

(i) A partition of community property between husband and wife, whereby a portion of the property became the separate property of each, is a conversion of community property.

(ii) A transfer of community property into some other form of coownership, such as a joint tenancy, is a conversion of the property.

(iii) An agreement (whether made before or after marriage) that future earnings and gains which would otherwise be community property shall be shared by the spouses as separate property effects a conversion of such earnings and gains.

(iv) A change in the form of ownership of property which causes future rentals, which would otherwise have been acquired as community property, to be acquired as separate property effects a conversion of the rentals.

(4) The rules of section 2523(f) are applicable, however, only if the conversion took place after December 31, 1941, and only to the extent stated in this section.

(5) If the value of the separate property acquired by the donor as a result of a conversion did not exceed the value of the separate property thus acquired by the donee spouse, the entire separate property thus acquired by the donor is to be considered, for the purposes of this section, as held by him and the donee spouse as community property. If the value (at the time of conversion) of the separate property so acquired by the donor exceeded the value (at that time) of the separate property so acquired by the donee spouse, only a part of the separate property so acquired by the donor (and only the same fractional part of property acquired by him in exchange for such separate property) is to be considered, for purposes of this section, as held by him and the donee spouse as community property. The part of such separate property (or property acquired in exchange for it) which is considered as so held is the same proportion of it which the value (at the time of the conversion) of the separate property so acquired by the donee spouse is of the value (at that time) of the separate property so acquired by the donor. The following example illustrates the appli-

cation of the provisions of this paragraph:

Example. During 1942 the donor and his spouse partitioned certain real property held by them under community property laws. The real property then had a value of \$224,000. A portion of the property, then having a value of \$160,000, was converted into the donor's separate property, and the remaining portion, then having a value of \$64,000, was converted into his spouse's separate property. In 1955 the donor made a gift to his spouse of the property acquired by him as a result of the partition, which property then had a value of \$200,000. The portion of the property transferred by gift which is considered as community property is

\$64,000 (value of property acquired by donee spouse) / \$160,000 (value of property acquired by donor spouse) × \$200,000 = \$80,000.

The marital deduction with respect to the gift is, therefore, limited to one-half of \$120,000 (the difference between \$200,000, the value of the gift, and \$80,000, the portion of the gift considered to have been of "community property"). The marital deduction with respect to the gift is, therefore, \$60,000.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 8522, 59 FR 9660, Mar. 1, 1994]

SPECIAL VALUATION RULES

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[T.D. 8395, 57 FR 4255, Feb. 4, 1992, as amended by T.D. 8536, 59 FR 23154, May 5, 1994]

§ 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. Section 25.2701-5 provides an adjustment to mitigate the effects of double taxation when an applicable retained interest is subsequently transferred.
- (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) (or a contribution to capital by an entity to the extent an individual indirectly holds an interest in the entity), 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 (or contribution) 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 transfer 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 re-

tained interest is of a class that is proportional to the class of the transferred interest. A class is the same class as (or 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 to a member of the individual's family 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).

[T.D. 8395, 57 FR 4255, Feb. 4, 1992; 57 FR 11264, Apr. 2, 1992, as amended by T.D. 8536, 59 FR 23154, May 5, 1994]

§ 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 de-

termined 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 conver-

sion 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 rule 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).

(6) *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 6, 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 80 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.

[T.D. 8395, 57 FR 4257, Feb. 4, 1992]

§ 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 interest*—(i) *In general.* Except as provided in paragraph (b)(1)(ii) of this section determine the fair market value of all family-held equity interests in the entity immediately after the transfer. The fair market value is determined by assuming that the interests are held by one individual, using a consistent set of assumptions.

(ii) *Special rule for contributions to capital.* In the case of a contribution to

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capital, determine the fair market value of the contribution.

(2) *Step 2—Subtract the value of senior equity interests*—(i) *In general.* If the amount determined in *Step 1* of paragraph (b)(1) of this section is not determined under the special rule for contributions to capital, from that value subtract the following amounts:

(A) An amount equal to the sum of the fair market value of all family-held senior equity interests, (other than applicable retained interests held by the transferor or applicable family members) and the fair market value of any family-held equity interests of the same class or a subordinate class to the transferred interests held by persons other than the transferor, members of the transferor's family, and applicable family members of the transferor. 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, immediately after the transfer, as is all family-held senior equity interests were held by one individual); and

(B) The value of all applicable retained interests held by the transferor or applicable family members (other than an interest received as consideration for the transfer) determined under § 25.2701-2, taking into account the adjustment described in paragraph (b)(5) of this section.

(ii) *Special rule for contributions to capital.* If the value determined in *Step 1* of paragraph (b)(1) of this section is determined under the special rule for contributions to capital, subtract the value of any applicable retained interest received in exchange for the contribution to capital determined under § 25.2701-2.

(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 in-

terests 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 subordinate equity interests held by the transferor, applicable family members, and members of the transferor's family. 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 interest in the entity other than the family-held interests

of the same class, 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 except that, in the case of a contribution to capital, the *Step 4* value of such an interest is zero.

(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 (including any interest received as consideration for the transfer) 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 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. 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 (600 shares \times \$800 (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: Because no consideration was furnished for the transfer, the adjustment under Step 4 is limited to the amount of any appropriate minority or similar discount. Before the application of Step 4 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 600 shares of preferred stock is \$600,000.

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 value of 500 shares of A's 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 (60 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 \times \$1,000). The balance of A's preferred stock is valued under section 2701 at \$400,000 (500 shares \times \$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: The adjustment under Step 4 is the same as 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 moneys' 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 transferred common stock is \$250,000 (250/1,000 \times \$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 \$83,333. If the section 2701 value of the applicable retained interest were \$100,000, the Step 4 adjustment would have been a \$33,333 reduction for consideration received ((250/750) \times \$100,000).

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 transferred common stock is \$666,667 ($500/750 \times \$1,000,000$). 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 \$666,667.

[T.D. 8395, 57 FR 4259, Feb. 4, 1992; T.D. 8395, 57 FR 11264, Apr. 2, 1992]

§ 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 of 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 in-

terest 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

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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.

[T.D. 8395, 57 FR 4261, Feb. 4, 1992]

§ 25.2701-5 Adjustments to mitigate double taxation.

(a) *Reduction of transfer tax base*—(1) *In general.* This section provides rules under which an individual (the initial transferor) making a transfer subject to section 2701 (the initial transfer) is entitled to reduce his or her taxable gifts or adjusted taxable gifts (the reduction). The amount of the reduction is determined under paragraph (b) of this section. See paragraph (e) of this section if section 2513 (split gifts) applied to the initial transfer.

(2) *Federal gift tax modification.* If, during the lifetime of the initial transferor, the holder of a section 2701 interest (as defined in paragraph (a)(4) of this section) transfers the interest to or for the benefit of an individual other than the initial transferor or an applicable family member of the initial transferor in a transfer subject to Federal estate or gift tax, the initial transferor may reduce the amount on which the initial transferor's tentative tax is computed under section 2502(a). The reduction is first applied on any gift tax return required to be filed for the calendar year in which the section 2701 interest is transferred; any excess reduction is carried forward and applied in each succeeding calendar year until the reduction is exhausted. The amount of the reduction that is used in a calendar year is the amount of the initial transferor's taxable gifts for that year. Any excess reduction remaining at the death of the initial transferor may be applied by the executor of the initial transferor's estate as provided under paragraph (a)(3) of this section. See paragraph (a)(4) of this section for the definition of a section 2701 interest. See § 25.2701-6 for rules relating to indirect ownership of equity interests transferred to trusts and other entities.

(3) *Federal estate tax modification.* Except as otherwise provided in this paragraph (a)(3), in determining the Federal estate tax with respect to an initial transferor, the executor of the initial transferor's estate may reduce the amount on which the decedent's tentative tax is computed under section 2001(b) (or section 2101(b)) by the amount of the reduction (including any excess reduction carried forward under paragraph (a)(2) of this section). The amount of the reduction under this paragraph (a)(3) is limited to the amount that results in zero Federal estate tax with respect to the estate of the initial transferor.

(4) *Section 2701 interest.* A section 2701 interest is an applicable retained interest that was valued using the special valuation rules of section 2701 at the time of the initial transfer. However, an interest is a section 2701 interest only to the extent the transfer of that interest effectively reduces the aggregate ownership of such class of interest

by the initial transferor and applicable family members of the initial transferor below that held by such persons at the time of the initial transfer (or the remaining portion thereof).

(b) *Amount of reduction.* Except as otherwise provided in paragraphs (c)(3)(iv) (pertaining to transfers of partial interests) and (e) (pertaining to initial split gifts) of this section, the amount of the reduction is the lesser of—

(1) The amount by which the initial transferor's taxable gifts were increased as a result of the application of section 2701 to the initial transfer; or

(2) The amount (determined under paragraph (c) of this section) duplicated in the transfer tax base at the time of the transfer of the section 2701 interest (the duplicated amount).

(c) *Duplicated amount—*(1) *In general.* The duplicated amount is the amount by which the transfer tax value of the section 2701 interest at the time of the subsequent transfer exceeds the value of that interest determined under section 2701 at the time of the initial transfer. If, at the time of the initial transfer, the amount allocated to the transferred interest under § 25.2701-3(b)(3) (*Step 3* of the valuation methodology) is less than the entire amount available for allocation at that time, the duplicated amount is a fraction of the amount described in the preceding sentence. The numerator of the fraction is the amount allocated to the transferred interest at the time of the initial transfer (pursuant to § 25.2701-3(b)(3)) and the denominator of the fraction is the amount available for allocation at the time of the initial transfer (determined after application of § 25.2701-3(b)(2)).

(2) *Transfer tax value—in general.* Except as provided in paragraph (c)(3) of this section, for purposes of paragraph (c)(1) of this section the transfer tax value of a section 2701 interest is the value of that interest as finally determined for Federal transfer tax purposes under chapter 11 or chapter 12, as the case may be (including the right to receive any distributions thereon (other than qualified payments)), reduced by the amount of any deduction allowed with respect to the section 2701 interest to the extent that the deduction

would not have been allowed if the section 2701 interest were not included in the transferor's total amount of gifts for the calendar year or the transferor's gross estate, as the case may be. Rules similar to the rules of section 691(c)(2)(C) are applicable to determine the extent that a deduction would not be allowed if the section 2701 interest were not so included.

(3) *Special transfer tax value rules*—(i) *Transfers for consideration.* Except as provided in paragraph (c)(3)(iii) of this section, if, during the life of the initial transferor, a section 2701 interest is transferred to or for the benefit of an individual other than the initial transferor or an applicable family member of the initial transferor for consideration in money or money's worth, or in a transfer that is treated as a transfer for consideration in money or money's worth, the transfer of the section 2701 interest is deemed to occur at the death of the initial transferor. In this case, the estate of the initial transferor is entitled to a reduction in the same manner as if the initial transferor's gross estate included a section 2701 interest having a chapter 11 value equal to the amount of consideration in money or money's worth received in the exchange (determined as of the time of the exchange).

(ii) *Interests held by applicable family members at date of initial transferor's death.* If a section 2701 interest in existence on the date of the initial transferor's death is held by an applicable family member and, therefore, is not included in the gross estate of the initial transferor, the section 2701 interest is deemed to be transferred at the death of the initial transferor to or for the benefit of an individual other than the initial transferor or an applicable family member of the initial transferor. In this case, the transfer tax value of that interest is the value that the executor of the initial transferor's estate can demonstrate would be determined under chapter 12 if the interest were transferred immediately prior to the death of the initial transferor.

(iii) *Nonrecognition transactions.* If an individual exchanges a section 2701 interest in a nonrecognition transaction (within the meaning of section 7701(a)(45)), the exchange is not treated

as a transfer of a section 2701 interest and the transfer tax value of that interest is determined as if the interest received in exchange is the section 2701 interest.

(iv) *Transfer of less than the entire section 2701 interest.* If a transfer is a transfer of less than the entire section 2701 interest, the amount of the reduction under paragraph (a)(2) or (a)(3) of this section is reduced proportionately.

(v) *Multiple classes of section 2701 interest.* For purposes of paragraph (b) of this section, if more than one class of section 2701 interest exists, the amount of the reduction is determined separately with respect to each such class.

(vi) *Multiple initial transfers.* If an initial transferor has made more than one initial transfer, the amount of the reduction with respect to any section 2701 interest is the sum of the reductions computed under paragraph (b) of this section with respect to each such initial transfer.

(d) *Examples.* The following examples illustrate the provisions of paragraphs (a) through (c) of this section.

Facts—(1) *In general.* (i) P, an individual, holds 1,500 shares of \$1,000 par value preferred stock of X corporation (bearing an annual noncumulative dividend of \$100 per share that may be put to X at any time for par value) and 1,000 shares of voting common stock of X. There is no other outstanding common stock of X.

(ii) On January 15, 1991, when the aggregate fair market value of the preferred stock is \$1,500,000 and the aggregate fair market value of the common stock is \$500,000, P transfers common stock to P's child. The fair market value of P's interest in X (common and preferred) immediately prior to the transfer is \$2,000,000, and the section 2701 value of the preferred stock (the section 2701 interest) is zero. Neither P nor P's spouse, S, made gifts prior to 1991.

(2) *Additional facts applicable to Examples 1 through 3.* P's transfer consists of all 1,000 shares of P's common stock. With respect to the initial transfer, the amount remaining after Step 2 of the subtraction method of § 25.2701-3 is \$2,000,000 (\$2,000,000 minus zero), all of which is allocated to the transferred stock. P's aggregate taxable gifts for 1991 (including the section 2701 transfer) equal \$2,500,000.

(3) *Additional facts applicable to Examples 4 and 5.* P's initial transfer consists of one-half of P's common stock. With respect to the initial transfer in this case, only \$1,000,000 (one-half of the amount remaining after Step 2 of the subtraction method of § 25.2701-3) is

allocated to the transferred stock. P's aggregate taxable gifts for 1991 (the section 2701 transfer and P's other transfers) equal \$2,500,000.

Example 1. Inter vivos transfer of entire section 2701 interest. (i) On October 1, 1994, at a time when the value of P's preferred stock is \$1,400,000, P transfers all of the preferred stock to P's child. In computing P's 1994 gift tax, P, as the initial transferor, is entitled to reduce the amount on which P's tentative tax is computed under section 2502(a) by \$1,400,000.

(ii) The amount of the reduction computed under paragraph (b) of this section is the lesser of \$1,500,000 (the amount by which the initial transferor's taxable gifts were increased as a result of the application of section 2701 to the initial transfer) or \$1,400,000 (the duplicated amount). The duplicated amount is 100 percent (the portion of the section 2701 interest subsequently transferred) times \$1,400,000 (the amount by which the gift tax value of the preferred stock (\$1,400,000 at the time of the subsequent transfer) exceeds zero (the section 2701 value of the preferred stock at the time of the initial transfer)).

(iii) The result would be the same if the preferred stock had been held by P's parent, GM, and GM had, on October 1, 1994, transferred the preferred stock to or for the benefit of an individual other than P or an applicable family member of P. In that case, in computing the tax on P's 1994 and subsequent transfers, P would be entitled to reduce the amount on which P's tentative tax is computed under section 2502(a) by \$1,400,000. If the value of P's 1994 gifts is less than \$1,400,000, P is entitled to claim the excess adjustment in computing the tax with respect to P's subsequent transfers.

Example 2. Transfer of section 2701 interest at death of initial transferor. (i) P continues to hold the preferred stock until P's death. The chapter 11 value of the preferred stock at the date of P's death is the same as the fair market value of the preferred stock at the time of the initial transfer. In computing the Federal estate tax with respect to P's estate, P's executor is entitled to a reduction of \$1,500,000 under paragraph (a)(3) of this section.

(ii) The result would be the same if P had sold the preferred stock to any individual other than an applicable family member at a time when the value of the preferred stock was \$1,500,000. In that case, the amount of the reduction is computed as if the preferred stock were included in P's gross estate at a fair market value equal to the sales price. If the value of P's taxable estate is less than \$1,500,000, the amount of the adjustment available to P's executor is limited to the actual value of P's taxable estate.

(iii) The result would also be the same if the preferred stock had been held by P's par-

ent, GM, and at the time of P's death, GM had not transferred the preferred stock.

Example 3. Transfer of after-acquired preferred stock. On September 1, 1992, P purchases 100 shares of X preferred stock from an unrelated party. On October 1, 1994, P transfers 100 shares of X preferred stock to P's child. In computing P's 1994 gift tax, P is not entitled to reduce the amount on which P's tentative tax is computed under section 2502(a) because the 1994 transfer does not reduce P's preferred stock holding below that held at the time of the initial transfer. See paragraph (a)(4) of this section.

Example 4. Inter vivos transfer of entire section 2701 interest. (i) On October 1, 1994, at a time when the value of P's preferred stock is \$1,400,000, P transfers all of the preferred stock to P's child. In computing P's 1994 gift tax, P, as the initial transferor, is entitled to reduce the amount on which P's tentative tax is computed under section 2502(a) by \$700,000.

(ii) The amount of the reduction computed under paragraph (b) of this section is the lesser of \$750,000 ($(\$1,500,000 \times .5 (\$1,000,000 \text{ over } \$2,000,000))$ the amount by which the initial transferor's taxable gifts were increased as a result of the application of section 2701 to the initial transfer) or \$700,000 ($(\$1,400,000 \times .5)$ the duplicated amount). The duplicated amount is 100 percent (the portion of the section 2701 interest subsequently transferred) times \$700,000; e.g., one-half (the fraction representing the portion of the common stock transferred in the initial transfer $(\$1,000,000/\$2,000,000)$) of the amount by which the gift tax value of the preferred stock at the time of the subsequent transfer (\$1,400,000) exceeds zero (the section 2701 value of the preferred stock at the time of the initial transfer).

Example 5. Subsequent transfer of less than the entire section 2701 interest. On October 1, 1994, at a time when the value of P's preferred stock is \$1,400,000, P transfers only 250 of P's 1,000 shares of preferred stock to P's child. In this case, the amount of the reduction computed under paragraph (b) is \$175,000 (one-fourth $(250/1,000)$ of the amount of the reduction available if P had transferred all 1,000 shares of preferred stock).

(e) *Computation of reduction if initial transfer is split under section 2513—(1) In general.* If section 2513 applies to the initial transfer (a split initial transfer), the special rules of this paragraph (e) apply.

(2) *Transfers during joint lives.* If there is a split initial transfer and the corresponding section 2701 interest is transferred during the joint lives of the donor and the consenting spouse, for purposes of determining the reduction under paragraph (a)(2) of this section

each spouse is treated as if the spouse was the initial transferor of one-half of the split initial transfer.

(3) *Transfers at or after death of either spouse*—(i) *In general.* If there is a split initial transfer and the corresponding section 2701 interest is transferred at or after the death of the first spouse to die, the reduction under paragraph (a)(2) or (a)(3) of this section is determined as if the donor spouse was the initial transferor of the entire initial transfer.

(ii) *Death of donor spouse.* Except as provided in paragraph (e)(3)(iv) of this section, the executor of the estate of the donor spouse in a split initial transfer is entitled to compute the reduction as if the donor spouse was the initial transferor of the section 2701 interest otherwise attributable to the consenting spouse. In this case, if the consenting spouse survives the donor spouse—

(A) The consenting spouse's aggregate sum of taxable gifts used in computing each tentative tax under section 2502(a) (and, therefore, adjusted taxable gifts under section 2001(b)(1)(B) (or section 2101(b)(1)(B)) and the tax payable on the consenting spouse's prior taxable gifts under section 2001(b)(2) (or section 2101(b)(2))) is reduced to eliminate the remaining effect of the section 2701 interest; and

(B) Except with respect to any excess reduction carried forward under paragraph (a)(2) of this section, the consenting spouse ceases to be treated as the initial transferor of the section 2701 interest.

(iii) *Death of consenting spouse.* If the consenting spouse predeceases the donor spouse, except for any excess reduction carried forward under paragraph (a)(2) of this section, the reduction with respect to any section 2701 interest in the split initial transfer is not available to the estate of the consenting spouse (regardless of whether the interest is included in the consenting spouse's gross estate). Similarly, if the consenting spouse predeceases the donor spouse, no reduction is available to the consenting spouse's adjusted taxable gifts under section 2001(b)(1)(B) (or section 2101(b)(1)(B)) or to the consenting spouse's gift tax payable under section

2001(b)(2) (or section 2101(b)(2)). See paragraph (a)(2) of this section for rules involving transfers by an applicable family member during the life of the initial transferor.

(iv) *Additional limitation on reduction.* If the donor spouse (or the estate of the donor spouse) is treated under this paragraph (e) as the initial transferor of the section 2701 interest otherwise attributable to the consenting spouse, the amount of additional reduction determined under paragraph (b) of this section is the amount determined under that paragraph with respect to the consenting spouse. If a reduction was previously available to the consenting spouse under this paragraph (e), the amount determined under this paragraph (e)(3)(iv) with respect to the consenting spouse is determined as if the consenting spouse's taxable gifts in the split initial transfer had been increased only by that portion of the increase that corresponds to the remaining portion of the section 2701 interest. The amount of the additional reduction (i.e., the amount determined with respect to the consenting spouse) is limited to the amount that results in a reduction in the donor spouse's Federal transfer tax no greater than the amount of the increase in the consenting spouse's gift tax incurred by reason of the section 2701 interest (or the remaining portion thereof).

(f) *Examples.* The following examples illustrate the provisions of paragraph (e) of this section. The examples assume the facts set out in this paragraph (f).

Facts. (1) In each example assume that P, an individual, holds 1,500 shares of \$1,000 par value preferred stock of X corporation (bearing an annual noncumulative dividend of \$100 per share that may be put to X at any time for par value) and 1,000 shares of voting common stock of X. There is no other outstanding stock of X. The annual exclusion under section 2503 is not allowable with respect to any gift.

(2) On January 15, 1991, when the aggregate fair market value of the preferred stock is \$1,500,000 and the aggregate fair market value of the common stock is \$500,000, P transfers all 1,000 shares of the common stock to P's child. Section 2701 applies to the initial transfer because P transferred an equity interest (the common stock) to a member of P's family and immediately thereafter

held an applicable retained interest (the preferred stock). The fair market value of P's interest in X immediately prior to the transfer is \$2,000,000 and the section 2701 value of the preferred stock (the section 2701 interest) is zero. With respect to the initial transfer, the amount remaining after Step 2 of the subtraction method of § 25.2701-3 was \$2,000,000 (\$2,000,000 minus zero), all of which is allocated to the transferred stock. P had made no gifts prior to 1991. The sum of P's aggregate taxable gifts for the calendar year 1991 (including the section 2701 transfer) is \$2,500,000. P's spouse, S, made no gifts prior to 1991.

(3) P and S elected pursuant to section 2513 to treat one-half of their 1991 gifts as having been made by each spouse. Without the application of section 2701, P and S's aggregate gifts would have been \$500,000 and each spouse would have paid no gift tax because of the application of the unified credit under section 2505. However, because of the application of section 2701, both P and S are each treated as the initial transferor of aggregate taxable gifts in the amount of \$1,250,000 and, after the application of the unified credit under section 2505, each paid \$255,500 in gift tax with respect to their 1991 transfers. On October 1, 1994, at a time when the value of the preferred stock is the same as at the time of the initial transfer, P transfers the preferred stock (the section 2701 interest) to P's child.

Example 1. Inter vivos transfer of entire section 2701 interest. P transfers all of the preferred stock to P's child. P and S are each entitled to a reduction of \$750,000 in computing their 1994 gift tax. P is entitled to the reduction because P subsequently transferred the one-half share of the section 2701 interest as to which P was the initial transferor to an individual who was not an applicable family member of P. S is entitled to the reduction because P, an applicable family member with respect to S, transferred the one-half share of the section 2701 interest as to which S was the initial transferor to an individual other than S or an applicable family member of S. S may claim the reduction against S's 1994 gifts. If S's 1994 taxable gifts are less than \$750,000, S may claim the remaining amount of the reduction against S's next succeeding lifetime transfers.

Example 2. Inter vivos transfer of portion of section 2701 interest. P transfers one-fourth of the preferred stock to P's child. In this case, P and S are each entitled to a reduction of \$187,500, the corresponding portion of the reduction otherwise available to each spouse (one-fourth of \$750,000).

Example 3. Transfer at death of donor spouse. P, the donor spouse in the section 2513 election, dies on October 1, 1994, while holding all of the preferred stock. The executor of P's estate is entitled to a reduction in the computation of the tentative tax under sec-

tion 2001(b). Since no reduction had been previously available with respect to the section 2701 interest, P's estate is entitled to a full reduction of \$750,000 with respect to the one-half share of the preferred stock as to which P was the initial transferor. In addition, P's estate is entitled to an additional reduction of up to \$750,000 for the remaining section 2701 interest as to which S was the initial transferor. The reduction for the consenting spouse's remaining section 2701 interest is limited to that amount that will produce a tax saving in P's Federal estate tax of \$255,500, the amount of gift tax incurred by S by reason of the application of section 2701 to the split initial transfer.

Example 4. Transfer after death of donor spouse. The facts are the same as in *Example 3*, except that S acquires the preferred stock from P's estate and subsequently transfers the preferred stock to S's child. S is not entitled to a reduction because S ceased to be an initial transferor upon P's death (and S's prior taxable gifts were automatically adjusted at that time to the level that would have existed had the split initial transfer not been subject to section 2701).

Example 5. Death of donor spouse after inter vivos transfer. (i) P transfers one-fourth of the preferred stock to P's child. In this case, P and S are each entitled to a reduction of \$187,500, the corresponding portion of the reduction otherwise available to each spouse (one-fourth of \$750,000). S may claim the reduction against S's 1994 or subsequent transfers. P dies on November 1, 1994.

(ii) P's executor is entitled to include, in computing the reduction available to P's estate, the remaining reduction to which P is entitled and an additional amount of up to \$562,500 (\$750,000 minus \$187,500, the amount of the remaining reduction attributable to the consenting spouse determined immediately prior to P's death). The amount of additional reduction available to P's estate cannot exceed the amount that will reduce P's estate tax by \$178,625, the amount that S's 1991 gift tax would have been increased if the application of section 2701 had increased S's taxable gifts by only \$562,500 (\$750,000 - \$187,500).

(g) *Double taxation otherwise avoided.* No reduction is available under this section if—

(1) Double taxation is otherwise avoided in the computation of the estate tax under section 2001 (or section 2101); or

(2) A reduction was previously taken under the provisions of section 2701(e)(6) with respect to the same section 2701 interest and the same initial transfer.

(h) *Effective date.* This section is effective for transfers of section 2701 interests after May 4, 1994. If the transfer of a section 2701 interest occurred on or before May 4, 1994, the initial transferor may rely on either this section, project PS-30-91 (1991-2 C.B. 1118, and 1992-1 C.B. 1239 (see § 601.601(d)(2)(ii)(b) of this chapter)) or any other reasonable interpretation of the statute.

[T.D. 8536, 59 FR 23154, May 5, 1994]

§ 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*—(i) *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 transferee;

(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 \times 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.

[T.D. 8395, 57 FR 4263, Feb. 4, 1992]

§ 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

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separate interests as may be necessary and appropriate to carry out the purposes of section 2701.

[T.D. 8395, 57 FR 4264, Feb. 4, 1992]

§ 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.

[T.D. 8395, 57 FR 4264, Feb. 4, 1992]

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This section lists the major paragraphs contained in §§ 25.2702-1 through 25.2702-7.

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- (1) Member of the family.
- (2) Transfer in trust.
- (3) Retained.
- (4) Interest.
- (5) Holder.
- (6) Qualified interest.
- (7) Qualified annuity interest.
- (8) Qualified unitrust interest.
- (9) Qualified remainder interest.
- (10) Governing instrument.
- (b) Valuation of retained interests.
- (1) In general.
- (2) Qualified interest.
- (c) Valuation of a term interest in certain tangible property.
- (1) In general.
- (2) Tangible property subject to rule.
- (3) Evidence of value of property.
- (4) Conversion of property.
- (5) Additions or improvements to property.
- (d) Examples.

§ 25.2702-3 *Qualified interests.*

- (a) In general.

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- (b) Special rules for qualified annuity interests.

- (1) Payment of annuity amount.
- (2) Incorrect valuations of trust property.
- (3) Computation of annuity amount in certain circumstances.

- (4) Additional contributions prohibited.
- (c) Special rules for qualified unitrust interests.

- (1) Payment of unitrust amount.
- (2) Incorrect valuations of trust property.
- (3) Computation of unitrust amount in certain circumstances.

- (d) Requirements applicable to qualified annuity interests and qualified unitrust interests.

- (1) In general.
- (2) Contingencies.
- (3) Amounts payable to other persons.
- (4) Term of the annuity or unitrust interest.

- (5) Commutation.
- (6) Use of debt obligations to satisfy the annuity or unitrust payment obligation.

- (e) Examples.
- (f) Qualified remainder interest.

- (1) Requirements.
- (2) Remainder interest.
- (3) Examples.

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

- (a) In general.
- (b) Leases.
- (c) Joint purchases.
- (d) Examples.

§ 25.2702-5 *Personal residence trusts.*

- (a) In general.
- (b) Personal residence trust.
- (1) In general.
- (2) Personal residence.
- (3) Qualified proceeds.
- (c) Qualified personal residence trust.
- (1) In general.
- (2) Personal residence.
- (3) Income of the trust.
- (4) Distributions from the trust to other persons.

- (5) Assets of the trust.
- (6) Commutation.
- (7) Cessation of use as a personal residence.
- (8) Disposition of trust assets on cessation as qualified personal residence trust.

- (d) Examples.

§ 25.2702-6 *Reduction in taxable gifts.*

- (a) Transfers of retained interests in trust.
- (1) Inter vivos transfers.
- (2) Testamentary transfers.
- (3) Gift splitting.
- (b) Amount of reduction.
- (1) In general.
- (2) Treatment of annual exclusion.
- (3) Overlap with section 2001.
- (c) Examples.

§ 25.2702-7 *Effective dates.*

[T.D. 6334, 23 FR 8904, Nov. 15, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 9181, 70 FR 9223, Feb. 25, 2005]

§ 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.* (i) For transfers made on or after May 19, 1997, a transfer to a pooled income fund described in section 642(c)(5); a transfer to a charitable remainder annuity trust described in section 664(d)(1); a transfer to a charitable remainder

unitrust described in section 664(d)(2) if under the terms of the governing instrument the unitrust amount can be computed only under section 664(d)(2)(A); and a transfer to a charitable remainder unitrust if under the terms of the governing instrument the unitrust amount can be computed under section 664(d)(2) and (3) and either there are only two consecutive noncharitable beneficial interests and the transferor holds the second of the two interests, or the only permissible recipients of the unitrust amount are the transferor, the transferor's U.S. citizen spouse, or both the transferor and the transferor's U.S. citizen spouse.

(ii) For transfers made before May 19, 1997, a transfer in trust if the remainder interest in the trust qualifies for a 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.

(8) *Transfer or assignment to a Qualified Domestic Trust.* A transfer or assignment (as described in section 2056(d)(2)(B)) by a noncitizen surviving spouse of property to a Qualified Domestic Trust under the circumstances described in § 20.2056A-4(b) of this chapter, where the surviving spouse retains an interest in the transferred property that is not a qualified interest and the

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transfer is not described in sections 2702(a)(3)(A)(ii) or 2702(c)(4).

[T.D. 8395, 57 FR 4265, Feb. 4, 1992, as amended by T.D. 8612, 60 FR 43554, Aug. 22, 1995; T.D. 8791, 63 FR 68194, Dec. 10, 1998]

§ 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) *Holder.* The holder is the person to whom the annuity or unitrust interest is payable during the fixed term of that interest. References to holder shall also include the estate of that person.

(6) *Qualified interest.* Qualified interest means a qualified annuity interest, a qualified unitrust interest, or a qualified remainder interest. If a transferor retains a power to revoke a qualified annuity interest or qualified unitrust interest of the transferor's spouse, then the revocable qualified annuity or unitrust interest of the transferor's spouse is treated as a retained qualified interest of the transferor. In order for

the transferor to be treated as having retained a qualified interest under the preceding sentence, the interest of the transferor's spouse (the successor holder) must be an interest that meets the requirements of a qualified annuity interest in accordance with § 25.2702-3(b) and (d), or a qualified unitrust interest in accordance with § 25.2702-3(c) and (d), but for the transferor's retained power to revoke the interest.

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

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

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

(10) *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.

(2) *Qualified interest.* The value of a qualified annuity interest and a qualified remainder interest following a qualified annuity interest are determined under section 7520. The value of a qualified unitrust interest and a qualified remainder interest following a qualified unitrust interest are determined as if they were interests described in section 664.

(c) *Valuation of a term interest in certain tangible property—(1) In general.* If section 2702 applies to a transfer in trust of tangible property described in paragraph (c)(2) of this section ("tangible property"), the value of a retained term interest (other than a qualified interest) is not determined under section 7520 but is the amount the transferor establishes as the amount a willing buyer would pay a willing seller for the interest, each having reasonable knowledge of the relevant facts and neither being under any compulsion to buy or sell. If the

transferor cannot reasonably establish the value of the term interest pursuant to this paragraph (c)(1), the interest is valued at zero.

(2) *Tangible property subject to rule*—(i) *In general.* Except as provided in paragraph (c)(2)(ii) of this section, paragraph (c)(1) of this section applies only to tangible property—

(A) For which no deduction for depreciation or depletion would be allowable if the property were used in a trade or business or held for the production of income; and

(B) As to which the failure to exercise any rights under the term interest would not increase the value of the property passing at the end of the term interest.

(ii) *Exception for de minimis amounts of depreciable property.* In determining whether property meets the requirements of this paragraph (c)(2) at the time of the transfer in trust, improvements that would otherwise cause the property not to qualify are ignored if the fair market value of the improvements, in the aggregate, do not exceed 5 percent of the fair market value of the entire property.

(3) *Evidence of value of property.* The best evidence of the value of any term interest to which this paragraph (c) applies is actual sales or rentals that are comparable both as to the nature and character of the property and the duration of the term interest. Little weight is accorded appraisals in the absence of such evidence. Amounts determined under section 7520 are not evidence of what a willing buyer would pay a willing seller for the interest.

(4) *Conversion of property*—(i) *In general.* Except as provided in paragraph (c)(4)(iii) of this section, if a term interest in property is valued under paragraph (c)(1) of this section, and during the term the property is converted into property a term interest in which would not qualify for valuation under paragraph (c)(1) of this section, the conversion is treated as a transfer for no consideration for purposes of chapter 12 of the value of the unexpired portion of the term interest.

(ii) *Value of unexpired portion of term interest.* For purposes of paragraph (c)(4)(i) of this section, the value of the unexpired portion of a term interest is

the amount that bears the same relation to the value of the term interest as of the date of conversion (determined under section 7520 using the rate in effect under section 7520 on the date of the original transfer and the fair market value of the property as of the date of the original transfer) as the value of the term interest as of the date of the original transfer (determined under paragraph (c)(1) of this section) bears to the value of the term interest as of the date of the original transfer (determined under section 7520).

(iii) *Conversion to qualified annuity interest.* The conversion of tangible property previously valued under paragraph (c)(1) of this section into property a term interest in which would not qualify for valuation under paragraph (c)(1) of this section is not a transfer of the value of the unexpired portion of the term interest if the interest thereafter meets the requirements of a qualified annuity interest. The rules of § 25.2702-5(d)(8) (including governing instrument requirements) apply for purposes of determining the amount of the annuity payment required to be made and the determination of whether the interest meets the requirements of a qualified annuity interest.

(5) *Additions or improvements to property*—(i) *Additions or improvements substantially affecting nature of property.* If an addition or improvement is made to property a term interest in which was valued under paragraph (c)(1) of this section, and the addition or improvement affects the nature of the property to such an extent that the property would not be treated as property meeting the requirements of paragraph (c)(2) of this section if the property had included the addition or improvement at the time it was transferred, the entire property is deemed, for purposes of paragraph (c)(4) of this section, to convert (effective as of the date the addition or improvement is commenced) into property a term interest in which would not qualify for valuation under paragraph (c)(1) of this section.

(ii) *Other additions or improvements.* If an addition or improvement is made to property, a term interest in which was valued under paragraph (c)(1) of this

section, and the addition or improvement does not affect the nature of the property to such an extent that the property would not be treated as property meeting the requirements of paragraph (c)(2) of this section if the property had included the addition or improvement at the time it was transferred, the addition or improvement is treated as an additional transfer (effective as of the date the addition or improvement is commenced) subject to § 25.2702-2(b)(1).

(d) *Examples.* (1) The following examples illustrate the rules of § 25.2702-1 and § 25.2702-2. Each example assumes that all applicable requirements of those sections not specifically described in the example are met.

Example 1. A transfers property to an irrevocable trust, retaining the right to receive the income of the trust 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. However, if A dies during the 10-year term, the entire trust corpus is to be paid to A's estate. Each retained interest is valued at zero because it is not a qualified interest. Thus, the amount of A's gift is the fair market value of the property transferred to the trust.

Example 2. A transfers property to an irrevocable trust, retaining a 10-year annuity interest that meets the requirements set forth in § 25.2702-3 for a qualified annuity interest. Upon expiration of the 10-year term, the trust is to terminate and the trust corpus is to be paid to A's child. The amount of A's gift is the fair market value of the property transferred to the trust less the value of the retained qualified annuity interest determined under section 7520.

Example 3. D transfers property to an irrevocable trust under which the income is payable to D's spouse for life. Upon the death of D's spouse, the trust is to terminate and the trust corpus is to be paid to D's child. D retains no interest in the trust. Although the spouse is an applicable family member of D under section 2702, the spouse has not retained an interest in the trust because the spouse did not hold the interest both before and after the transfer. Section 2702 does not apply because neither the transferor nor an applicable family member has retained an interest in the trust. The result is the same whether or not D elects to treat the transfer as a transfer of qualified terminable interest property under section 2056(b)(7).

Example 4. A transfers property to an irrevocable trust, under which the income is to be paid to A for life. Upon termination of the trust, the trust corpus is to be distributed to A's child. A also retains certain powers over

principal that cause the transfer to be wholly incomplete for federal gift tax purposes. Section 2702 does not apply because no portion of the transfer would be treated as a completed gift.

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.

(2) The following facts apply for *Examples 6 through 8* (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 \$500,000 for the interest.

Example 6. 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 \$500,000. The amount of A's gift is \$1,500,000, the difference between the fair market value of the painting and the amount determined under § 25.2702-2(c)(1).

Example 7. 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 8. 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 in \$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 \$500,000 (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).

[T.D. 8395, 57 FR 4265, Feb. 4, 1992, as amended by T.D. 9181, 70 FR 9223, Feb. 25, 2005]

§ 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 at least annually. A right of withdrawal, whether or not cumulative, is not a qualified annuity interest. Issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount.

(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 pur-

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

(4) *Payment of the annuity amount in certain circumstances.* An annuity amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days

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

(5) *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 at least annually. A right of withdrawal, whether or not cumulative, is not a qualified unitrust interest. Issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the unitrust amount does not constitute payment of the unitrust amount.

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

(4) *Payment of the unitrust amount in certain circumstances.* A unitrust amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days after the anniversary date. A unitrust amount payable based on the taxable year of the trust may be paid after the close of the taxable year, provided the payment is made no later than the date by which the trustee is required to file the Federal income tax return of the trust for the taxable year (without regard to extensions). If the trustee reports for the taxable year pursuant to § 1.671-4(b) of this chapter, the unitrust payment must be made no later than

the date by which the trustee would have been required to file the Federal income tax return of the trust for the taxable year (without regard to extensions) had the trustee reported pursuant to § 1.671-4(a) of this chapter.

(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) *Contingencies.* A holder's qualified interest must be payable in any event to or for the benefit of the holder for the fixed term of that interest. Thus, payment of the interest cannot be subject to any contingency other than either the survival of the holder until the commencement, or throughout the term, of that holder's interest, or, in the case of a revocable interest described in § 25.2702-2(a)(6), the transferor's right to revoke the qualified interest of that transferor's spouse.

(3) *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.

(4) *Term of the annuity or unitrust interest.* The governing instrument must fix the term of the annuity or unitrust and the term of the interest must be fixed and ascertainable at the creation of the trust. The term must be for the life of the 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.

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

(6) *Use of debt obligations to satisfy the annuity or unitrust payment obligation*—

(i) *In general.* In the case of a trust created on or after September 20, 1999, the trust instrument must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity or unitrust payment obligation.

(ii) *Special rule in the case of a trust created prior to September 20, 1999.* In the case of a trust created prior to September 20, 1999, the interest will be treated as a qualified interest under section 2702(b) if—

(A) Notes, other debt instruments, options, or similar financial arrangements are not issued after September 20, 1999, to satisfy the annuity or unitrust payment obligation; and

(B) Any notes or any other debt instruments that were issued to satisfy the annual payment obligation on or prior to September 20, 1999, are paid in full by December 31, 1999, and any option or similar financial arrangement issued to satisfy the annual payment obligation is terminated by December 31, 1999, such that the grantor receives cash or other trust assets in satisfaction of the payment obligation. For purposes of the preceding sentence, an option will be considered terminated only if the grantor receives cash or other trust assets equal in value to the greater of the required annuity or unitrust payment plus interest computed under section 7520 of the Internal Revenue Code, or the fair market value of the option.

(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. The interest of A (and A's estate) to receive the unitrust amount for the specified term of 10 years in all events is a qualified unitrust interest for a term of 10 years.

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. As in *Example 5*, the interest of A (and A's estate) to receive the unitrust amount for a specified term of 10 years in all events is a qualified unitrust interest for a term of 10 years. However, the right of A's estate to continue to receive the unitrust amount after the expiration of the 10-year term if A dies within that 10-year period is not fixed and ascer-

tainable at the creation of the interest and is not a qualified unitrust 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.

Example 8. A transfers property to an irrevocable trust, retaining the right to receive an annuity equal to 6 percent of the initial net fair market value of the trust property for 10 years, or until A's prior death. At the expiration of the 10-year term, or on A's death prior to the expiration of the 10-year term, the annuity is to be paid to B, A's spouse, if then living, for 10 years or until B's prior death. A retains an inter vivos and testamentary power to revoke B's interest during the initial 10-year term. If not exercised by A during the initial 10-year term (whether during A's life or on A's death), A's right to revoke B's interest will lapse upon either A's death during the 10-year term, or the expiration of A's 10-year term (assuming A survives the term). Upon expiration of B's interest (or on the expiration of A's interest if A revokes B's interest or if B predeceases A), the trust terminates and the trust corpus is payable to A's child. Because A has made a completed gift of the remainder interest, the transfer of property to the trust is not incomplete as to all interests in the property and section 2702 applies. A's annuity interest (A's right to receive the annuity for 10 years, or until A's prior death) is a retained interest that is a qualified annuity interest under paragraphs (b) and (d) of this section. In addition, because A has retained the power to revoke B's interest, B's interest is treated as an interest retained by A for purposes of section 2702. B's successive annuity interest otherwise satisfies the requirements for a qualified interest contained in paragraph (d) of this section, but for A's power to revoke. The term of B's interest is specified in the governing instrument and is fixed and ascertainable at the creation of the trust, and B's right to receive the annuity is contingent only on B's survival, and A's power to revoke. Following the expiration of A's interest, the annuity is to be paid for a 10-year term or for B's (the successor holder's) life, whichever is shorter. Accordingly, A is treated as retaining B's revocable qualified annuity interest pursuant to § 25.2702-2(a)(6). Because both A's interest and B's interest are treated as qualified interests retained by A,

the value of the gift is the value of the property transferred to the trust less the value of both A's qualified interest and B's qualified interest (subject to A's power to revoke), each valued as a single-life annuity. If A survives the 10-year term without having revoked B's interest, then A's power to revoke lapses and A will make a completed gift to B at that time. Further, if A revokes B's interest prior to the commencement of that interest, A is treated as making an additional completed gift at that time to A's child. In either case, the amount of the gift would be the present value of B's interest determined under section 7520 and the applicable regulations, as of the date the revocation power lapses or the interest is revoked. See § 25.2511-2(f).

Example 9. (i) A transfers property to an irrevocable trust, retaining the right to receive 6 percent of the initial net fair market value of the trust property for 10 years, or until A's prior death. If A survives the 10-year term, the trust terminates and the trust corpus is payable to A's child. If A dies prior to the expiration of the 10-year term, the annuity is payable to B, A's spouse, if then living, for the balance of the 10-year term, or until B's prior death. A retains the right to revoke B's interest. Upon expiration of B's interest (or upon A's death if A revokes B's interest or if B predeceases A), the trust terminates and the trust corpus is payable to A's child. As is the case in *Example 8*, A's retained annuity interest (A's right to receive the annuity for 10 years, or until A's prior death) is a qualified annuity interest under paragraphs (b) and (d) of this section. However, B's interest does not meet the requirements of paragraph (d) of this section. The term of B's annuity is not fixed and ascertainable at the creation of the trust, because it is not payable for the life of B, a specified term of years, or for the shorter of those periods. Rather, B's annuity is payable for an unspecified period that will depend upon the number of years left in the original term after A's death. Further, B's annuity is payable only if A dies prior to the expiration of the 10-year term. Thus, payment of B's annuity is not dependent solely on B's survival, but rather is dependent on A's failure to survive.

(ii) Accordingly, the amount of the gift is the fair market value of the property transferred to the trust reduced by the value of A's qualified interest (A's right to receive the stated annuity for 10 years or until A's prior death). B's interest is not a qualified interest and is thus valued at zero under section 2702.

(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

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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.

[T.D. 8395, 57 FR 4267, Feb. 4, 1992, as amended by T.D. 8536, 59 FR 23157, May 5, 1994; T.D. 8633, 60 FR 66090, Dec. 21, 1995; T.D. 8899, 65 FR 53588, Sept. 5, 2000; 65 FR 70792, Nov. 28, 2000; T.D. 9181, 70 FR 9224, Feb. 25, 2005]

§ 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 entirety, 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.

[T.D. 8395, 57 FR 4269, Feb. 4, 1992]

§ 25.2702-5 Personal residence trusts.

(a)(1) *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.

(2) *Modification of trust.* A trust that does not comply with one or more of the regulatory requirements under paragraph (b) or (c) of this section will, nonetheless, be treated as satisfying these requirements if the trust is modified, by judicial reformation (or non-judicial reformation if effective under state law), to comply with the requirements. In the case of a trust created after December 31, 1996, the reformation must be commenced within 90 days after the due date (including extensions) for the filing of the gift tax return reporting the transfer of the residence under section 6075 and must be completed within a reasonable time after commencement. If the reformation is not completed by the due date (including extensions) for filing the gift tax return, the grantor or grantor's spouse must attach a statement to the gift tax return stating that

the reformation has been commenced or will be commenced within the 90-day period. In the case of a trust created before January 1, 1997, the reformation must be commenced within 90 days after December 23, 1997 and must be completed within a reasonable time after commencement.

(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. In addition, the trust does not meet the requirements of this section unless the governing instrument prohibits the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse, at any time after the original duration of the term interest during which the trust is a grantor trust. For purposes of the preceding sentence, a sale or transfer to another grantor trust of the grantor or the grantor's spouse is considered a sale or transfer to the grantor or the grantor's spouse; however, a distribution (for no consideration) upon or after the expiration of the original duration of the term interest to another grantor trust of the grantor or the grantor's spouse pursuant to the express terms of the trust will not be considered a sale or transfer to the grantor or the grantor's spouse if such other grantor trust prohibits the sale or transfer of the property to the grantor, the grantor's spouse, or an entity controlled by the

grantor or the grantor's spouse. In the event the grantor dies prior to the expiration of the original duration of the term interest, this paragraph (b)(1) does not apply to the distribution (for no consideration) of the residence to any person (including the grantor's estate) pursuant to the express terms of the trust or pursuant to the exercise of a power retained by the grantor under the terms of the trust. Further, this paragraph (b)(1) does not apply to any outright distribution (for no consideration) of the residence to the grantor's spouse after the expiration of the original duration of the term interest pursuant to the express terms of the trust. For purposes of this paragraph (b)(1), a *grantor trust* is a trust treated as owned in whole or in part by the grantor or the grantor's spouse pursuant to sections 671 through 678, and *control* is defined in § 25.2701-2(b)(5)(ii) and (iii). 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. 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 (except as set forth in paragraph (c)(9) of this section) and may permit the trust to hold proceeds from the sale of the residence, in a separate account.

(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 conver-

sion (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; and

(ii) At the rate used in valuing the retained interest at the time of the original transfer.

(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 fair market value of the assets as to which the trust continues as a qualified personal residence trust, and the denominator of the fraction is the fair market value of the trust assets on the conversion date.

(9) *Sale of residence to grantor, grantor's spouse, or entity controlled by grantor or grantor's spouse.* The governing instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the

grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse during the retained term interest of the trust, or at any time after the retained term interest that the trust is a grantor trust. For purposes of the preceding sentence, a sale or transfer to another grantor trust of the grantor or the grantor's spouse is considered a sale or transfer to the grantor or the grantor's spouse; however, a distribution (for no consideration) upon or after the expiration of the retained term interest to another grantor trust of the grantor or the grantor's spouse pursuant to the express terms of the trust will not be considered a sale or transfer to the grantor or the grantor's spouse if such other grantor trust prohibits the sale or transfer of the property to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse. In the event the grantor dies prior to the expiration of the retained term interest, this paragraph (c)(9) does not apply to the distribution (for no consideration) of the residence to any person (including the grantor's estate) pursuant to the express terms of the trust or pursuant to the exercise of a power retained by the grantor under the terms of the trust. Further, this paragraph (c)(9) does not apply to an outright distribution (for no consideration) of the residence to the grantor's spouse after the expiration of the retained trust term pursuant to the express terms of the trust. For purposes of this paragraph (c)(9), a *grantor trust* is a trust treated as owned in whole or in part by the grantor or the grantor's spouse pursuant to sections 671 through 678, and *control* is defined in § 25.2701-2(b)(5)(ii) and (iii).

(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 rented 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 6 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.

[T.D. 8395, 57 FR 4269, Feb. 4, 1992; T.D. 8395, 57 FR 11265, Apr. 2, 1992, as amended by T.D. 8743, 62 FR 66988, Dec. 23, 1997]

§ 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*. If either—

(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 2503(b) applies first to transfers in that 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 2001(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 G, 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

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amount determined under paragraph (b) of this section.

[T.D. 8395, 57 FR 4272, Feb. 4, 1992]

§ 25.2702-7 Effective dates.

Except as provided in this section, §§ 25.2702-1 through 25.2702-6 apply 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. The fourth through eighth sentences of § 25.2702-5(b)(1) and § 25.2702-5(c)(9) apply with respect to trusts created after May 16, 1996. Section 25.2702-2(a)(5), the second and third sentences of § 25.2702-2(a)(6), § 25.2702-3(d)(2), the first two sentences of § 25.2702-3(d)(4), the last sentence of § 25.2702-3(e), *Example 5*, the last two sentences of § 25.2702-3(e), *Example 6*, and § 25.2702-3(e), *Examples 8 and 9*, apply for trusts created on or after July 26, 2004. However, the Internal Revenue Service will not challenge any prior application of the changes to *Examples 5 and 6* in § 25.2702-3(e).

[T.D. 8395, 57 FR 4273, Feb. 4, 1992, as amended by T.D. 8743, 62 FR 66989, Dec. 23, 1997; T.D. 9181, 70 FR 9224, Feb. 25, 2005]

§ 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, cor-

porate 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.

[T.D. 8395, 57 FR 4273, Feb. 4, 1992]

§ 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.

[T.D. 8395, 57 FR 4274, Feb. 4, 1992]

§ 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 it 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 by-laws, 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 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 $\frac{1}{2}$ 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 $3\frac{1}{3}$ 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

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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.

[T.D. 8395, 57 FR 4274, Feb. 4, 1992]

§ 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(c)(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 60 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 60 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

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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 3.33 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.

[T.D. 8395, 57 FR 4276, Feb. 4, 1992; T.D. 8395, 57 FR 11265, Apr. 2, 1992]

§ 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.

[T.D. 8395, 57 FR 4277, Feb. 4, 1992; T.D. 8395, 57 FR 11265, Apr. 2, 1992]

PROCEDURE AND ADMINISTRATION

§ 25.6001-1 Records required to be kept.

(a) *In general.* Every person subject to taxation under Chapter 12 of the Internal Revenue Code of 1954 shall for the purpose of determining the total amount of his gifts, keep such permanent books of account or records as are necessary to establish the amount of his total gifts (limited as provided by section 2503(b)), together with the deductions allowable in determining the amount of his taxable gifts, and the other information required to be shown in a gift tax return. All documents and vouchers used in preparing the gift tax return (see § 25.6019-1) shall be retained by the donor so as to be available for inspection whenever required.

(b) *Supplemental data.* In order that the Internal Revenue Service may determine the correct tax the donor shall furnish such supplemental data as may be deemed necessary by the Internal Revenue Service. It is, therefore, the duty of the donor to furnish, upon request, copies of all documents relating to his gift or gifts, appraisal lists of any items included in the total amount of gifts, copies of balance sheets or other financial statements obtainable by him relating to the value of stock constituting the gift, and any other information obtainable by him that may be necessary in the determination of the tax. See section 2512 and the regulations issued thereunder. For every policy of life insurance listed on the return, the donor must procure a statement from the insurance company on Form 712 and file it with the internal revenue officer with whom the return is filed. If specifically requested by an internal revenue officer, the insurance company shall file this statement direct with the internal revenue officer.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7012, 34 FR 7691, May 15, 1969; T.D. 7517, 42 FR 58935, Nov. 14, 1977]