

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 20, 25 and 301

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Special Valuation Rules

AGENCY: Internal Revenue Service,
Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to chapter 14 of the Internal Revenue Code as enacted in the Omnibus Budget Reconciliation Act of 1990, Public Law 101-508, 104 Stat. 1388. These regulations provide special valuation rules for purposes of the Federal estate and gift taxes imposed under chapters 1 and 12 of the Code. In addition these regulations provide rules involving lapsing rights and other transactions that are treated as completed transfers under chapter 14.

EFFECTIVE DATES: These regulations are effective as of January 28, 1992.

FOR FURTHER INFORMATION CONTACT: Fred E. Grundeman, (202) 535-9512 (not a toll free number).

SUPPLEMENTARY INFORMATION:**A. Paperwork Reduction Act**

The collection of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)) under control numbers 1545-1241 and 1545-1273. The estimated average annual burden per recordkeeper is two minutes. The estimated average annual burden per respondent is ten minutes.

These estimates approximate the average time expected to be necessary for the collection of information. They are based upon the information available to the Internal Revenue Service and do not include the estimate of burden that is included in the burden applicable to Forms 706 and 709. Individual respondents and record keepers may require more or less time, depending on their particular circumstances.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, T.F.P., Washington, DC 20224, and to the Office of Management and Budget, Paperwork Reduction Project, Washington, DC 20503.

B. Background*April 9, 1991 Proposed Regulations*

On April 9, 1991, a Notice of Proposed Rulemaking (PS-82-90 (1991-1 C.B. 998)) relating to the special valuation rules of sections 2701 through 2703 of the Internal Revenue Code was published in the Federal Register (56 FR 14321). These sections, along with section 2704, were enacted as chapter 14 of the Code in the Omnibus Budget Reconciliation Act of 1990, Public Law 101-508 (1991-48 I.R.B. 7). The Internal Revenue Service received written comments on the proposed regulations and, on September 20, 1991, held a public hearing on those regulations. After consideration of the comments received and the statements made at the public hearing, the proposed regulations are revised and adopted as final regulations by this Treasury decision.

September 11, 1991 Proposed Regulations

On September 11, 1991, a Notice of Proposed Rulemaking (PS-30-91 (1991-42 I.R.B. 36)) relating to additional special valuation rules under chapter 14 was published in the Federal Register (56 FR 46244). This notice proposed rules under sections 2701 and 2702 regarding adjustments to mitigate double taxation. Rules under section 2704 of the Internal Revenue Code were also proposed. The Internal Revenue Service received written comments from the public on the proposed regulations and, on November 1, 1991, held a public hearing concerning the regulations. After consideration of the comments received and the statements made at the public hearing, the proposed regulations, other than proposed § 25.2701-5 (relating to adjustments to mitigate double taxation), are revised and adopted as final regulations by this Treasury decision. An amendment to proposed § 25.2701-5 is proposed by a Notice of Proposed Rulemaking published elsewhere in this issue of the Federal Register.

The following discusses the more significant comments received on the proposed regulations and the reasons for accepting or rejecting those comments in the final regulations.

C. Section 2701*Scope of Section 2701*

Several commentators urged that the definition of "transfer" should be restricted. In response to this comment, the final regulations clarify the situations in which a "capital structure transaction" will be treated as a transfer subject to section 2701. Generally, if an

individual receives an applicable retained interest in connection with a redemption, recapitalization, or other change in the capital structure of an entity, the transaction is subject to section 2701 if the other conditions of that section are met. In addition, if an individual holding an applicable retained interest surrenders a senior equity interest in a corporation or partnership and the fair market value of an applicable retained interest already held by that individual increases, the transaction is potentially subject to section 2701. Similarly, if an individual surrenders a junior equity interest while a member of the individual's family holds a junior equity interest, and the individual or an applicable family member simultaneously holds an applicable retained interest, the transaction is potentially subject to section 2701.

The final regulations also clarify the application of section 2701 to the termination of an interest held indirectly through a trust. As proposed, the rule could unfairly subject an individual to section 2701. The final regulations narrow the application of the rule to circumstances where (1) the indirectly-held property would have been includible in the gross estate of the individual if the individual had died at the time of the termination, or (2) the indirectly-held property is in a trust as to which the individual is considered the owner under the grantor trust rules. See sections 671 through 678.

The final regulations provide that in determining whether a class of interest is proportional to another class, differences between classes attributable to non-lapsing provisions necessary to comply with partnership allocation requirements of the Internal Revenue Code (e.g., section 704(b)) are treated as nonlapsing differences with respect to limitations on liability.

In response to comments regarding the exception for proportionate transfers in § 25.2701-1(c)(4), the final regulations provide that the exception is available to the extent the transfer results in the required proportionate reduction in the holdings of the transferor and applicable family members. The final regulations clarify that this exception applies only with respect to a transfer by a single individual.

Valuation of Applicable Retained Interests

The final regulations clarify that, for purposes of section 2701, a payment that is contingent as to time or amount is not a guaranteed payment of a fixed amount.

The final regulations adopt the recommendation of one commentator that a right to receive a specific amount payable at death should qualify as a mandatory payment right.

Responding to several comments, the final regulations clarify that voting rights that confer an ability to compel liquidation are not valued at zero but instead are valued without regard to the ability to compel liquidation or, if the holder's rights are valued under the "lower of" valuation rule, in a manner consistent with the assumptions of that rule.

Several commentators suggested that partial elections be allowed under § 25.2701-2(c)(2). The final regulations adopt this suggestion.

The Subtraction Method of Valuation

Comments variously suggested that the proposed subtraction method of valuation is too restrictive, acceptable as written, or lacking in necessary specificity.

The valuation of a closely-held business interest is one of the most difficult administrative problems presented by the transfer tax system and courts have varied widely on the applicability of the subtraction method in that process.

Some commentators argue that section 2701 does not require use of a subtraction method. They argue, contrary to the conference report reference to "present law principles," that there are no such present law principles. Other commentators suggest that section 2701 should apply only if (and to the extent) a subtraction method would be appropriate under present law.

These and similar comments are based on the premise that section 2701 operates within the general framework of section 2512 of the Internal Revenue Code, i.e., that the special valuation rules are to be used to determine the value of the transferred property which, in turn, measures the amount of the gift. They ignore the operative language of section 2701 that the amount of the gift is to be determined by valuing certain retained rights under the special rules in section 2701. If use of the subtraction method is not required by section 2701, valuation of retained rights would have no bearing on the amount of the gift. That interpretation would cause section 2701 to be a nullity in that the valuation of retained rights cannot affect the amount of the gift other than by subtraction from a pretransfer aggregate value.

The Treasury Department and the Service do not believe that section 2701 was intended to be a nullity or merely an appendix to section 2512, but rather

that chapter 14 provides an independent set of rules intended to ensure more accurate gift tax valuation.

Present gift tax regulations provide a subtraction method for determining the amount of the gift if a donor retains an interest in the transferred property. In such a case, the amount of the gift is the value of the entire property less the value of the donor's retained interest. See § 25.2512-9(a)(1)(i). The proposed regulations paralleled that rule.

Although the Treasury Department and the Service believe that the subtraction method set forth in the April 9, 1991 proposed regulations is the appropriate method for determining the amount of the gift under section 2701, changes have been made, in response to comments, to the specific methodology set forth in the proposed regulations.

The 3-step method of valuation outlined in § 25.2701-3 of the proposed regulations is modified as follows. In Step 1, only the interests held by the individuals whose holdings are taken into account in determining "control" under § 25.2701-2(b)(5) ("family-held interests") are valued. The family-held interests are valued as if held by a single individual. Thus, the final regulations substantially simplify the valuation procedure by eliminating unnecessary valuations with respect to the entire entity and unrelated parties. By providing for a single-shareholder assumption in valuing the family-held interests in Step 1, the final regulations adopt the position of several commentators that the minority discount with respect to the transferred interest is appropriately applied at the end of the section 2701 valuation process rather than at the beginning. Steps 2 and 3 (including the special adjustment in Step 2) remain basically unchanged. However, Step 2 provides a rule that has the effect of allocating any "control premium" reflected in the value determined in Step 1 among the corresponding family-held interests on a pro rata basis. The final regulations add Step 4 to the valuation methodology. In Step 4, adjustments are made to the total amount of the gift to reflect consideration received for the transfer, appropriate discounts, and the value of certain retained interests if the property is transferred in trust. Consistent with the position of the regulations that section 2701 does not affect the value of the transferred property and the legislative history indicating that chapter 14 does not affect minority discounts otherwise available under the law in effect before enactment of chapter 14, any minority discount taken in Step 4 generally is limited to the amount that would have been available

under chapter 12 with respect to the transfer if section 2701 had not been applicable.

Minimum Value Rule

The final regulations clarify that, in applying the minimum value rule, the value of any junior equity interest is not less than a pro rata portion of 10 percent of the sum of the value of all equity interests including indebtedness to the transferor and applicable family members determined without regard to guarantees and qualified deferred compensation.

Accumulated Qualified Payments

The final regulations permit a qualified payment to be made in the form of a debt instrument, the term of which does not exceed four years, that bears compound interest at a rate no less than the appropriate discount rate payable from the due date of the qualified payment.

Adjustment to Mitigate Double Taxation

In response to numerous comments, proposed § 25.2701-5 is being substantially modified by a Notice of Proposed Rulemaking published elsewhere in this issue of the Federal Register. Rather than provide a credit against the Federal estate tax as contained in the September 11 proposed regulations, the revised proposed regulations provide for a reduction to a decedent's adjusted taxable gifts. In general, the amount of the reduction is the lesser of: (1) The amount by which the transferor's taxable gifts were increased as a result of the application of section 2701, and (2) the increase in the decedent's gross estate (or adjusted taxable gifts) attributable to the portion of the value of the applicable retained interest that was subject to gift tax at the time of the initial transfer. The limitation in the regulation assures that aggregate value includible in the decedent's transfer tax base is the sum of: (1) The value (on the date of the section 2701 transfer) of the family-held applicable retained interests allocable to the transferred subordinate equity interests, and (2) the value (as of the date the interest is subsequently transferred by the transferor) of the transferor's portion of family-held applicable retained interests not previously subject to tax.

Under certain circumstances, the transferor's spouse is treated as the transferor. The reduction is otherwise not assignable or transferable.

Indirect Ownership

Several comments were received regarding the indirect ownership rules in § 25.2701-6. Most of these comments arose from concern over the definition of transfer that included the termination of any indirectly-held interest. The revision to the definition of transfer discussed above generally makes changes to the indirect ownership rules unnecessary. Other suggested changes were rejected because of the additional complexity that would be introduced into these rules.

Effect on Other Internal Revenue Code Sections

Some commentators argued that determining the amount of a gift under section 2701 necessarily affects the results under other provisions of the Internal Revenue Code (such as the determination of basis under section 1015) that are based on the value of the transferred property. As discussed above, the final regulations reject the argument that section 2701 determines the value of the transferred property.

D. Section 2702

Exceptions

The final regulations provide that section 2702 does not apply to the transfer of an interest in trust if the only interest in the trust, other than the remainder interest or a qualified annuity or unitrust interest, is an interest qualifying for the charitable deduction under section 2522 (a charitable lead trust).

Other commentators recommended exceptions for lapses of "Crummey" powers and for certain transfers of annuity or unitrust interests. Those changes are made.

Retained Rights

Several commentators requested that the application of section 2702 to retained powers be clarified. In response, the final regulations provide that an "interest" includes a power if retention of the power prevents the transfer of an interest in property from being a completed gift under chapter 12. Without this rule, section 2702 could be avoided merely by retaining a power over a term income interest rather than the income interest itself.

In response to one comment, the final regulations provide that section 2702 does not apply if the only retained interest is as a permissible recipient of income.

Tangible Property Exception

Several commentators suggested eliminating the evidentiary requirement

necessary to qualify for valuation under the special rule for certain tangible property. This change is not made. Without a standard such as that set forth in the proposed regulations (e.g., actual evidence of rentals) against which proffered appraisals can be tested, the likelihood of significant overvaluations is very high. On the other hand, the recommendation that the burden of proof be placed on the transferor rather than the term holder is adopted in the final regulations.

One commentator suggested that depreciable property should qualify for the tangible property exception. This recommendation was not adopted. Generally, the use or non-use of such property during the term would affect the value of the property passing to the remainder beneficiary, and thus, the property would not come within the statutory exception. Congress intended, in enacting this exception, to provide limited relief to a class of property the value of which would not be affected by use or non-use.

As suggested by commentators, the rule regarding valuation of the unexpired portion of a term interest at the time of a conversion is expanded and clarified.

One commentator requested that the regulations permit a term interest in property that ceases to qualify for the tangible property exception to be converted to a qualified unitrust interest rather than a qualified annuity interest. This is not done, primarily because of the complexity involved in determining the appropriate amount of the unitrust payment.

In response to one comment, the final regulations clarify that the date on which tangible property is deemed to be converted as the result of an addition or improvement is the date on which the addition or improvement is commenced.

Qualified Interests

The final regulations clarify that a cumulative power of withdrawal does not meet the requirements of a qualified interest. Congress clearly intended that retained interests that are given value at the time of the transfer must reflect amounts that will actually be paid to the term holder. Section 2702 could be avoided if powers of withdrawal are considered qualified interests.

In response to comments requesting that increases in the annuity and unitrust amounts be permitted throughout the term, the final regulations provide flexibility to taxpayers by permitting the annuity or unitrust amount to be 120 percent of the annuity or unitrust amount paid for the preceding year. The proposed

regulations prohibited increases to prevent transferors from "zeroing out" a gift while still effectively transferring the appreciation on all the property during the term to the remainder beneficiary, (e.g., by providing for a balloon payment in the final year of the term). The Treasury Department and the Service believe that such a result would be inconsistent with the principles of section 2702. The final regulations, with minimal complexity, strike a balance between the government's policy concerns and taxpayers' desire for planning flexibility.

In response to a comment, the final regulations permit the payment of the greater (but not the lesser) of an annuity or unitrust amount. In that case, the retained interest is valued at the higher of the values of the two interests.

Commentators suggested allowing additional contributions to a trust from which a qualified annuity interest is payable. This is not done. Without this prohibition, additional contributions would arguably pass to the remainder beneficiary under certain circumstances without appropriate transfer taxes being paid.

Commentators suggested that commutation of qualified interests be permitted. This change is not made. Commutation (i.e., the prepayment of the term holder's interest) shifts the risk of a decline in interest rates from the remainder beneficiaries to the term holder. Therefore, a commuted term interest may not ultimately yield the same value to the term holder as the annuity or unitrust interest originally retained by the transferor. Congress intended in enacting section 2702, that a term interest would be valued at an amount greater than zero, only if the form of the term interest insures that the holder actually receives the value attributed to the interest. Allowing commutation would be inconsistent with this intent.

Joint Purchases

In response to another comment, the limit on the amount the term holder is considered to transfer in a joint purchase is clarified.

Personal Residence Trusts

The final regulations adopt the suggestion of commentators that an individual be permitted in certain circumstances to hold term interests in more than two personal residence trusts (or qualified personal residence trusts).

The final regulations make no changes in the definition of personal residence. Since the transfer in trust of a personal residence arguably presents the same

opportunity for valuation abuse that Congress sought to prevent by enactment of section 2702, the Treasury Department and the Service believe that Congress intended the personal residence exception to be a narrow exception to enable transferors to pass the family home, whether the principal residence or a vacation home, to younger members of the family. Therefore, the most recent Congressional statutory expression of what constitutes a personal residence, as found in section 163(h), is most pertinent in this situation. That provision defines personal residence as the principal residence and one other residence.

The final regulations address the concern of one commentator by permitting a single trust to be used to hold the interests of both spouses in a personal residence under certain circumstances.

The final regulations permit personal residence trusts to hold (for two years) proceeds payable as a result of damage, destruction or involuntary conversion of the personal residence. However, consistent with the explicit statutory language requiring that the only property in the trust be a residence, the final regulations continue to prohibit the holding of any other assets by the trust, including proceeds from the sale of the personal residence.

Qualified Personal Residence Trusts

Because of the restrictive statutory limitations on a personal residence trust, the safe harbor for a qualified personal residence trust is retained with slight modifications.

The final regulations clarify that a qualified personal residence trust must distribute any income to the term holder not less frequently than annually.

Commentators generally proposed that the regulations explicitly permit certain actions during the term of the trust. These comments were not adopted because the regulations are intended only to set out governing instrument requirements. The suggestion of one commentator that upon termination of the term interest, any cash in the trust be permitted to be used to pay unpaid expenses and termination expenses, was adopted.

The final regulations revise the provisions concerning cessation of use of the residence as a personal residence in several respects. First, the governing instrument must require either that the trust be terminated (and all trust assets distributed to the term holder) or that the term interest be converted to a qualified annuity interest. The trustee may be given the sole discretion to

select between those two options. Under the final regulations, the distribution or conversion must occur within 30 days of the date on which the trust ceases to be a qualified personal residence trust. The final regulations also permit excess sale proceeds not reinvested in a new personal residence to be converted to a qualified annuity interest.

Finally, one commentator requested that, upon cessation of use as a personal residence, the interest of the term holder be permitted to convert to a qualified unitrust interest. This is not done because of the complexity in determining the appropriate unitrust amount.

Adjustment to Mitigate Double Taxation

Comments were received suggesting that adjustments be permitted in situations not covered by the proposed regulations. None of these proposed changes are included in the final regulations. Section 2702 does not require an adjustment to mitigate double taxation. The final regulations intend relief only if the retained interest itself is taxed in a transfer subsequent to the original transfer to which section 2702 applied.

The final regulations provide that a reduction in adjusted taxable gifts is available if a term interest is included in the transferor's gross estate solely by reason of section 2033.

In response to one comment, the final regulations clarify the interaction of § 25.2702-6 and section 2001.

E. Section 2703

Exceptions

The final regulations provide that perpetual restrictions on the use of real property that qualified for either the gift or estate tax charitable deduction are not subject to section 2703. The specific reference to section 170(h) is deleted.

As suggested by several commentators, the final regulations expand the exception in the proposed regulations for rights and restrictions among unrelated parties. The final regulations provide that a right or restriction is not disregarded if more than 50 percent by value of the property subject to the right or restriction is owned by persons who are not family members of the transferor. "Member of the family" is defined by cross-reference to § 25.2701-2(b)(5) and also includes any other individual who is the natural object of the transferor's bounty.

One comment asked that the final regulations specifically state that a right of first refusal among family member co-owners of a business is never disregarded if the right can be exercised

only by matching the price offered by an outside purchaser. The Treasury Department and the Service do not believe that every such restriction necessarily meets the tests of section 2703.

Substantial Modification

The final regulations clarify when a transfer to a family member of an interest in property that is subject to a right or restriction is a substantial modification of the right or restriction. The final regulations provide that the addition of a family member in a generation no lower than the lowest generation occupied by persons already party to the right or restriction is not a substantial modification.

Other Issues

One commentator requested that the final regulations define the term "natural objects of the bounty." The final regulations do not provide a definition of this term. This concept has long been part of the transfer tax system and cannot be reduced to a simple formula or specific classes of relationship. The class of persons who may be the objects of an individual's bounty is not necessarily limited to persons related by blood or marriage.

In response to a comment, the final regulations clarify that if property is subject to multiple rights or restrictions, each separate right or restriction is tested independently. Whether separate provisions constitute separate rights or restrictions or are integral elements of a single right or restriction depends on the facts and circumstances in the particular case.

An example is added to the final regulations to clarify that a lease is a right or restriction with respect to the use of property that is disregarded in certain circumstances.

F. Section 2704

Lapsing Rights

One set of comments was received regarding section 2704. The commentator argued that applying section 2704(a) to a transfer of a voting interest that results in the termination of a liquidation right with respect to an interest other than the transferred interest was inappropriate in some cases. In response to that comment, the final regulations limit the scope of the rule to situations where the transferred interest is senior to the interest as to which the liquidation right terminates.

The final regulations clarify the exception for the lapse of liquidation rights valued under section 2701 is provided to mitigate double taxation.

chapter 14 are set forth in §§ 25.2701-1 through 25.2704-3.

Par. 7. Section 25.2502-1 is amended by adding a new sentence to the end of paragraph (a)(3) to read as follows:

§ 25.2502-1 Rate of Tax

(3) See § 25.2702-8 for an adjustment to the total amount of an individual's taxable gifts where the individual's current taxable gifts include the transfer of certain interests in trust that were previously valued under the provisions of section 2702.

Par. 8. Section 25.2512-1 is amended by adding two new sentences to the end to read as follows:

§ 25.2512-1 Valuation of property in general

See section 2701 and the regulations at § 25.2701 for special rules for valuing transfers of an interest in a corporation or a partnership and for the treatment of unpaid qualified payments at the subsequent transfer of an applicable retained interest by the transferor or by an applicable family member. See section 2704(b) and the regulations at § 25.2704-2 for special valuation rules where an interest in property is subject to an applicable restriction.

Par. 9. Section 25.2512-5 is amended by adding a new sentence to paragraph (a)(1)(i) immediately after the sixth sentence to read as follows:

§ 25.2512-5 Valuation of annuities, life estates, terms for years, remainders, and reversions transferred after November 30, 1983.

(a) In general. (1)(i) See section 2702 and the regulations at § 25.2702 for special rules for valuing transfers of interests in trust after October 8, 1990.

Par. 10. Section 25.2512-8 is amended by adding a sentence to the end to read as follows:

§ 25.2512-8 Transfers for insufficient consideration

See also sections 2701, 2702, 2703 and 2704 and the regulations at §§ 25.2701-0 through 25.2704-3 for special rules for valuing transfers of business interests, transfers in trust, and transfers pursuant to options and purchase agreements.

Par. 11. A new undesignated centerheading and new §§ 25.2701-0 through 25.2701-8, 25.2702-0 through 25.2702-7, 25.2703-1 and 25.2703-2, and 25.2704-1 through 25.2704-3 are added to read as follows:

Special Valuation Rules

§ 25.2701-0 Table of contents

This section lists the major paragraphs contained in §§ 25.2701-1 through 25.2701-8.

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§ 25.2701-5 Adjustments to mitigate double taxation

[Reserved].

§ 25.2701-6 Indirect holding of interests

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§ 25.2701-7 Separate interests

§ 25.2701-8 Effective dates

§ 25.2701-1 Special valuation rules in the case of transfers of certain interests in corporations and partnerships

(a) In general.—(1) Scope of section 2701. Section 2701 provides special valuation rules to determine the amount of the gift when an individual transfers an equity interest in a corporation or partnership to a member of the individual's family. For section 2701 to apply, the transferor or an applicable family member (as defined in paragraph (d)(2) of this section) must immediately after the transfer, hold an applicable retained interest (a type of equity interest defined in § 25.2701-2(b)(1)). If certain subsequent payments with respect to the applicable retained interest do not conform to the assumptions used in valuing the interest at the time of the initial transfer, § 25.2701-4 provides a special rule to increase the individual's later taxable gifts or taxable estate.

(2) Effect of section 2701. If section 2701 applies to a transfer, the amount of the transferor's gift, if any, is determined using a subtraction method of valuation (described in § 25.2701-3). Under this

method, the amount of the gift is determined by subtracting the value of any family-held applicable retained interests and other non-transferred equity interests from the aggregate value of family-held interests in the corporation or partnership (the "entity"). Generally, in determining the value of any applicable retained interest held by the transferor or an applicable family member—

(i) Any put, call, or conversion right, any right to compel liquidation, or any similar right is valued at zero if the right is an "extraordinary payment right" (as defined in § 25.2701-2(b)(2));

(ii) Any distribution right in a controlled entity (e.g., a right to receive dividends) is valued at zero unless the right is a "qualified payment right" (as defined in § 25.2701-2(b)(6)); and

(iii) Any other right (including a qualified payment right) is valued as if any right valued at zero did not exist but otherwise without regard to section 2701.

(3) *Example.* The following example illustrates rules of this paragraph (a).

Example. A, an individual, holds all the outstanding stock of S Corporation. A exchanges A's shares in S for 100 shares of 10-percent cumulative preferred stock and 100 shares of voting common stock. A transfers the common stock to A's child. Section 2701 applies to the transfer because A has transferred an equity interest (the common stock) to a member of A's family, and immediately thereafter holds an applicable retained interest (the preferred stock). A's preferred stock is valued under the rules of section 2701. A's gift is determined under the subtraction method by subtracting the value of A's preferred stock from the value of A's interest in S immediately prior to the transfer.

(b) *Transfers and other triggering events—(1) Completed transfers.* Section 2701 applies to determine the existence and amount of any gift, whether or not the transfer would otherwise be a taxable gift under chapter 12 of the Internal Revenue Code. For example, section 2701 applies to a transfer that would not otherwise be a gift under chapter 12 because it was a transfer for full and adequate consideration.

(2) *Transactions treated as transfers—(i) In general.* Except as provided in paragraph (b)(3) of this section, for purposes of section 2701, transfer includes the following transactions:

(A) A contribution to the capital of a new or existing entity;

(B) A redemption, recapitalization, or other change in the capital structure of an entity (a "capital structure transaction"), if—

(1) The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction;

(2) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest that is junior to the applicable retained interest (a "subordinate interest") and receives property other than an applicable retained interest; or

(3) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity (other than a subordinate interest) and the fair market value of the applicable retained interest is increased; or

(C) The termination of an indirect holding in an entity (as defined in § 25.2701-6), if—

(1) The property is held in a trust as to which the indirect holder is treated as the owner under subchapter J of chapter 1 of the Internal Revenue Code; or

(2) If the termination is not treated as a transfer under paragraph (b)(2)(i)(C)(1) of this section, to the extent the value of the indirectly-held interest would have been included in the value of the indirect holder's gross estate for Federal estate tax purposes if the indirect holder died immediately prior to the termination.

(ii) *Multiple attribution.* For purposes of paragraph (b)(2)(i)(C) of this section, if the termination of an indirect holding in property is treated as a transfer with respect to more than one indirect holder, the transfer is attributed in the following order:

(A) First, to the indirect holder(s) who transferred the interest to the entity (without regard to section 2513);

(B) Second, to the indirect holder(s) possessing a presently exercisable power to designate the person who shall possess or enjoy the property;

(C) Third, to the indirect holder(s) presently entitled to receive the income from the interest;

(D) Fourth, to the indirect holder(s) specifically entitled to receive the interest at a future date; and

(E) Last to any other indirect holder(s) proportionally.

(3) *Excluded transactions.* For purposes of section 2701, a transfer does not include the following transactions:

(i) A capital structure transaction, if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction. For this purpose, common

stock with non-lapsing voting rights and nonvoting common stock are interests that are substantially the same;

(ii) A shift of rights occurring upon the execution of a qualified disclaimer described in section 2518; and

(iii) A shift of rights occurring upon the release, exercise, or lapse of a power of appointment other than a general power of appointment described in section 2514, except to the extent the release, exercise, or lapse would otherwise be a transfer under chapter 12.

(c) *Circumstances in which section 2701 does not apply.* To the extent provided, section 2701 does not apply in the following cases:

(1) *Marketable transferred interests.* Section 2701 does not apply if there are readily available market quotations on an established securities market for the value of the transferred interests.

(2) *Marketable retained interests.* Section 25.2701-2 does not apply to any applicable retained interest if there are readily available market quotations on an established securities market for the value of the applicable retained interests.

(3) *Interests of the same class.* Section 2701 does not apply if the retained interest is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest. A class is proportional to the class of the transferred interest if the rights are identical or proportional to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability). For purposes of this section, non-lapsing provisions necessary to comply with partnership allocation requirements of the Internal Revenue Code (e.g., section 704(b)) are non-lapsing differences with respect to limitations on liability. A right that lapses by reason of Federal or State law is treated as a non-lapsing right unless the Secretary determines, by regulation or by published revenue ruling, that it is necessary to treat such a right as a lapsing right to accomplish the purposes of section 2701. An interest in a partnership is not an interest in the same class as the transferred interest if the transferor or applicable family members have the right to alter the liability of the transferee.

(4) *Proportionate transfers.* Section 2701 does not apply to a transfer by an individual of equity interests to the extent the transfer by that individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family

members in the aggregate immediately before the transfer. Thus, for example, section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P's child in a manner that reduces each interest held by P and any applicable family members, in the aggregate, by 10 percent even if the transfer does not proportionately reduce P's interest in each class. See § 25.2701-6 regarding indirect holding of interests.

(d) *Family definitions*—(1) *Member of the family*. A member of the family is, with respect to any transferor—

- (i) The transferor's spouse;
- (ii) Any lineal descendant of the transferor or the transferor's spouse; and
- (iii) The spouse of any such lineal descendant.

(2) *Applicable family member*. An applicable family member is, with respect to any transferor—

- (i) The transferor's spouse;
- (ii) Any ancestor of the transferor or the transferor's spouse; and
- (iii) The spouse of any such ancestor.

(3) *Relationship by adoption*. For purposes of section 2701, any relationship by legal adoption is the same as a relationship by blood.

(e) *Examples*. The following examples illustrate provisions of this section:

Example 1. P, an individual, holds all the outstanding stock of X Corporation. Assume the fair market value of P's interest in X immediately prior to the transfer is \$1.5 million. X is recapitalized so that P holds 1,000 shares of \$1,000 par value preferred stock bearing an annual cumulative dividend of \$100 per share (the aggregate fair market value of which is assumed to be \$1 million) and 1,000 shares of voting common stock. P transfers the common stock to P's child. Section 2701 applies to the transfer because P has transferred an equity interest (the common stock) to a member of P's family and immediately thereafter holds an applicable retained interest (the preferred stock). P's right to receive annual cumulative dividends is a qualified payment right and is valued for purposes of section 2701 at its fair market value of \$1,000,000. The amount of P's gift, determined using the subtraction method of § 25.2701-3, is \$500,000 (\$1,500,000 minus \$1,000,000).

Example 2. The facts are the same as in Example 1, except that the preferred dividend right is noncumulative. Under § 25.2701-2, P's preferred dividend right is valued at zero because it is a distribution right in a controlled entity, but is not a qualified payment right. All of P's other rights in the preferred stock are valued as if P's dividend right does not exist but otherwise without regard to section 2701. The amount of P's gift, determined using the subtraction method, is \$1,500,000 (\$1,500,000 minus \$0). P may elect, however, to treat the dividend right as a qualified payment right as provided in § 25.2701-2(c)(2).

§ 25.2701-2 *Special valuation rules for applicable retained interests.*

(a) *In general*. In determining the amount of a gift under § 25.2701-3, the value of any applicable retained interest (as defined in paragraph (b)(1) of this section) held by the transferor or by an applicable family member is determined using the rules of chapter 12, with the modifications prescribed by this section. See § 25.2701-6 regarding the indirect holding of interests.

(1) *Valuing an extraordinary payment right*. Any extraordinary payment right (as defined in paragraph (b)(2) of this section) is valued at zero.

(2) *Valuing a distribution right*. Any distribution right (as defined in paragraph (b)(3) of this section) in a controlled entity is valued at zero, unless it is a qualified payment right (as defined in paragraph (b)(6) of this section). Controlled entity is defined in paragraph (b)(5) of this section.

(3) *Special rule for valuing a qualified payment right held in conjunction with an extraordinary payment right*. If an applicable retained interest confers a qualified payment right and one or more extraordinary payment rights, the value of all these rights is determined by assuming that each extraordinary payment right is exercised in a manner that results in the lowest total value being determined for all the rights, using a consistent set of assumptions and giving due regard to the entity's net worth, prospective earning power, and other relevant factors (the "lower of" valuation rule). See §§ 20.2031-2(f) and 20.2031-3 for rules relating to the valuation of business interests generally.

(4) *Valuing other rights*. Any other right (including a qualified payment right not subject to the prior paragraph) is valued as if any right valued at zero does not exist and as if any right valued under the lower of rule is exercised in a manner consistent with the assumptions of that rule but otherwise without regard to section 2701. Thus, if an applicable retained interest carries no rights that are valued at zero or under the lower of rule, the value of the interest for purposes of section 2701 is its fair market value.

(5) *Example*. The following example illustrates rules of this paragraph (a).

Example. P, an individual, holds all 1,000 shares of X Corporation's \$1,000 par value preferred stock bearing an annual cumulative dividend of \$100 per share and holds all 1,000 shares of X's voting common stock. P has the right to put all the preferred stock to X at any time for \$900,000. P transfers the common stock to P's child and immediately thereafter holds the preferred stock. Assume that at the time of the transfer, the fair market value of

X is \$1,500,000, and the fair market value of P's annual cumulative dividend right is \$1,000,000. Because the preferred stock confers both an extraordinary payment right (the put right) and a qualified payment right (i.e., the right to receive cumulative dividends), the lower of rule applies and the value of these rights is determined as if the put right will be exercised in a manner that results in the lowest total value being determined for the rights (in this case, by assuming that the put will be exercised immediately). The value of P's preferred stock is \$900,000 (the lower of \$1,000,000 or \$900,000). The amount of the gift is \$600,000 (\$1,500,000 minus \$900,000).

(b) *Definitions*—(1) *Applicable retained interest*. An applicable retained interest is any equity interest in a corporation or partnership with respect to which there is either—

(i) An extraordinary payment right (as defined in paragraph (b)(2) of this section), or

(ii) In the case of a controlled entity (as defined in paragraph (b)(5) of this section), a distribution right (as defined in paragraph (b)(3) of this section).

(2) *Extraordinary payment right*. Except as provided in paragraph (b)(4) of this section, an extraordinary payment right is any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest. A call right includes any warrant, option, or other right to acquire one or more equity interests.

(3) *Distribution right*. A distribution right is the right to receive distributions with respect to an equity interest. A distribution right does not include—

(i) Any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest;

(ii) Any extraordinary payment right; or

(iii) Any right described in paragraph (b)(4) of this section.

(4) *Rights that are not extraordinary payment rights or distribution rights*. Mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under section 707(c), and non-lapsing conversion rights are neither extraordinary payment rights nor distribution rights.

(i) *Mandatory payment right*. A mandatory payment right is a right to receive a payment required to be made at a specific time for a specific amount. For example, a mandatory redemption right in preferred stock requiring that the stock be redeemed at its fixed par value on a date certain is a mandatory payment right and therefore not an

extraordinary payment right or a distribution right. A right to receive a specific amount on the death of the holder is a mandatory payment right.

(ii) *Liquidation participation rights.* A liquidation participation right is a right to participate in a liquidating distribution. If the transferor, members of the transferor's family, or applicable family members have the ability to compel liquidation, the liquidation participation right is valued as if the ability to compel liquidation—

(A) Did not exist, or
(B) If the lower of rate applies, is exercised in a manner that is consistent with that rule.

(iii) *Right to a guaranteed payment of a fixed amount under section 707(c).* The right to a guaranteed payment of a fixed amount under section 707(c) is the right to a guaranteed payment (within the meaning of section 707(c)) the amount of which is determined at a fixed rate (including a rate that bears a fixed relationship to a specified market interest rate). A payment that is contingent as to time or amount is not a guaranteed payment of a fixed amount.

(iv) *Non-lapsing conversion right—(A) Corporations.* A non-lapsing conversion right, in the case of a corporation, is a non-lapsing right to convert an equity interest in a corporation into a fixed number or a fixed percentage of shares of the same class as the transferred interest (or into an interest that would be of the same class but for non-lapsing differences in voting rights), that is subject to proportionate adjustments for changes in the equity ownership of the corporation and to adjustments similar to those provided in section 2701(d) for unpaid payments.

(B) *Partnerships.* A non-lapsing conversion right, in the case of a partnership, is a non-lapsing right to convert an equity interest in a partnership into a specified interest (other than an interest represented by a fixed dollar amount) of the same class as the transferred interest (or into an interest that would be of the same class but for non-lapsing differences in management rights or limitations on liability) that is subject to proportionate adjustments for changes in the equity ownership of the partnership and to adjustments similar to those provided in section 2701(d) for unpaid payments.

(C) *Proportionate adjustments in equity ownership.* For purposes of this paragraph (b)(4), an equity interest is subject to proportionate adjustments for changes in equity ownership if, in the case of a corporation, proportionate adjustments are required to be made for splits, combinations, reclassifications, and similar changes in capital stock, or

in the case of a partnership, the equity interest is protected from dilution resulting from changes in the partnership structure.

(D) *Adjustments for unpaid payments.* For purposes of this paragraph (b)(4), an equity interest is subject to adjustments similar to those provided in section 2701(d) if it provides for—

(1) Cumulative payments;
(2) Compounding of any unpaid payments at the rate specified in § 25.2701-4(c)(2); and
(3) Adjustment of the number or percentage of shares or the size of the interest into which it is convertible to take account of accumulated but unpaid payments.

(5) *Controlled entity—(i) In general.* For purposes of section 2701, a controlled entity is a corporation or partnership controlled, immediately before a transfer, by the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse. See § 25.2701-6 regarding indirect holding of interests.

(ii) *Corporations—(A) In general.* In the case of a corporation, control means the holding of at least 50 percent of the total voting power or total fair market value of the equity interests in the corporation.

(B) *Voting rights.* Equity interests that carry no right to vote other than on liquidation, merger, or a similar event are not considered to have voting rights for purposes of this paragraph (b)(5)(ii). Generally, a voting right is considered held by an individual to the extent that the individual, either alone or in conjunction with any other person, is entitled to exercise (or direct the exercise of) the right. However, if an equity interest carrying voting rights is held in a fiduciary capacity, the voting rights are not considered held by the fiduciary, but instead are considered held by each beneficial owner of the interest and by each individual who is a permissible recipient of the income from the interest. A voting right does not include a right to vote that is subject to a contingency that has not occurred, other than a contingency that is within the control of the individual holding the right.

(iii) *Partnerships.* In the case of any partnership, control means the holding of at least 50 percent of either the capital interest or the profits interest in the partnership. Any right to a guaranteed payment under section 707(c) of a fixed amount is disregarded in making this determination. In addition, in the case of a limited partnership, control means the holding of any equity interest as a general

partner. See § 25.2701-2(b)(4)(iii) for the definition of a right to a guaranteed payment of a fixed amount under section 707(c).

(8) *Qualified payment right—(i) In general.* A qualified payment right is a right to receive qualified payments. A qualified payment is a distribution that is—

(A) A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate;

(B) Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount; or

(C) Any distribution right for which an election has been made pursuant to paragraph (c)(2) of this section.

(ii) *Fixed rate.* For purposes of this section, a payment rate that bears a fixed relationship to a specified market interest rate is a payment determined at a fixed rate.

(c) *Qualified payment elections—(1) Election to treat a qualified payment right as other than a qualified payment right.* Any transferor holding a qualified payment right may elect to treat all rights held by the transferor of the same class as rights that are not qualified payment rights. An election may be a partial election, in which case the election must be exercised with respect to a consistent portion of each payment right in the class as to which the election has been made.

(2) *Election to treat other distribution rights as qualified payment rights.* Any individual may elect to treat a distribution right held by that individual in a controlled entity as a qualified payment right. An election may be a partial election, in which case the election must be exercised with respect to a consistent portion of each payment right in the class as to which the election has been made. An election under this paragraph (c)(2) will not cause the value of the applicable retained interest conferring the distribution right to exceed the fair market value of the applicable retained interest (determined without regard to section 2701). The election is effective only to the extent—

(i) Specified in the election, and
(ii) That the payments elected are permissible under the legal instrument giving rise to the right and are consistent with the legal right of the entity to make the payment.

(3) *Elections irrevocable.* Any election under paragraph (c)(1) or (c)(2) of this section is revocable only with the consent of the Commissioner.

(4) *Treatment of certain payments to applicable family members.* Any payment right described in paragraph (b)(6) of this section held by an applicable family member is treated as a payment right that is not a qualified payment right unless the applicable family member elects (pursuant to paragraph (c)(2) of this section) to treat the payment right as a qualified payment right. An election may be a partial election, in which case the election must be exercised with respect to a consistent portion of each payment right in the class as to which the election has been made.

(5) *Time and manner of elections.* Any election under paragraph (c)(1) or (c)(2) of this section is made by attaching a statement to the Form 709, Federal Gift Tax Return, filed by the transferor on which the transfer is reported. An election filed after the time of the filing of the Form 709 reporting the transfer is not a valid election. An election filed as of April 8, 1992, for transfers made prior to its publication is effective. The statement must—

(i) Set forth the name, address, and taxpayer identification number of the electing individual and of the transferor, if different;

(ii) If the electing individual is not the transferor filing the return, state the relationship between the individual and the transferor;

(iii) Specifically identify the transfer disclosed on the return to which the election applies;

(iv) Describe in detail the distribution right to which the election applies;

(v) State the provision of the regulation under which the election is being made; and

(vi) If the election is being made under paragraph (c)(2) of this section—

(A) State the amounts that the election assumes will be paid, and the times that the election assumes the payments will be made;

(B) Contain a statement, signed by the electing individual, in which the electing individual agrees that—

(1) If payments are not made as provided in the election, the individual's subsequent taxable gifts or taxable estate will, upon the occurrence of a taxable event (as defined in § 25.2701-4(b)), be increased by an amount determined under § 25.2701-4(c), and

(2) The individual will be personally liable for any increase in tax attributable thereto.

(d) *Examples.* The following examples illustrate provisions of this section:

Example 1. On March 30, 1991, P transfers non-voting common stock of X Corporation to P's child, while retaining \$100 par value voting preferred stock bearing a cumulative

annual dividend of \$10. Immediately before the transfer, P held 100 percent of the stock. Because X is a controlled entity (within the meaning of paragraph (b)(5) of this section), P's dividend right is a distribution right that is subject to section 2701. See § 25.2701-2(b)(3). Because the distribution right is an annual cumulative dividend, it is a qualified payment right. See § 25.2701-2(b)(6).

Example 2. The facts are the same as in *Example 1*, except that the dividend right is non-cumulative. P's dividend right is a distribution right in a controlled entity, but is not a qualified payment right because the dividend is non-cumulative. Therefore, the non-cumulative dividend right is valued at zero under § 25.2701-2(a)(2). If the corporation were not a controlled entity, P's dividend right would be valued without regard to section 2701.

Example 3. The facts are the same as in *Example 1*. Because P holds sufficient voting power to compel liquidation of X, P's right to participate in liquidation is an extraordinary payment right under paragraph (b)(2) of this section. Because P holds an extraordinary payment right in conjunction with a qualified payment right (the right to receive cumulative dividends), the lower of rule applies.

Example 4. The facts are the same as in *Example 1*, except that immediately before the transfer, P, applicable family members of P, and members of P's family, hold 60 percent of the voting rights in X. Assume that 60 percent of the vote is required to compel liquidation of any interest in X. P's right to participate in liquidation is not an extraordinary payment right under paragraph (b)(2) of this section, because P and P's family cannot compel liquidation of X. P's preferred stock is an applicable retained interest that carries no rights that are valued under the special valuation rules of section 2701. Thus, in applying the valuation method of § 25.2701-3, the value of P's preferred stock is its fair market value determined without regard to section 2701.

Example 5. L holds 10-percent non-cumulative preferred stock and common stock in a corporation that is a controlled entity. L transfers the common stock to L's child. L holds no extraordinary payment rights with respect to the preferred stock. L elects under paragraph (c)(2) of this section to treat the noncumulative dividend right as a qualified payment right consisting of the right to receive a cumulative annual dividend of 5 percent. Under § 25.2701-2(c)(2), the value of the distribution right pursuant to the election is the lesser of—

(A) The fair market value of the right to receive a cumulative 5-percent dividend from the corporation, giving due regard to the corporation's net worth, prospective earning power, and dividend-paying capacity; or

(B) The value of the distribution right determined without regard to section 2701 and without regard to the terms of the qualified payment election.

§ 25.2701-3 Determination of amount of gift.

(a) *Overview—(1) In general.* The amount of the gift resulting from any transfer to which section 2701 applies is determined by a subtraction method of

valuation. Under this method, the amount of the transfer is determined by subtracting the values of all family-held senior equity interests from the fair market value of all family-held interests in the entity determined immediately before the transfer. The values of the senior equity interests held by the transferor and applicable family members generally are determined under section 2701. Other family-held senior equity interests are valued at their fair market value. The balance is then appropriately allocated among the transferred interests and other family-held subordinate equity interests. Finally, certain discounts and other appropriate reductions are provided, but only to the extent permitted by this section.

(2) *Definitions.* The following definitions apply for purposes of this section.

(i) *Family-held.* Family-held means held (directly or indirectly) by an individual described in § 25.2701-2(b)(5)(i).

(ii) *Senior equity interest.* Senior equity interest means an equity interest in the entity that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest.

(iii) *Subordinate equity interest.* Subordinate equity interest means an equity interest in the entity as to which an applicable retained interest is a senior equity interest.

(b) *Valuation methodology.* The following methodology is used to determine the amount of the gift when section 2701 applies.

(1) *Step 1—Valuation of family-held interests.* Determine the fair market value of all family-held equity interests in the entity. The fair market value is determined by assuming that the interests are held by one individual, using a consistent set of assumptions.

(2) *Step 2—Subtract the value of senior equity interests.* From the value determined in Step 1, subtract the following amounts:

(i) An amount equal to the fair market value of all family-held senior equity interests, other than applicable retained interests held by the transferor or applicable family members. The fair market value of an interest is its pro rata share of the fair market value of all family-held senior equity interests of the same class (determined as if all family-held senior equity interests were held by one individual); and

(ii) The value of all applicable retained interests held by the transferor or applicable family members determined under § 25.2701-2, taking

into account the adjustment described in paragraph (b)(5) of this section.

(3) *Step 3—Allocate the remaining value among the transferred interests and other family-held subordinate equity interests.* The value remaining after Step 2 is allocated among the transferred interests and other family-held subordinate equity interests. If more than one class of family-held subordinate equity interest exists, the value remaining after Step 2 is allocated, beginning with the most senior class of subordinate equity interest, in the manner that would most fairly approximate their value if all rights valued under section 2701 at zero did not exist (or would be exercised in a manner consistent with the assumptions of the rule of § 25.2702-2(a)(4), if applicable). If there is no clearly appropriate method of allocating the remaining value pursuant to the preceding sentence, the remaining value (or the portion remaining after any partial allocation pursuant to the preceding sentence) is allocated to the interests in proportion to their fair market values determined without regard to section 2701.

(4) *Step 4—Determine the amount of the gift—(i) In general.* The amount allocated to the transferred interests in Step 3 is reduced by the amounts determined under this paragraph (b)(4).

(ii) *Reduction for minority or similar discounts.* Except as provided in § 25.2701-3(c), if the value of the transferred interest (determined without regard to section 2701) would be determined after application of a minority or similar discount with respect to the transferred interest, the amount of the gift determined under section 2701 is reduced by the excess, if any, of—

(A) A pro rata portion of the fair market value of the family-held interests of the same class (determined as if all voting rights conferred by family-held equity interests were held by one person who had no other interest in the entity, but otherwise without regard to section 2701), over

(B) The value of the transferred interest (without regard to section 2701).

(iii) *Adjustment for transfers with a retained interest.* If the value of the transferor's gift (determined without regard to section 2701) would be reduced under section 2702 to reflect the value of a retained interest, the value determined under section 2701 is reduced by the same amount.

(iv) *Reduction for consideration.* The amount of the transfer (determined under section 2701) is reduced by the amount of consideration in money or money's worth received by the transferor, but not in excess of the

amount of the gift (determined without regard to section 2701). The value of consideration received by the transferor in the form of an applicable retained interest in the entity is determined under section 2701.

(5) *Adjustment in Step 2—(i) In general.* For purposes of paragraph (b)(2) of this section, if the percentage of any class of applicable retained interest held by the transferor and by applicable family members exceeds the family interest percentage, the excess is treated as a family-held interest that is not held by the transferor or an applicable family member.

(ii) *Family interest percentage.* The family interest percentage is the highest ownership percentage (determined on the basis of relative fair market values) of family-held interests in—

(A) Any class of subordinate equity interest; or

(B) All subordinate equity interests, valued in the aggregate.

(c) *Minimum value rule—(1) In general.* If section 2701 applies to the transfer of an interest in an entity, the value of a junior equity interest is not less than its pro-rata portion of 10 percent of the sum of—

(i) The total value of all equity interests in the entity, and

(ii) The total amount of any indebtedness of the entity owed to the transferor and applicable family members.

(2) *Junior equity interest.* For purposes of paragraph (c)(1) of this section, junior equity interest means common stock or, in the case of a partnership, any partnership interest under which the rights to income and capital are junior to the rights of all other classes of partnership interests. Common stock means the class or classes of stock that, under the facts and circumstances, are entitled to share in the reasonably anticipated residual growth in the entity.

(3) *Indebtedness—(i) In general.* For purposes of paragraph (c)(1) of this section, indebtedness owed to the transferor (or an applicable family member) does not include—

(A) Short-term indebtedness incurred with respect to the current conduct of the entity's trade or business (such as amounts payable for current services);

(B) Indebtedness owed to a third party solely because it is guaranteed by the transferor or an applicable family member; or

(C) Amounts permanently set aside in a qualified deferred compensation arrangement, to the extent the amounts are unavailable for use by the entity.

(ii) *Leases.* A lease of property is not indebtedness, without regard to the length of the lease term, if the lease

payments represent full and adequate consideration for use of the property. Lease payments are considered full and adequate consideration if a good faith effort is made to determine the fair rental value under the lease and the terms of the lease conform to the value so determined. Arrearages with respect to a lease are indebtedness.

(d) *Examples.* The application of the subtraction method described in this section is illustrated by the following Examples:

Example 1. Corporation X has outstanding 1,000 shares of \$1,000 par value voting preferred stock, each share of which carries a cumulative annual dividend of 8 percent and a right to put the stock to X for its par value at any time. In addition, there are outstanding 1,000 shares of non-voting common stock. A holds 800 shares of the preferred stock and 750 shares of the common stock. The balance of the preferred and common stock is held by B, a person unrelated to A. Because the preferred stock confers both a qualified payment right and an extraordinary payment right, A's rights are valued under the "lower of" rule of § 25.2701-2(a)(3). Assume that A's rights in the preferred stock are valued at \$800 per share under the "lower of" rule (taking account of A's voting rights). A transfers all of A's common stock to A's child. The method for determining the amount of A's gift is as follows—

Step 1: Assume the fair market value of all the family-held interests in X, taking account of A's control of the corporation, is determined to be \$1 million.

Step 2: From the amount determined under Step 1, subtract \$480,000 (800 shares × \$600 (the section 2701 value of A's preferred stock, computed under the "lower of" rule of § 25.2701-2(a)(3))).

Step 3: The result of Step 2 is a balance of \$520,000. This amount is fully allocated to the 750 shares of family-held common stock.

Step 4: No adjustment is made under Step 4 because no consideration was furnished for the transfer and because no minority or similar discount is appropriate. Thus, the amount of A's gift is \$520,000.

Example 2. The facts are the same as in Example 1, except that prior to the transfer A holds only 50 percent of the common stock and B holds the remaining 50 percent. Assume that the fair market value of A's 800 shares of preferred stock is \$800,000.

Step 1: Assume that the result of this step (determining the value of the family-held interest) is \$980,000.

Step 2: From the amount determined under Step 1, subtract \$500,000 (\$400,000, the fair market value of 500 shares of A's preferred stock determined under section 2701 plus \$100,000, the fair market value of A's other 300 shares of preferred stock determined without regard to section 2701 pursuant to the valuation adjustment determined under paragraph (b)(5) of this section). The adjustment in step 2 applies in this example because A's percentage ownership of the preferred stock (80 percent) exceeds the family interest percentage of the common

stock (50 percent). Therefore, 100 shares of A's preferred stock are valued at fair market value, or \$100,000 (100 × \$1,000). The balance of A's preferred stock is valued under section 2701 at \$400,000 (500 shares × \$800). The value of A's preferred stock for purposes of section 2701 equals \$500,000 (\$100,000 plus \$400,000).

Step 3: The result of Step 2 is \$480,000 (\$980,000 minus \$500,000) which is allocated to the family-held common stock. Because A transferred all of the family-held subordinate equity interests, all of the value determined under Step 2 is allocated to the transferred shares.

Step 4: No adjustment is made under Step 4 for the same reasons set forth in *Example 1*. Thus, the amount of the gift is \$480,000.

Example 3. Corporation X has outstanding 1,000 shares of \$1,000 par value non-voting preferred stock, each share of which carries a cumulative annual dividend of 8 percent and a right to put the stock to X for its par value at any time. In addition, there are outstanding 1,000 shares of voting common stock. A holds 600 shares of the preferred stock and 750 shares of the common stock. The balance of the preferred and common stock is held by B, a person unrelated to A. Assume further that steps one through three, as in *Example 1*, result in \$520,000 being allocated to the family-held common stock and that A transfers only 75 shares of A's common stock. The transfer fragments A's voting interest. Under Step 4, an adjustment is appropriate to reflect the fragmentation of A's voting rights. The amount of the adjustment is the difference between 10 percent (75/750) of the fair market value of A's common shares and the fair market value of the transferred shares, each determined as if the holder thereof had no other interest in the corporation.

Example 4. On December 31, 1990, the capital structure of Y corporation consists of 1,000 shares of voting common stock held three-fourths by A and one-fourth by A's child, B. On January 15, 1991, A transfers 250 shares of common stock to Y in exchange for 300 shares of nonvoting, noncumulative 8% preferred stock with a section 2701 value of zero. Assume that the fair market value of Y is \$1,000,000 at the time of the exchange and that the exchange by A is for full and adequate consideration in money's worth. However, for purposes of section 2701, if a subordinate equity interest is transferred in exchange for an applicable retained interest, consideration in the exchange is determined with reference to the section 2701 value of the senior interest. Thus, A is treated as transferring the common stock to the corporation for no consideration. Immediately after the transfer, B is treated as holding one-third (250/750) of the common stock and A is treated as holding two-thirds (500/750). The amount of the gift is determined as follows:—

Step 1. Because Y is held exclusively by A and B, the Step 1 value is \$1,000,000.

Step 2. The result of Step 2 is \$1,000,000 (\$1,000,000 - 0).

Step 3. The amount allocated to the common stock is \$250,000 (250/1,000 × \$1,000,000). That amount is further allocated in proportion to the respective holdings of A

and B in the common stock (\$166,667 and \$83,333, respectively).

Step 4. There is no Step 4 adjustment because the section 2701 value of the consideration received by A was zero and no minority discount would have been involved in the exchange. Thus, the amount of the gift is the difference between \$83,333 and the fair market value of B's shares immediately prior to the transfer to which section 2701 applied.

Example 5. The facts are the same as in *Example 4*, except that on January 6, 1992, when the fair market value of Y is still \$1,000,000, A transfers A's remaining 500 shares of common stock to Y in exchange for 2500 shares of preferred stock. The second transfer is also for full and adequate consideration in money or money's worth. The result of Step 2 is the same—\$1,000,000.

Step 3. The amount allocated to the common stock is \$666,667 (500/750 × \$1,000,000). Since A holds no common stock immediately after the transfer, A is treated as transferring the entire interest to the other shareholder (B). Thus, \$666,667 is fully allocated to the shares held by B.

Step 4. There is no Step 4 adjustment because the section 2701 value of the consideration received by A was zero and no minority discount would have been involved in the exchange. Thus, the amount of the gift is the difference between \$666,667 and the fair market value of B's shares immediately prior to the transfer to which section 2701 applied.

§ 25.2701-4 Accumulated qualified payments.

(a) *In general.* If a taxable event occurs with respect to any applicable, retained interest conferring a distribution right that was previously valued as a qualified payment right (a "qualified payment interest"), the taxable estate or taxable gifts of the individual holding the interest are increased by the amount determined under paragraph (c) of this section.

(b) *Taxable event—(1) In general.* Except as otherwise provided in this section, taxable event means the transfer of a qualified payment interest, either during life or at death, by the individual in whose hands the interest was originally valued under section 2701 (the "interest holder") or by any individual treated pursuant to paragraph (b)(3) of this section in the same manner as the interest holder. Except as provided in paragraph (a)(2) of this section, any termination of an individual's rights with respect to a qualified payment interest is a taxable event. Thus, for example, if an individual is treated as indirectly holding a qualified payment interest held by a trust, a taxable event occurs on the earlier of—

(i) The termination of the individual's interest in the trust (whether by death or otherwise), or

(ii) The termination of the trust's interest in the qualified payment interest (whether by disposition or otherwise).

(2) *Exception.* If, at the time of a termination of an individual's rights with respect to a qualified payment interest, the value of the property would be includible in the individual's gross estate for Federal estate tax purposes if the individual died immediately after the termination, a taxable transfer does not occur until the earlier of—

(i) The time the property would no longer be includible in the individual's gross estate (other than by reason of section 2035), or

(ii) The death of the individual.

(3) *Individual treated as interest holder—(i) In general.* If a taxable event involves the transfer of a qualified payment interest by the interest holder (or an individual treated as the interest holder) to an applicable family member of the individual who made the transfer to which section 2701 applied (other than the spouse of the individual transferring the qualified payment interest), the transferee applicable family member is treated in the same manner as the interest holder with respect to late or unpaid qualified payments first due after the taxable event. Thus, for example, if an interest holder transfers during life a qualified payment interest to an applicable family member, that transfer is a taxable event with respect to the interest holder whose taxable gifts are increased for the year of the transfer as provided in paragraph (c) of this section. The transferee is treated thereafter in the same manner as the interest holder with respect to late or unpaid qualified payments first due after the taxable event.

(ii) *Transfers to spouse—(A) In general.* If an interest holder (or an individual treated as the interest holder) transfers a qualified payment interest, the transfer is not a taxable event to the extent a marital deduction is allowed with respect to the transfer under sections 2056, 2106(a)(3), or 2523 or, in the case of a transfer during the individual's lifetime, to the extent the spouse furnishes consideration for the transfer. If this exception applies, the transferee spouse is treated as if he or she were the holder of the interest from the date the transferor spouse acquired the interest. If the deduction for a transfer to a spouse is allowable under section 2056(b)(8) or 2523(g) (relating to charitable remainder trusts), the transferee spouse is treated as the holder of the entire interest passing to the trust.

(B) *Marital bequests.* If the selection of property with which a marital bequest is funded is discretionary, a transfer of a qualified payment interest will not be considered a transfer to the surviving spouse unless—

(1) The marital bequest is funded with the qualified payment interest before the due date for filing the decedent's Federal estate tax return (including extensions actually granted) (the "due date"), or

(2) The executor—

(i) Files a statement with the return indicating the extent to which the marital bequest will be funded with the qualified payment interest, and

(ii) Before the date that is one year prior to the expiration of the period of limitations on assessment of the Federal estate tax, notifies the District Director having jurisdiction over the return to the extent to which the bequest was funded with the qualified payment interest (or the extent to which the qualified payment interest has been permanently set aside for that purpose).

(C) *Purchase by the surviving spouse.* For purposes of this section, the purchase (before the date prescribed for filing the decedent's estate tax return, including extensions actually granted) by the surviving spouse (or a trust described in section 2056(b)(7)) of a qualified payment interest held (directly or indirectly) by the decedent immediately before death is considered a transfer with respect to which a deduction is allowable under section 2056 or section 2106(a)(3), but only to the extent that the deduction is allowed to the estate. For example, assume that A bequeaths \$50,000 to A's surviving spouse, B, in a manner that qualifies for deduction under section 2056, and that subsequent to A's death B purchases a qualified payment interest from A's estate for \$200,000, its fair market value. The economic effect of the transaction is the equivalent of a bequest by A to B of the qualified payment interest, one-fourth of which qualifies for the marital deduction. Therefore, for purposes of this section, one-fourth of the qualified payment interest purchased by B (\$50,000 ÷ \$200,000) is considered a transfer of an interest with respect to which a deduction is allowed under 2056. If the purchase by the surviving spouse is not made before the due date of the decedent's return, the purchase of the qualified payment interest will not be considered a bequest for which a marital deduction is allowed unless the executor—

(1) Files a statement with the return indicating the qualified payment interests to be purchased by the

surviving spouse (or a trust described in section 2056(b)(7)), and

(2) Before the date that is one year prior to the expiration of the period of limitations on assessment of the Federal estate tax, notifies the District Director having jurisdiction over the return that the purchase of the qualified payment interest has been made (or that the funds necessary to purchase the qualified payment interest have been permanently set aside for that purpose).

(c) *Amount of increase—(1) In general.* Except as limited by paragraph (c)(6) of this section, the amount of the increase to an individual's taxable estate or taxable gifts is the excess, if any, of—

(i) The sum of—

(A) The amount of qualified payments payable during the period beginning on the date of the transfer to which section 2701 applied (or, in the case of an individual treated as the interest holder, on the date the interest of the prior interest holder terminated) and ending on the date of the taxable event; and

(B) The earnings on those payments, determined hypothetically as if each payment were paid on its due date and reinvested as of that date at a yield equal to the appropriate discount rate (as defined below); over

(ii) The sum of—

(A) The amount of the qualified payments actually paid during the same period;

(B) The earnings on those payments, determined hypothetically as if each payment were reinvested as of the date actually paid at a yield equal to the appropriate discount rate; and

(C) To the extent required to prevent double inclusion, by an amount equal to the sum of—

(1) The portion of the fair market value of the qualified payment interest solely attributable to any right to receive unpaid qualified payments determined as of the date of the taxable event;

(2) The fair market value of any equity interest in the entity received by the individual in lieu of qualified payments and held by the individual at the taxable event, and

(3) The amount by which the individual's aggregate taxable gifts were increased by reason of the failure of the individual to enforce the right to receive qualified payments.

(2) *Due date of qualified payments.* With respect to any qualified payment, the "due date" is that date specified in the governing instrument as the date on which payment is to be made. If no date is specified in the governing instrument, the due date is the last day of each calendar year.

(3) *Appropriate discount rate.* The appropriate discount rate is the discount rate that was applied in determining the value of the qualified payment right at the time of the transfer to which section 2701 applied.

(4) *Application of payments.* For purposes of this section, any payment of an unpaid qualified payment is applied in satisfaction of unpaid qualified payments beginning with the earliest unpaid qualified payment. Any payment in excess of the total of all unpaid qualified payments is treated as a prepayment of future qualified payments.

(5) *Payment.* For purposes of this paragraph (c), the transfer of a debt obligation bearing compound interest from the due date of the payment at a rate not less than the appropriate discount rate is a qualified payment if the term of the obligation (including extensions) does not exceed four years from the date issued. A payment in the form of an equity interest in the entity is not a qualified payment. Any payment of a qualified payment made (or treated as made) either before or during the four-year period beginning on the due date of the payment but before the date of the taxable event is treated as having been made on the due date.

(6) *Limitation—(i) In general.* The amount of the increase to an individual's taxable estate or taxable gifts is limited to the applicable percentage of the excess, if any, of—

(A) The sum of—

(1) The fair market value of all outstanding equity interests in the entity that are subordinate to the applicable retained interest, determined as of the date of the taxable event without regard to any accrued liability attributable to unpaid qualified payments; and

(2) Any amounts expended by the entity to redeem or otherwise acquire any such subordinate interest during the period beginning on the date of the transfer to which section 2701 applied (or, in the case of an individual treated as an interest holder, on the date the interest of the prior interest holder terminated) and ending on the date of the taxable event (reduced by any amounts received on the resale or issuance of any such subordinate interest during the same period); over

(B) The fair market value of all outstanding equity interests in the entity that are subordinate to the applicable retained interest, determined as of the date of the transfer to which section 2701 applied (or, in the case of an individual treated as an interest holder, on the date the interest of the prior interest holder terminated).

(ii) *Computation of limitation.* For purposes of computing the limitation applicable under this paragraph (c)(6), the aggregate fair market value of the subordinate interests in the entity are determined without regard to § 25.2701-3(c).

(iii) *Applicable percentage.* The applicable percentage is determined by dividing the number of shares or units of the applicable retained interest held by the interest holder (or an individual treated as the interest holder) on the date of the taxable event by the total number of such shares or units outstanding on the same date. If an individual holds applicable retained interests in two or more classes of interests, the applicable percentage is equal to the largest applicable percentage determined with respect to any class. For example, if T retains 40 percent of the class A preferred and 60 percent of the class B preferred in a corporation, the applicable percentage with respect to T's holdings is 60 percent.

(d) *Taxpayer election—(1) In general.* An interest holder (or individual treated as an interest holder) may elect to treat as a taxable event the payment of an unpaid qualified payment occurring more than four years after its due date. Under this election, the increase under paragraph (c) of this section is determined only with respect to that payment and all previous payments for which an election was available but not made. Payments for which an election applies are treated as having been paid on their due dates for purposes of subsequent taxable events. The election is revocable only with the consent of the Commissioner.

(2) *Limitation not applicable.* If a taxable event occurs by reason of an election described in paragraph (d)(1) of this section, the limitation described in paragraph (c)(6) of this section does not apply.

(3) *Time and manner of election—(i) Timely-filed returns.* The election may be made by attaching a statement to a Form 709, Federal Gift Tax Return, filed by the recipient of the qualified payment on a timely basis for the year in which the qualified payment is received. In that case, the taxable event is deemed to occur on the date the qualified payment is received.

(ii) *Election on late returns.* The election may be made by attaching a statement to a Form 709, Federal Gift Tax Return, filed by the recipient of the qualified payment other than on a timely basis for the year in which the qualified payment is received. In that case, the taxable event is deemed to occur on the first day of the month immediately

preceding the month in which the return is filed. If an election, other than an election on a timely return, is made after the death of the interest holder, the taxable event with respect to the decedent is deemed to occur on the later of—

(A) The date of the recipient's death, or

(B) The first day of the month immediately preceding the month in which the return is filed.

(iii) *Requirements of statement.* The statement must—

(A) Provide the name, address, and taxpayer identification number of the electing individual and the interest holder, if different;

(B) Indicate that a taxable event election is being made under paragraph (d) of this section;

(C) Disclose the nature of the qualified payment right to which the election applies, including the due dates of the payments, the dates the payments were made, and the amounts of the payments;

(D) State the name of the transferor, the date of the transfer to which section 2701 applied, and the discount rate used in valuing the qualified payment right; and

(E) State the resulting amount of increase in taxable gifts.

(4) *Example.* The following example illustrates the rules of this paragraph (d).

Example. A holds cumulative preferred stock that A retained in a transfer to which section 2701 applied. No dividends were paid in years 1 through 5 following the transfer. In year 6, A received a qualified payment that, pursuant to paragraph (c)(3) of this section, is considered to be in satisfaction of the unpaid qualified payment for year 1. No election was made to treat that payment as a taxable event. In year 7, A receives a qualified payment that, pursuant to paragraph (c)(4) of this section, is considered to be in satisfaction of the unpaid qualified payment for year 2. A elects to treat the payment in year 7 as a taxable event. The election increases A's taxable gifts in year 7 by the amount computed under paragraph (c) of this section with respect to the payments due in both year 1 and year 2. For purposes of any future taxable events, the payments with respect to years 1 and 2 are treated as having been made on their due dates.

§ 25.2701-5 Adjustments to mitigate double taxation. (Reserved)

§ 25.2701-6 Indirect holding of interests.

(a) *In general—(1) Attribution to individuals.* For purposes of section 2701, an individual is treated as holding an equity interest to the extent the interest is held indirectly through a corporation, partnership, estate, trust, or other entity. If an equity interest is treated as held by a particular individual in more than one capacity,

the interest is treated as held by the individual in the manner that attributes the largest total ownership of the equity interest. An equity interest held by a lower-tier entity is attributed to higher-tier entities in accordance with the rules of this section. For example, if an individual is a 50-percent beneficiary of a trust that holds 50 percent of the preferred stock of a corporation, 25 percent of the preferred stock is considered held by the individual under these rules.

(2) *Corporations.* A person is considered to hold an equity interest held by or for a corporation in the proportion that the fair market value of the stock the person holds bears to the fair market value of all the stock in the corporation (determined as if each class of stock were held separately by one individual). This paragraph applies to any entity classified as a corporation or as an association taxable as a corporation for federal income tax purposes.

(3) *Partnerships.* A person is considered to hold an equity interest held by or for a partnership in the proportion that the fair market value of the larger of the person's profits interest or capital interest in the partnership bears to the total fair market value of the corresponding profits interests or capital interests in the partnership, as the case may be (determined as if each class were held by one individual). This paragraph applies to any entity classified as a partnership for federal income tax purposes.

(4) *Estates, trusts and other entities—(i) In general.* A person is considered to hold an equity interest held by or for an estate or trust to the extent the person's beneficial interest therein may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, assuming the maximum exercise of discretion in favor of the person. A beneficiary of an estate or trust who cannot receive any distribution with respect to an equity interest held by the estate or trust, including the income therefrom or the proceeds from the disposition thereof, is not considered the holder of the equity interest. Thus, if stock held by a decedent's estate has been specifically bequeathed to one beneficiary and the residue of the estate has been bequeathed to other beneficiaries, the stock is considered held only by the beneficiary to whom it was specifically bequeathed. However, any person who may receive distributions from a trust is considered to hold an equity interest held by the trust if the distributions may be made from current or accumulated

income from or the proceeds from the disposition of the equity interest, even though under the terms of the trust the interest can never be distributed to that person. This paragraph applies to any entity that is not classified as a corporation, an association taxable as a corporation, or a partnership for federal income tax purposes.

(ii) **Special rules**—(A) Property is held by a decedent's estate if the property is subject to claims against the estate and expenses of administration.

(B) A person holds a beneficial interest in a trust or an estate so long as the person may receive distributions from the trust or the estate other than payments for full and adequate consideration.

(C) An individual holds an equity interest held by or for a trust if the individual is considered an owner of the trust (a "grantor trust") under subpart E, part 1, subchapter J of the Internal Revenue Code (relating to grantors and others treated as substantial owners). However, if an individual is treated as the owner of only a fractional share of a grantor trust because there are multiple grantors, the individual holds each equity interest held by the trust, except to the extent that the fair market value of the interest exceeds the fair market value of the fractional share.

(5) **Multiple attribution**—(f) **Applicable retained interests.** If this section attributes an applicable retained interest to more than one individual in a class consisting of the transferor and one or more applicable family members, the interest is attributed within that class in the following order—

(A) If the interest is held in a grantor trust, to the individual treated as the holder thereof;

(B) To the transferor;

(C) To the transferor's spouse; or

(D) To each applicable family member on a pro rata basis.

(ii) **Subordinate equity interests.** If this section attributes a subordinate equity interest to more than one individual in a class consisting of the transferor, applicable family members, and members of the transferor's family, the interest is attributed within that class in the following order—

(A) To the transferor;

(B) To each member of the transferor's family on a pro rata basis;

(C) If the interest is held in a grantor trust, to the individual treated as the holder thereof;

(D) To the transferor;

(E) To the transferor's spouse; or

(F) To each applicable family member on a pro rata basis.

(b) **Examples.** The following examples illustrate the provisions of this section:

Example 1. A, an individual, holds 25 percent by value of each class of stock of Y Corporation. Persons unrelated to A hold the remaining stock. Y holds 50 percent of the stock of Corporation X. Under paragraph (a)(2) of this section, Y's interests in X are attributed proportionately to the shareholders of Y. Accordingly, A is considered to hold a 12.5 percent (25 percent X 50 percent) interest in X.

Example 2. Z Bank's authorized capital consists of 100 shares of common stock and 100 shares of preferred stock. A holds 60 shares of each (common and preferred) and A's child, B, holds 40 shares of common stock. Z holds the balance of its own preferred stock, 30 shares as part of a common trust fund it maintains and 10 shares permanently set aside to satisfy a deferred obligation. For purposes of section 2701, A holds 60 shares of common stock and 66 shares of preferred stock in Z, 60 shares of each class directly and 6 shares of preferred stock indirectly (60 percent of the 10 shares set aside to fund the deferred obligation).

Example 3. An irrevocable trust holds a 10-percent general partnership interest in Partnership Q. One-half of the trust income is required to be distributed to O Charity. The other one-half of the income is to be distributed to D during D's life and thereafter to E for such time as E survives D. D holds one-half of the trust's interest in Q by reason of D's present right to receive one-half of the trust's income, and E holds one-half of the trust's interest in Q by reason of E's future right to receive one-half of the trust's income. Nevertheless, no family member is treated as holding more than one-half of the trust's interest in Q because at no time will either D or E actually hold, in the aggregate, any right with respect to income or corpus greater than one-half.

Example 4. An irrevocable trust holds a 10-percent general partnership interest in partnership M. One-half of the trust income is to be paid to D for D's life. The remaining income may, in the trustee's discretion, be accumulated or paid to or for the benefit of a class that includes D's child F, in such amounts as the trustee determines. On the death of the survivor of D and F, the trust corpus is required to be distributed to O Charity. The trust's interest in M is held by the trust's beneficiaries to the extent that present and future income or corpus may be distributed to them. Accordingly, D holds one-half of the trust's interest in M because D is entitled to receive one-half of the trust income currently, F holds the entire value of the interest because F is a member of the class eligible to receive the entire trust income for such time as F survives D. See paragraph (a)(5) of this section for rules applicable in the case of multiple attribution.

Example 5. The facts are the same as in Example 4, except that all the income is required to be paid to O Charity for the trust's initial year. The result is the same as in Example 4.

§ 25.2701-7 Separate interests.

The Secretary may, by regulation, revenue ruling, notice, or other document of general application, prescribe rules under which an

applicable retained interest is treated as two or more separate interests for purposes of section 2701. In addition, the Commissioner may, by ruling issued to a taxpayer upon request, treat any applicable retained interest as two or more separate interests as may be necessary and appropriate to carry out the purposes of section 2701.

§ 25.2701-8 Effective dates.

Sections 25.2701-1 through 25.2701-4 and §§ 25.2701-6 and 25.2701-7 are effective as of January 28, 1992. For transfers made prior to January 28, 1992, taxpayers may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of the proposed regulations and the final regulations are considered a reasonable interpretation of the statutory provisions.

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§ 25.2702-7 Effective dates.

§ 25.2702-1 Special valuation rules in the case of transfers of interests in trust.

(a) *Scope of section 2702.* Section 2702 provides special rules to determine the amount of the gift when an individual makes a transfer in trust to (or for the benefit of) a member of the individual's family and the individual or an applicable family member retains an interest in the trust. Section 25.2702-4 treats certain transfers of property as transfers in trust. Certain transfers, including transfers to a personal residence trust, are not subject to

section 2702. See paragraph (c) of this section. Member of the family is defined in § 25.2702-2(a)(1). Applicable family member is defined in § 25.2701-1(d)(2).

(b) *Effect of section 2702.* If section 2702 applies to a transfer, the value of any interest in the trust retained by the transferor or any applicable family member is determined under § 25.2702-2(b). The amount of the gift, if any, is then determined by subtracting the value of the interests retained by the transferor or any applicable family member from the value of the transferred property. If the retained interest is not a qualified interest (as defined in § 25.2702-3), the retained interest is generally valued at zero, and the amount of the gift is the entire value of the property.

(c) *Exceptions to section 2702.* Section 2702 does not apply to the following transfers.

(1) *Incomplete gift.* A transfer no portion of which would be treated as a completed gift without regard to any consideration received by the transferor. If a transfer is wholly incomplete as to an undivided fractional share of the property transferred (without regard to any consideration received by the transferor), for purposes of this paragraph the transfer is treated as incomplete as to that share.

(2) *Personal residence trust.* A transfer in trust that meets the requirements of § 25.2702-5.

(3) *Charitable remainder trust.* A transfer in trust if the remainder interest in the trust qualifies for deduction under section 2522.

(4) *Pooled income fund.* A transfer of property to a pooled income fund (as defined in section 642(c)(5)).

(5) *Charitable lead trust.* A transfer in trust if the only interest in the trust, other than the remainder interest or a qualified annuity or unitrust interest, is an interest that qualifies for deduction under section 2522.

(6) *Certain assignments of remainder interests.* The assignment of a remainder interest if the only retained interest of the transferor or an applicable family member is as the permissible recipient of distributions of income in the sole discretion of an independent trustee (as defined in section 674(c)).

(7) *Certain property settlements.* A transfer in trust if the transfer of an interest to a spouse is deemed to be for full and adequate consideration by reason of section 2516 (relating to certain property settlements) and the remaining interests in the trust are retained by the other spouse

§ 25.2702-2 Definitions and valuation rules.

(a) *Definitions.* The following definitions apply for purposes of section 2702 and the regulations thereunder.

(1) *Member of the family.* With respect to any individual, member of the family means the individual's spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any brother or sister of the individual, and any spouse of the foregoing.

(2) *Transfer in trust.* A transfer in trust includes a transfer to a new or existing trust and an assignment of an interest in an existing trust. Transfer in trust does not include—

(i) The exercise, release or lapse of a power of appointment over trust property that is not a transfer under chapter 12; or

(ii) The execution of a qualified disclaimer (as defined in section 2518).

(3) *Retained.* Retained means held by the same individual both before and after the transfer in trust. In the case of the creation of a term interest, any interest in the property held by the transferor immediately after the transfer is treated as held both before and after the transfer.

(4) *Interest.* An interest in trust includes a power with respect to a trust if the existence of the power would cause any portion of a transfer to be treated as an incomplete gift under chapter 12.

(5) *Qualified interest.* Qualified interest means a qualified annuity interest, a qualified unitrust interest, or a qualified remainder interest. Retention of a power to revoke a qualified annuity interest (or unitrust interest) of the transferor's spouse is treated as the retention of a qualified annuity interest (or unitrust interest).

(6) *Qualified annuity interest.* Qualified annuity interest means an interest that meets all the requirements of § 25.2702-3(b) and (d).

(7) *Qualified unitrust interest.* Qualified unitrust interest means an interest that meets all the requirements of § 25.2702-3(c) and (d).

(8) *Qualified remainder interest.* Qualified remainder interest means an interest that meets all the requirements of § 25.2702-3(f).

(9) *Governing instrument.* Governing instrument means the instrument or instruments creating and governing the operation of the trust arrangement.

(b) *Valuation of retained interests—*
 (1) *In general.* Except as provided in paragraphs (b)(2) and (c) of this section, the value of any interest retained by the transferor or an applicable family member is zero.

Example 5. The facts are the same as in Example 4, except that the trust is divided into separate fractional shares and A's retained powers apply to only one of the shares. Section 2702 applies except with respect to the share of the trust as to which A's retained powers cause the transfer to be an incomplete gift.

Example 6. A transfers property to an irrevocable trust, retaining the right to receive the income for 10 years. Upon expiration of 10 years, the income of the trust is payable to A's spouse for 10 years if living. Upon expiration of the spouse's interest, the trust terminates and the trust corpus is payable to A's child. A retains the right to revoke the spouse's interest. Because the transfer of property to the trust is not incomplete as to all interests in the property (i.e., A has made a completed gift of the remainder interest), section 2702 applies. A's power to revoke the spouse's term interest is treated as a retained interest for purposes of section 2702. Because no interest retained by A is a qualified interest, the amount of the gift is the fair market value of the property transferred to the trust.

Example 7. The facts are the same as in Example 6, except that both the term interest retained by A and the interest transferred to A's spouse (subject to A's right of revocation) are qualified annuity or unitrust interests. The amount of the gift is the fair market value of the property transferred to the trust reduced by the value of both A's qualified interest and the value of the qualified interest transferred to A's spouse (subject to A's power to revoke).

(2) The following facts apply for Examples 8-10 (examples illustrating § 25.2702-2(c)—tangible property exception):

Facts. A transfers a painting having a fair market value of \$2,000,000 to A's child, B, retaining the use of the painting for 10 years. The painting does not possess an ascertainable useful life. Assume that the painting would not be depreciable if it were used in a trade or business or held for the production of income. Assume that the value of A's term interest, determined under section 7520, is \$1,220,000, and that A establishes that a willing buyer of A's interest would pay \$300,000 for the interest.

Example 8. A's term interest is not a qualified interest under § 25.2702-3. However, because of the nature of the property, A's failure to exercise A's rights with regard to the painting would not be expected to cause the value of the painting to be higher than it would otherwise be at the time it passes to B. Accordingly, A's interest is valued under § 25.2702-2(c)(1) at \$300,000. The amount of A's gift is \$1,300,000, the difference between the fair market value of the painting and the amount determined under § 25.2702-2(c)(1).

Example 9. Assume that the only evidence produced by A to establish the value of A's 10-year term interest is the amount paid by a museum for the right to use a comparable painting for 1 year. A asserts that the value of the 10-year term is 10 times the value of the 1-year term. A has not established the value of the 10-year term interest because a series of

short-term rentals the aggregate duration of which equals the duration of the actual term interest does not establish what a willing buyer would pay a willing seller for the 10-year term interest. However, the value of the 10-year term interest is not less than the value of the 1-year term because it can be assumed that a willing buyer would pay no less for a 10-year term interest than a 1-year term interest.

Example 10. Assume that after 24 months A and B sell the painting for \$2,000,000 and invest the proceeds in a portfolio of securities. A continues to hold an income interest in the securities for the duration of the 10-year term. Under § 25.2702-2(c)(4) the conversion of the painting into a type of property a term interest in which would not qualify for valuation under § 25.2702-2(c)(1) is treated as a transfer by A of the value of the unexpired portion of A's original term interest, unless the property is thereafter held in a trust meeting the requirements of a qualified annuity interest. Assume that the value of A's remaining term interest is \$2,000,000 (determined under section 7520 using the section 7520 rate in effect on the date of the original transfer) is \$1,060,000. The value of the unexpired portion of A's interest is \$434,426, the amount that bears the same relation to \$1,060,000 as \$300,000 (the value of A's interest as of the date of the original transfer determined under paragraph (c)(1) of this section) bears to \$1,220,000 (the value of A's interest as of the date of the original transfer determined under section 7520).

§ 25.2702-3 Qualified interests.

(a) *In general.* This section provides rules for determining if an interest is a qualified annuity interest, a qualified unitrust interest, or a qualified remainder interest.

(b) *Special rules for qualified annuity interests.* An interest is a qualified annuity interest only if it meets the requirements of this paragraph and paragraph (d) of this section.

(1) *Payment of annuity amount—(i) In general.* A qualified annuity interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest for each taxable year of the term. A right of withdrawal, whether or not cumulative, is not a qualified annuity interest. The annuity payment may be made after the close of the taxable year, provided the payment is made no later than the date by which the trustee is required to file the Federal income tax return of the trust for the taxable year (without regard to extensions).

(ii) *Fixed amount.* A fixed amount means—

(A) A stated dollar amount payable periodically, but not less frequently than annually, but only to the extent the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year; or

(B) A fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for Federal tax purposes, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year.

(iii) *Income in excess of the annuity amount.* An annuity interest does not fail to be a qualified annuity interest merely because the trust permits income in excess of the amount required to pay the annuity amount to be paid to or for the benefit of the holder of the qualified annuity interest. Nevertheless, the right to receive the excess income is not a qualified interest and is not taken into account in valuing the qualified annuity interest.

(2) *Incorrect valuations of trust property.* If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iii) of this chapter (relating to adjustments for any incorrect determination of the fair market value of the property in the trust).

(3) *Computation of annuity amount in certain circumstances.* The governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iv) of this chapter (relating to the computation of the annuity amount in the case of short taxable years and the last taxable year of the term).

(4) *Additional contributions prohibited.* The governing instrument must prohibit additional contributions to the trust.

(c) *Special rules for qualified unitrust interests.* An interest is a qualified unitrust interest only if it meets the requirements of this paragraph and paragraph (d) of this section.

(1) *Payment of unitrust amount—(i) In general.* A qualified unitrust interest is an irrevocable right to receive payment periodically, but not less frequently than annually, of a fixed percentage of the net fair market value of the trust assets, determined annually. For rules relating to computation of the net fair market value of the trust assets see § 25.2522(c)-3(c)(2)(vii). The unitrust amount must be payable to (or for the benefit of) the holder of the unitrust interest for each taxable year of the term. A right of withdrawal, whether or not cumulative, is not a qualified unitrust interest. The unitrust payment may be made after the close of the taxable year, provided that the payment

is made no later than the date by which the trustee is required to file the Federal income tax return of the trust for the year (without regard to extensions).

(ii) *Fixed percentage.* A fixed percentage is a fraction or percentage of the net fair market value of the trust assets, determined annually, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year.

(iii) *Income in excess of unitrust amount.* A unitrust interest does not fail to be a qualified unitrust interest merely because the trust permits income in excess of the amount required to pay the unitrust amount to be paid to or for the benefit of the holder of the qualified unitrust interest. Nevertheless, the right to receive the excess income is not a qualified interest and is not taken into account in valuing the qualified unitrust interest.

(2) *Incorrect valuations of trust property.* The governing instrument must contain provisions meeting the requirements of § 1.664-3(a)(1)(iii) of this chapter (relating to the incorrect determination of the fair market value of the property in the trust).

(3) *Computation of unitrust amount in certain circumstances.* The governing instrument must contain provisions meeting the requirements of § 1.664-3(a)(1)(v) of this chapter (relating to the computation of the unitrust amount in the case of short taxable years and the last taxable year of the term).

(d) *Requirements applicable to qualified annuity interests and qualified unitrust interests—(1) In general.* To be a qualified annuity or unitrust interest, an interest must be a qualified annuity interest in every respect or a qualified unitrust interest in every respect. For example, if the interest consists of the right to receive each year a payment equal to the lesser of a fixed amount of the initial trust assets or a fixed percentage of the annual value of the trust assets, the interest is not a qualified interest. If, however, the interest consists of the right to receive each year a payment equal to the greater of a stated dollar amount or a fixed percentage of the initial trust assets or a fixed percentage of the annual value of the trust assets, the interest is a qualified interest that is valued at the greater of the two values. To be a qualified interest, the interest must meet the definition of and function exclusively as a qualified interest from the creation of the trust.

(2) *Amounts payable to other persons.* The governing instrument must prohibit

distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity or unitrust interest during the term of the qualified interest.

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

(4) *Commutation.* The governing instrument must prohibit commutation (prepayment) of the interest of the term holder.

(e) *Examples.* The following examples illustrate the rules of paragraphs (b), (c), and (d) of this section. Each example assumes that all applicable requirements for a qualified interest are met unless otherwise specifically stated.

Example 1. A transfers property to an irrevocable trust, retaining the right to receive the greater of \$10,000 or the trust income in each year for a term of 10 years. Upon expiration of the 10-year term, the trust is to terminate and the entire trust corpus is to be paid to A's child, provided that if A dies within the 10-year term the trust corpus is to be paid to A's estate. A's annual payment right is a qualified annuity interest to the extent of the right to receive \$10,000 per year for 10 years or until A's prior death, and is valued under section 7520 without regard to the right to receive any income in excess of \$10,000 per year. The contingent reversion is valued at zero. The amount of A's gift is the fair market value of the property transferred to the trust less the value of the qualified annuity interest.

Example 2. U transfers property to an irrevocable trust, retaining the right to receive \$10,000 in each of years 1 through 3, \$12,000 in each of years 4 through 6, and \$15,000 in each of years 7 through 10. The interest is a qualified annuity interest to the extent of U's right to receive \$10,000 per year in years 1 through 3, \$12,000 in years 4 through 6, \$14,400 in year 7, and \$15,000 in years 8 through 10, because those amounts represent the lower of the amount actually payable each year or an amount that does not exceed 120 percent of the stated dollar amount for the preceding year.

Example 3. S transfers property to an irrevocable trust, retaining the right to receive \$50,000 in each of years 1 through 3 and \$10,000 in each of years 4 through 10. S's entire retained interest is a qualified annuity interest.

Example 4. R transfers property to an irrevocable trust retaining the right to receive annually an amount equal to the lesser of 8 percent of the initial fair market value of the trust property or the trust income for the year. R's annual payment right is not a qualified annuity interest to any extent because R does not have the irrevocable right to receive a fixed amount for each year of the term.

Example 5. A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years or until A's prior death.

Example 6. The facts are the same as in Example 5, except that if A dies within the 10-year term the unitrust amount will be paid to A's estate for an additional 35 years. The result is the same as in Example 5, because the 10-year term is the only term that is fixed and ascertainable at the creation of the interest.

Example 7. B transfers property to an irrevocable trust retaining the right to receive annually an amount equal to 8 percent of the initial fair market value of the trust property for 10 years. Upon expiration of the 10-year term, the trust is to terminate and the entire trust corpus is to be paid to B's child. The governing instrument provides that income in excess of the annuity amount may be paid to B's child in the trustee's discretion. B's interest is not a qualified annuity interest to any extent because a person other than the individual holding the term interest may receive distributions from the trust during the term.

(f) *Qualified remainder interest—(1) Requirements.* An interest is a qualified remainder interest only if it meets all of the following requirements:

(i) It is a qualified remainder interest in every respect.

(ii) It meets the definition of and functions exclusively as a qualified interest from the creation of the interest.

(iii) It is non-contingent. For this purpose, an interest is non-contingent only if it is payable to the beneficiary or the beneficiary's estate in all events.

(iv) All interests in the trust, other than non-contingent remainder interests, are qualified annuity interests or qualified unitrust interests. Thus, an interest is a qualified remainder interest only if the governing instrument does not permit payment of income in excess of the annuity or unitrust amount to the holder of the qualified annuity or unitrust interest.

(2) *Remainder interest.* Remainder interest is the right to receive all or a fractional share of the trust property on termination of all or a fractional share of the trust. Remainder interest includes a reversion. A transferor's right to receive an amount that is a stated or pecuniary amount is not a remainder interest. Thus, the right to receive the original value of the trust corpus (or a fractional share) is not a remainder interest.

(3) *Examples.* The following examples illustrate rules of this paragraph (f). Each example assumes that all applicable requirements of a qualified

interest are met unless otherwise specifically stated.

Example 1. A transfers property to an irrevocable trust. The income of the trust is payable to A's child for life. On the death of A's child, the trust is to terminate and the trust corpus is to be paid to A. A's remainder interest is not a qualified remainder interest because the interest of A's child is neither a qualified annuity interest nor a qualified unitrust interest.

Example 2. The facts are the same as in Example 1, except that A's child has the right to receive the greater of the income of the trust or \$10,000 per year. A's remainder interest is not a qualified remainder interest because the right of A's child to receive income in excess of the annuity amount is not a qualified interest.

Example 3. A transfers property to an irrevocable trust. The trust provides a qualified annuity interest to A's child for 12 years. An amount equal to the initial value of the trust corpus is to be paid to A at the end of that period and the balance is to be paid to A's grandchild. A's interest is not a qualified remainder interest because the amount A is to receive is not a fractional share of the trust property.

Example 4. U transfers property to an irrevocable trust. The trust provides a qualified unitrust interest to U's child for 15 years, at which time the trust terminates and the trust corpus is paid to U or, if U is not then living, to U's child. Because U's remainder interest is contingent, it is not a qualified remainder interest.

§ 25.2702-4 Certain property treated as held in trust.

(a) *In general.* For purposes of section 2702, a transfer of an interest in property with respect to which there are one or more term interests is treated as a transfer in trust. A term interest is one of a series of successive (as contrasted with concurrent) interests. Thus, a life interest in property or an interest in property for a term of years is a term interest. However, a term interest does not include a fee interest in property merely because it is held as a tenant in common, a tenant by the entireties, or a joint tenant with right of survivorship.

(b) *Leases.* A leasehold interest in property is not a term interest to the extent the lease is for full and adequate consideration (without regard to section 2702). A lease will be considered for full and adequate consideration if, under all the facts and circumstances as of the time the lease is entered into or extended, a good faith effort is made to determine the fair rental value of the property and the terms of the lease conform to the value so determined.

(c) *Joint purchases.* Solely for purposes of section 2702, if an individual acquires a term interest in property and, in the same transaction or series of transactions, one or more members of the individual's family acquire an

interest in the same property, the individual acquiring the term interest is treated as acquiring the entire property so acquired, and transferring to each of those family members the interests acquired by that family member in exchange for any consideration paid by that family member. For purposes of this paragraph (c), the amount of the individual's gift will not exceed the amount of consideration furnished by that individual for all interests in the property.

(d) *Examples.* The following examples illustrate rules of this section:

Example 1. A purchases a 20-year term interest in an apartment building and A's child purchases the remainder interest in the property. A and A's child each provide the portion of the purchase price equal to the value of their respective interests in the property determined under section 7520. Solely for purposes of section 2702, A is treated as acquiring the entire property and transferring the remainder interest to A's child in exchange for the portion of the purchase price provided by A's child. In determining the amount of A's gift, A's retained interest is valued at zero because it is not a qualified interest.

Example 2. K holds rental real estate valued at \$100,000. K sells a remainder interest in the property to K's child, retaining the right to receive the income from the property for 20 years. Assume the purchase price paid by K's child for the remainder interest is equal to the value of the interest determined under section 7520. K's retained interest is not a qualified interest and is therefore valued at zero. K has made a gift in the amount of \$100,000 less the consideration received from K's child.

Example 3. G and G's child each acquire a 50 percent undivided interest as tenants in common in an office building. The interests of G and G's child are not term interests to which section 2702 applies.

Example 4. B purchases a life estate in property from R, B's grandparent, for \$100 and B's child purchases the remainder interest for \$50. Assume that the value of the property is \$300, the value of the life estate determined under section 7520 is \$250 and the value of the remainder interest is \$50. B is treated as acquiring the entire property and transferring the remainder interest to B's child. However, the amount of B's gift is \$100, the amount of consideration (\$100) furnished by B for B's interest.

Example 5. H and W enter into a written agreement relative to their marital and property rights that requires W to transfer property to an irrevocable trust, the terms of which provide that the income of the trust will be paid to H for 10 years. On the expiration of the 10-year term, the trust is to terminate and the trust corpus is to be paid to W. H and W divorce within two years after the agreement is entered into. Pursuant to section 2516, the transfer to H would otherwise be deemed to be for full and adequate consideration. Section 2702 does not apply to the acquisition of the term interest by H because no member of H's

family acquired an interest in the property in the same transaction or series of transactions. The result would not be the same if, on the termination of H's interest in the trust, the trust corpus were distributable to the children of H and W rather than W.

§ 25.2702-5 Personal residence trusts.

(a) *In general.* Section 2702 does not apply to a transfer in trust meeting the requirements of this section. A transfer in trust meets the requirements of this section only if the trust is a personal residence trust (as defined in paragraph (b) of this section). A trust meeting the requirements of a qualified personal residence trust (as defined in paragraph (c) of this section) is treated as a personal residence trust. A trust of which the term holder is the grantor that otherwise meets the requirements of a personal residence trust (or a qualified personal residence trust) is not a personal residence trust (or a qualified personal residence trust) if, at the time of transfer, the term holder of the trust already holds term interests in two trusts that are personal residence trusts (or qualified personal residence trusts) of which the term holder was the grantor. For this purpose, trusts holding fractional interests in the same residence are treated as one trust.

(b) *Personal residence trust—(1) In general.* A personal residence trust is a trust the governing instrument of which prohibits the trust from holding, for the original duration of the term interest, any asset other than one residence to be used or held for use as a personal residence of the term holder and qualified proceeds (as defined in paragraph (b)(3) of this section). 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. A trust does not meet the requirements of this section if, during the original duration of the term interest, the residence may be sold or otherwise transferred by the trust or may be used for a purpose other than as a personal residence of the term holder. Expenses of the trust whether or not attributable to trust principal may be paid directly by the term holder of the trust.

(2) *Personal residence—(i) In general.* For purposes of this paragraph (b), a personal residence of a term holder is either—

(A) The principal residence of the term holder (within the meaning of section 1034);

(B) One other residence of the term holder (within the meaning of section

280A(d)(1) but without regard to section 280A(d)(2); or

(C) An undivided fractional interest in either.

(ii) *Additional property.* A personal residence may include appurtenant structures used by the term holder for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location). The fact that a residence is subject to a mortgage does not affect its status as a personal residence. The term personal residence does not include any personal property (e.g., household furnishings).

(iii) *Use of residence.* 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 section 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 (e.g., 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.

(iv) *Interests of spouses in the same residence.* If spouses hold interests in the same residence (including community property interests), the spouses may transfer their interests in the residence (or a fractional portion of their interests in the residence) to the same personal residence trust, provided that the governing instrument prohibits any person other than one of the spouses from holding a term interest in the trust concurrently with the other spouse.

(3) *Qualified proceeds.* Qualified proceeds means the proceeds payable as a result of damage to, or destruction or involuntary conversion (within the meaning of section 1033) of, the residence held by a personal residence trust, provided that the governing instrument requires that the proceeds (including any income thereon) be reinvested in a personal residence within two years from the date on which the proceeds are received.

(c) *Qualified personal residence trust—(1) In general.* A qualified personal residence trust is a trust meeting all the requirements of this

paragraph (c). These requirements must be met by provisions in the governing instrument, and these governing instrument provisions must by their terms continue in effect during the existence of any term interest in the trust.

(2) *Personal residence—(i) In general.* For purposes of this paragraph (c), a personal residence of a term holder is either—

(A) The principal residence of the term holder (within the meaning of section 1034);

(B) One other residence of the term holder (within the meaning of section 280A(d)(1) but without regard to section 280A(d)(2)); or

(C) An undivided fractional interest in either.

(ii) *Additional property.* A personal residence may include appurtenant structures used by the term holder for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location). The fact that a residence is subject to a mortgage does not affect its status as a personal residence. The term personal residence does not include any personal property (e.g., household furnishings).

(iii) *Use of residence.* 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 section 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 (e.g., 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.

(iv) *Interests of spouses in the same residence.* If spouses hold interests in the same residence (including community property interests), the spouses may transfer their interests in the residence (or a fractional portion of their interests in the residence) to the same qualified personal residence trust, provided that the governing instrument prohibits any person other than one of

the spouses from holding a term interest in the trust concurrently with the other spouse.

(3) *Income of the trust.* The governing instrument must require that any income of the trust be distributed to the term holder not less frequently than annually.

(4) *Distributions from the trust to other persons.* The governing instrument must prohibit distributions of corpus to any beneficiary other than the transferor prior to the expiration of the retained term interest.

(5) *Assets of the trust—(i) In general.* Except as otherwise provided in paragraphs (c)(5)(ii) and (c)(8) of this section, the governing instrument must prohibit the trust from holding, for the entire term of the trust, any asset other than one residence to be used or held for use (within the meaning of paragraph (c)(7)(i) of this section) as a personal residence of the term holder (the "residence").

(ii) *Assets other than personal residence.* Except as otherwise provided, the governing instrument may permit a qualified personal residence trust to hold the following assets (in addition to the residence) in the amounts and in the manner described in this paragraph (c)(5)(ii):

(A) *Additions of cash for payment of expenses, etc.—(1) Additions.* The governing instrument may permit additions of cash to the trust, and may permit the trust to hold additions of cash in a separate account, in an amount which, when added to the cash already held in the account for such purposes, does not exceed the amount required:

(i) For payment of trust expenses (including mortgage payments), already incurred or reasonably expected to be paid by the trust within six months from the date the addition is made;

(ii) For improvements to the residence to be paid by the trust within six months from the date the addition is made; and

(iii) For purchase by the trust of the initial residence, within three months of the date the trust is created, provided that no addition may be made for this purpose, and the trust may not hold any such addition, unless the trustee has previously entered into a contract to purchase that residence; and

(iv) For purchase by the trust of a residence to replace another residence, within three months of the date the addition is made, provided that no addition may be made for this purpose, and the trust may not hold any such addition, unless the trustee has previously entered into a contract to purchase that residence.

(2) *Distributions of excess cash.* If the governing instrument permits additions

of cash to the trust pursuant to paragraph (c)(5)(ii)(A)(I) of this section, the governing instrument must require that the trustee determine, not less frequently than quarterly, the amounts held by the trust for payment of expenses in excess of the amounts permitted by that paragraph and must require that those amounts be distributed immediately thereafter to the term holder. In addition, the governing instrument must require, upon termination of the term holder's interest in the trust, any amounts held by the trust for the purposes permitted by paragraph (c)(5)(ii)(A)(I) of this section that are not used to pay trust expenses due and payable on the date of termination (including expenses directly related to termination) be distributed outright to the term holder within 30 days of termination.

(B) *Improvements.* The governing instrument may permit improvements to the residence to be added to the trust and may permit the trust to hold such improvements, provided that the residence, as improved, meets the requirements of a personal residence.

(C) *Sale proceeds.* The governing instrument may permit the sale of the residence and may permit the trust to hold proceeds from the sale of the residence, in a separate account.

(D) *Insurance and insurance proceeds.* The governing instrument may permit the trust to hold one or more policies of insurance on the residence. In addition, the governing instrument may permit the trust to hold, in a separate account, proceeds of insurance payable to the trust as a result of damage to or destruction of the residence. For purposes of this paragraph, amounts (other than insurance proceeds payable to the trust as a result of damage to or destruction of the residence) received as a result of the involuntary conversion (within the meaning of section 1033) of the residence are treated as proceeds of insurance.

(6) *Commutation.* The governing instrument must prohibit commutation (prepayment) of the term holder's interest.

(7) *Cessation of use as a personal residence—(i) In general.* The governing instrument must provide that a trust ceases to be a qualified personal residence trust if the residence ceases to be used or held for use as a personal residence of the term holder. A residence is held for use as a personal residence of the term holder so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence. See

§ 25.2702-5(c)(8) for rules governing disposition of assets of a trust as to which the trust has ceased to be a qualified personal residence trust.

(ii) *Sale of personal residence.* The governing instrument must provide that the trust ceases to be a qualified personal residence trust upon sale of the residence if the governing instrument does not permit the trust to hold proceeds of sale of the residence pursuant to paragraph (c)(5)(ii)(C) of this section. If the governing instrument permits the trust to hold proceeds of sale pursuant to that paragraph, the governing instrument must provide that the trust ceases to be a qualified personal residence trust with respect to all proceeds of sale held by the trust not later than the earlier of—

(A) The date that is two years after the date of sale;

(B) The termination of the term holder's interest in the trust; or

(C) The date on which a new residence is acquired by the trust.

(iii) *Damage to or destruction of personal residence—(A) In general.* The governing instrument must provide that, if damage or destruction renders the residence unusable as a residence, the trust ceases to be a qualified personal residence trust on the date that is two years after the date of damage or destruction (or the date of termination of the term holder's interest in the trust, if earlier) unless, prior to such date—

(1) Replacement of or repairs to the residence are completed; or

(2) A new residence is acquired by the trust.

(B) *Insurance proceeds.* For purposes of this paragraph (C)(7)(iii), if the governing instrument permits the trust to hold proceeds of insurance received as a result of damage to or destruction of the residence pursuant to paragraph (c)(5)(ii)(D) of this section, the governing instrument must contain provisions similar to those required by paragraph (c)(7)(ii) of this section.

(8) *Disposition of trust assets on cessation as personal residence trust—*

(i) *In general.* The governing instrument must provide that, within 30 days after the date on which the trust has ceased to be a qualified personal residence trust with respect to certain assets, either—

(A) The assets be distributed outright to the term holder;

(B) The assets be converted to and held for the balance of the term holder's term in a separate share of the trust meeting the requirements of a qualified annuity interest; or

(C) In the trustee's sole discretion, the trustee may elect to comply with either

paragraph (c)(8)(i) (A) or (B) of this section pursuant to their terms.

(ii) *Requirements for conversion to a qualified annuity interest—(A) Governing instrument requirements.* For assets subject to this paragraph (c)(8) to be converted to and held as a qualified annuity interest, the governing instrument must contain all provisions required by § 25.2702-3 with respect to a qualified annuity interest.

(B) *Effective date of annuity.* The governing instrument must provide that the right of the term holder to receive the annuity amount begins on the date of sale of the residence, the date of damage to or destruction of the residence, or the date on which the residence ceases to be used or held for use as a personal residence, as the case may be ("the cessation date"). Notwithstanding the preceding sentence, the governing instrument may provide that the trustee may defer payment of any annuity amount otherwise payable after the cessation date until the date that is 30 days after the assets are converted to a qualified annuity interest under paragraph (c)(8)(i)(B) of this section ("the conversion date"); provided that any deferred payment must bear interest from the cessation date at a rate not less than the section 7520 rate in effect on the cessation date. The governing instrument may permit the trustee to reduce aggregate deferred annuity payments by the amount of income actually distributed by the trust to the term holder during the deferral period.

(C) *Determination of annuity amount—(1) In general.* The governing instrument must require that the annuity amount be no less than the amount determined under this paragraph (C).

(2) *Entire trust ceases to be a qualified personal residence trust.* If, on the conversion date, the assets of the trust do not include a residence used or held for use as a personal residence, the annuity may not be less than an amount determined by dividing the lesser of the value of all interests retained by the term holder (as of the date of the original transfer or transfers) or the value of all the trust assets (as of the conversion date) by an annuity factor determined—

(i) For the original term of the term holder's interest;

(ii) Using the rate determined under section 7520 (as of the date of the original transfer); and

(iii) Assuming the annuity percentage equals the rate determined in (ii).

(3) *Portion of trust continues as qualified personal residence trust.* If, on the conversion date, the assets of the

trust include a residence used or held for use as a personal residence, the annuity must not be less than the amount determined under paragraph (c)(8)(ii)(C)(2) of this section multiplied by a fraction. The numerator of the fraction is the excess of the fair market value of the trust assets on the conversion date over the amount (including acquisition costs) reinvested in the new residence or expended for repairs of the existing residence, and the denominator of the fraction is the fair market value of the trust assets on the conversion date.

(d) *Examples.* The following examples illustrate rules of this section. Each example assumes that all applicable requirements of a personal residence trust (or qualified personal residence trust) are met unless otherwise stated.

Example 1. C maintains C's principal place of business in one room of C's principal residence. The room meets the requirements of section 280A(c)(1) for deductibility of expenses related to such use. The residence is a personal residence.

Example 2. L owns a vacation condominium that L rents out for six months of the year, but which is treated as L's residence under section 280A(d)(1) because L occupies it for at least 18 days per year. L provides no substantial services in connection with the rental of the condominium. L transfers the condominium to an irrevocable trust, the terms of which meet the requirements of a qualified personal residence trust. L retains the right to use the condominium during L's lifetime. The trust is a qualified personal residence trust.

Example 3. W owns a 200-acre farm. The farm includes a house, barns, equipment buildings, a silo, and enclosures for confinement of farm animals. W transfers the farm to an irrevocable trust, retaining the use of the farm for 20 years, with the remainder to W's child. The trust is not a personal residence trust because the farm includes assets not meeting the requirements of a personal residence.

Example 4. A transfers A's principal residence to an irrevocable trust, retaining the right to use the residence for a 20-year term. The governing instrument of the trust does not prohibit the trust from holding personal property. The trust is not a qualified personal residence trust.

Example 5. T transfers a personal residence to a trust that meets the requirements of a qualified personal residence trust, retaining a term interest in the trust for 10 years. During the period of T's retained term interest, T is forced for health reasons to move to a nursing home. T's spouse continues to occupy the residence. If the residence is available at all times for T's use as a residence during the term (without regard to T's ability to actually use the residence), the residence continues to be held for T's use and the trust does not cease to be a qualified personal residence trust. The residence would cease to be held for use as a personal residence of T if the trustee retained

the residence to an unrelated party, because the residence would no longer be available for T's use at all times.

Example 6. T transfers T's personal residence to a trust that meets the requirements of a qualified personal residence trust, retaining the right to use the residence for 12 years. On the date the residence is transferred to the trust, the fair market value of the residence is \$100,000. After 8 years, the trustee sells the residence, receiving net proceeds of \$250,000, and invests the proceeds of sale in common stock. After an additional eighteen months, the common stock has paid \$15,000 in dividends and has a fair market value of \$260,000. On that date, the trustee purchases a new residence for \$200,000. On the purchase of the new residence, the trust ceases to be a qualified personal residence trust with respect to any amount not reinvested in the new residence. The governing instrument of the trust provides that the trustee, in the trustee's sole discretion, may elect either to distribute the excess proceeds or to convert the proceeds into a qualified annuity interest. The trustee elects the latter option. The amount of the annuity is the amount of the annuity that would be payable if no portion of the sale proceeds had been reinvested in a personal residence multiplied by a fraction. The numerator of the fraction is \$60,000 (the amount remaining after reinvestment) and the denominator of the fraction is \$260,000 (the fair market value of the trust assets on the conversion date). The obligation to pay the annuity commences on the date of sale, but payment of the annuity that otherwise would have been payable during the period between the date of sale and the date on which the trust ceased to be a qualified personal residence trust with respect to the excess proceeds may be deferred until 30 days after the date on which the new residence is purchased. Any amount deferred must bear compound interest from the date the annuity is payable at the section 7520 rate in effect on the date of sale. The \$15,000 of income distributed to the term holder during that period may be used to reduce the annuity amount payable with respect to that period if the governing instrument so provides and thus reduce the amount on which compound interest is computed.

§ 25.2702-6 Reduction in taxable gifts.

(a) *Transfers of retained interests in trust—(1) Inter vivos transfers.* If an individual subsequently transfers by gift an interest in trust previously valued (when held by that individual) under § 25.2702-2 (b)(1) or (c), the individual is entitled to a reduction in aggregate taxable gifts. The amount of the reduction is determined under paragraph (b) of this section. Thus, for example, if an individual transferred property to an irrevocable trust, retaining an interest in the trust that was valued at zero under § 25.2702-2(b)(1), and the individual later transfers the retained interest by gift, the individual is entitled to a reduction in aggregate taxable gifts on the

subsequent transfer. For purposes of this section, aggregate taxable gifts means the aggregate sum of the individual's taxable gifts for the calendar year determined under section 2502(a)(1).

(2) Testamentary transfers.

(i) A term interest in trust is included in an individual's gross estate solely by reason of section 2033, or

(ii) A remainder interest in trust is included in an individual's gross estate,

and the interest was previously valued (when held by that individual) under § 25.2702-2(b)(1) or (c), the individual's estate is entitled to a reduction in the individual's adjusted taxable gifts in computing the Federal estate tax payable under section 2001. The amount of the reduction is determined under paragraph (b) of this section.

(3) *Gift splitting on subsequent transfer.* If an individual who is entitled to a reduction in aggregate taxable gifts (or adjusted taxable gifts) subsequently transfers the interest in a transfer treated as made one-half by the individual's spouse under section 2513, the individual may assign one-half of the amount of the reduction to the consenting spouse. The assignment must be attached to the Form 709 on which the consenting spouse reports the split gift.

(b) *Amount of reduction—(1) In general.* The amount of the reduction in aggregate taxable gifts (or adjusted taxable gifts) is the lesser of—

(i) The increase in the individual's taxable gifts resulting from the interest being valued at the time of the initial transfer under § 25.2702-2(b)(1) or (c); or

(ii) The increase in the individual's taxable gifts (or gross estate) resulting from the subsequent transfer of the interest.

(2) *Treatment of annual exclusion.* For purposes of determining the amount under paragraph (b)(1)(ii) of this section, the exclusion under section 2513(b) applies first to transfers in the year other than the transfer of the interest previously valued under § 25.2702-2(b)(1) or (c).

(3) *Overlap with section 2001.* Notwithstanding paragraph (b)(1) of this section, the amount of the reduction is reduced to the extent section 2001 would apply to reduce the amount of an individual's adjusted taxable gifts with respect to the same interest to which paragraph (b)(1) of this section would otherwise apply.

(c) *Examples.* The rules of this section are illustrated by the following examples. The following facts apply for *Examples 1-4*:

Facts. In 1992, X transferred property to an irrevocable trust retaining the right to receive the trust income for life. On the death of X, the trust is to terminate and the trust corpus is to be paid to X's child, C. X's income interest had a value under section 7520 of \$40,000 at the time of the transfer; however, because X's retained interest was not a qualified interest, it was valued at zero under § 25.2702-2(b)(1) for purposes of determining the amount of X's gift. X's taxable gifts in 1992 were therefore increased by \$40,000. In 1993, X transfers the income interest to C for no consideration.

Example 1. Assume that the value under section 7520 of the income interest on the subsequent transfer to C is \$30,000. If X makes no other gifts to C in 1993, X is entitled to a reduction in aggregate taxable gifts of \$20,000, the lesser of the amount by which X's taxable gifts were increased as a result of the income interest being valued at zero on the initial transfer (\$40,000) or the amount by which X's taxable gifts are increased as a result of the subsequent transfer of the income interest (\$30,000 minus \$10,000 annual exclusion).

Example 2. Assume that in 1993, 4 months after X transferred the income interest to C, X transferred \$5,000 cash to C. In determining the increase in taxable gifts occurring on the subsequent transfer, the annual exclusion under section 2503(b) is first applied to the cash gift. X is entitled to a reduction in aggregate taxable gifts of \$25,000, the lesser of the amount by which X's taxable gifts were increased as a result of the income interest being valued at zero on the initial transfer (\$40,000) or the amount by which X's taxable gifts are increased as a result of the subsequent transfer of the income interest (\$25,000 [(\$30,000 + \$5,000) - \$10,000 annual exclusion]).

Example 3. Assume that the value under section 7520 of the income interest on the subsequent transfer to C is \$55,000. X is entitled to reduce aggregate taxable gifts by \$40,000, the lesser of the amount by which X's taxable gifts were increased as a result of the income interest being valued at zero on the initial transfer (\$40,000) or the amount by which X's taxable gifts are increased as a result of the subsequent transfer of the income interest (\$55,000 minus \$10,000 annual exclusion = \$45,000).

Example 4. Assume that X and X's spouse, S, split the subsequent gift to C. X is entitled to assign one-half the reduction to S. If the assignment is made, each is entitled to reduce aggregate taxable gifts by \$17,500, the lesser of their portion of the increase in taxable gifts on the initial transfer by reason of the application of section 2702 (\$20,000) and their portion of the increase in taxable gifts on the subsequent transfer of the retained interest (\$27,500 - \$10,000 annual exclusion).

Example 5. In 1992, A transfers property to an irrevocable trust retaining the right to receive the trust income for 10 years. On the expiration of the 10-year term, the trust is to terminate and the trust corpus is to be paid to A's child, B. Assume that A's term interest has a value under section 7520 of \$20,000 at the time of the transfer; however, because A's retained interest was not a qualified interest,

it was valued at zero under § 25.2702-2(b)(1) for purposes of determining the amount of A's gift. Assume also that A and A's spouse, S, split the gift of the remainder interest under section 2513. In 1993, A transfers A's term interest to D, A's other child, for no consideration. A is entitled to reduce A's aggregate taxable gifts on the transfer. Assume that A and S also split the subsequent gift to D, and that A dies one month after making the subsequent transfer of the term interest and S dies six months later. The gift of the term interest is included in A's gross estate under section 2035(d)(2). To the extent S's taxable gifts are reduced pursuant to section 2007(e), S is entitled to no reduction in aggregate or adjusted taxable gifts under this section.

Example 6. T transfers property to an irrevocable trust retaining the power to direct the distribution of trust income for 10 years among T's descendants in whatever shares T deems appropriate. On the expiration of the 10-year period, the trust corpus is to be paid in equal shares to T's children. T's transfer of the remainder interest is a completed gift. Because T's retained interest is not a qualified interest, it is valued at zero under § 25.2702-2(b)(1) and the amount of T's gift is the fair market value of the property transferred to the trust. The distribution of income each year is not a transfer of a retained interest in trust. Therefore, T is not entitled to reduce aggregate taxable gifts as a result of the distributions of income from the trust.

Example 7. The facts are the same as in Example 6, except that after 3 years T exercises the right to direct the distribution of trust income by assigning the right to the income for the balance of the term to T's child, C. The exercise is a transfer of a retained interest in trust for purposes of this section. T is entitled to reduce aggregate taxable gifts by the lesser of the increase in taxable gifts resulting from the application of section 2702 to the initial transfer or the increase in taxable gifts resulting from the transfer of the retained interest in trust.

Example 8. In 1992, V purchases an income interest for 10 years in property in the same transaction or series of transactions in which C, V's child, purchases the remainder interest in the same property. V dies in 1997 still holding the term interest, the value of which is includible in V's gross estate under section 2033. V's estate would be entitled to a reduction in adjusted taxable gifts in the amount determined under paragraph (b) of this section.

§ 25.2702-7 Effective dates.

Sections 25.2702-1 through 25.2702-6 are effective as of January 28, 1992. With respect to transfers to which section 2702 applied made prior to January 28, 1992, taxpayers may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of the proposed regulations and the final regulations are considered a reasonable interpretation of the statutory provisions.

§ 25.2703-1 Property subject to restrictive arrangements.

(a) **Disregard of rights or restrictions—(1) In general.** For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), the value of any property is determined without regard to any right or restriction relating to the property.

(2) **Right or restriction.** For purposes of this section, right or restriction means—

(i) Any option, agreement, or other right to acquire or use the property at a price less than fair market value (determined without regard to the option, agreement, or right); or

(ii) Any restriction on the right to sell or use the property.

(3) **Agreements, etc. containing rights or restrictions.** A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement. A right or restriction may be implicit in the capital structure of an entity.

(4) **Qualified easements.** A perpetual restriction on the use of real property that qualified for a charitable deduction under either section 2522(d) or section 2055(f) of the Internal Revenue Code is not treated as a right or restriction.

(b) **Exceptions—(1) In general.** This section does not apply to any right or restriction satisfying the following three requirements—

(i) The right or restriction is a bona fide business arrangement;

(ii) The right or restriction is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth; and

(iii) At the time the right or restriction is created, the terms of the right or restriction are comparable to similar arrangements entered into by persons in an arm's length transaction.

(2) **Separate requirements.** Each of the three requirements described in paragraph (b)(1) of this section must be independently satisfied for a right or restriction to meet this exception. Thus, for example, the mere showing that a right or restriction is a bona fide business arrangement is not sufficient to establish that the right or restriction is not a device to transfer property for less than full and adequate consideration.

(3) **Exception for certain rights or restrictions.** A right or restriction is considered to meet each of the three requirements described in paragraph (b)(1) of this section if more than 50 percent by value of the property subject to the right or restriction is owned

directly or indirectly (within the meaning of § 25.2701-6) by individuals who are not members of the transferor's family. In order to meet this exception, the property owned by those individuals must be subject to the right or restriction to the same extent as the property owned by the transferor. For purposes of this section, members of the transferor's family include the persons described in § 25.2701-2(b)(5) and any other individual who is a natural object of the transferor's bounty. Any property held by a member of the transferor's family under the rules of § 25.2701-6 (without regard to § 25.2701-6(a)(5)) is treated as held only by a member of the transferor's family.

(4) *Similar arrangement*—(i) *In general.* A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length. A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business. This determination generally will entail consideration of such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted.

(ii) *Evidence of general business practice.* Evidence of general business practice is not met by showing isolated comparables. If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods. It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement. If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.

(5) *Multiple rights or restrictions.* If property is subject to more than one right or restriction described in paragraph (a)(2) of this section, the failure of a right or restriction to satisfy the requirements of paragraph (b)(1) of this section does not cause any other right or restriction to fail to satisfy those requirements if the right or restriction otherwise meets those requirements. Whether separate provisions are separate rights or restrictions, or are

integral parts of a single right or restriction, depends on all the facts and circumstances.

(c) *Substantial modification of a right or restriction*—(1) *In general.* A right or restriction that is substantially modified is treated as a right or restriction created on the date of the modification. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a *de minimis* change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification. If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless it can be shown that updating would not have resulted in a substantial modification. The addition of any family member as a party to a right or restriction (including by reason of a transfer of property that subjects the transferee family member to a right or restriction with respect to the transferred property) is considered a substantial modification unless the addition is mandatory under the terms of the right or restriction or the added family member is assigned to a generation (determined under the rules of section 2651 of the Internal Revenue Code) no lower than the lowest generation occupied by individuals already party to the right or restriction).

(2) *Exceptions.* A substantial modification does not include—

- (i) A modification required by the terms of a right or restriction;
- (ii) A discretionary modification of an agreement conferring a right or restriction if the modification does not change the right or restriction;
- (iii) A modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate; and
- (iv) A modification that results in an option price that more closely approximates fair market value.

(d) *Examples.* The following examples illustrate the provisions of this section:

Example 1. T dies in 1992 owning title to Blackacre. In 1991, T and T's child entered into a lease with respect to Blackacre. At the time the lease was entered into, the terms of the lease were not comparable to leases of similar property entered into among unrelated parties. The lease is a restriction on the use of the property that is disregarded in valuing the property for Federal estate tax purposes.

Example 2. T and T's child, C, each own 50 percent of the outstanding stock of X corporation. T and C enter into an agreement

in 1987 providing for the disposition of stock held by the first to die at the time of death. The agreement also provides certain restrictions with respect to lifetime transfers. In 1992, as permitted (but not required) under the agreement, T transfers one-half of T's stock to T's spouse, S. S becomes a party to the agreement between T and C by reason of the transfer. The transfer is the addition of a family member to the right or restriction. However, it is not a substantial modification of the right or restriction because the added family member would be assigned to a generation under section 2651 of the Internal Revenue Code no lower than the generation occupied by C.

Example 3. The facts are the same as in *Example 2.* In 1993, the agreement is amended to reflect a change in the company's name and a change of address for the company's registered agent. These changes are not a substantial modification of the agreement conferring the right or restriction because the right or restriction has not changed.

§ 25.2703-2 Effective date.

Section 25.2703-1 applies to any right or restriction created or substantially modified after October 8, 1990, and is effective as of January 28, 1992. With respect to transfers occurring prior to January 28, 1992, and for purposes of determining whether an event occurring prior to January 28, 1992 constitutes a substantial modification, taxpayers may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of the proposed regulations and the final regulations are considered a reasonable interpretation of the statutory provisions.

§ 25.2704-1 Lapse of certain rights.

(a) *Lapse treated as transfer*—(1) *In general.* The lapse of a voting right or a liquidation right in a corporation or partnership (an "entity") is a transfer by the individual directly or indirectly holding the right immediately prior to its lapse (the "holder") to the extent provided in paragraphs (b) and (c) of this section. This section applies only if the entity is controlled by the holder and members of the holder's family immediately before and after the lapse. The amount of the transfer is determined under paragraph (d) of this section. If the lapse of a voting right or a liquidation right occurs during the holder's lifetime, the lapse is a transfer by gift. If the lapse occurs at the holder's death, the lapse is a transfer includible in the holder's gross estate.

(2) *Definitions.* The following definitions apply for purposes of this section.

- (i) *Control.* Control has the meaning given it in § 25.2701-2(b)(5).

(ii) *Member of the family.* Member of the family has the meaning given in § 25.2702-2(a)(1).

(iii) *Directly or indirectly held.* An interest is directly or indirectly held, only to the extent the value of the interest would have been includible in the gross estate of the individual if the individual had died immediately prior to the lapse.

(iv) *Voting right.* Voting right means a right to vote with respect to any matter of the entity. In the case of a partnership, the right of a general partner to participate in partnership management is a voting right. The right to compel the entity to acquire all or a portion of the holder's equity interest in the entity by reason of aggregate voting power is treated as a liquidation right and is not treated as a voting right.

(v) *Liquidation right.* Liquidation right means a right or ability to compel the entity to acquire all or a portion of the holder's equity interest in the entity, including by reason of aggregate voting power, whether or not its exercise would result in the complete liquidation of the entity.

(vi) *Subordinate.* Subordinate has the meaning given it in § 25.2701-3(a)(2)(iii).

(3) *Certain temporary lapses.* If a lapsed right may be restored only upon the occurrence of a future event not within the control of the holder or members of the holder's family, the lapse is deemed to occur at the time the lapse becomes permanent with respect to the holder, i.e. either by a transfer of the interest or otherwise.

(4) *Source of right or lapse.* A voting right or a liquidation right may be conferred by and may lapse by reason of a State law, the corporate charter or bylaws, an agreement, or other means.

(b) *Lapse of voting right.* A lapse of a voting right occurs at the time a presently exercisable voting right is restricted or eliminated.

(c) *Lapse of liquidation right—(1) In general.* A lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated. Except as otherwise provided, a transfer of an interest that results in the lapse of a liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated. However, a transfer that results in the elimination of the transferor's right or ability to compel the entity to acquire an interest retained by the transferor that is subordinate to the transferred interest is a lapse of a liquidation right with respect to the subordinate interest.

(2) *Exceptions.* Section 2704(a) does not apply to the lapse of a liquidation right under the following circumstances.

(i) *Family cannot obtain liquidation or value—(A) In general.* Section 2704(a) does not apply to the lapse of a liquidation right to the extent the holder (or the holder's estate) and members of the holder's family cannot immediately after the lapse liquidate an interest that the holder held directly or indirectly and could have liquidated prior to the lapse.

(B) *Ability to liquidate.* Whether an interest can be liquidated immediately after the lapse is determined under the State law generally applicable to the entity, as modified by the governing instruments of the entity, but without regard to any restriction described in section 2704(b). Thus, if, after any restriction described in section 2704(b) is disregarded, the remaining requirements for liquidation under the governing instruments are less restrictive than the State law that would apply in the absence of the governing instruments, the ability to liquidate is determined by reference to the governing instruments.

(ii) *Rights valued under section 2701.* Section 2704(a) does not apply to the lapse of a liquidation right previously valued under section 2701 to the extent necessary to prevent double taxation (taking into account any adjustment available under § 25.2701-5).

(iii) *Certain changes in State law.* Section 2704(a) does not apply to the lapse of a liquidation right that occurs solely by reason of a change in State law. For purposes of this paragraph, a change in the governing instrument of an entity is not a change in State law.

(d) *Amount of transfer.* The amount of the transfer is the excess, if any, of—

(1) The value of all interests in the entity owned by the holder immediately before the lapse (determined immediately after the lapse as if the lapsed right was nonlapsing); over

(2) The value of the interests described in the preceding paragraph immediately after the lapse (determined as if all such interests were held by one individual).

(e) *Application to similar rights.* [Reserved]

(f) *Examples.* The following examples illustrate the provisions of this section:

Example 1. Prior to D's death, D owned all the preferred stock of Corporation Y and D's children owned all the common stock. At that time, the preferred stock had 60 percent of the total voting power and the common stock had 40 percent. Under the corporate by-laws, the voting rights of the preferred stock terminated on D's death. The value of D's interest immediately prior to D's death (determined as if the voting rights were nonlapsing) was \$100X. The value of that interest immediately after death would have been \$90X if the voting rights had been nonlapsing. The decrease in value reflects the

loss in value resulting from the death of D (whose involvement in Y was a key factor in Y's profitability). Section 2704(a) applies to the lapse of voting rights on D's death. D's gross estate includes an amount equal to the excess, if any, of \$90X over the fair market value of the preferred stock determined after the lapse of the voting rights.

Example 2. Prior to D's death, D owned all the preferred stock of Corporation Y. The preferred stock and the common stock each carried 50 percent of the total voting power of Y. D's children owned 40 percent of the common stock and unrelated parties own the remaining 60 percent. Under the corporate by-laws, the voting rights of the preferred stock terminate on D's death. Section 2704(a) does not apply to the lapse of D's voting rights because members of D's family do not control Y after the lapse.

Example 3. The by-laws of Corporation Y provide that the voting rights of any transferred shares of the single outstanding class of stock are reduced to 1/4 vote per share after the transfer but are fully restored to the transferred shares after 5 years. D owned 60 percent of the shares prior to death and members of D's family owned the balance. On D's death, D's shares pass to D's children and the voting rights are reduced pursuant to the by-laws. Section 2704(a) applies to the lapse of D's voting rights. D's gross estate includes an amount equal to the excess, if any, of the fair market value of D's stock (determined immediately after D's death as though the voting rights had not been reduced and would not be reduced) over the stock's fair market value immediately after D's death.

Example 4. D owns 84 percent of the single outstanding class of stock of Corporation Y. The by-laws require at least 70 percent of the vote to liquidate Y. D gives one-half of D's stock in equal shares to D's three children (14 percent to each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y, because the voting rights with respect to the corporation are not restricted or eliminated by reason of the transfer.

Example 5. D and D's two children, A and B, are partners in Partnership X. Each has a 1/3 percent general partnership interest and a 30 percent limited partnership interest. Under State law, a general partner has the right to participate in partnership management. The partnership agreement provides that when a general partner withdraws or dies, X must redeem the general partnership interest for its liquidation value. Also, under the agreement any general partner can liquidate the partnership. A limited partner cannot liquidate the partnership and a limited partner's capital interest will be returned only when the partnership is liquidated. A deceased limited partner's interest continues as a limited partnership interest. D dies, leaving his limited partnership interest to D's spouse. Because of a general partner's right to dissolve the partnership, a limited partnership interest has a greater fair market value when held in conjunction with a general partnership interest than when held alone. Section 2704(a) applies to the lapse of D's liquidation right because after the lapse, members of D's family could liquidate D's

limited partnership interest. D's gross estate includes an amount equal to the excess of the value of all D's interests in X immediately before D's death (determined immediately after D's death but as though the liquidation right had not lapsed and would not lapse) over the fair market value of all D's interests in X immediately after D's death.

Example 6. The facts are the same as in Example 5, except that under the partnership agreement D is the only general partner who holds a unilateral liquidation right. Assume further that the partnership agreement contains a restriction described in section 2704(b) that prevents D's family members from liquidating D's limited partnership interest immediately after D's death. Under State law, in the absence of the restriction in the partnership agreement, D's family members could liquidate the partnership. The restriction on the family's ability to liquidate is disregarded and the amount of D's gross estate is increased by reason of the lapse of D's liquidation right.

Example 7. D owns all the stock of Corporation X, consisting of 100 shares of non-voting preferred stock and 100 shares of voting common stock. Under the by-laws, X can only be liquidated with the consent of at least 80 percent of the voting shares. D transfers 30 shares of common stock to D's child. The transfer is not a lapse of a liquidation right with respect to the common stock because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated. The transfer is not a lapse of a liquidation right with respect to the retained preferred stock because the preferred stock is not subordinate to the transferred common stock.

Example 8. D owns all of the single class of stock of Corporation Y. D recapitalizes Y, exchanging D's common stock for voting common stock and non-voting, non-cumulative preferred stock. The preferred stock carries a right to put the stock for its par value at any time during the next 10 years. D transfers the common stock to D's grandchild in a transfer subject to section 2701. In determining the amount of D's gift under section 2701, D's retained put right is valued at zero. D's child, C, owns the preferred stock when the put right lapses. Section 2704(a) applies to the lapse, without regard to the application of section 2701, because the put right was not valued under section 2701 in the hands of C.

Example 9. A and A's two children are equal general and limited partners in Partnership Y. Under the partnership agreement, each general partner has a right to liquidate the partnership at any time. Under State law that would apply in the absence of contrary provisions in the partnership agreement, the death or incompetency of a general partner terminates the partnership. However, the partnership agreement provides that the partnership does not terminate on the incompetency or death of a general partner, but that an incompetent partner cannot exercise rights as a general partner during any period of incompetency. A partner's full rights as general partner are restored if the partner regains competency. A becomes incompetent. The lapse of A's voting right on becoming incompetent is not subject

to section 2704(a) because it may be restored to A in the future. However, if A dies while incompetent, a lapse subject to section 2704(a) is deemed to occur at that time because the lapsed right cannot thereafter be restored to A.

§ 25.2704-2 Transfers subject to applicable restrictions.

(a) *In general.* If an interest in a corporation or partnership (an "entity") is transferred to or for the benefit of a member of the transferor's family, any applicable restriction is disregarded in valuing the transferred interest. This section applies only if the transferor and members of the transferor's family control the entity immediately before the transfer. For the definition of control, see § 25.2701-2(b)(5). For the definition of member of the family, see § 25.2702-2(a)(1).

(b) *Applicable restriction defined.* An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction. A restriction is an applicable restriction only to the extent that either the restriction by its terms will lapse at any time after the transfer, or the transferor (or the transferor's estate) and any members of the transferor's family can remove the restriction immediately after the transfer. Ability to remove the restriction is determined by reference to the State law that would apply but for a more restrictive rule in the governing instruments of the entity. See § 25.2704-1(e)(1)(B) for a discussion of the term "State law." An applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b) of the Internal Revenue Code, provided that for purposes of this section the term "fiduciary of a trust" as used in section 267(b) does not include a bank as defined in section 581 of the Internal Revenue Code. A restriction imposed or required to be imposed by Federal or State law is not an applicable restriction. An option, right to use property, or agreement that is subject to section 2703 is not an applicable restriction.

(c) *Effect of disregarding an applicable restriction.* If an applicable restriction is disregarded under this section, the transferred interest is valued as if the restriction does not exist

and as if the rights of the transferor are determined under the State law that would apply but for the restriction. For example, an applicable restriction with respect to preferred stock will be disregarded in determining the amount of a transfer of common stock under section 2701.

(d) *Examples.* The following examples illustrate the provisions of this section:

Example 1. D owns a 76 percent interest and each of D's children, A and B, owns a 12 percent interest in General Partnership X. The partnership agreement requires the consent of all the partners to liquidate the partnership. Under the State law that would apply in the absence of the restriction in the partnership agreement, the consent of partners owning 70 percent of the total partnership interests would be required to liquidate X. On D's death, D's partnership interest passes to D's child, C. The requirement that all the partners consent to liquidation is an applicable restriction. Because A, B and C (all members of D's family), acting together after the transfer, can remove the restriction on liquidation, D's interest is valued without regard to the restriction; i.e., as though D's interest is sufficient to liquidate the partnership.

Example 2. D owns all the preferred stock in Corporation X. The preferred stock carries a right to liquidate X that cannot be exercised until 1999. D's children, A and B, own all the common stock of X. The common stock is the only voting stock. In 1994, D transfers the preferred stock to D's child, A. The restriction on D's right to liquidate is an applicable restriction that is disregarded. Therefore, the preferred stock is valued as though the right to liquidate were presently exercisable.

Example 3. D owns 80 percent of the stock of Corporation X. The corporate by-laws provide that the corporation cannot be liquidated for 10 years after which time liquidation requires approval by 80 percent of the voting interests. In the absence of the provision in the by-laws, State law would require approval by 80 percent of the voting interests to liquidate X. D transfers the stock to a trust for the benefit of D's child, A, during the 10-year period. The 10-year restriction is an applicable restriction and is disregarded. Therefore, the value of the stock is determined as if the transferred block could currently liquidate X.

Example 4. D and D's children, A and B, are partners in Limited Partnership Y. Each has a 33 percent general partnership interest and a 30 percent limited partnership interest. Any general partner has the right to liquidate the partnership at any time. As part of a loan agreement with a lender who is related to D, each of the partners agree that the partnership may not be liquidated without the lender's consent while any portion of the loan remains outstanding. During the term of the loan agreement, D transfers one-half of both D's partnership interests to each of A and B. Because the lender is a related party, the requirement that the lender consent to liquidation is an applicable restriction and the transfers of D's

interests are valued as if such consent were not required.

Example 5. D owns 60 percent of the preferred and 70 percent of the common stock in Corporation X. The remaining stock is owned by individuals unrelated to D. The preferred stock carries a put right that cannot be exercised until 1999. In 1995, D transfers the common stock to D's child in a transfer that is subject to section 2701. The restriction on D's right to liquidate is an applicable restriction that is disregarded in determining the amount of the gift under section 2701.

§ 25.2704-3 Effective date.

Section 25.2704-1 applies to lapses occurring after January 28, 1992 of rights created after October 8, 1990. Section 25.2704-2 applies to transfers occurring after January 28, 1992 of property subject to applicable restrictions created after October 8, 1990. In determining whether a voting right or a liquidation right has lapsed prior to that date, and for purposes of determining whether the lapse is subject to section 2704(a), taxpayers may rely on any reasonable interpretation of the statutory provisions. For transfers of interests occurring before January 28, 1992, taxpayers may rely on any reasonable interpretation of the statutory provisions in determining whether a restriction is an applicable restriction that must be disregarded in determining the value of the transferred interest. For these purposes, the provisions of the proposed regulations and the final regulations are considered a reasonable interpretation of the statutory provisions.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 12. The authority for part 301 continues to read, in part:

Authority: Sec 7805, I.R.C. 1954; 68A Stat. 917; 26 U.S.C. 7805.

Par. 13. In § 301.6501(c)-7, new paragraph (e) is added in the appropriate place to read as follows:

§ 301.6501(c)-7 Exceptions to general period of limitations on assessment and collection.

(e) Certain gifts not shown on return—

(1) *In general.* If any transfer of property subject to the special valuation rules of section 2701 or section 2702, or if the occurrence of any taxable event described in section § 25.2701-4 of this chapter, is not adequately shown on a return of tax imposed by chapter 12 of subtitle B of the Internal Revenue Code (without regard to section 2503(b)), any tax imposed by chapter 12 of subtitle B of the Code on the transfer or resulting from the taxable event may be assessed, or a proceeding in court for the collection of the appropriate tax may be begun without assessment, at any time.

(2) *Adequately shown.* A transfer of property valued under the rules of section 2701 or section 2702 or any taxable event described in § 25.2701-4 of this chapter will be considered adequately shown on a return of tax imposed by chapter 12 of subtitle B of the Internal Revenue Code only if, with respect to the entire transaction or series of transactions (including any transaction that affected the transferred interest) of which the transfer (or taxable event) was a part, the return provides:

(i) A description of the transactions, including a description of transferred and retained interests and the method (or methods) used to value each;

(ii) The identity of, and relationship between, the transferor, transferee, all other persons participating in the transactions, and all parties related to the transferor holding an equity interest in any entity involved in the transaction; and

(iii) A detailed description (including all actuarial factors and discount rates used) of the method used to determine the amount of the gift arising from the transfer (or taxable event), including, in the case of an equity interest that is not actively traded, the financial and other data used in determining value. Financial data should generally include balance sheets and statements of net earnings, operating results, and dividends paid for each of the 5 years immediately before the valuation date.

(3) *Effective date.* The provisions of this paragraph (e) are effective as of January 28, 1992. In determining whether a transfer or taxable event is adequately shown on a gift tax return filed prior to that date, taxpayers may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of the proposed regulations and the final regulations are considered a reasonable interpretation of the statutory provisions.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved: January 2, 1992.
Kenneth W. Gideon,
Assistant Secretary of the Treasury.
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