, and “control” is as defined in § 25.2701-2(b)(5)(ii) and (iii).

This prohibition, however, does not apply to a distribution for no consideration either to: (i) another grantor trust of the transferor or the transferor’s spouse, if the

distributee-grantor trust includes the same prohibition against a sale or transfer; (ii) the transferor's spouse after the term of the QPRT; or (iii) any person pursuant to the trust instrument or the exercise of the transferor's retained power of appointment, if any, if the transferor dies prior to the expiration of the retained term interest. Section 25.2702-5(c)(9).

(5) Termination of Trust (Article II, Paragraph C).

(a) Termination on Death of Transferor. If the trust terminates by reason of the death of the transferor, and therefore terminates prior to the end of the term interest, the trust property will be includible in the transferor's gross estate for federal estate tax purposes because the transferor will have retained an interest in the trust for a period that did not in fact end before the transferor's death. Section 2036(a)(1). Therefore, consideration should be given to designing the dispositive provisions to take advantage of marital or charitable deductions that may be available for estate tax purposes.

(b) Generation-Skipping Transfer Tax. Consideration also should be given to potential generation-skipping transfer (GST) tax consequences under § 2601 upon termination of the trust by reason of the death of the transferor during the QPRT term. The transferor may prefer to design the dispositive provisions to avoid any generation-skipping transfer in the event of the transferor's death during the term because, pursuant to § 2642(f), no allocation of GST exemption can be made until the end of the term of the QPRT (the transferor's death).

(6) Cessation of Use As a Personal Residence (Article II, Paragraph D).

The governing instrument must provide that a trust ceases to be a QPRT if the residence ceases to be used or held for use as a personal residence of the term holder. Under § 25.2702-5(c)(7)(i), 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.

.03 Annotation for Article III, Grantor Retained Annuity Trust (GRAT).

(1) Payment of Annuity (Article III, Paragraph C). Allowing deferral of the annuity payment is an optional provision and is not required in order to qualify as a QPRT. If the trustee is given the power to defer payment of any annuity amount, then the trust may (but is not required to) provide that the aggregate deferred annuity payments must be reduced by the amount of income actually distributed to the transferor during the deferral period. Section 25.2702-5(c)(8)(ii)(B).

(2) Computation of Annuity Amount (Article III, Paragraph D). The annuity amount may be greater than the amount identified in the sample trust, but may not be less than that amount. See Example 6 in § 25.2702-5(d) for a numerical example of how the annuity formulas operate.

.04 Annotation for Article IV, General Provisions.

Trustee Powers. The trust instrument may contain administrative provisions relating to the trustee's duties and powers, as long as the provisions do not conflict with the rules governing QPRTs under § 2702(a)(3)(A) and § 25.2702-5(c), or the rules governing qualified annuity interests under § 25.2702-3. A clause may be included that provides: "Except to the extent provided otherwise in Article II and Article III, the Trustee has the following powers"

SECTION 6. ALTERNATIVE OR OPTIONAL PROVISIONS FOR SAMPLE QUALIFIED PERSONAL RESIDENCE TRUST

.01 Contribution(s) of Cash to Purchase Personal Residence.

(1) Explanation. If the transferor does not currently own the personal residence that will constitute the trust corpus, cash may be transferred to the QPRT for the purchase of the initial residence. However, the purchase must take place within 3 months of the date the trust is created. Except for a nominal amount that may be required under state law to create the trust, before any contribution, the trustee must have previously entered into a contract to purchase that residence. Section 25.2702-5(c)(5)(ii)(A)(iii).

(2) Instructions for use. Replace Paragraphs A(1) and A(3) of Article II with the following paragraphs:

A(1) Cash for Purchase of Residence. The Transferor transfers \$_____ to the Trustee and confirms that the Transferor intends to transfer to the Trustee additional cash in an amount sufficient to allow the Trustee to purchase a residence to be used as a personal residence of the Transferor. The Trustee accepts that amount, agrees to hold it in a separate account, and agrees to use it and any additional cash contributed under Paragraph A(3)(d) of this Article to purchase, within 3 months after the date on which this trust is created, such a residence (hereinafter referred to as "the Residence"). The Trustee agrees to hold, manage, and distribute the Residence and any other trust property under the terms set forth in this instrument.

A(3) Additions to QPRT. From time to time, the Trustee may accept an addition of cash to the QPRT in an amount which, when added to any cash already held, does not exceed the amount reasonably required for: (a) the payment of QPRT expenses (including without limitation mortgage payments) already incurred or reasonably expected to be paid by the trust within 6 months after the date the addition is made; (b) the cost of improvements to the Residence to be paid by the trust within 6 months after the date the addition is made; (c) the purchase by the trust of a replacement Residence within 3 months after the date the addition is made, provided that no addition may be made, or held by the Trustee, for this purpose unless the Trustee has, prior to receipt of the addition, entered into a contract to purchase that Residence; and (d) the purchase by the trust of the initial Residence within 3 months of the date the trust is created, provided that no addition may be made, or held by the Trustee, for the purchase of the initial Residence unless the Trustee has, prior to receipt of the addition, entered into a contract to purchase that Residence. The Trustee shall hold the additions of cash received in accordance with this paragraph in a separate account.

.02 Disposition of Trust Assets on Cessation as QPRT.

(1) Explanation. The sample trust provides that, if the trust ceases to qualify as a QPRT, the assets are to be held as a separate share in a GRAT pursuant to which a qualified annuity interest is to be paid to the transferor until the QPRT's date of termination. Alternatively, the trust instrument may direct that the assets be returned to the transferor, or may give to a trustee, who is independent of the transferor, the discretion either to elect to return the assets to the transferor or to hold the assets in a GRAT. Section 25.2702-5(c)(8).

(2) Instructions for use if outright distribution. If the assets are to be distributed outright to the term holder, delete all of Article III, delete the reference to GRAT at the end of Paragraph B of Article I and Paragraph B of Article IV, delete Paragraph D(3) of Article II, and replace Paragraph D(2) of Article II with the following paragraph:

D(2) Distribution on Cessation. Within 30 days after the date on which the trust ceases to be a QPRT with respect to any assets, the Trustee shall distribute those assets outright to the Transferor.

(3) Instructions for use if trustee's discretion. If the trustee is to be given the discretion to either distribute the assets outright or establish a GRAT, replace Paragraph D(2) of Article II with the following paragraph:

D(2) Distribution on Cessation. Within 30 days after the date on which the trust ceases to be a QPRT with respect to any of its assets, and after satisfying the provisions of Paragraph B(3) of this Article II, the Trustee shall distribute any trust assets with respect to which the trust has ceased to qualify as a QPRT in one of two ways, as the Trustee may select in the Trustee's sole discretion. Specifically, the Trustee shall distribute the assets with respect to which the trust no longer qualifies as a QPRT either: (i) to the Transferor, outright; or (ii) to a separate share of this trust to be referred to and administered as a GRAT in accordance with Article III below. That GRAT shall continue until the date of termination as defined in Paragraph C above.

DRAFTING INFORMATION

The principal author of this revenue procedure is Mary Berman of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Mary Berman on (202) 622-3090 (not a toll-free call).

