

(v) A computation of the deduction showing the applicable section 7520 interest rate that is used to value the transferred interest.

(5) *Place for filing returns.* See section 6091 of the Internal Revenue Code and the regulations thereunder for the place for filing the return or other document required by this section.

(b) *Election of interest rate component—*  
(1) *Time for making election.* An executor makes a prior-month election under paragraph (a)(2) of this section by attaching the information described in paragraph (b)(2) of this section to the decedent's estate tax return or by filing a supplemental statement of the election information within 24 months after the later of the date the original estate tax return was filed or the due date for filing the return.

(2) *Manner of making election.* A statement that the prior-month election under section 7520(a) of the Internal Revenue Code is being made and that identifies the elected month must be attached to the estate tax return (or by subsequently filing the statement as supplemental information to the return).

(3) *Revocability.* The prior-month election may be revoked by filing a statement of supplemental information within 24 months after the later of the date the original return of tax for the decedent's estate was filed or the due date for filing the return. The revocation must be filed in the place referred to in paragraph (a)(5) of this section.

(c) *Effective dates.* Paragraph (a) of this section is effective as of May 1, 1989. Paragraph (b) of this section is effective for elections made after June 10, 1994.

**§ 20.7520-3 Limitation on the application of section 7520.**

(a) *Internal Revenue Code sections to which section 7520 does not apply.* Section 7520 of the Internal Revenue Code does not apply for purposes of:

(1) Part I, subchapter D of subtitle A (section 401 et. seq.), relating to the income tax treatment of certain qualified plans. (However, section 7520 does apply to the estate and gift tax treatment of certain qualified plans and for purposes of determining excess accumulations under section 4980A);

(2) Sections 72 and 101(b), relating to the income taxation of life insurance, endowment, and annuity contracts, unless otherwise provided for in the regulations under sections 72, 101, and 1011 (see, particularly, §§ 1.101-2(e)(1)(iii)(b)(2), and 1.1011-2(c), *Example 8*);

(3) Sections 83 and 451, unless otherwise provided for in the regulations under those sections;

(4) Section 457, relating to the valuation of deferred compensation, unless otherwise provided for in the regulations under section 457;

(5) Sections 3121(v) and 3306(r), relating to the valuation of deferred amounts, unless otherwise provided for in the regulations under those sections;

(6) Section 6058, relating to valuation statements evidencing compliance with qualified plan requirements, unless otherwise provided for in the regulations under section 6058;

(7) Section 7872, relating to income and gift taxation of interest-free loans and loans with below-market interest rates, unless otherwise provided for in the regulations under section 7872; or

(8) Section 2702(a)(2)(A), relating to the value of a nonqualified retained interest upon a transfer of an interest in trust to or for the benefit of a member of the transferor's family; and

(9) Any other sections of the Internal Revenue Code to the extent provided by the Internal Revenue Service in revenue rulings or revenue procedures. (See §§ 601.201 and 601.601 of this chapter).

(b) *Other limitations on the application of section 7520—*(1) *In general—*(i) *Ordinary beneficial interests.* For purposes of this section:

(A) An *ordinary annuity interest* is the right to receive a fixed dollar amount at the end of each year during one or more measuring lives or for some other defined period. A standard section 7520 annuity factor for an ordinary annuity interest represents the present worth of the right to receive \$1.00 per year for a defined period, using the interest rate prescribed under section 7520 for the appropriate month. If an annuity interest is payable more often than annually or is payable at the beginning of each period, a special adjustment must

be made in any computation with a standard section 7520 annuity factor.

(B) An *ordinary income interest* is the right to receive the income from or the use of property during one or more measuring lives or for some other defined period. A standard section 7520 income factor for an ordinary income interest represents the present worth of the right to receive the use of \$1.00 for a defined period, using the interest rate prescribed under section 7520 for the appropriate month.

(C) An *ordinary remainder or reversionary interest* is the right to receive an interest in property at the end of one or more measuring lives or some other defined period. A standard section 7520 remainder factor for an ordinary remainder or reversionary interest represents the present worth of the right to receive \$1.00 at the end of a defined period, using the interest rate prescribed under section 7520 for the appropriate month.

(ii) *Certain restricted beneficial interests.* A *restricted beneficial interest* is an annuity, income, remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances. In general, a standard section 7520 annuity, income, or remainder factor may not be used to value a restricted beneficial interest. However, a special section 7520 annuity, income, or remainder factor may be used to value a restricted beneficial interest under some circumstances. See paragraphs (b)(2)(v) *Example 4* and (b)(4) *Example 1* of this section, which illustrate situations where special section 7520 actuarial factors are needed to take into account limitations on beneficial interests. See § 20.7520-1(c) for requesting a special factor from the Internal Revenue Service.

(iii) *Other beneficial interests.* If, under the provisions of this paragraph (b), the interest rate and mortality components prescribed under section 7520 are not applicable in determining the value of any annuity, income, remainder, or reversionary interest, the actual fair market value of the interest (determined without regard to section 7520)

is based on all of the facts and circumstances if and to the extent permitted by the Internal Revenue Code provision applicable to the property interest.

(2) *Provisions of governing instrument and other limitations on source of payment—(i) Annuities.* A standard section 7520 annuity factor may not be used to determine the present value of an annuity for a specified term of years or the life of one or more individuals unless the effect of the trust, will, or other governing instrument is to ensure that the annuity will be paid for the entire defined period. In the case of an annuity payable from a trust or other limited fund, the annuity is not considered payable for the entire defined period if, considering the applicable section 7520 interest rate at the valuation date of the transfer, the annuity is expected to exhaust the fund before the last possible annuity payment is made in full. For this purpose, it must be assumed that it is possible for each measuring life to survive until age 110. For example, for a fixed annuity payable annually at the end of each year, if the amount of the annuity payment (expressed as a percentage of the initial corpus) is less than or equal to the applicable section 7520 interest rate at the date of the transfer, the corpus is assumed to be sufficient to make all payments. If the percentage exceeds the applicable section 7520 interest rate and the annuity is for a definite term of years, multiply the annual annuity amount by the Table B term certain annuity factor, as described in § 20.7520-1(c)(1), for the number of years of the defined period. If the percentage exceeds the applicable section 7520 interest rate and the annuity is payable for the life of one or more individuals, multiply the annual annuity amount by the Table B annuity factor for 110 years minus the age of the youngest individual. If the result exceeds the limited fund, the annuity may exhaust the fund, and it will be necessary to calculate a special section 7520 annuity factor that takes into account the exhaustion of the trust or fund. This computation would be modified, if appropriate, to take into account annuities with different payment terms. See § 25.7520-3(b)(2)(v) *Example 5* of this

chapter, which provides an illustration involving an annuity trust that is subject to exhaustion.

(ii) *Income and similar interests*—(A) *Beneficial enjoyment*. A standard section 7520 income factor for an ordinary income interest may not be used to determine the present value of an income or similar interest in trust for a term of years, or for the life of one or more individuals, unless the effect of the trust, will, or other governing instrument is to provide the income beneficiary with that degree of beneficial enjoyment of the property during the term of the income interest that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust for a similar period of time. This degree of beneficial enjoyment is provided only if it was the transferor's intent, as manifested by the provisions of the governing instrument and the surrounding circumstances, that the trust provide an income interest for the income beneficiary during the specified period of time that is consistent with the value of the trust corpus and with its preservation. In determining whether a trust arrangement evidences that intention, the treatment required or permitted with respect to individual items must be considered in relation to the entire system provided for in the administration of the subject trust. Similarly, in determining the present value of the right to use tangible property (whether or not in trust) for one or more measuring lives or for some other specified period of time, the interest rate component prescribed under section 7520 and §1.7520-1 of this chapter may not be used unless, during the specified period, the effect of the trust, will or other governing instrument is to provide the beneficiary with that degree of use, possession, and enjoyment of the property during the term of interest that applicable state law accords to a person who is unqualifiedly designated as a life tenant or term holder for a similar period of time.

(B) *Diversions of income and corpus*. A standard section 7520 income factor for an ordinary income interest may not be used to value an income interest or similar interest in property for a term

of years, or for one or more measuring lives, if—

(1) The trust, will, or other governing instrument requires or permits the beneficiary's income or other enjoyment to be withheld, diverted, or accumulated for another person's benefit without the consent of the income beneficiary; or

(2) The governing instrument requires or permits trust corpus to be withdrawn from the trust for another person's benefit without the consent of the income beneficiary during the income beneficiary's term of enjoyment and without accountability to the income beneficiary for such diversion.

(iii) *Remainder and reversionary interests*. A standard section 7520 remainder interest factor for an ordinary remainder or reversionary interest may not be used to determine the present value of a remainder or reversionary interest (whether in trust or otherwise) unless, consistent with the preservation and protection that the law of trusts would provide for a person who is unqualifiedly designated as the remainder beneficiary of a trust for a similar duration, the effect of the administrative and dispositive provisions for the interest or interests that precede the remainder or reversionary interest is to assure that the property will be adequately preserved and protected (e.g., from erosion, invasion, depletion, or damage) until the remainder or reversionary interest takes effect in possession and enjoyment. This degree of preservation and protection is provided only if it was the transferor's intent, as manifested by the provisions of the arrangement and the surrounding circumstances, that the entire disposition provide the remainder or reversionary beneficiary with an undiminished interest in the property transferred at the time of the termination of the prior interest.

(iv) *Pooled income fund interests*. In general, pooled income funds are created and administered to achieve a special rate of return. A beneficial interest in a pooled income fund is not ordinarily valued using a standard section 7520 income or remainder interest factor. The present value of a beneficial interest in a pooled income fund is determined according to rules and special

remainder factors prescribed in § 1.642(c)-6 of this chapter and, when applicable, the rules set forth under paragraph (b)(3) of this section if the individual who is the measuring life is terminally ill at the time of the transfer.

(v) *Examples.* The provisions of this paragraph (b)(2) are illustrated by the following examples:

*Example 1. Unproductive property.* A died, survived by B and C. B died two years after A. A's will provided for a bequest of corporation stock in trust under the terms of which all of the trust income was paid to B for life. After the death of B, the trust terminated and the trust property was distributed to C. The trust specifically authorized, but did not require, the trustee to retain the shares of stock. The corporation paid no dividends on this stock during the 5 years before A's death and the 2 years before B's death. There was no indication that this policy would change after A's death. Under applicable state law, the corporation is considered to be a sound investment that satisfies fiduciary standards. The facts and circumstances, including applicable state law, indicate that B did not have the legal right to compel the trustee to make the trust corpus productive in conformity with the requirements for a lifetime trust income interest under applicable local law. Therefore, B's life income interest in this case is considered nonproductive. Consequently, B's income interest may not be valued actuarially under this section.

*Example 2. Beneficiary's right to make trust productive.* The facts are the same as in *Example 1*, except that the trustee is not specifically authorized to retain the shares of stock. Further, the terms of the trust specifically provide that B, the life income beneficiary, may require the trustee to make the trust corpus productive consistent with income yield standards for trusts under applicable state law. Under that law, the minimum rate of income that a productive trust may produce is substantially below the section 7520 interest rate for the month of A's death. In this case, because B has the right to compel the trustee to make the trust productive for purposes of applicable local law during the beneficiary's lifetime, the income interest is considered an ordinary income interest for purposes of this paragraph, and the standard section 7520 life income interest factor may be used to determine the present value of B's income interest.

*Example 3. Discretionary invasion of corpus.* The decedent, A, transferred property to a trust under the terms of which all of the trust income is to be paid to A's child for life and the remainder of the trust is to be distributed to a grandchild. The trust authorizes the trustee without restriction to distribute corpus to A's surviving spouse for the

spouse's comfort and happiness. In this case, because the trustee's power to invade trust corpus is unrestricted, the exercise of the power could result in the termination of the income interest at any time. Consequently, the income interest is not considered an ordinary income interest for purposes of this paragraph, and may not be valued actuarially under this section.

*Example 4. Limited invasion of corpus.* The decedent, A, bequeathed property to a trust under the terms of which all of the trust income is to be paid to A's child for life and the remainder is to be distributed to A's grandchild. The trust authorizes the child to withdraw up to \$5,000 per year from the trust corpus. In this case, the child's power to invade trust corpus is limited to an ascertainable amount each year. Annual invasions of any amount would be expected to progressively diminish the property from which the child's income is paid. Consequently, the income interest is not considered an ordinary income interest for purposes of this paragraph, and the standard section 7520 income interest factor may not be used to determine the present value of the income interest. Nevertheless, the present value of the child's income interest is ascertainable by making a special actuarial calculation that would take into account not only the initial value of the trust corpus, the section 7520 interest rate for the month of the transfer, and the mortality component for the child's age, but also the assumption that the trust corpus will decline at the rate of \$5,000 each year during the child's lifetime. The child's right to receive an amount not in excess of \$5,000 per year may be separately valued in this instance and, assuming the trust corpus would not exhaust before the child would attain age 110, would be considered an ordinary annuity interest.

*Example 5. Power to consume.* The decedent, A, devised a life estate in 3 parcels of real estate to A's surviving spouse with the remainder to a child, or, if the child doesn't survive, to the child's estate. A also conferred upon the spouse an unrestricted power to consume the property, which includes the right to sell part or all of the property and to use the proceeds for the spouse's support, comfort, happiness, and other purposes. Any portion of the property or its sale proceeds remaining at the death of the surviving spouse is to vest by operation of law in the child at that time. The child predeceased the surviving spouse. In this case, the surviving spouse's power to consume the corpus is unrestricted, and the exercise of the power could entirely exhaust the remainder interest during the life of the spouse. Consequently, the remainder interest that is includible in the child's estate is not considered an ordinary remainder interest for purposes of this paragraph and may not be valued actuarially under this section.

(3) *Mortality component*—(i) *Terminal illness*. Except as provided in paragraph (b)(3)(ii) of this section, the mortality component prescribed under section 7520 may not be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life is terminally ill at the time of the decedent's death. For purposes of this paragraph (b)(3), an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within 1 year. However, if the individual survives for eighteen months or longer after the date of the decedent's death, that individual shall be presumed to have not been terminally ill at the date of death unless the contrary is established by clear and convincing evidence.

(ii) *Terminal illness exceptions*. In the case of the allowance of the credit for tax on a prior transfer under section 2013, if a final determination of the federal estate tax liability of the transferor's estate has been made under circumstances that required valuation of the life interest received by the transferee, the value of the property transferred, for purposes of the credit allowable to the transferee's estate, shall be the value determined previously in the transferor's estate. Otherwise, for purposes of section 2013, the provisions of paragraph (b)(3)(i) of this section shall govern in valuing the property transferred. The value of a decedent's reversionary interest under sections 2037(b) and 2042(2) shall be determined without regard to the physical condition, immediately before the decedent's death, of the individual who is the measuring life.

(iii) *Death resulting from common accidents*. The mortality component prescribed under section 7520 may not be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if the decedent, and the individual who is the measuring life, die as a result of a common accident or other occurrence.

(4) *Examples*. The provisions of paragraph (b)(3) of this section are illustrated by the following examples:

*Example 1. Terminal illness*. The decedent bequeaths \$1,000,000 to a trust under the terms of which the trustee is to pay \$103,000 per year to a charitable organization during the life of the decedent's child. Upon the death of the child, the remainder in the trust is to be distributed to the decedent's grandchild. The child, who is age 60, has been diagnosed with an incurable illness, and there is at least a 50 percent probability of the child dying within 1 year. Assuming the presumption provided for in paragraph (b)(3)(i) of this section does not apply, the standard life annuity factor for a person age 60 may not be used to determine the present value of the charitable organization's annuity interest because there is at least a 50 percent probability that the child, who is the measuring life, will die within 1 year. Instead, a special section 7520 annuity factor must be computed that takes into account the projection of the child's actual life expectancy.

*Example 2. Deaths resulting from common accidents, etc.* The decedent's will establishes a trust to pay income to the decedent's surviving spouse for life. The will provides that, upon the spouse's death or, if the spouse fails to survive the decedent, upon the decedent's death the trust property is to pass to the decedent's children. The decedent and the decedent's spouse die simultaneously in an accident under circumstances in which it was impossible to determine who survived the other. Even if the terms of the will and applicable state law presume that the decedent died first with the result that the property interest is considered to have passed in trust for the benefit of the spouse for life, after which the remainder is to be distributed to the decedent's children, the spouse's life income interest may not be valued by use of the mortality component described under section 7520. The result would be the same even if it was established that the spouse survived the decedent.

(5) *Additional limitations*. Section 7520 does not apply to the extent as may otherwise be provided by the Commissioner.

(c) *Effective date*. Section § 20.7520-3(a) is effective as of May 1, 1989. The provisions of paragraph (b) of this section are effective with respect to estates of decedents dying after December 13, 1995.

[T.D. 8540, 59 FR 30170, June 10, 1994, as amended by T.D. 8630, 60 FR 63916, Dec. 13, 1995]

#### § 20.7520-4 Transitional rules.

(a) *Reliance*. If the valuation date is after April 30, 1989, and before June 10, 1994, an executor can rely on Notice 89-