PART VIII: FEDERAL ESTATE TAX, GIFT TAX, GENERATION-SKIPPING TRANSFER TAX, AND VALUATION

Estate Tax

675. What is the federal estate tax?

The federal estate tax is an excise tax on the right to transfer property at death.[1]

The "Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010" ("2010 TRA") was enacted on December 17, 2010 and notably impacted the estate, gift, and generation-skipping transfer tax changes enacted in 2001 as part of EGTRRA. 2010 TRA generally repealed the estate tax for 2010 with an option to pay, and provided only two years of tax certainty. After 2012, the estate, gift, and GST rules were scheduled to return to pre-EGTRRA levels unless Congress acted to extend the rules enacted by EGTRRA and 2010 TRA.

Congress enacted the American Taxpayer Relief Act of 2012 ("ATRA") on January 1, 2013, making the estate, gift, and GST tax rules that 2010 TRA implemented permanent.

Under 2010 TRA, the estate, gift and GST exemptions were $5 million for 2010-2012, with an inflation adjustment to $5.12 million for 2012. ATRA made this exemption level permanent, so that the $5 million exemption will be adjusted annually for inflation for all tax years beginning after 2012. In 2013, the exemption amount was adjusted upward to $5.25 million and in 2014, the amount was increased to $5.34 million.[2]

While no estate tax could be imposed for 2010 under 2001 EGTRRA, the "penalty" of choosing to have no estate tax apply is that the estate was then subject to certain carryover basis rules. 2010 TRA allowed estates of decedents dying in 2010 to elect to fall under the $5 million exemption (and 35 percent estate tax rate) or be subject to the carryover basis rules. Estates electing the carryover basis rules must file a Form 8939 to report information about property acquired from a decedent and to allocate basis increases to certain property acquired from a decedent.

Under 2010 TRA, a surviving spouse may use any unused estate tax exemption from his or her deceased spouse.[3] This "portability" rule also allows a surviving spouse to use the deceased spouse's unused exemption for gift tax purposes, but apparently not for GST exemption purposes. (See Q 677.) ATRA made this portability rule permanent as long as an estate tax return is filed and the portability election is made.

Under 2010 TRA, the gift tax applicable exclusion amount was $1 million for 2010 and increased to $5 million for 2011 and $5.12 million for 2012. ATRA made the $5 million exemption permanent (as indexed for inflation in all tax years beginning after 2012).

1. IRC Sec. 2001.
2. Rev. Proc. 2013-15, 2013-5 IRB 444, Rev. Proc. 2013-35, 2013-47 IRB 537.
3. IRC Section 2010(c).

BK-SBM-15TFINS-V1-140466-Part08.indd 611 10/14/2014 8:31:51 PM

The maximum estate tax rate and gift tax rate for 2010 through 2012 was 35 percent. The GST tax rate was zero in 2010 and 35 percent for 2011 and 2012. Under ATRA, the maximum estate, gift, and GST tax rates were permanently increased to 40 percent for the largest estates.

The estate tax is measured by the value of the property or property interests transferred. The estate tax is also an extension of the gift tax, with the gift tax being an excise tax on the right to transfer property during life (see Q 739). Generally, both types of transfers are taxed according to the same rate schedule and a unified credit applies to both. As is explained in Q 739, the gift tax is cumulative and the tax rates are progressive. Thus, while taxable lifetime gifts may cause gifts made in subsequent years to be taxed at higher rates, all lifetime taxable gifts (if substantial enough) tend to push the taxable estate into higher tax brackets. That is, the cumulative effect follows through to the last taxable transfer a person makes–at death. This effect is seen clearly when the steps in the computation of the estate tax are followed.

Planning Point: Lifetime gifts, however, are often preferred to transfer at death because lifetime gifts are "tax exclusive" as the amount of tax paid is not subject to gift tax while the estate tax is "tax inclusive" since the assets used to pay the estate tax are also subject to tax.

An estate tax return, if required, must generally be filed within nine months after the decedent's death. A six month extension for filing is available. Tax is generally due within nine months after the decedent's death, but certain extensions for payment may be available. See Q 711.

Property includable in the gross estate is generally valued at fair market value on the date of death (Q 759). An election may be available to use an alternative valuation date six months after death (Q 760).

Certain deductions (Q 700) are available against the gross estate. Deductions for funeral and administration expenses, debts and taxes, and losses are subtracted from the gross estate to produce an adjusted gross estate. The adjusted gross estate is used to determine qualification for a few tax benefits, such as estate tax deferral under IRC Section 6166 (see Q 711).

Unlimited marital and charitable deductions are available for certain transfers to surviving spouses and charities. The taxable estate equals the gross estate reduced by all deductions.

Tax is imposed on the taxable estate. Tax rates (Appendix D) are generally progressive and tax is based on cumulative taxable transfers during lifetime and at death. To implement this, the tentative tax is calculated on the sum of the taxable estate and adjusted taxable gifts (the computation base), and the gift tax that would have been payable on adjusted taxable gifts (using the tax rates in effect at decedent's death) is then subtracted out. Adjusted taxable gifts are taxable gifts (the balance after subtracting allowable exclusions and deductions) made by the decedent after 1976 other than gifts includable in the decedent's gross estate.

Planning Point: A gift made after August 5, 1997, cannot be revalued, if the gift was adequately disclosed on a gift tax return and the gift tax statute of limitations (generally, three years) has passed.[1] Consider filing gift tax returns and adequately disclosing even annual exclusion gifts to start the limitation period.

1. IRC Sec. 2001(f).

The tentative tax is then reduced by credits (Q 710) to produce estate tax payable. The unified credit is generally the most important credit available.

676. What are the steps that must be taken to calculate the federal estate tax?

The Federal Estate Tax Worksheet, below, shows the steps for calculating the estate tax. Calculation starts with determining what is includable in the decedent's gross estate (see Q 679). In general, the gross estate includes property owned by the decedent at death, as well as property in which the decedent retained or held certain strings such as a retained income interest, a reversionary interest, a right to change beneficial interests, jointly owned property, a general power of appointment, certain interests in annuities or life insurance, and certain transfers within three years of death. A limited exclusion is available from the gross estate for conservation easements (Q 699).

Federal Estate Tax Worksheet

1	Year of Death		________
2	Gross Estate (before exclusions)		$ Q 679
3	– Conservation Easement Exclusion		($ Q 699)
4	Gross Estate		$ Q 679
5	– Funeral and Administration Expenses Deduction	$ Q 700	
6	– Debts and Taxes Deduction	$ Q 700	
7	– Losses Deduction	$ Q 700	
8	– Subtotal: 5 to 7		($________)
9	Adjusted Gross Estate		($________)
10	– Marital Deduction	$ Q 700	
11	– Charitable Deduction	$ Q 700	
12	– Other Deductions	$ Q 700	
13	– Subtotal: 10 to 12		($________)
14	Taxable Estate		$________
15	+ Adjusted Taxable Gifts		$________
16	Computation Base		$________
17	Tax on Computation Base		$ Appendix D
18	– Gift Tax on Adjusted Taxable Gifts		($ Appendix D)
19	Tentative Tax		$ Appendix D
20	– Unified Credit	$ Q 710	
21	– State Death Tax Credit (now a deduction)	$ Q 710	
22	– Pre–1977 Gift Tax Credit	$ Q 710	
23	– Previously Taxed Property Credit	$ Q 710	
24	– Foreign Death Tax Credit	$ Q 710	
25	– Total Credits		($ Q 710)
26	Federal Estate Tax		$________

677. Should estates of decedents dying in 2010 elect to be subject to the estate tax?

It depends. The question of whether a 2010 estate should elect estate tax treatment must be answered on a case by case basis. Generally, the decision will be driven by the size of the taxable estate and the basis of the property held by the estate.

Here is a general guide to the decision of whether an estate should elect estate tax treatment in 2010, or elect not to have the estate tax apply to the estate.

Estates Valued at $5 Million or Less

Estates of $5 million or less will generally best be served by electing estate tax treatment, since the applicable exclusion amount will cover that amount, and beneficiaries will receive stepped up basis in the property.

For example, consider an estate that is valued at $5 million, holding a piece of property valued at $4 million on the date of the decedent's death with a basis of $1 million. The decedent's son is the estate's only beneficiary. If the estate elects not to be subject to the estate tax, no estate tax will be due, and the property will pass to the decedent's son with a basis of $2.3 million ($1.3 million [allocable basis] + $1 million [decedent's adjusted basis]).

If the decedent's son sells the property when its FMV is still $5 million, he will pay tax of $405,000 ($5 million [sale price] – $2.3 million [basis] = $27 million × 15 percent LTCG rate = $405,000).

If, on the other hand, the estate elects estate tax treatment, no estate tax will be due on the $5 million dollar estate since the applicable exclusion amount in 2010 is $5 million. And Son will receive the property with a stepped-up $5 million basis. If he sells the property at its FMV, he will not owe any tax on the sale.

As a result, in the example, Son nets $5 million from Father's estate if the estate elects estate tax treatment and only $ 4,595,000 if the estate does not.

If, instead of passing to Son, the property passes to Wife, she will take a $4 million basis in the property ($3 million [allocable basis] + $1 million [decedent's adjusted basis]). If Wife sells the property when its FMV is still $5 million, she will pay $150,000 in tax on the sale ($5 million – $4 million [basis] = $1 million × 15 percent LTCG rate = $150,000). Wife will net $4,850,000. Again, the beneficiary in this case will be better off financially if the estate elects estate tax treatment; although amounts remaining in Wife's estate at her death will be taxed in her estate.

Note that the preceding examples are highly simplified. In some cases, both choices will have the same economic effect for beneficiaries. Estates usually include more than a single piece of property. As a result, a beneficiary who is in a lower tax bracket may be able to utilize the 0 percent LTCG rate by selling only enough stock (or other property) each year so that the beneficiary is not pushed into one of the higher capital gains rates. For instance, a beneficiary with no other source of income who is granted 100,000 shares of GE stock could dispose of $34,000 worth of stock each year without being pushed out of the 0 percent capital gains rate (assuming current capital gains rates are continued indefinitely). This beneficiary would not suffer appreciably under the 2010 carry-forward basis rules as long as she keeps her stock sales at or below $34,000.

Estates Valued at More Than $5 Million

Estates of decedents dying in 2010 that are worth more than $5 million will often be better served by electing against estate tax treatment; however, depending on the basis of the estate's assets, election to be subject to the estate tax may be warranted. A couple of simplified examples illustrate.

Father, who died in 2010, has a gross estate of $6 million, consisting of $6 million in stock with a basis of $1 million. If his estate elects estate tax treatment, $1 million of the estate will be subject to the estate tax, resulting in estate tax owed of $350,000. If Son is the sole beneficiary of the estate, he takes the stock with a carryover basis of $6 million. If he sells the stock when its value is still $6 million, he will not be subject to tax on the sale. Son will net $5,650,000 from the estate.

If Father's estate elects against estate tax treatment, his estate will not be subject to tax. If his son is the sole beneficiary of the estate, he will receive basis in the stock of $2.3 million ($1 million [carryover basis] + $1.3 million [allocable basis]). If he sells the stock when its FMV is still $6 million, he will pay LTCG tax of $555,000 on the sale. As a result, Son will net $5,445,000 on the sale.

In this simplified case, the estate should elect estate tax treatment.

But, taking the same facts except that Father's basis in the property was $3 million, if the estate elects against estate tax treatment, Son will receive a basis in the stock of $4.3 million ($3 million [carryover basis] + $1.3 million [allocable basis]). If Son sells the stock when its FMV is still $6 million, he will be subject to LTCG tax of $255,000 ($6 million [sale price] – $4.3 million [basis] = $1.7 million × 15 percent = $255,000). Under this scenario, Son will net $5,745,000.

If the estate elects estate tax treatment, the result will be the same as when the basis of the stock was only $1 million (see previous example). As a result, Son will net $5,650,000 if the estate elects estate tax treatment, less than he would have netted had the estate elected against estate tax treatment.

Estates of $10 million or more will generally elect against estate tax treatment, regardless of the basis of the estate's property.

These examples do not touch on all of the intricacies of administering an estate. The decision-making involved in determining whether to elect estate tax treatment in a particular case will be more nuanced. In particular, the examples assume that the long-term capital gains rate will not rise significantly between the time when property is distributed to a beneficiary and when the beneficiary sells the property. Also, if beneficiaries are taxed at short-term capital gains rates, the calculus will change dramatically.

678. Is the exclusion amount of the first spouse to die portable? What is "portability"?

Yes. The 2010 Tax Relief Act introduced a new estate tax concept for 2011 and 2012, the ***deceased spouse unused exclusion amount*** (DSUEA). The DSUEA is portable, meaning that a surviving spouse can utilize the unused exclusion amount of the first spouse to die. ATRA made this portability concept permanent for tax years beginning in 2013 and thereafter.

In general, under the provision, an estate's exclusion amount, referred to as its applicable exclusion amount, is the sum of two components: the ***basic exclusion amount*** and the DSUEA. The basic exclusion amount for estates of decedents dying in 2011 is $5 million, in 2012, $5.12 million, in 2013, $5.25 million and in 2014, $5.34 million. The second part of the equation, the DSUEA, is the amount of the first-to-die spouse's exclusion amount that is not used by that spouse's estate. Note that a surviving spouse's DSUEA is equal to the unused exclusion amount of the surviving spouse's *last* deceased spouse. The decedent's executor must make the election on a timely filed estate tax return and include the computation of the DSUEA.

679. What items are includable in a decedent's gross estate for federal estate tax purposes?

The items that comprise the gross estate are described in IRC Sections 2033-2046 and the regulations thereunder. See Q 680 to Q 693 for a detailed discussion of these includable items. Gratuitous transfers of federal, state, and municipal obligations are discussed in Q 745. See Q 699 for the qualified conservation easement exclusion from the gross estate.

680. What property in which the decedent had an interest is includable in the gross estate under IRC Section 2033?

"The gross estate of a decedent who was a citizen or resident of the United States at the time of his death includes under IRC Section 2033 the value of all property, whether real or personal, tangible or intangible, and wherever situated, beneficially owned by the decedent at the time of his death …(see Q 745). Real property is included whether it came into the possession and control of the executor or administrator or passed directly to heirs or devisees …. Interest and rents accrued at the date of the decedent's death constitute a part of the gross estate. Similarly, dividends which are payable to the decedent or his estate by reason of the fact that on or before the date of the decedent's death he was a stockholder of record (but which have not been collected at death) constitute a part of the gross estate."[1]

Interest accrued, for example, on certificates of deposit owned at death and payable after death but forfeitable in the event of surrender during the owner's life[2] is includable in the decedent's

1. Treas. Reg. §20.2033-1.
2. See Federal Reserve Banking Regulation Section 217.4.

estate under IRC Section 2033. The result is not changed by the fact that the decedent owned the CDs as a joint tenant at the time of death.[1]

Note that it is only property "beneficially owned" by the decedent that is includable under IRC Section 2033. Thus, IRC Section 2033 does not reach property held by the decedent in trust for others. On the other hand, the decedent's beneficial interest in property held by another as trustee is includable under IRC Section 2033 unless the decedent's death terminates his interest.

IRC Section 2033 does not include interests which terminate on the decedent's death, such as a life interest in a trust. (But such termination may be subject to the tax on generation-skipping transfers–see Q 722). Similarly, if a decedent sells property in exchange for notes which provide that his death will extinguish the balance owing at that time, such balance will not be includable in the decedent's estate under IRC Section 2033 if the sale was for an adequate and full consideration and the cancellation provision was part of the bargained for consideration.[2]

Among the items includable in a decedent's gross estate are rights to future income (for example, the right to payments under an individual deferred compensation agreement or partnership income continuation plan). Such rights – called "income in respect of a decedent" – are included at their present (commuted) value. Since the income is also subject to income tax in the hands of the person who receives it (decedent's estate or beneficiary), the recipient is allowed an income tax deduction for the estate tax paid on the income right (see Q 636).

Planning Point: In light of the double taxation, taxpayers beyond retirement age should consider alternatives for removing the funds from the retirement account during life to fund other investments.

The decedent's interest in any business owned at death, whether as a proprietor, a partner, or a shareholder in a corporation, is likewise includable under IRC Section 2033. However, the decedent's interest may be subject to certain discounts for lack of marketability and lack of control.

Local property law (state law) determines the nature and extent of decedent's ownership rights in property at the time of death. Under community property law, for instance, property acquired by a husband or wife during marriage by purchase with community funds is generally considered to be owned one-half by each spouse. Consequently, upon the death of the spouse who dies first, only one-half of the community property is includable in his gross estate. Ten states–Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin–operate under some form of community property system.

The value of social security survivor benefits, either lump sum or monthly annuity, is not includable in the decedent's estate under IRC Section 2033.[3]

1. *Jeschke v. U.S.*,814 F2d 568, 87-1 USTC ¶13,713 (10th Cir. 1987).
2. *Est. of Moss v. Comm.*, 74 TC 1239 (1980), acq. in result, 1981-1 CB 2.
3. Rev. Rul. 55-87, 1955-1 CB 112; Rev. Rul. 67-277, 1967-2 CB 322; Rev. Rul. 81-182, 1981-2 CB 179.

681. Are dower and curtesy interests and their statutory substitutes includable in a decedent's gross estate under IRC Section 2034?

IRC Section 2034 specifically includes in the gross estate the interest of the decedent's surviving spouse "existing at the time of the decedent's death as dower or curtesy, or by virtue of a statute creating an estate in lieu of dower or curtesy."

At one time, certain courts held that dower and curtesy interests were not subject to death taxes because they were not received by transfer from the decedent. IRC Section 2034 was enacted to make sure that these marital interests would not escape the federal estate tax. The full value of the property without deduction of the surviving spouse's interest is includable in the gross estate.

682. When are gifts made within three years of death includable in a decedent's gross estate under IRC Section 2035?

Gift tax paid by the decedent or his estate on any gifts made by the decedent or his spouse within three years of the decedent's death is includable in the gross estate in any case, regardless of whether the value of the gift itself is includable under IRC Section 2035 or any other IRC section.[1] Gift tax paid by decedent's spouse on a split-gift within three years of decedent's death was included in decedent's estate where the decedent had funneled money to his spouse who then transferred the money to a life insurance trust (and to the IRS to pay gift tax); the transfers were treated as collapsed into one transaction under the step-transaction doctrine.[2]

Under Section 2035, the value of the gross estate also includes the value of property to the extent a donor gratuitously transferred property within three years of death but retained an interest in that property described in IRC Section 2036 (transfer with a retained life estate), 2037 (transfer taking effect at death with reversionary interest retained), 2038 (transfer with power retained to revoke or amend), or 2042 (incidents of ownership in insurance on life of donor); or if a donor transferred property subject to such retained interests more than three years before death, but relinquishes that interest within three years of death. The three-year rule applies to these transfers whether or not a gift tax return was required to be filed.[3] The entire value of the property transferred under this exception is includable in the decedent's gross estate, including the value of the property, if any, transferred by the decedent's consenting spouse (i.e., a split gift–see Q 752). If the consenting spouse dies within three years of the gift and the entire value of the gift was includable in the donor spouse's estate under IRC Section 2035, the consenting spouse's portion of the gift is not an adjusted taxable gift and is not includable in the consenting spouse's gross estate.[4] The gift tax paid by the donor spouse or his estate is includable in the donor spouse's estate, and the gift tax paid by the consenting spouse or her estate is includable in the consenting spouse's estate.[5] However, gift tax paid by decedent's spouse on a gift split

1. *Estate of Hester v. United States*, 2007 WL 703170, 99 A.F.T.R. 2d 2007-1288 (W.D. Va., 2007), afff'd per curiam, 297 Fed. Appx. 276, 2008 WL 4660189, 102 A.F.T.R. 2d 2008-6714 (4th Cir. Oct. 21 2008), Cert. denied sub nom. IRC Sec. 2035(b); Rev. Rul. 81-229, 1981-2 CB 176; Rev. Rul. 82-198, 1982-2 CB 206.
2. *Brown v. U.S.*, 2003-1 USTC ¶60,462 (9th Cir. 2003).
3. IRC Sec. 2035(a).
4. IRC Sec. 2001(e); Rev. Rul. 82-198, 1982-2 CB 206.
5. IRC Sec. 2035(b); Rev. Rul. 82-198, above.

between the spouses within three years of decedent's death was included in decedent's estate where the spouse did not have sufficient assets to pay the spouse's share of the gift tax and the decedent transferred assets to the spouse to pay the taxes.[1]

A transfer from a revocable trust is treated as made directly by the grantor and therefore included in the gross estate.[2] Such a transfer will generally be subject to the Section 2035 inclusion rule also with respect to gift tax paid within three years of death and for the limited purpose of the second exception below.

IRC Section 2035 also applies to increase the gross estate for the purposes of the following:

(1) determining the estate's qualification for

(a) IRC Section 303 stock redemptions (redemption of stock held by a decedent at death in an amount not in excess of death taxes and settlement costs under special income tax rules that treat the redemption as a capital transaction rather than as a dividend), and

(b) current use valuation for qualified real property (see Q 759); and

(2) determining property subject to estate tax liens.[3] With respect to the IRC Section 6166 extension of the time to pay estate tax (see Q 711), the requirement that the decedent's interest in a closely held business must exceed 35 percent of the adjusted gross estate is met by an estate only if the estate meets the requirement both with and without the application of the bringback rule.[4] An exception to this second exception is that any gifts (other than a transfer with respect to a life insurance policy) not required to be reported on a gift tax return filed by the decedent for the year the gift was made are not includable in the gross estate. Gifts up to the limit of the gift tax annual exclusion and qualified transfers (see Q 752), but not split gifts, do not require the filing of a return. Another exception to the second exception is a gift which qualifies for the gift tax marital deduction (see Q 755).[5]

The Bringback Rule

The three-year rule of IRC Section 2035, referred to above, operates as follows: In general, gifts made by the decedent (in trust or otherwise) which are caught by the three-year rule, are includable in the decedent's gross estate. Also includable is the amount of any gift tax paid by the decedent or his estate on any gifts made by the decedent or his spouse within three years prior to decedent's death; the gift tax is includable regardless of whether the value of the gift itself is includable under IRC Section 2035 or any other IRC section.[6] Where the decedent made a "net

1. TAM 9729005.
2. IRC Sec. 2035(e).
3. IRC Sec. 2035(c)(1).
4. IRC Sec. 2035(c)(2).
5. IRC Sec. 2035(c)(3).
6. IRC Sec. 2035(b); Rev. Rul. 81-229, 1981-2 CB 176; Rev. Rul. 82-198, 1982-2 CB 206.

gift" (i.e., a gift made on the condition that the donee pay the gift tax–see Q 747), the amount includable in the gross estate is the total value of the property transferred.[1]

683. When are gifts with a life interest retained includable in a decedent's gross estate under IRC Section 2036?

IRC Section 2036 is one of the three sections (2036, 2037, 2038) dealing with lifetime transfers whereby the donor retained some rights over the property given. IRS Section 2036 brings into the gross estate lifetime transfers of property where the decedent retained the use of the property or the income from the property for life. Included are transfers made directly to a donee and transfers made to an irrevocable trust for designated beneficiaries, and transfers made to entities such as a partnership, if the decedent retained the prohibited "strings."

Specifically, IRC Section 2036 requires any property which an individual gratuitously transfers during lifetime to be included in the gross estate if he retains "for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death," either:

"(1) the possession or enjoyment of, or the right to income from, the property, or

"(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

The IRS asserts the decedent's retention of possession or enjoyment of, or the right to income from, property may be evidenced by an agreement, or by prearrangement, or merely by circumstantial evidence.[2]

In November 2011, the IRS finalized regulations regarding the includability of property (including property held in trust) in the grantor's gross estate under Section 2036 where the grantor retained: (i) the use of the property; (ii) the right to an annuity or unitrust; (iii) a graduated retained interest; or (iv) other payment from the property.

Excepted from the scope of IRC Section 2036 is a transfer of property by way of "a bona fide sale for an adequate and full consideration in money or money's worth."[3] This exception to Section 2036 is often referred to as the "bona fide sale exception." Courts have wrestled with the interpretation of this exception in "widow's election" cases. Typically, a married decedent leaves certain property (and/or certain community property) in trust for his children, with all income to the surviving spouse for her lifetime, on the condition that the surviving spouse transfer certain of her property (or community property share) to the trust. The surviving spouse thus has her choice between what has been provided for her in the will and her statutory (intestate) share (or community property share). If the widow elects to take under the will, and transfers the agreed-upon property to the trust in exchange for a life income from all the trust assets, what has she transferred for purposes of IRC Section 2036? Has she transferred

1. Let. Rul. 8317010.
2. See *Lee v. U.S.*, 86-1 USTC ¶13,649 (W.D. Ky. 1985).
3. IRC Sec. 2036(a).

the entire property, or has she transferred only a remainder interest? If she is considered to have transferred the entire property, and the value of property transferred exceeds the value of the life income interest she receives in return, then she has not made a "bona fide sale for an adequate and full consideration" and the entire value of the property she transferred is includable in her gross estate under IRC Section 2036. If, however, she is considered to have transferred only a remainder interest, and that interest is of less value than the value of her life income from trust assets in excess of the value of the property she actually transferred, then she will have received adequate and full consideration for the transfer, and none of the property she actually transferred will be includable in her estate under IRC Section 2036. Case law appears to support the former interpretation.[1]

For purposes of analyzing the bona fide sale exception to contributions/transfers to family entities, such as LLCs or limited partnerships, courts analyze whether a "legitimate and significant," non-tax purpose existed for the formation of the partnership and whether the decedent received a share in the entity proportionate to her contribution.[2] If these conditions are satisfied, Section 2036 does not apply and the gross estate includes the value of the decedent's interest in the entity at the time of death (after gifts of interests, etc.). If, on the other hand, Section 2036 does apply (bona fide sale exception not satisfied and decedent retained prohibited rights), the gross estate includes the value of the assets contributed (without consideration of the entity, discounts applicable to ownership of an interest in the closely-held entity, or gifts made during life of interests).[3]

684. When are gifts taking effect at death includable in a decedent's gross estate under IRC Section 2037?

IRC Section 2037 requires inclusion in the gross estate of any interest in property transferred by the decedent if both of the following conditions are met:

(1) Possession or enjoyment of the property can, through ownership of the transferred interest, be obtained only by surviving the decedent; and

(2) The decedent has retained a reversionary interest in the property which, immediately before his death, exceeded 5 percent of the value of the property.

A simple example would be a transfer to an irrevocable living trust under the following terms: income to grantor's wife for her life; property to revert to grantor if living at wife's death and if not, property to their daughter.

Assuming that the grantor predeceases his wife and daughter, the value of the daughter's interest – the value of the property less the wife's life interest – is includable in the grantor's gross estate. Obviously, the daughter had to survive her grantor father in order to receive the property. And in all probability, the grantor's reversionary interest, valued immediately before his death, exceeded 5 percent of the value of the property.

1. *Gradow v. U.S.*, 897 F2d 516, 90-1 USTC ¶60,010 (9th Cir. 1990).
2. *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005).
3. *Estate of Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004).

The term "reversionary interest" means any possibility that the *property* may return to the donor or to his estate, and any possibility that the property may become subject to a power of disposition by him. The term does not, however, include a possibility that the income alone may return to the donor or his estate. Thus, retention of a secondary life estate would not constitute a reversionary interest (although it would cause inclusion under IRC Section 2036). Also, the term "reversionary interest" does not include a mere expectancy by the decedent that upon the death of the transferee he (or his estate) may reacquire the property under the will of the transferee or under state inheritance laws.[1]

685. When are gifts where a decedent retains the power to revoke or amend includable in the decedent's gross estate under IRC Section 2038?

IRC Section 2038 brings into a decedent's gross estate property that he has gratuitously transferred if immediately before his death he possessed the power to alter, amend, revoke, or terminate the transfer.

The language of the section refers to transfers "by trust or otherwise," but generally the section applies to transfers in trust. The most obvious example of the applicability of IRC Section 2038 is, of course, the revocable living trust. Where the grantor of a trust retains until his death the power to revoke the trust, the full value of the trust corpus is includable in his gross estate.

It makes no difference whether the decedent could exercise the power alone or only in conjunction with another person.

It also makes no difference in what capacity the decedent could exercise the power–whether as grantor, trustee, or co-trustee.

IRC Section 2038 is not limited to transfers where the decedent *retained* the power to alter, amend, revoke, or terminate at the time of transfer, except with respect to transfers made on or before June 22, 1936. With respect to transfers made after that date, possession of such a power at death will cause inclusion in the gross estate regardless of when or from what source the decedent acquired the power. Thus, IRC Section 2038 would reach a case in which the decedent, who had not originally retained the power, subsequently succeeded to it by being appointed a trustee.

IRC Section 2038 also reaches transfers to an *irrevocable* trust if the settlor possesses at his death the power to alter or amend the trust.[2] However, the provision in a trust instrument for the inclusion of all the settlor's after-born and after-adopted children as additional beneficiaries is not the retention of a power to change the beneficial interests of the trust within the meaning of IRC Section 2038.[3]

1. Treas. Reg. §20.2037-1(c)(2).
2. *Marshall v. U.S.*, 338 F. Supp. 1321 (D. Md. 1972).
3. Rev. Rul. 80-255, 1980-2 CB 272.

The regulations also make it clear that the mere discretionary power reserved to the grantor to accumulate or distribute trust income for a single beneficiary is sufficient to bring the trust property into the grantor's estate under IRC Section 2038.[1]

However, if the grantor's power to affect the beneficial enjoyment of the transferred property is limited by an ascertainable objective and external standard, the power will not fall within IRC Section 2038. The IRS acquiesces in the ascertainable standard doctrine established by the cases.[2]

If a grantor creates an irrevocable trust under which the trustee is given the power to distribute income and principal unlimited by an ascertainable standard, the value of the trust property will be includable in the grantor's estate under IRC Section 2038 (and also under IRC Section 2036) if (1) the grantor names himself as trustee or retains at his death the power to do so, or (2) the grantor retains at his death the power to remove the trustee without cause and replace him with another.[3] However, a later revenue ruling modified Revenue Ruling 79-353 to provide that the above-described estate tax holding will not be applied to a transfer, or to an addition to a trust, made before October 29, 1979 (the date of publication of the revenue ruling) if the trust was irrevocable on October 28, 1979.[4] However, for purposes of IRC Section 2036 or IRC Section 2038, the Service will no longer include trust property in a decedent-grantor's estate where the grantor retains the right to replace the trustee, but can replace the trustee with only an independent corporate trustee.[5]

686. When are annuities or annuity payments includable in a decedent's gross estate under IRC Section 2039?

IRC Section 2039 deals with annuities or other payments receivable by any beneficiary under any form of contract or agreement by reason of surviving the decedent. Subsections (a) and (b) of that section state the circumstances under which such an annuity or payment is includable in the decedent's gross estate. Thus, IRC Section 2039 applies to death and survivor benefits under annuity contracts and under optional settlements of living proceeds from life insurance policies and endowment contracts.

Exclusions under various provisions of IRC Section 2039 may apply to employee annuities which are part of qualified pension and profit sharing plans; to employee annuities payable under nonqualified deferred compensation plans, including death benefit only plans; to certain tax sheltered annuity plans; and to individual retirement savings plans.

687. Are joint interests includable in a decedent's gross estate under IRC Section 2040?

Yes. IRC Section 2040 deals with all classes of property held jointly with a right of survivorship. This includes, for example, jointly held real estate, jointly held bonds, and joint bank

1. Treas. Reg. §20.2038-1(a).
2. 1947-2 CB 2; Rev. Rul. 73-143, 1973-1 CB 407. For more information on the ascertainable standard doctrine, see Stephens, Maxfield, Lind & Calfee, Federal Estate and Gift Taxation (Boston: Warren, Gorham & Lamont, 7th ed.), ¶4.10[5], and the cases cited therein.
3. Treas. Reg. §20.2038-1(a)(3); Rev. Rul. 79-353, 1979-2 CB 325.
4. Rev. Rul. 81-51, 1981-1 CB 458.
5. Rev. Rul. 95-58, 1995-2 CB 191; *Est. of Wall v. Comm.*, 101 TC 300 (1993).

accounts. IRC Section 2040 does not deal with other forms of co-ownership in which property interests pass at death other than automatically to surviving co-owners. Thus, tenancies in common and community property interests are includable under IRC Section 2033, not under IRC Section 2040.

The general rule of IRC Section 2040 requires that the entire value of the jointly owned property must be included in the gross estate of the joint owner who dies first, except such part as can be shown to have originally belonged to the survivor and never to have been acquired from the decedent "for less than an adequate and full consideration in money or money's worth."[1] Thus, the rule is as follows: if the decedent furnished the entire purchase price, the entire property is includable; if the decedent furnished only a part of the purchase price, only a corresponding proportion of the property is includable; if the decedent furnished no part of the purchase price, no part of the property is includable.[2] (But see below for the special rule applicable to spouses who own property jointly).

Planning Point: As a result of these rules, it is important that joint owners keep good records of the funding for the jointly-owned property.

Where the joint owners are related (not spouses) and the survivor paid part of the purchase price, he must be able to prove that the funds did not come to him by way of gift from the decedent. In other words, the purchase price will be traced to its original source; and the burden of proof is not on the IRS but on the survivor. It is often difficult to prove the amount of contribution of the survivor to the joint ownership. If the assets of the joint owners became inextricably commingled prior to acquisition of the jointly owned property, proof may be impossible and the property will be wholly includable in the decedent's gross estate.

But while money or property acquired by the surviving joint owner by gift from the decedent and contributed to the purchase price of the jointly held property is traced to the decedent for purposes of IRC Section 2040, *income* from property so acquired which is contributed to the purchase price is treated as the survivor's own contribution for purposes of IRC Section 2040.[3] Further, the IRS has ruled that where the survivor's contribution to the purchase price of jointly held property was traced to proceeds from the sale of property acquired by the survivor with money received from the decedent by gift, the sale proceeds attributable to appreciation in value of the property during the period the survivor owned the property were treated as the survivor's own contribution for purposes of IRC Section 2040. Also, consistent with the above-cited regulation, the Service ruled that sale proceeds attributable to income from the property received by the survivor and reinvested were treated as the survivor's individual contribution.[4]

Revenue Ruling 79-372 is also consistent with earlier case law, as noted in the Ruling. However, the Regulations call for a different result when the survivor's contribution was of property received by gift from the decedent (rather than of proceeds from the sale of such property),

1. IRC Sec. 2040(a).
2. Treas. Reg. §20.2040-1(c).
3. Treas. Reg. §20.2040-1(c)(5).
4. Rev. Rul. 79-372, 1979-2 CB 330.

which property had appreciated in value during the period held by the survivor. In this situation the regulations require that the portion of the purchase price attributable to such appreciation be traced to the decedent for purposes of IRC Section 2040.[1]

Where the property was acquired by the decedent and the other joint owner by devise, bequest, or inheritance, or by gift from a third party, the decedent's fractional share of the property is included in his gross estate. For example, if the decedent's father has conveyed the property by gift to the decedent and his wife in joint tenancy or tenancy by the entirety, one-half of the property will be includable in the gross estate of whichever spouse dies first.[2]

Spouses Who Own Property Jointly: Qualified Joint Interests

Effective for estates of decedents dying after 1981, in the case of joint interests created after 1976, notwithstanding the provisions of IRC Section 2040 explained above (subsection (a)), only one-half the value of a *qualified joint interest* is included in a decedent's gross estate under IRC Section 2040. [The rule for inclusion in a decedent's estate for spousal jointly owned property is still based upon consideration furnished if the joint interest was created prior to 1977.[3]] A *qualified joint interest* means any interest in property held by the decedent and the decedent's spouse as (1) tenants by the entirety; or (2) joint tenants with right of survivorship, but only if the decedent and the spouse of the decedent are the only joint tenants.[4] However, with respect to decedents dying after November 10, 1988, if the decedent's spouse is not a United States citizen, interests in property held by the decedent and the decedent's spouse are not treated as a *qualified joint interest* (apparently unless the transfer to the surviving spouse is in a qualified domestic trust, see Q 700).[5] For purposes of applying the consideration furnished test (see above) where the *qualified joint interest* rule does not apply because the decedent's spouse is not a United States citizen, consideration furnished by the decedent to the decedent's spouse before July 14, 1988 is generally treated as consideration furnished by the decedent's spouse.[6]

688. When are powers of appointment includable in a decedent's gross estate under IRC Section 2041?

IRC Section 2041 governs the includability in the decedent's gross estate of property subject to his power of appointment. For estate tax purposes, a "power of appointment" is a power which has been given to the decedent by another person, as distinguished from a power *retained* by him over property which he formerly owned. A power of appointment enables the holder thereof to dispose of property he does not own.

> *Example*: Husband's will provides that part of his estate is to be placed in trust. The will gives his wife all the trust income for her life and also the power to designate who shall receive the trust principal after her death. If the wife fails to exercise her power, the trust principal is to go to their daughter. His wife exercises her power by executing a will in which she directs the trust principal to their son.

1. Treas. Reg. §20.2040-1(c)(4).
2. IRC Sec. 2040(a).
3. *Gallenstein v. U.S.*,975 F2d 286 92-2 USTC ¶60,114 (6th Cir. 1992); *Patten v. U.S.*, 116 F.3d 1029, 97-2 USTC ¶60,279 (4th Cir. 1997); *Anderson v. U.S.*, 96-2 USTC ¶60,235 (D.C. Md. 1996); *Hahn v. Comm.*, 110 TC 140 (1998), acq. 2001-42 IRB iii.
4. IRC Sec. 2040(b).
5. IRC Sec. 2056(d).
6. OBRA '89, Sec. 7815(d)(16).

In this example, the husband is the *donor* of the power; the wife is the *donee* of the power; their son is the *appointee* of the power; and the daughter, had the wife failed to exercise her power, would have been the *taker in default of appointment*.

Of course, powers of appointment can be created otherwise than by a testamentary trust. They can also be created, for example, by the terms of a living trust, or by the terms of a life insurance beneficiary arrangement.

The law provides two sets of rules for gift and estate taxation of powers of appointment. The first set of rules deals with powers created before October 22, 1942, sometimes called "pre-1942" powers. The second set of rules governs powers created after October 21, 1942, sometimes called "post-1942" powers.

A power of appointment created by will is considered as created on the date of the testator's death. A power created by an inter vivos instrument is considered created on the date the instrument takes effect.[1] Thus, in the case of a living trust, the power is created when the trust takes effect, even though the trust is revocable. Likewise, in the case of life insurance, the power is created when the beneficiary designation is made, even though the designation is revocable.

Regardless of when the power is created, however, it is not taxable in any event unless it is a "general" power of appointment.

General Power of Appointment

The IRC defines a general power of appointment as a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. Here the "decedent" is, of course, the donee – that is, the holder of the power.

A power exercisable in favor of the holder, his estate, his creditors, or the creditors of his estate is a general power of appointment; it need not be exercisable in favor of both.[2] Thus, if the holder can withdraw all or part of the principal for any purpose, he has a general power of appointment exercisable in favor of himself. Or, if he can will (or bequeath) the property to anyone he wishes, including his own estate, he has a general power of appointment exercisable in favor of his estate.

However, a power to "consume, invade, or appropriate" the principal for the holder's own benefit is not a general power of appointment if it is limited by an "ascertainable standard" relating to the holder's "health, education, support, or maintenance." According to the Regulations, "A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words 'support' and 'maintenance' are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard.

1. Treas. Reg. §20.2041-1(e).
2. Treas. Reg. §20.2041-1(c)(1).

Planning Point: To ensure a power of appointment is limited by an ascertainable standard, the drafter must use the exact terms referenced in the Regulations. Too much is at stake to use terms the drafter may believe are "similar."

Examples of powers which are limited by the requisite standard are powers exercisable for the holder's 'support,' 'support in reasonable comfort,' 'maintenance in health and reasonable comfort,' 'support in his accustomed manner of living,' 'education, including college and professional education,' 'health,' and 'medical, dental, hospital and nursing expenses and expenses of invalidism.' In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised."[1]

A pre-1942 power is not considered to be a "general" power of appointment if it is exercisable only in conjunction with another person. And a post-1942 power is not considered to be a "general" power of appointment if it is exercisable only in conjunction with the donor of the power or only in conjunction with someone who has a substantial interest in the property which is adverse to the holder's interest.[2] It has been held that a trustee does not have a substantial and adverse interest simply because the trust is a taker in default of exercise of the power, so long as the trustee himself is not a beneficiary of the trust.[3]

In the past, a number of letter rulings have determined that a beneficiary who has the power to remove a trustee will be treated as holding any powers held by the trustee for purpose of determining whether the beneficiary holds a general power of appointment.[4] However, for purposes of IRC Section 2036 or IRC Section 2038, the Service will no longer include trust property in a decedent grantor's estate where the grantor retains the right to replace the trustee but can replace the trustee with an independent trustee "that was not related or subordinate to the decedent (within the meaning of Section 672(c)), the decedent would not have retained a trustee's discretionary control over trust income."[5]

More recently, the power to remove a trustee and replace the trustee with an independent corporate trustee was not treated as the retention of powers held by the trustee for purposes of IRC Section 2041.[6] Hopefully, this represents an extension by the Service of its new policy with regard to trustee removal under IRC Section 2036 and IRC Section 2038 to IRC Section 2041. Similarly, a beneficiary's right to veto a replacement trustee and to petition a court for appointment of an independent replacement trustee was not treated as a general power of appointment.[7]

Any power of appointment which is not a general power is called a "special" or "limited" power. A special power of appointment is not taxable in the holder's estate regardless of when it was created.

1. Treas. Reg. §20.2041-1(c)(2).
2. Est. of Maxant, TC Memo 1980-414, nonacq. 1981 AOD LEXIS 58; Rev. Rul. 82-156, 1982-2 CB 206.
3. *Miller v. U.S.*, 387 F.2d 866 (3rd Cir. 1968); *Est. of Towle v. Comm.*, 54 TC 368 (1970).
4. Let. Ruls. 8916032, 9113026 (does not apply to transfers in trust before October 29, 1979, if trust was irrevocable on October 28, 1979).
5. IRC Section 2041.
6. Let. Rul. 9607008.
7. Let. Rul. 9741009.

Post-1942 Power: Generally

The *mere possession* at death of a post-1942 general power of appointment will cause the property to be included in the holder's gross estate. Thus:

(1) If the decedent had a general power of appointment which he could have exercised by will in favor of his estate, the property subject to the power is taxable in his estate whether or not he exercised the power; or

(2) If, immediately before his death, the decedent had a general power of appointment which he could have exercised in his own favor during his lifetime, the property subject to the power is taxable in his estate.

But even though the decedent does not still possess the power at the time of his death, if he has had such a power and has exercised or released it or allowed it to lapse during his lifetime, the property which was subject to the power may, under some circumstances, be included in his gross estate.

Thus, if the decedent once possessed a general power of appointment and has exercised or released it in such a way that, had the property been his own, it would have been included in his gross estate under one of the IRC Sections 2035 through 2038, then the property that was subject to the power is includable in his gross estate.

Post-1942 Power: Non-Cumulative Annual Withdrawal Rights

In many situations, an insured or the grantor of a trust will wish to give his beneficiary not only all the income from the fund, but also a right to withdraw some limited amount of principal each year. If the beneficiary does not exercise his right of withdrawal in any year, the right expires or "lapses" at the end of the year. Where it cannot be carried forward to subsequent years, it is characterized as a "non-cumulative" withdrawal right.

Where the beneficiary permits such a right to lapse, gift and estate taxes may result by reason of the lapse. In other words, by not withdrawing the amount she could have withdrawn, the beneficiary has made a gift to those persons designated to receive the principal.

However, in framing the powers of appointment tax law, Congress recognized that modest annual withdrawal rights are socially desirable and that their use, within limits, should not be discouraged. Therefore, an exemption is granted in an amount equal to whichever is greater: (1) $5,000; or (2) 5 percent of the value of the fund as of the date of the lapse of the power.

Consequently, where a non-cumulative power of withdrawal is permitted to lapse, only the excess over and above the "$5,000 or 5 percent of the fund" limit will be subject to gift and estate taxes. This excess is treated as a transfer with life income retained. But the entire amount which could have been withdrawn in the year of death, but was not withdrawn, is includable in the gross estate since this power has not lapsed at the time of death.

Pre-1942 Power

Prior to 1942, property subject to a general power of appointment was taxable in the donee's estate only if the power was *exercised*. Thus, the property is includable in the holder's gross estate only if (1) he has exercised the power by will at his death, or (2) he has exercised the power during life in such a way that, had the property been owned by him, it would have been includable under one of the IRC Sections 2035-2038.

689. When are life insurance proceeds includable in a decedent's gross estate under IRC Section 2042?

IRC Section 2042 deals specifically with the includability of life insurance proceeds in the gross estate of the *insured*. The proceeds are includable in the insured's gross estate under IRC Section 2042 if they are as follows:

(1) Receivable by or for the benefit of insured's estate; or

(2) Receivable by a beneficiary other than the insured's estate *and* the insured possessed at his death any of the incidents of ownership in the policy (whether exercisable by the insured alone or only in conjunction with another person).

Planning Point: Generally, the dispute arises as to whether the decedent held any "incidents of ownership" in the policy. A decedent may have an incident of ownership if he has the power to change the beneficial ownership in the policy regarding its proceeds. To help remove the insurance proceeds from the insured's estate, it may be desirable to acquire the policy in the name of a life insurance trust or "ILIT".

690. Are transfers made for insufficient consideration includable in a decedent's gross estate under IRC Section 2043?

If any one of the transfers described in IRC Sections 2035 through 2038 and 2041 is made for consideration in money or money's worth, but the consideration is not adequate and full, the excess of the fair market value of the property transferred over the consideration received is the amount includable in the gross estate.[1] There is a split of authority over whether adequate and full consideration is measured by reference to what would otherwise be included in the estate or using time value of money discounts.[2]

In general, for purposes of the estate tax, a relinquishment or promised relinquishment of dower or curtesy, or of a statutory substitute therefor, or of other marital rights in the decedent's property or estate, is not considered consideration "in money or money's worth." However, an exception is made for the limited purpose of allowing a deduction from the gross estate in the case of a transfer which meets the following conditions: Where a husband and wife enter into a written agreement relative to their marital and property rights and divorce occurs within the

1. IRC Sec. 2043(a).
2. *Gradow v. U.S.*,897 F2d 516, 90-1 USTC ¶60,010 (Fed. Cir. 1990); *Pittman v. U.S.*,878 F. Supp. 833, 95-1 USTC ¶60,186 (E.D.N.C. 1994); *Parker v. U.S.*, 894 F. Supp. 445, 95-1 USTC ¶60,199 (N.D. Ga. 1995); *Est. of D'Ambrosio v. Comm.*, 101 F3d 309, 96-2 USTC ¶60,252 (3rd Cir. 1996), rev'g 105 TC 252 (1995); *Wheeler v. Comm.*, 116 F.3d 749, 97-2 USTC ¶60,278 (5th Cir. 1997), rev'g 96-1 USTC ¶60,226 (W.D. Tex. 1996); *Est. of Magnin v. Comm.*, 184 F3d 1074, 99-2 USTC ¶60,347 (9th Cir. 1999), rev'g TC Memo 1996-25.

three-year period beginning on the date one year before the agreement is entered into, any transfer of property or interests in property made pursuant to the agreement to either spouse in settlement of his or her marital or property rights is deemed to be a transfer made for a full and adequate consideration in money or money's worth. The deduction allowed is for the value of the property transferred as a claim against the estate (see Q 700).

691. When is marital deduction property in which a decedent had a qualifying income interest includable in the gross estate under IRC Section 2044?

A marital deduction is allowed for transfers of "qualified terminable interests" property, commonly referred to as "QTIP," if the decedent's executor (or donor) so elects and the spouse receives a "qualifying income interest" in the property for life. (See Q 700, Q 755). If the property subject to the qualifying income interest is not disposed of prior to the death of the surviving spouse, the fair market value of the property determined as of the date of the spouse's death (or alternate valuation date, if so elected) is included in the spouse's gross estate pursuant to IRC Section 2044.

692. When are disclaimers includable in a decedent's gross estate under IRC Section 2046?

It is possible for a person who is (or would be) the transferee of an interest in property to refuse to accept the interest and thus prevent any part of the value of the property from being included in his gross estate at his death. However, with respect to transfers creating an interest in the person disclaiming made after December 31, 1976, the refusal must take the form of a *qualified disclaimer*.[1]

A *qualified disclaimer* is an irrevocable and unqualified refusal to accept an interest in property. The refusal must satisfy four conditions: First, the refusal must be in writing. Second, the written refusal must be received by the transferor of the interest, his legal representative, or the holder of the legal title to the property not later than nine months after the day on which the transfer creating the interest is made. However, if later, the period for making the disclaimer will not expire in any case until nine months after the day on which the person making the disclaimer attains age 21. Third, the person must not have accepted the interest or any of its benefits before making the disclaimer. Fourth, the interest must pass to a person other than the person making the disclaimer as a result of the refusal to accept the property.[2]

A qualified disclaimer can be made up of an undivided portion of any separate interest in property, even if the disclaiming person has another interest in the same property.[3] In addition, the question of whether a separate interest may be disclaimed depends upon whether the interest is severable.[4]

1. IRC Secs. 2046, 2518(a).
2. IRC Sec. 2518(b).
3. Treas. Reg. §25.2518-3.
4. Treas. Reg. §25.2518-3(a)(1)(ii).

A power with respect to property[1] is treated as an interest in such property.[2] The exercise of a power of appointment to any extent by the donee of the power is an acceptance of its benefits.[3]

A written transfer of the transferor's (disclaimant's) entire interest in property to the person or persons who would otherwise have received the property if an effective disclaimer had been made will be treated as a valid disclaimer for federal estate and gift tax purposes provided the transfer is timely made and the transferor has not accepted any of the interest or any of its benefits.[4]

693. What additional amounts may be includable in a decedent's gross estate?

IRC Section 2701
Recapture of Qualified Payments

Additional estate tax may be due with respect to certain transfers of interests in corporations or partnerships to reflect cumulative but unpaid distributions on retained interests (see Q 777).[5]

IRC Section 2704
Deemed Transfer of Lapsing Right

There may be a deemed transfer at death upon the lapse of certain voting or liquidation rights in a corporation or partnership (see Q 785).[6]

IRC Section 2801
Property Received from Expatriate

A United States citizen or resident who receives a covered bequest from certain expatriates may owe estate tax on the transfer.

694. In whose estate is property held in custodianship under the Uniform Gifts to Minors Act or the Uniform Transfers to Minors Act includable for federal estate tax purposes?

The value of property transferred under either of the Uniform Acts is includable in the gross estate of the *donor* if the donor dies while serving as custodian and before the donee attains the age of 21. (But see the discussion of gifts made within three years of death at Q 679). In all other circumstances, custodial property is includable only in the gross estate of the donee.[7] If H and W make identical gifts under a Uniform Act, each naming the other as custodian, for

1. See IRC Section 2041, Powers of Appointment, above.
2. IRC Sec. 2518(c)(2).
3. Treas. Reg. §25.2518-2(d)(1)(i); Let. Rul. 8142008.
4. IRC Sec. 2518(c)(3), as added by ERTA '81, and effective for transfers creating an interest in the person disclaiming made after 1981.
5. IRC Sec. 2701.
6. IRC Sec. 2704.
7. Rev. Rul. 57-366, 1957-2 CB 618; Treas. Reg. §20.2038-1(a); Rev. Rul. 59-357, 1959-2 CB 212; Rev. Rul. 70-348, 1970-2 CB 193; *Est. of Prudowsky*, 55 TC 890 (1971), aff'd per curiam, 465 F.2d 62 (7th Cir. 1972); *Stuit v. Comm.*, 452 F.2d 190 (7th Cir. 1971).

federal estate tax purposes each will be deemed to have transferred the property over which he held custodianship rights at death, even though the property actually transferred by him was in the custody of the other.[1] Custodial property is not included in the estate of a custodian who consented to a split gift of the property by her spouse.[2]

Where the donor dies while serving as custodian, the value of the custodial property is includable in his estate under IRC Section 2038(a)(1), as a transfer with the power retained to alter, amend, revoke, or terminate. This result is reached because of the custodian's power, under Section 4 of the Uniform Act, to withhold enjoyment of the custodial property until the donee reaches majority. To avoid this result, the donor should name someone other than himself as custodian, and should not accept appointment as successor custodian.

The IRS has ruled that the power given the donee's parent (under section 4(c) of the Gifts to Minors Act) or interested person (under section 14(b) of the Transfers to Minors Act) to petition the court to order the custodian to expend funds for the minor's support, maintenance, or education is not a general power of appointment; therefore, the custodial property is not includable in the parent's or interested person's gross estate under IRC Section 2041.[3]

695. Is an education savings account includable in an individual's gross estate?

Upon the distribution of an education savings account on account of the death of the beneficiary, the amount of the education savings account is includable in the estate of the beneficiary, not the contributor. However, where a donor elects to have contributions prorated over a five year period for gift tax purposes (see Q 749) and dies during such period, the gross estate of the donor includes prorated contributions allocated to periods after the donor's death.[4]

See Q 749 for the gift tax treatment and Q 592 for the income tax treatment of education savings accounts.

696. Is a qualified tuition program includable in an individual's gross estate?

No interest in a qualified tuition program is includable in the estate of any individual for purposes of the estate tax, with two exceptions: (1) distributions made to the estate of the beneficiary upon the beneficiary's death; and (2) if such a donor dies before the end of a five-year gift tax proration period (see Q 750), the gross estate of the donor will include the portion of contributions allocable to periods after the death of the donor.[5]

See Q 750 for the gift tax treatment and Q 595 for the income tax treatment of qualified tuition programs.

1. *Exchange Bank & Trust Co. of Fla. v. U.S.*,694 F2d 1261, 82-2 USTC ¶13,505 (Fed. Cir. 1982).
2. Rev. Rul. 74-556, 1974-2 CB 300.
3. Rev. Rul. 77-460, 1977-2 CB 323.
4. IRC Secs. 530(d)(3), 529(c)(4).
5. IRC Sec. 529(c)(4).

697. Is the value of a life insurance agent's renewal commissions includable in the gross estate?

Yes, assuming that he owns the right to the renewal commissions at the time of his death. The value includable will be the fair market value of the renewals at the time of death. Following the agent's death, the actuaries of the company will value the renewal account using some appropriate persistency table and an assumed rate of interest. If desired, the renewal commissions can be made to qualify for the marital deduction. For example, the value of the commissions will qualify for the marital deduction if all commissions are payable to the surviving spouse during her lifetime, and to her estate at her death. They should also qualify if she has the right to all renewals payable during her lifetime and a power to appoint who shall receive the commissions payable after her death. But if the surviving spouse is given only a right to those commissions which are payable during her lifetime, and someone else will receive the remaining payments in the event of her death during the renewal period, she will have only a "terminable interest" in the commissions, and they will not qualify unless a QTIP election is made.[1] The recipient must pay income tax on the renewals as received but is entitled to an income tax deduction for the estate tax attributable including the value of the renewals in the agent's gross estate.

698. Under what circumstances is the value of property transferred by gift within three years of the donor's death includable in the donor's gross estate?

One of the most overlooked rules by estates and return preparers of estate tax returns (Form 706) is the rule that gift tax paid on any post-1976 gifts made by a decedent within three years of his death is includable in the gross estate, regardless of whether the value of the gift itself is includable under any IRC section.[2] Gift tax paid by a decedent's spouse on a split-gift within three years of decedent's death was included in decedent's estate where the decedent had funneled money to his spouse who then transferred the money to a life insurance trust (and to the IRS to pay gift tax); the transfers were treated as collapsed into one transaction under the step-transaction doctrine.[3]

Under Section 2035, the value of the gross estate includes the value of property to the extent a donor gratuitously transferred property within three years of death but retained an interest in that property described in IRC Section 2036 (transfer with a retained life estate), IRC Section 2037 (transfer taking effect at death with reversionary interest retained), IRC Section 2038 (transfer with power retained to revoke or amend), or IRC Section 2042 (incidents of ownership in insurance on life of donor); or if a donor transferred property subject to such a retained interest more than three years before death, but relinquishes that interest within three years of death. The three-year rule applies to these transfers whether or not a gift tax return was required to be filed.[4] The entire value of the property transferred under this exception is includable in the decedent's gross estate, including the value of the property, if any, transferred by the decedent's consenting spouse (i.e., a split gift). If the consenting spouse dies within three years

1. *Est. of Selling v. Comm.*, 24 TC 191 (1955); *Est. of Baker v. Comm.*, TC Memo 1988-483; Let. Rul. 9016084.
2. IRC Sec. 2035(b); Rev. Rul. 81-229, 1981-2 CB 176.
3. *Brown v. U.S.*, 2003-1 USTC ¶60,462 (9th Cir. 2003).
4. IRC Sec. 2035(a).

of the gift and the entire value of the gift was includable in the donor spouse's estate under IRC Section 2035, the consenting spouse's portion of the gift is not an adjusted taxable gift and is not includable in the consenting spouse's gross estate.[1] The gift tax paid by the donor spouse or his estate is includable in the donor spouse's estate, and the gift tax paid by the consenting spouse or her estate is includable in the consenting spouse's estate.[2] For the effect of this exception on transfers of life insurance, see Q 91, Q 94. However, gift tax paid by a decedent's spouse on a gift split between the spouses within three years of decedent's death was included in a decedent's estate where the spouse did not have sufficient assets to pay the spouse's share of the gift tax and the decedent transferred assets to the spouse to pay the taxes.[3]

A transfer from a revocable trust is treated as if made directly by the grantor.[4] Such a transfer will generally be subject to inclusion in the gross estate under the three-year rule only with respect to gift tax paid within three years of death and for the limited purpose under IRC Section 303, discussed below.

The three-year rule of IRC Section 2035 applies for purposes of determining the estate's qualification for (1) IRC Section 303 stock redemptions (see Q 288), (2) current use valuation for qualified real property, and (3) determining property subject to estate tax liens.[5] With respect to the IRC Section 6166 extension of time to pay estate tax, the requirement that the decedent's interest in a closely held business must exceed 35 percent of the adjusted gross estate is met by an estate only if the estate meets the requirement both with and without the application of the three-year rule under IRC Section 2035.[6] However, any gifts (other than a transfer with respect to a life insurance policy, see Q 91, Q 94) not required to be reported on a gift tax return filed by the decedent for the year the gift is made are not includable in the gross estate for purposes of this rule. Gifts up to the limit of the gift tax annual exclusion and qualified transfers, but not split gifts, do not require the filing of a return. Another exception to the second exception is a gift which qualifies for the gift tax marital deduction.[7]

699. What estate tax exclusion is available for a qualified conservation easement?

An estate tax exclusion is provided for qualified conservation easements.[8] An irrevocable election must be made by the executor if the exclusion is to apply. The exclusion is available for the lesser of (1) the applicable percentage of the value of land subject to the qualified conservation easement, reduced by the amount of any charitable deduction for the easement under IRC Section 2055(f), or (2) the exclusion limitation.[9] The applicable percentage is equal to 40 percent reduced (but not below zero) by two percentage points for every percentage point (or fraction thereof) by which the value of the conservation easement is less than 30 percent of the value of

1. IRC Sec. 2001(e); Rev. Rul. 82-198, 1982-2 CB 206.
2. IRC Sec. 2035(b); Rev. Rul. 82-198, above.
3. TAM 9729005.
4. IRC Sec. 2035(e).
5. IRC Sec. 2035(c)(1).
6. IRC Sec. 2035(c)(2).
7. IRC Sec. 2035(c)(3).
8. IRC Sec. 2031(c).
9. IRC Secs. 2031(c)(1), 2031(c)(6).

the land (determined without regard to the easement and reduced by any development right).[1] After 2001, the exclusion limitation is $500,000.[2] See Appendix D for limitations in other years.

The land subject to the conservation easement must be located in the United States or its possessions (for decedents dying in 2001 and thereafter).[3] For decedents dying before 2000, the land subject to the conservation easement must generally, on the date of the decedent's death, be located within one of the following: (1) 25 miles of a metropolitan area; (2) 25 miles of part of the National Wilderness Preservation System; or (3) 10 miles of an Urban National Forest.

The land subject to the conservation easement must be owned by decedent or members of decedent's family at all times during the three year period ending at decedent's death.[4]

The exclusion is not available to the extent that the land is subject to acquisition indebtedness or retained development rights (excludes certain farming uses).[5] Nor is the exclusion available if the easement is granted after the death of the decedent and anyone receives an income tax deduction with regard to granting of the easement.[6]

A conservation easement is not available if it is not exclusively for conservation purposes.[7]

700. What deductions are allowed from the gross estate in arriving at the taxable estate for federal estate tax purposes?

The following deductions are allowed from the gross estate in arriving at the taxable estate (see Q 675):

(1) (a) funeral expenses, (b) administration expenses, (c) claims against the estate, and (d) unpaid mortgages on or other indebtedness against property included at its full value in the gross estate (see Q 701);

(2) casualty and theft losses incurred during settlement of the estate and not compensated for by insurance or otherwise (see Q 702);

(3) the charitable bequests deduction (see Q 703);

(4) the marital deduction (see Q 704 through Q 708);

(5) the (pre-2005) qualified family-owned business interest deduction (see Q 709); and

(6) state death taxes (see Q 710).[8]

1. IRC Sec. 2031(c)(2).
2. IRC Sec. 2031(c)(3).
3. IRC Sec. 2031(c)(8)(A)(i), as amended by EGTRRA 2001.
4. IRC Sec. 2031(c)(8)(A)(ii).
5. IRC Secs. 2031(c)(4), 2031(c)(5).
6. IRC Sec. 2031(c)(9).
7. *Herman v. Commissioner*, T.C. Memo 2009-205.
8. IRC Secs. 2053-2058, as amended by EGTRRA 2001.

701. What deductions for expenses, indebtedness and taxes are allowed from the gross estate in arriving at the taxable estate for federal estate tax purposes?

Most of the claims, expenses, and charges payable by the estate under local law are allowable deductions from the gross estate. These include the following: (1) funeral expenses; (2) administration expenses; (3) certain taxes; and (4) indebtedness and claims against the estate.

Funeral expenses are generally allowable, although the regulations limit expenditures for a tombstone, monument, mausoleum, or burial lot to a reasonable amount.

Administration expenses include primarily fees or commissions of executors, accountants, and attorneys, and miscellaneous costs incurred in connection with the preservation and settlement of the estate, including determination and contest of death taxes. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions.[1] Expenses for selling property of the estate are deductible if the sale is necessary in order to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution.

Planning Point: The estate should document contemporaneously with the sale why the estate needed to sell the property in order to avoid a future challenge.

The phrase "expenses for selling property" includes brokerage fees and other expenses attending the sale, such as the fees of an auctioneer if it is reasonably necessary to employ one.[2]

A large estate may include a large block of stock in a single corporation that the executor determines must be sold to meet estate settlement costs and death taxes. Often, it is found that the best method of sale in these circumstances is to register the securities with the SEC for public sale by means of a secondary offering through an underwriter. The agreement between the executor and the underwriter may be one of two types:

> "Under a 'firm commitment' agreement the underwriter agrees to purchase a specific amount of stock for a fixed price at a certain time. In contrast, under a 'best efforts' agreement the underwriter sells the stock for the stockholder as an agent and only agrees to use its best efforts in obtaining sales."[3]

Under a firm commitment agreement, the executor undertakes to pay all registration and incidental selling expenses plus an "underwriting discount" paid to the underwriter. The underwriting discount amounts to the difference between the amount realized on sale of the shares to the public and the amount paid by the underwriter for the shares. The IRS has taken the position that "underwriting fees" (by which the Service clearly means to include the "underwriting discount") are not considered in determining the blockage discount to be accorded in valuing the stock for federal estate tax purposes (see Q 762), but instead are deductible under

1. Treas. Reg. §20.2053-3(a); *Est. of Posen v. Comm.*, 75 TC 355 (1980).
2. Treas. Reg. §20.2053-3(d)(2).
3. *Est. of Jenner v. Comm.*, 577 F.2d 1100, footnote 3 (7th Cir. 1978).

IRC Section 2053 as administration expenses (assuming the sale was necessary to administer the estate).[1] The Tax Court held that expenses of a secondary offering should not be allowed to reduce the value of the stock and at the same time be allowed as IRC Section 2053 expenses.[2] As for the underwriting discount, the Tax Court disallowed it as an IRC Section 2053 expense, viewing the transaction between the underwriter and the estate as simply a sale of stock from the estate to the underwriter.[3] The U.S. Court of Appeals for the Ninth Circuit has allowed the underwriting discount as an IRC Section 2053 expense when it has been allowed as an administration expense by the probate court and without regard to whether it has been considered in valuing the stock.[4] The Seventh Circuit appears generally in accord with the Ninth Circuit.[5] For a discussion of these cases and others, see *Rifkind v. U.S.*[6]

IRC Section 642(g) says that amounts allowable under IRC Section 2053 or 2054 as a deduction in computing the taxable estate shall not be allowed as a deduction (or as an offset against the sales price of property in determining gain or loss) in computing the taxable income of the estate unless the executor files a statement that the amounts have not been allowed as deductions under IRC Section 2053 or 2054 and waives the right to claim such deductions in the future. It has been held that where an estate necessarily incurred expenses in selling securities for the purpose of obtaining funds with which to pay estate settlement costs and taxes and used such expenses as offsets against the selling price of the securities in computing estate income taxes, and where the IRS did not require the above-described statement and waiver, the estate was free to claim the selling expenses as an estate tax deduction under IRC Section 2053.[7]

IRC Section 265(1) says that no deduction will be allowed for federal income tax purposes for expenses for production of income (see Q 7949) allocable to tax-exempt income. Assume, for example, that during a taxable year an estate receives $200,000 of income, $25,000 of which is tax-exempt because it is interest on municipal bonds. Assume, also, that in the same period the estate disbursed $50,000 for attorneys' fees and $30,000 for miscellaneous administration expenses, neither amount attributable to either the taxable or the tax-exempt income. By virtue of the above-described limitation of IRC Section 265, the executor is allowed to deduct on the estate's federal income tax return no more than $70,000 of the $80,000 in fees and expenses, the portion allocable to includable income. The following formula illustrates this calculation.

$$\frac{\$200{,}000 - 25{,}000}{\$200{,}000} \times 80{,}000 = \$70{,}000$$

Assume that as a condition of allowance of the income tax deduction, the IRS required of the executor the statement and waiver described in the preceding paragraph. The waiver would not preclude the executor from claiming a deduction on the estate tax return under

1. Rev. Rul. 83-30, 1983-1 CB 722.
2. *Est. of Joslyn v. Comm.*, 57 TC 722 (1972), rev'd 500 F.2d 382 (9th Cir. 1974).
3. *Est. of Joslyn*, above, 63 TC 478 (1975), on remand from the Ninth Circuit.
4. *Est. of Joslyn*, above, 566 F.2d 677 (9th Cir. 1977), rev'g 63 TC 478 (1975).
5. *Est. of Jenner v. Comm.*, 577 F.2d 1100 (7th Cir. 1978), rev'g TC Memo 1977-54.
6. 5 Cl Ct 362, 84-2 USTC ¶13577 (Cl. Ct. 1984).
7. *Smith v. U.S.*, 26 AFTR 2d ¶147,513 (E.D. Mo. 1970).

IRC Section 2053, for the $10,000 balance of fees and expenses he was not allowed to deduct on the income tax return.[1]

As a general rule, claims against the estate which are founded on a promise or agreement are not deductible unless they were contracted for an adequate consideration in money or money's worth. An exception is made for enforceable pledges to qualified charitable organizations. Such pledges are deductible even though not contracted for an adequate consideration in money or money's worth. A release of dower or other marital rights generally is not deemed an adequate consideration; but a claim for alimony is fully deductible if founded on a divorce decree.

Final amendments to the regulations under Section 2053 are effective for the estates of decedents dying after October 19, 2009. The basic focus of the regulations is the extent to which post-death events may be considered in determining the deductible amount of the claim or expense. The significance of these new regulations is that generally the right to take a deduction (and the value of the deduction) is determined at the moment of death but the new regulations mandate consideration of postmortem facts (i.e., resolution of the claim) for deduction purposes.[2]

Planning Point: An estate must analyze the judicial decisions in its district in order to determine if a conflict exists between the new 2053 Regulations and the earlier decisions interpreting the deductibility of "claims against the estate" under Section 2053.

A payment in settlement of a will contest is generally not deductible from the gross estate. A claim to share in the estate is to be distinguished from a claim against the estate.[3]

Unpaid mortgages are deductible provided the property subject to the mortgage is included at its full value in the gross estate.

Property taxes accrued prior to the decedent's death, and taxes on income received during the decedent's life, are deductible. The property taxes, however, must be enforceable obligations (a lien upon the property) at the time of death. Ordinarily, state and foreign death taxes are not deductible, but may be taken as a credit against the tax (see Q 711). As an exception, however, the executor may elect to deduct any state or foreign taxes paid on bequests which qualify as charitable deductions under the federal estate tax law. If deducted, they cannot, of course, be taken as a credit against the tax. An estate tax deduction is not allowed for death taxes paid to a city even though a credit is not allowed for such taxes (see Q 711).[4]

In community property states, the extent to which administration expenses and claims are deductible depends upon their treatment under state law. If they are expenses or debts of the entire community, only one-half is deductible.

A deduction is allowed for expenses and debts attributable to non-probate property includable in the gross estate. They are deductible even though they exceed the property in the gross estate which under local law is subject to the claims against the estate. However, to the extent

1. Rev. Rul. 59-32, 1959-1 CB 245; Rev. Rul. 63-27, 1963-1 CB 57, clarifying Rev. Rul. 59-32.
2. T.D. 9468; Notice 2009-84; Treasury – IRS 2009-10 Priority Guidance Plan; CCA 200848045.
3. *Est. of Moore v. Comm.*, TC Memo 1987-587.
4. TAM 9422002.

that they exceed such property they are not deductible unless actually paid before the due date for filing the estate tax return.

702. What deductions for casualty and theft losses may be taken from the gross estate?

Under IRC Section 2054, losses incurred during the period of administration from fire, storm, or other casualty, or from theft, are deductible to the extent not compensated by insurance or otherwise. Therefore, post-death events, such as destruction to estate assets from a storm, generate an estate tax deduction that can offset the date-of-death value of the property destroyed or damaged.

703. What deductions for charitable bequests are allowed from the gross estate in arriving at the taxable estate for federal estate tax purposes?

An estate tax deduction is allowed for the full amount of bequests to charity (but not in excess of the value of the transferred property required to be included in the gross estate). The deduction is not subject to percentage limitations such as are applicable to the charitable deduction under the income tax.

Specifically, IRC Section 2055 provides a deduction for bequests:

(1) to or for the use of the United States, any state, territory, any political subdivision thereof, or the District of Columbia, for exclusively public purposes;

(2) to or for the use of corporations organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster amateur sports competition, and the prevention of cruelty to children or animals (and which meet certain other conditions);

(3) to trustees, or fraternal societies, orders or associations operating under the lodge system, but only if the bequests are to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals (and if certain other conditions are met); and

(4) to or for the use of any veterans' organization incorporated by Act of Congress or to any of its components, so long as no part of the net earnings inures to the benefit of any private shareholder or individual.[1]

If any death taxes are, either by the terms of the will, by the law of the jurisdiction under which the estate is administered, or by the law of the jurisdiction imposing the particular tax, payable in whole or in part out of the bequests otherwise deductible as charitable contributions, then the amount deductible is the amount of such bequests reduced by the amount of such taxes.[2] Prior to the issuance of regulations discussed below, in a similar situation, it was

1. IRC Sec. 2055(a).
2. IRC Sec. 2055(c).

held that the marital deduction (see Q 704) was reduced where administration expenses were paid from the marital share principal, but not where administration expenses were paid from income from the marital share.[1]

Regulations, effective for estates of decedents dying after December 3, 1999, now provide rules for reducing the charitable share by administration expenses depending on the type of expense: transmission expenses or management expenses.[2]

Transmission expenses are defined as expenses that would not have been incurred but for the decedent's death. Transmission expenses are also defined as any administration expense that is not a management expense. Transmission expenses paid from the charitable share reduce the charitable share.

Management expenses are defined as expenses related to investment, preservation, and maintenance of the assets during a reasonable period of estate administration. Management expenses attributable to the charitable share do not reduce the charitable share except to the extent that the expense is deducted under IRC Section 2053 as an administration expense. Management expenses which are paid by the charitable share, but which are not attributable to the charitable share, reduce the charitable share.

In *U.S. Trust Co. (Chisholm Est.) v. U.S.*,[3] the executors satisfied a charitable bequest by making the distribution out of estate income. The estate claimed and was allowed an estate tax deduction under IRC Section 2055 for the bequest. The estate could not claim an income tax charitable contributions deduction because the will did not specify that the bequest be paid out of estate income.[4] The estate claimed, but was not allowed, an income tax distribution deduction under IRC Section 661(a)(2) for the same distribution.

Property which is transferred to the charity by the exercise or nonexercise of a general power of appointment is considered transferred by the donee of the power rather than by the donor of the power. Or, to paraphrase, property includable in the decedent's gross estate under IRC Section 2041 (see Q 679) received by a charity is considered a bequest of such decedent.[5]

Distributions of trust income to charity pursuant to a beneficiary's power of appointment will qualify for a charitable contribution deduction.

An estate tax charitable deduction was denied for the transfer of a residuary interest in the estate to charity where the amount of the charitable deduction was not ascertainable at the time of death because of discretionary powers given to personal representatives to distribute the estate to other potential beneficiaries.[6] Also, in Technical Advice Memorandum (TAM) 9327006, an estate tax charitable deduction was denied where a trustee was given discretion to select donees

1. *Comm. v. Est. of Hubert*, 520 US 93, 117 SCt 1124, 97-1 USTC ¶60,261 (U.S. 1997).
2. Treas. Reg. §20.2055-3.
3. 803 F2d 1363, 86-2 USTC ¶13,698 (5th Cir. 1986), rev'g and remanding 617 F. Supp. 575, 85-2 USTC ¶13,642 (S.D. Miss. 1985).
4. IRC Sec. 642(c).
5. IRC Sec. 2055(b).
6. Let. Rul. 200906008. *Est. of Marine v. Comm.*, 990 F2d 136, 93-1 USTC ¶60,131 (4th Cir. 1993).

from among various charities, and not all of the charities were on the IRS list of charities for which a charitable deduction is permitted.

Where an interest in property (other than a remainder interest in a personal residence or farm or an undivided portion of the decedent's entire interest in property) passes from the decedent to a charity and an interest in the same property passes (for less than adequate and full consideration in money or money's worth) from the decedent to a non-charity, no estate tax charitable contributions deduction is allowed for the interest going to the charity unless–

(a) in the case of a remainder interest, such interest is in a trust which is a *charitable remainder annuity trust* (see Q 7979) or a *charitable remainder unitrust* (see Q 7980) or a *pooled income fund* (see Q 7988), or

(b) in the case of any other interest, such interest is in the form of a guaranteed annuity or is a fixed percentage of the fair market value of the property that is distributed yearly (the fair market value is to be determined yearly).[1]

If the decedent has created a qualified charitable remainder trust in which his surviving spouse is the only noncharitable beneficiary other than certain ESOP remainder beneficiaries (see Q 704), the estate will receive a charitable contributions deduction for the value of the remainder interest. However, if the property in the trust is "qualified terminable interest property" and the surviving spouse's interest is a "qualifying income interest for life" (see Q 707), the charitable contributions deduction may be taken by the surviving spouse's estate upon her death, the decedent's estate having taken a marital deduction (assuming the executor's election) for the entire value of the property.[2]

Where a decedent left shares of stock to a charity but specified in his will that dividends from the stock during administration of the estate be paid to an individual, it was held that the estate tax charitable contributions deduction was not allowable.[3] However, in Letter Ruling 8506089, a decedent left the residue of his estate to a charity on the condition that the charity take on the obligation to pay an annuity equal to 7 percent of the value of the estate assets going to the charity to his brother for his lifetime. The Service ruled that because the annuity was payable out of the general assets of the charity rather than out of the assets in the decedent's estate going to the charity, the bequest was not a split interest gift in the same property; accordingly, a charitable contributions deduction was allowed equal to the amount by which the value of the property transferred by the decedent to the charity exceeded the present value of the annuity payable to the decedent's brother.

In *Oetting v. U.S.*,[4] a trust received assets from the residue of an estate that provided that the assets would be used first to provide life incomes of $100 per month for the lifetimes of three elderly ladies, with the remainder paid to four qualified charities. Since the total assets received by the trust greatly exceeded expectations, the trustees petitioned the probate court

1. IRC Sec. 2055(e)(2).
2. Treas. Reg. §20.2044-1(b).
3. Rev. Rul. 83-45, 1983-1 CB 233.
4. 712 F2d 358, 83-2 USTC ¶13,533 (8th Cir. 1983).

for permission to buy annuities for the income beneficiaries with a fraction of the trust assets and to pay the balance immediately to the charities. The court agreed, so the trustees bought the annuities for $23,000 and paid the balance, $558,000, to the charities. The court allowed the estate a charitable contributions deduction for the amount paid to the charities, reasoning that since the amount going to the charities was certain, it was not a split interest in the same property for purposes of IRC Section 2055.

In general, a trust can be reformed to qualify for the estate tax charitable deduction if the following occur:

(1) the difference in actuarial value of the qualified trust at time of death and its value at time of reformation is no greater than 5 percent of its value at time of reformation;

(2) the term of the trust is the same before and after reformation (however, if the term of years for a trust exceeds 20 years, the term can be shortened to 20 years);

(3) any changes are effective as of date of death;

(4) the charitable deduction would have been allowable at death if not for the split-interest rules (which generally require use of annuity, unitrust, and pooled income interests); and

(5) any payment to a noncharitable beneficiary before the remainder vests in possession must have been an annuity or unitrust interest (the lower of income or the unitrust amount, with make-up provisions, is permitted). This fifth provision does not apply if judicial proceedings are started to qualify the interests for the estate tax charitable deduction no later than 90 days after (a) the due date (including extensions) for filing the estate tax return, or (b) if no estate tax return is required, the due date (including extensions) for filing the income tax return for the first taxable year of the trust for which such a return must be filed.[1]

A reformation done solely to obtain a charitable deduction (in contrast to a reformation done pursuant to a will contest) must meet the requirements of IRC Section 2055(e)(3).[2] The amount of a charitable deduction taken with respect to property transferred to charity pursuant to a will contest cannot exceed the actuarial value of what the charity could have received under a will or through intestate succession.[3]

704. What is the estate tax marital deduction?

The estate tax marital deduction is a deduction allowed from the gross estate for interests in property (including community property) which pass from the decedent to his (or her) surviving spouse and which are included in determining the value of the gross estate; the deduction is limited only by the value of such qualifying interests.[4] In general, a marital deduction is

1. IRC Sec. 2055(e)(3).
2. *Est. of Burdick v. Comm.*, 979 F.2d 1369 (9th Cir. 1992).
3. *Terre Haute First Nat'l Bank v. U.S.*,67 AFTR 2d 91-1217, 91-1 USTC ¶60,070 (S.D. Ind. 1991).
4. IRC Sec. 2056(a).

not available if the surviving spouse is not a United States citizen unless property passes to the surviving spouse in a qualified domestic trust (QDOT) (see Q 708).

The deduction is limited to the *net* value of qualifying property interests passing to the surviving spouse. Thus, the value of such interests must be reduced by federal and state death taxes payable out of those interests, by encumbrances on those interests, and by any obligation imposed by the decedent upon the surviving spouse with respect to the passing of such interests.[1] Prior to the issuance of regulations discussed below, the marital deduction was reduced where administration expenses were paid from the marital share principal, but not where administration expenses were paid from income from the marital share.[2]

Regulations, effective for estates of decedents dying after December 3, 1999, provide rules for reducing the marital share by administration expenses depending on the type of expense: transmission expenses or management expenses.[3]

Transmission expenses are defined as expenses that would not have been incurred but for the decedent's death. Transmission expenses are also defined by exclusion to include any administration expense that is not a management expense. Transmission expenses paid from the marital share reduce the marital share.

Management expenses are defined as expenses related to investment, preservation, and maintenance of the assets during a reasonable period of estate administration. Management expenses attributable to the marital share do not reduce the marital share except to the extent that the expense is deducted under IRC Section 2053 as an administration expense. Management expenses which are paid by the marital share but which are not attributable to the marital share reduce the marital share.

To qualify for the marital deduction, the property interest must be includable in decedent's gross estate, and must "pass from" the decedent to his surviving spouse.[4] (A duty of consistency may require that property be includable in the surviving spouse's estate if a marital deduction was claimed in the first spouse's estate even if the marital deduction was improperly claimed in the first spouse's estate).[5] It may come to the surviving spouse in any of the following ways: (1) by will; (2) under state inheritance laws; (3) by dower or curtesy (or statute in lieu of dower or curtesy); (4) by lifetime gift (made in such way as to cause inclusion in the gross estate–see Q 679); (5) by right of survivorship in jointly owned property; (6) by power of appointment; (7) as proceeds of insurance on decedent's life; or (8) as survivor's interest in an annuity.[6]

705. What is qualified terminable interest property (QTIP)?

"Qualified terminable interest property" (QTIP) means property (1) which passes from the decedent, (2) in which the surviving spouse has a "qualifying income interest for life," and (3) as

1. IRC Sec. 2056(b)(4); *Adee v. U.S.*, 83-2 USTC ¶13,534 (D. Kan. 1983).
2. *Comm. v. Est. of Hubert*, 520 U.S. 93, 97-1 USTC ¶60,261 (U.S. 1997).
3. Treas. Reg. §20-2056(b)-4.
4. IRC Sec. 2056(a).
5. *Est. of Letts v. Comm.*, 109 T.C. 290 (1997); TAM 200407018.
6. IRC Sec. 2056(c).

to which the executor makes an irrevocable election on the federal estate tax return to have the marital deduction apply. The surviving spouse has a "qualifying income interest for life" if (1) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, and (2) no person has a power to appoint any part of the property to any person other than the surviving spouse unless the power is exercisable only at or after the death of the surviving spouse.[1] Apparently, the last requirement is violated even if it is the surviving spouse who is given the lifetime power to appoint to someone other than the surviving spouse.[2] A QTIP allows a decedent to provide for a surviving spouse, receive the marital deduction, and pass the remainder to beneficiaries the decedent selects in his will.

Certain "terminable interests" in property do not qualify for the marital deduction. The purpose of this rule is to ensure inclusion in the surviving spouse's estate of any property remaining in her estate at her death which escaped the initial tax in the predeceased spouse's estate.

A "terminable interest" in property is an interest which will terminate or fail on the lapse of time or on the occurrence or the failure to occur of some contingency. Life estates, terms for years, annuities, patents, and copyrights are therefore terminable interests.[3] Some terminable interests are deductible and some are nondeductible under the marital deduction law. In general, a "terminable interest" is nondeductible if (1) another interest in the same property passes (for less than an adequate consideration) from the decedent to someone other than his spouse or his spouse's estate, and (2) the other person may possess or enjoy any part of the property after the spouse's interest ends.[4]

706. When will a terminable interest in property cause that property to fail to qualify for the estate tax marital deduction?

Generally speaking, a terminable interest is *deductible* if *no* interest in the property passes to someone other than the surviving spouse or her estate which may be possessed or enjoyed after the spouse's interest ends. So if the decedent transfers all his interest in a straight life annuity, for instance, the interest will ordinarily qualify. There are two exceptions to this rule, however: Even though no one else takes an interest in the same property, a terminable interest will not qualify if (1) the decedent has *directed* his executor or trustee to acquire a terminable interest for his surviving spouse; or (2) an interest passing to the surviving spouse may be satisfied out of a group of assets which includes a nondeductible interest.[5]

Where spouses own property as joint tenants with right of survivorship or as tenants by the entirety, upon the death of one spouse, the surviving spouse succeeds to absolute ownership of the entire property. This succession occurs by virtue of the form of ownership, not by virtue of any will provision or intestate succession laws. Such succession qualifies for the marital deduction, but only, of course, to the extent the interest to which the surviving spouse succeeds was includable in the decedent's gross estate. (see Q 679).

1. IRC Sec. 2056(b)(7).
2. TAM 200234017.
3. IRC Sec. 2056(b); Treas. Reg. §20.2056(b)-1(b).
4. IRC Sec. 2056(b)(1).
5. IRC Secs. 2056(b)(1)(C), 2056(b)(2).

A terminable interest passing to decedent's spouse may be a deductible interest even though an interest in the property may be enjoyed by someone else after her interest ends if the interest is as follows: (1) terminable only because of a survivorship clause; (2) the right to income for life with general power of appointment over the property producing the income; (3) consists of life insurance or annuity proceeds held by the insurer under an agreement that gives the spouse a life income interest in the proceeds plus a general power of appointment over the proceeds; (4) a "qualifying income interest for life" in "qualified terminable interest property" (see Q 705).

A survivorship clause will preserve the marital deduction if (1) the only condition under which the surviving spouse's interest will terminate is the death of the surviving spouse within six months after decedent's death, or her death as a result of a common disaster, and (2) the condition does not occur.[1]

The IRS permits a QTIP trust to be reformed to meet the requirements of the estate tax marital deduction.[2] ~~5~~

An income interest does not fail to qualify as a qualifying income interest for life merely because the income accumulated by the trust between the last date of distribution and the surviving spouse's death is not required to be either distributed to such spouse's estate or subject to a general power of appointment exercisable by such spouse.[3] However, any income from the property from the date the QTIP interest is created to the death of the spouse with the QTIP interest which has not been distributed before such spouse's death is included in such spouse's estate under IRC Section 2044 to the extent it is not included in the estate under any other IRC provision.[4]

In TAM 9139001, the marital deduction was denied because (1) a son's right to purchase stock in a QTIP trust at book value was treated as the power to withdraw property from the trust (i.e., as a power to appoint property to someone other than the spouse), and (2) the spouse and the trustee lacked the right to make the closely held stock, in which the son held all voting rights, income productive. Similarly, a marital deduction was denied where the trustee could sell stock in a QTIP trust to a son at book value.[5] While Technical Advice Memorandum 9113009 had provided that a QTIP marital deduction would be denied if the non-QTIP portion of the estate were not funded with an amount equal to the face value of loans guaranteed by the decedent, it was withdrawn by Technical Advice Memorandum 9409018, which provided instead that the marital deduction would not be reduced by the entire unpaid balance of the guaranteed loans unless (1) at the time of death it would appear that a default after the marital deduction were funded would be likely, (2) that marital deduction property would be used to pay the entire unpaid balance of such loans, and (3) that subrogation rights held by the marital portion would appear to be worthless. According to Technical Advice Memorandum 9206001, a QTIP marital

1. IRC Sec. 2056(b)(3).
2. Treas. Reg. §20.2044-1(d)(2).
3. Let. Rul. 200919003. Treas. Reg. §20.2056(b)-7(d)(4).
4. Treas. Reg. §20.2044-1(d)(2).
5. *Est. of Rinaldi v. U.S.*, 97-2 USTC ¶60,281 (Ct. Cl. 1997).

deduction was not available where the spouse was given an income interest in only certain types of property held in a trust and the trustee could change the mix of assets in the trust.

The IRS has conceded the validity of the contingent QTIP marital deduction (i.e., where the surviving spouse's qualifying income interest is contingent upon the QTIP election being made), if the QTIP election is made.[1]

The term "property" includes an interest in property, and a specific portion of property is treated as separate property.[2] However, a specific portion must be determined on a fractional or percentage basis.[3] The term "property" also contemplates income-producing property; the deduction will thus be disallowed as to nonincome-producing property if under local law the spouse has no power to convert the property to income-producing property or to compel such conversion.[4]

A survivor annuity in which only the surviving spouse has a right to receive payments during such spouse's life is treated as a qualifying income interest for life unless otherwise elected on the decedent spouse's estate tax return.[5]

707. When will property held in trust qualify for the marital deduction?

There are five kinds of trusts that will qualify for the marital deduction: (1) the "qualified terminable interest property trust," (2) the "life estate with power of appointment trust," (3) the "estate trust," (4) the "special rule charitable remainder trust," and (5) the "qualified domestic trust." The first two and the fourth are specific exceptions to the nondeductible terminable interest rule; the third does not come under the rule; the fifth is the only form permitted if the surviving spouse is not a United States citizen (see Q 708).

If qualified terminable interest property, as defined in Q 705, passes to the surviving spouse in trust, the trust is called a qualified terminable interest property trust (or QTIP trust). The surviving spouse must have a qualifying interest for life in the trust property; neither the trustee nor anyone else may have the power to appoint any part of the trust property to anyone other than the surviving spouse during her lifetime; and the decedent's executor must make the election to have the trust qualify for the marital deduction.

An *estate trust* is a trust in which the property interest transferred from the decedent passes only to the surviving spouse (and the estate of the surviving spouse) and to no other person.

A *life estate with power of appointment trust* is a trust in which the property interest transferred from the decedent passes not only to the surviving spouse but to someone else (for less than an adequate consideration) who may possess or enjoy any part of the property after the spouse's interest ends. If such a trust is to avoid failing to qualify for the marital deduction by reason of being a nondeductible terminable interest, it must meet the requirements of IRC Section 2056(b)

1. Treas. Regs. §§20-2056(b)-7(d)(3), 20-2056(b)-7(h)(Ex. 6).
2. IRC Sec. 2056(b)(7).
3. IRC Sec. 2056(b)(10).
4. Let. Ruls. 8304040, 8339018, 8745003.
5. IRC Sec. 2056(b)(7)(C).

(5). In general, the surviving spouse must be given an income interest for life and the power to appoint the property to the surviving spouse or the surviving spouse's estate.

If the surviving spouse is the only noncharitable beneficiary (other than certain ESOP remainder beneficiaries) of a "qualified charitable remainder trust" created by the decedent, the spouse's interest is not considered a nondeductible terminable interest and the value of such interest will qualify for the marital deduction. A "qualified charitable remainder trust" means a charitable remainder annuity trust (see Q 7979) or a charitable remainder unitrust (see Q 7980).[1]

708. How is the availability of the estate tax marital deduction affected when the surviving spouse is not a United States citizen? What is a QDOT?

Generally, there are five kinds of trusts that will qualify for the marital deduction: (1) the "qualified terminable interest property trust," (2) the "life estate with power of appointment trust," (3) the "estate trust," (4) the "special rule charitable remainder trust," and (5) the "qualified domestic trust." The first two and the fourth are specific exceptions to the nondeductible terminable interest rule; the third does not come under the rule; the fifth is the only form permitted if the surviving spouse is not a United States citizen. See Q 707.

A marital deduction is usually not available for a transfer to a surviving spouse who is not a United States citizen unless the transfer is to a *qualified domestic trust (QDOT)* for which the executor has made an election.[2] A QDOT must qualify for the marital deduction under (1), (2), (3), or (4) (above), as well as meet the following requirements.

At least one trustee of the QDOT must be a United States citizen or a domestic corporation and no distribution (other than a distribution of income) may be made from the trust unless that trustee has the right to withhold any additional gift or estate tax imposed on the trust. Additional gift tax is due on any distribution while the surviving spouse is still alive (other than a distribution to the surviving spouse of income or on account of hardship). Additional estate tax is due on any property remaining in the QDOT at the death of the surviving spouse (or at the time the trust ceases to qualify as a QDOT, if earlier). The additional gift or estate tax is calculated as if any property subject to the tax had been included in the taxable estate of the first spouse to die.[3]

Regulations add additional requirements in order to ensure the collection of the deferred estate tax. If the fair market value (as finally determined for estate tax purposes, see Q 760, but determined without regard to any indebtedness with respect to the assets) of the assets passing to the QDOT exceeds $2,000,000, then the QDOT must provide that either (1) at least one U.S. trustee is a bank,[4] (2) at least one trustee is a U.S. branch of a foreign bank and another trustee is a U.S. trustee, or (3) the U.S. trustee furnish a bond or security or a line of credit equal to 65 percent of the fair market value of the QDOT corpus. The line of credit must be issued

1. IRC Sec. 2056(b)(8).
2. IRC Sec. 2056(d).
3. IRC Sec. 2056A.
4. As defined in IRC Section 581.

by (1) a U.S. bank, (2) a U.S. branch of a foreign bank, or (3) a foreign bank and confirmed by a U.S. bank.[1]

A QDOT with assets of less than $2,000,000 must either (a) meet one of the requirements for a trust exceeding $2,000,000, or (b) provide that (1) no more than 35 percent of the fair market value (determined annually on last day of trust's taxable year) of assets consists of real property located outside the U.S., and (2) all other QDOT assets be physically located within the U.S. at all times during the trust term. All QDOTs for the benefit of a surviving spouse are aggregated for purposes of the $2,000,000 threshold. A QDOT owning more than 20 percent of the voting stock or value in a corporation with 15 or fewer shareholders (or 20 percent of the capital interest in a partnership with 15 or fewer partners) is deemed to own a pro rata share of the assets of the corporation (or the pro rata share of the greater of the QDOT's interest in the capital or profits of the partnership) for purposes of the 35 percent foreign real property limitation. All interests in the corporation (or partnership) held by or for the benefit of the surviving spouse or the surviving spouse's family (includes brothers, sisters, ancestors, and lineal descendants) are treated as one person for purpose of determining the number of shareholders (or partners) and whether a 20 percent or more interest exists. However, the attribution rules do not apply in determining the QDOT's pro rata share of the corporation's (or partnership's) assets. Interests in other entities (such as another trust) are treated similarly to corporations (and partnerships).[2]

For purposes of the $2,000,000 QDOT threshold and the amount of a bond or letter of credit required, up to $600,000 in value attributable to the surviving spouse's personal residence and related furnishings held by the QDOT may be excluded. However, the personal residence exclusion does not apply for purposes of determining whether 35 percent of the fair market value of assets consists of real property located outside the U.S. A personal residence is either the principal residence of the surviving spouse or one other residence of the surviving spouse. A personal residence must be available for use by the surviving spouse at all times and may not be rented to another party. Related furnishings include furniture and commonly used items within the value associated with normal household use; rare artwork, valuable antiques, and automobiles are not included.

If a residence ceases to be used as the surviving spouse's personal residence or a residence is sold, the personal residence exclusion ceases to apply with regard to that residence. However, if part or all of the amount of the adjusted sales price of the residence is reinvested in a new personal residence within 12 months of the date of sale, the exclusion continues to the extent the adjusted sales price is reinvested in the new residence. Also, if a residence ceases to be used as the surviving spouse's personal residence or a residence is sold, the exclusion can be allocated to another personal residence of the surviving spouse that is held by a QDOT of the surviving spouse. In this instance, the exclusion can be up to $600,000 (less the amount previously allocated to a personal residence that continues to qualify for the exclusion).[3]

1. Treas. Reg. §20.2056A-2(d)(1)(i)(C).
2. Treas. Reg. §20.2056A-2(d)(1)(ii).
3. Treas. Reg. §20.2056A-2(d)(1)(iv).

709. What is the estate tax deduction for qualified family-owned business interests?

For decedents dying before 2005, an estate tax deduction was available for up to $675,000 of qualified family-owned business interests.[1] If the deduction was taken, the unified credit equivalent (see Q 711) was changed to equal the lesser of (1) the regular unified credit equivalent, or (2) $1,300,000 minus the amount of the qualified family-owned business deduction. EGTRRA repealed the deduction for qualified family-owned business interests for tax years beginning between 2005 and 2012. Though the EGTRRA provisions were scheduled to sunset (expire) after 2012, ATRA made its changes permanent for tax years beginning after 2012 by repealing the sunset provisions contained in EGTRRA.[23]

Despite the unavailability of this deduction, the unified credit was increased substantially for tax years beginning after 2004 (see Appendix D). ATRA also made the increased exemption level ($5.25 million in 2013 and $5.34 million in 2014) permanent for tax years beginning after 2012.[4]

Pre-2005 Family-Owned Business Deduction

In order to qualify for the family-owned business deduction, at least 50 percent of the value of the adjusted gross estate must consist of the sum of (1) family-owned business interests included in the estate; and (2) certain gifts of family-owned business interests.[5] Gifts of family-owned business interests include family-owned business interests that decedent gave to members of decedent's family if the members of decedent's family retained such interests until decedent's death.[6] The family-owned business interest is not reduced by an IRC Section 303 redemption for purposes of making the initial determination of qualifying for the family-owned business deduction.[7]

For this purpose, the adjusted gross estate means the gross estate reduced by the estate tax deductions for claims against the estate and debts under IRC Sections 2053(a)(3) and 2053(a)(4), and increased by certain gifts. These gifts include (to the extent not otherwise includable in the estate): (1) family-owned business interests that decedent gave to members of decedent's family if the members of decedent's family retained such interests until decedent's death; (2) gifts to spouse within 10 years of decedent's death (excluding those under (1)); and (3) gifts within three years of death (excluding annual exclusion gifts to family members and those under (1) or (2)).[8]

Family-owned means that either (1) 50 percent of the business must be owned by decedent and members of decedent's family; or (2) 30 percent of the business must be owned by decedent and members of decedent's family and (a) 70 percent of the business is owned by two families, or (b) 90 percent of the business is owned by three families.[9]

1. IRC Sec. 2057.
2. American Taxpayer Relief Act of 2012, Pub. Law No. 112-240, Sec. 101.
3. IRC Secs. 2057(j), 2210, as added by EGTRRA 2001
4. See Rev. Proc. 2013-15, 2013-5 IRB 444, Rev. Proc. 2013-35, 2013-47 IRB 537.
5. IRC Sec. 2057(b)(1)(C).
6. IRC Sec. 2057(b)(3).
7. Rev. Rul. 2003-61, 2003-24 IRB 1015.
8. IRC Sec. 2057(c).
9. IRC Sec. 2057(e)(1).

Family-owned business interests include only equity interests.[1] Also, family-owned business interests do not include (1) a business whose principal place of business is not in the United States; (2) any entity whose stock or debt is readily traded on an established securities or secondary market; (3) an entity, other than a bank or building and loan association, if more than 35 percent of the adjusted gross income of the entity for the year which includes the date of decedent's death is personal holding company income; and (4) the portion of the business which consists of (a) cash or marketable securities in excess of reasonably expected day-to-day working capital needs, and (b) assets held for the production of personal holding company income or foreign personal holding company income.[2]

Personal holding company income generally includes dividends, interest, royalties, annuities, rents, personal property use by a shareholder, and personal service contracts.[3] However, personal holding company income does not include income from a net cash lease of property to another family member who uses the property in a way which would not cause income from the property to be treated as personal holding company income if the lessor had engaged directly in the activity of the lessee.[4]

Similar to the requirements for special use valuation, (1) for at least five of the eight years ending on decedent's death, the business interests must have been owned by decedent or members of decedent's family, and decedent or members of decedent's family must have materially participated in the business,[5] and (2) for 10 years after decedent's death (or until the earlier death of the qualified heir), such business interests must be owned by qualified heirs, and qualified heirs must materially participate in the business.[6] Qualified heirs include members of decedent's family, as well as any employee who has been an active employee of the business for at least 10 years before the decedent's death.[7]

Additional tax, plus interest thereon, is due if the ownership or material participation requirements are not met after decedent's death.[8] The additional tax is equal to the following percentage of the tax savings attributable to use of the family-owned business deduction, depending on when the failure to meet the requirements occurs.

Year	Recapture Percentage
1-6	100
7	80
8	60
9	40
10	20

1. *Est. of Farnam v. Comm.*,583 F 3d 581, 2009-2 USTC ¶60,582 (8th Cir. 2009), aff'g 130 TC 34 (2008).
2. IRC Sec. 2057(e)(2).
3. IRC Sec. 543(a).
4. IRC Sec. 2057(e)(2).
5. IRC Sec. 2057(b)(1)(D).
6. IRC Sec. 2057(f)(1).
7. IRC Sec. 2057(j)(1).
8. IRC Sec. 2057(f).

For this purpose, an IRC Section 303 redemption is not treated as a disposition of the family-owned business interest.[1]

710. What estate tax deduction is allowed for death taxes paid at the state level?

A deduction is available for federal estate tax purposes for estate, inheritance, legacy, or succession taxes (i.e., death taxes) paid to any state or the District of Columbia with respect to the estate of the decedent.[2] The deduction is available for tax years beginning in 2005 and thereafter. A credit for state death taxes (see Q 711) was available before 2005.

The deduction is available only for state death taxes actually paid and claimed as a deduction before the later of (1) 4 years after the filing of the federal estate tax return; (2) 60 days after a decision of the Tax Court with respect to a timely filed petition for redetermination of a deficiency; or (3) with respect to a timely filed claim for refund or credit of the federal estate tax, the later of (a) 60 days of the mailing of a notice of disallowance by the IRS, (b) 60 days after the decision of any court of competent jurisdiction on such claim, or (c) 2 years after the taxpayer files a notice of waiver of disallowance.

711. What credits are allowed against the federal estate tax?

After the tax is computed (see Q 675), some of the following credits, as may be applicable, may be taken against the tax to determine the tax actually payable:

(1) Unified credit (Q 712);[3]

(2) Credit for state death taxes (Q 713);[4]

(3) Credit for gift tax (Q 714);[5]

(4) Credit for estate tax on prior transfers (Q 715);[6] and

(5) Foreign death tax credit (Q 716).[7]

712. What is the Section 2010 "unified credit" that is allowed against the federal estate tax?

The unified credit is a dollar amount allocated to each taxpayer that can be applied against the gift tax and the estate tax. The estate tax unified credit was equal to $1,455,800 in 2009, which translates into a tentative tax base (or unified credit exemption equivalent or applicable exclusion amount) of $3,500,000 in 2009.[8] In 2010 and 2011, the estate tax credit was $1,730,800

1. Rev. Rul. 2003-61, 2003-24 IRB 1015.
2. IRC Sec. 2058, as added by EGTRRA 2001.
3. IRC Sec. 2010.
4. IRC Sec. 2011.
5. IRC Sec. 2012.
6. IRC Sec. 2013.
7. IRC Sec. 2014.
8. IRC Sec. 2010, as amended by EGTRRA 2001.

($5 million) and in 2012 the tax credit is $1,772,800 ($5.12 million). In 2013, the estate tax credit is $2,045,800 ($5.25 million) and in 2014, the estate tax credit is $2,081,800 ($5.34 million).[1] See Appendix D for amounts in other years (and gift tax amounts). Under EGTRRA 2001, no estate tax is imposed on an estate if the decedent died in 2010, but the beneficiaries are subject to a modified carryover basis. Therefore, 2010 TRA permits estates to elect to be subject to the modified carryover basis rules and no estate tax or subject to an estate tax, with a step-up in basis, and a $5 million applicable exclusion amount.

The credit is reduced directly by 20 percent of the amount of lifetime gift tax exemption the decedent elected to use on any gifts made after September 8, 1976 (this $30,000 exemption was repealed by the Tax Reform Act of 1976 as to gifts made after 1976). The 20 percent reduction is made even though the value of the property to which the exemption applied is brought back into the estate for estate tax purposes. The reduction is not a deprivation of property under the due process clause of the U. S. Constitution.[2]

The credit is also reduced (but indirectly) by the amount of unified credit applied against any gift tax imposed on the decedent's post-1976 gifts. The indirect reduction is accomplished by adding to the taxable estate the amount of all taxable gifts made by the decedent after 1976, other than gifts includable in the gross estate, and then applying the estate tax rates to the sum (see Q 675).

713. What is the Section 2011 credit for state death taxes that can be taken against the federal estate tax?

For decedents dying before 2005, a credit is allowed against the federal estate tax for state death taxes–inheritance, legacy, estate and succession taxes–paid to any state of the United States or the District of Columbia with respect to property included in the gross estate (but see phase-out of credit, below).[3] The federal estate tax credit for state death taxes paid was not available where the property subject to state death taxes was not includable in the federal gross estate.[4] The credit is limited to the amount of state death taxes actually paid and does not include, for instance, the amount of any discount allowed by the state for prompt payment.

The credit is limited to specified percentages of the "adjusted taxable estate" in excess of $40,000 (see Appendix D). The "adjusted taxable estate" is the taxable estate reduced by $60,000. The maximum amount for which a credit can be taken was reduced by 25 percent in 2002, 50 percent in 2003, and 75 percent in 2004.[5] The credit was replaced by a deduction for state death taxes (see Q 700) in 2005.[6]

All states collect at least the maximum credit. Some states have enacted estate taxes exactly equal to the maximum credit. Some states refer to the maximum credit as it existed prior to the

1. Rev. Proc. 2013-15, 2013-5 IRB 444, Rev. Proc. 2013-35, 2013-47 IRB 537.
2. *U.S. v. Hemme*, 476 US 558, 86-1 USTC ¶13,671 (U.S. 1986); *Est. of Allgood v. Comm.*, TC Memo 1986-455.
3. IRC Sec. 2011.
4. *Est. of Owen v. Comm.*, 104 TC 498 (1995).
5. IRC Sec. 2011(b)(2), as added by EGTRRA 2001. See IRC Sec. 2011(b), Appendix D.
6. IRC Sec. 2011(g), as added by EGTRRA 2001.

phaseout by EGTRRA 2001. States that impose an inheritance tax also have an "additional estate tax" which is designed to absorb the difference between the inheritance tax and the maximum credit should the inheritance tax be less than the maximum credit. In most cases, however, the basic inheritance tax will exceed the maximum amount allowable as a credit.

714. What is the Section 2012 credit for gift tax that can be taken against the federal estate tax?

A credit is allowed for federal gift tax paid on property transferred by the decedent during life but included in the gross estate, *but only as to gifts made on or before December 31, 1976*.[1] The credit cannot exceed an amount which bears the same ratio to the estate tax imposed (after deducting the unified credit and the credit for state death taxes) as the value of the gift(s) (at time of gift or at time of death, whichever is lower) bears to the value of the gross estate minus charitable and marital deductions allowed.[2] In the case of (pre-1977) "split gifts" made by the decedent and his consenting spouse (see Q 753), the gift taxes paid with respect to both halves of the gift are eligible for the credit.[3]

The gift tax credit cannot be taken with respect to gifts made after December 31, 1976. However, in the computation of the estate tax, an adjustment is made for federal gift tax paid on post-1976 gifts not included in the donor-decedent's gross estate (see Q 675).

715. What is the Section 2013 credit for estate tax on prior transfers that can be taken against the federal estate tax?

Under IRC Section 2013, the federal estate tax otherwise payable by a decedent's estate is credited with all or a part of the amount of federal estate tax paid with respect to the transfer of property to the decedent (the transferee) by a person (the transferor) who died within 10 years before, or within two years after, the decedent's death. The credit is designed, of course, to alleviate the impact of repeated estate taxation where successive deaths of the transferor and transferee occur within a relatively short time of each other.

The full amount of the credit is available if the transferor died within two years of the death of the decedent (either before or after). If the transferor predeceased the decedent by more than two years, the credit allowed is the following percentage of the full credit:

(1) 80 percent, if transferor died within the 3rd or 4th years preceding decedent's death;

(2) 60 percent, if transferor died within the 5th or 6th years preceding decedent's death;

(3) 40 percent, if transferor died within the 7th or 8th years preceding decedent's death; and

1. IRC Sec. 2012(e).
2. IRC Sec. 2012(a).
3. IRC Sec. 2012(c).

(4) 20 percent, if transferor died within the 9th or 10th years preceding decedent's death;

No credit is allowable if the transferee predeceased the transferor by more than 2 years.[1]

The credit (before percentage reductions, if applicable) is the portion of the *transferor's* federal estate tax attributable to the value of the property transferred, *but limited to* the portion of the *transferee's* federal estate tax attributable to the value of the property transferred.[2]

When there are two or more transferor estates, the credit is computed separately for each transferor estate. But the *limitation* is computed concurrently, i.e., by aggregating the value of the property received from the transferor estates.[3] And each transfer meeting the requirements of IRC Section 2013 must be taken into account in computing the credit; no waiver of the credit with respect to any transfer that meets the requirements of IRC Section 2013 is permitted.[4] Also, the limitation must be apportioned among the transferors so that the credit and the limitation are computed separately for each transferor. Thus, as to each transferor, the potential credit will be the lesser of the estate tax attributable to the transferred property in the transferor's estate or that portion of the estate tax attributable to the transferred property in the decedent's estate. The lesser of the credit or the limitation is then multiplied by the applicable percentage (determined by when the transferor's death occurred relative to the time of the transferee's death, as described above) to determine the allowable credit.[5]

The prior transfer is not required to be traced into the decedent's gross estate. The credit is available even though the property was given away, consumed, or destroyed by the decedent during his life. Further, the term "property" includes any beneficial interest in property, including a general power of appointment (see Q 679).[6] The term includes also a life estate in property.[7]

The credit may be allowed against the present decedent's estate even though the prior decedent from whom he received the property was his spouse. However, the credit is allowed only with respect to property for which no marital deduction was allowed in the prior decedent's estate.[8]

716. What is the Section 2014 foreign death tax credit that can be taken against the federal estate tax?

A foreign death tax credit is provided for United States citizens and residents. The credit applies to property which is subject to both federal and foreign death taxes.[9] However, if there is a treaty with the foreign country levying a tax for which a credit is allowable, the executor may elect whether to rely on the IRC credit provisions or the treaty provisions.

1. IRC Sec. 2013(a).
2. IRC Secs. 2013(b), 2013(c)(1).
3. IRC Sec. 2013(c)(2).
4. Rev. Rul. 73-47, 1973-1 CB 397.
5. Treas. Reg. §20.2013-6, Example (2); *Est. of Meyer v. Comm.*, 83 TC 350 (1984), *aff'd 778 F2d 125*, 86-1 USTC ¶13,650 (2nd Cir. 1985).
6. IRC Sec. 2013(e).
7. Rev. Rul. 59-9, 1959-1 CB 232.
8. IRC Sec. 2013(d)(3).
9. IRC Sec. 2014.

717. What are the requirements for filing the federal estate tax return and paying the tax?

Except for extensions of time granted under conditions explained in Q 719, a federal estate tax return (Form 706), if required, must be filed, and the tax paid, by the executor within nine months after the decedent's death.[1] A six month extension for filing is available if requested prior to the due date and the estimated correct amount of tax is paid before the original due date.

The 2010TRA provided that, for estates of decedents dying after Dec. 31, 2009 and before Dec. 17, 2010, the due date for filing an estate tax return, paying the estate tax, and making a disclaimer of an interest in property passing by reason of the decedent's death, is not earlier than the date which is nine months after Dec. 17, 2010. However, an estate of a decedent who died in 2010 may file an election and not be subject to an estate tax, but instead be bound by the modified carryover basis rules under IRC Section 1022. An estate that makes such election must file a Form 8939.[2]

The executor cannot escape responsibility for timely filing of an estate tax return or timely payment of the tax by delegating the responsibility to his attorney or accountant. Ignorance of the necessity to file a return or of the due date of the return is generally no excuse; the executor is required to exercise reasonable care in ascertaining these requirements. An exception to the general rule may exist if an attorney or accountant advised the executor no return was required to be filed.[3] However, the penalty for late filing[4] does not apply to an executor who by reason of his age, health, and lack of experience is incapable of meeting the criteria of ordinary business care and prudence required by the regulations.[5]

718. What are the minimum return requirements for determining whether an estate tax return must be filed?

Whether or not a return is required depends on the size of the gross estate (see Q 679), and possibly also on what kinds of gifts were made by the decedent during life. Generally, a return must be filed if the gross estate of a decedent who is a U.S. citizen or resident exceeds the estate tax unified credit equivalent ($5,000,000, as adjusted annually for inflation. The exemption amount is $5.34 million in 2014).[6] However, the exemption amount is reduced by the amount of *taxable* gifts (the value of the property given after subtracting allowable exclusions and deductions–see Q 740) made by the decedent after December 31, 1976, except gifts includable in the gross estate. Also, if the decedent made any gifts after September 8, 1976 and before January 1, 1977, the above amounts are further reduced by any amount allowed as a specific gift tax exemption (see Q 758) with respect to such gifts.[7] See Appendix D for the exemption amounts for tax years prior to 2013.

1. IRC Secs. 6018(a), 6075(a), 6151(a).
2. See IRS Notice 2011-66.
3. *U.S. v. Boyle*, 105 S. Ct. 687 (1985).
4. IRC Sec. 6151(a)(1).
5. *U.S. v. Boyle* (concurring opinion), above; *Brown v. U.S.*, 630 F Supp 57, 86-1 USTC ¶13,656 (M.D. Tenn. 1985).
6. Rev. Proc. 2013-35, 2013-47 IRB 537.
7. IRC Sec. 6018(a).

719. Can the time for paying the estate tax be extended?

Yes.

The estate tax is due nine months after decedent's death, whether or not an extension of time for filing the return has been granted.[1] However, an extension of time for payment of any part of the tax shown on the return, not to exceed 12 months, may be granted by the district director or the director of a service center, at the request of the executor, if an examination of all the facts and circumstances discloses that such request is based upon reasonable cause.[2] In addition, the Service has been given authority to enter into written agreements to pay taxes in installments when the Service determines that such an agreement will facilitate the payment of taxes.[3] Interest must be paid on any extension (see "Extension of Time for Payment," below).

Extension of Time for Payment: Reasonable Cause (10-year maximum)

The IRS may, for "reasonable cause," extend the time for payment of any part of the estate tax for a reasonable period not in excess of 10 years from the date the tax is due under the general rule (nine months after decedent's death). This "reasonable cause" extension also applies to any part of any installment payment of the tax (and deficiency, if any, added to such installment) where an extension has been granted under the "closely held business interest" provisions (see Q 720).[4] Interest is compounded daily and charged on these reasonable cause extensions at an annual rate adjusted quarterly so as to be three percentage points over the short-term federal rate.[5] The underpayment rate for the first quarter of 2014 is 3 percent.[6]

720. Can the time for paying the estate tax be extended if the estate includes a closely held business interest?

Under IRC Section 6166, if the decedent's interest in a closely held business exceeds 35 percent of the *adjusted gross estate*, the portion of the federal estate tax (including the generation-skipping transfer tax if it is imposed on a direct skip transfer occurring as a result of decedent's death) attributable to that interest may be paid in annual installments (maximum of 10), and the executor may elect to delay the beginning of the installment payments up to five years.[7] The *adjusted gross estate* is the gross estate less deductions allowable under IRC Section 2053 and IRC Section 2054 (see Q 700).[8] In the case of a gift within three years of death (see Q 679), the requirement that the value of the business interest exceed 35 percent of the gross estate is met by the estate only if the estate meets the requirement both with and without the application of the bringback rule.[9]

1. IRC Sec. 6151(a).
2. IRC Sec. 6161(a)(1).
3. IRC Sec. 6159.
4. IRC Sec. 6161(a)(2).
5. IRC Secs. 6601(a), 6621(a)(2).
6. Rev. Rul. 2012-32, 2012-52 IRB 762, Rev. Rul. 2013-25, 2013-52 IRB 802.
7. IRC Sec. 6166(a).
8. IRC Sec. 6166(b)(6).
9. IRC Sec. 2035(c)(2).

Planning Point: Section 6166 is one of the only estate tax deferral options for estates. Depending on the circumstances, an estate may elect to borrow funds to pay the entire estate tax liability rather than take advantage of Section 6166 as the interest payments should be deductible for estate tax purposes.

For decedents dying prior to 1998, a special 4 percent interest rate applies to the portion of tax on which payment is deferred under IRC Section 6166. However, if such portion exceeds $345,800, reduced by the amount of unified credit allowable against the tax, the excess amount will bear interest at the regular underpayment rate (see Q 719).[1] In 1997, the maximum amount of deferred tax eligible for the 4 percent interest rate was $153,000.

For decedents dying after 1997, a special 2 percent interest rate applies to the portion of tax on which payment is deferred under IRC Section 6166. However, if such portion exceeds the amount of tax which would be calculated on the sum of $1,000,000 as indexed ($1,450,000 in 2014) plus the unified credit equivalent, reduced by the amount of the unified credit (see "IRC Section 2010, Unified Credit," in Q 711) allowable against the tax, the excess amount will bear interest at 55 percent of the regular underpayment rate (see above). The $1,000,000 amount is adjusted for inflation, rounded down to the next lowest multiple of $10,000, after 1998.[2] No deduction is permitted for estate or income tax purposes for the interest payable on such deferred tax.[3] In 2010, the maximum amount of deferred tax eligible for the 2 percent interest rate was $603,000 (based upon $1,340,000 as indexed for 2010 and 2009 unified credit and tax rates). In 2012, the maximum amount of deferred tax eligible for the 2 percent interest rate was $486,500. For 2013, the amount is $572,000 and for 2014, the amount is $580,000. See Appendix D for amounts in other years.

If an election to defer taxes was made for a decedent dying before 1998, an irrevocable election could be made before 1999 to apply the lower interest rates (and the corresponding interest deduction disallowance) to payments due after the election was made (however, the 2 percent portion is equal to the amount which would be the 4 percent portion were it not for this election).[4]

For purposes of determining whether an estate qualifies for an IRC Section 6166 extension, the term "interest in a closely held business" means–

(A) an interest as a proprietor in a trade or business carried on as a proprietorship;

(B) an interest as a partner in a partnership carrying on a trade or business, if–

  (i) 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or

  (ii) such partnership had 45 (15 for decedents dying before 2002) or fewer partners; or

1. IRC Sec. 6601(j), prior to amendment by TRA '97.
2. IRC Sec. 6601(j).
3. IRC Secs. 163(k), 2053(c)(1)(D).
4. TRA '97, Sec. 503(d)(2).

(C) stock in a corporation carrying on a trade or business if–

(i) 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or

(ii) such corporation had 45 (15 for decedents dying before 2002) or fewer shareholders.[1]

For purposes of applying the foregoing rules, community property or property the income from which is community property and property held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common is treated as though the property were owned by one shareholder or one partner, as the case may be. Also, property owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered as being owned proportionately by or for its shareholders, partners, or beneficiaries. For purposes of the preceding sentence, a person is treated as a beneficiary of any trust only if he has a present interest in the trust. All stock and partnership interests owned by the decedent and his family are treated as owned by the decedent. The decedent's family for this purpose includes only his spouse, his ancestors, his lineal descendants, and his brothers and sisters.[2] As to any capital interest in a partnership or any nonreadily-tradable stock (i.e., stock for which at the time of decedent's death there was no market on a stock exchange or in an over-the-counter market) attributable to the decedent under the rules described in this paragraph, the value of such interest does not qualify for the five-year deferral or the special 2 percent or 4 percent interest rates.[3]

The term "interest in a closely held business" means (with regard to a stockholder interest) "stock in a corporation carrying on a trade or business." "Business," for purposes of IRC Section 6166, according to the IRS, refers to a business such as manufacturing, mercantile or service enterprise, as distinguished from management of investment assets.[4] According to the IRS, the level of activity is the factor that distinguishes an "active business" from mere passive ownership and management of income producing assets. In several rulings since 1961, the Service has tried to make the distinction in various fact situations:

Revenue Ruling 61-55:[5] The ownership, exploration, development, and operation of oil and gas properties is a "trade or business" within the meaning of IRC Section 6166, but the mere ownership of royalty interests in oil properties is not.

Revenue Ruling 75-366:[6] Farms operated by tenant farmers under agreements that the decedent would pay 40 percent of the expenses and receive 40 percent of the crops, and in which the decedent had actively participated in the important management decisions, constitute an interest in a closely held business for purposes of IRC Section 6166.

1. IRC Sec. 6166(b)(1).
2. IRC Sec. 6166(b)(2).
3. IRC Sec. 6166(b)(7).
4. Let. Ruls. 8352086, 8451014, 8524037, 8529026, 8942018, 9621007.
5. 1961-1 CB 713.
6. 1975-2 CB 472.

Revenue Ruling 75-367:[1] A decedent's ownership of an electing small business corporation engaged in home construction on the decedent's land, a sole proprietorship that developed the land and sold the homes, and a business office and warehouse shared with the corporation, constitute an interest in a closely held business for purposes of IRC Section 6166.

Letter Ruling 8524037: Commercial rental property as to which the decedent maintained a business office, hired a janitor/maintenance man, plumber, carpenter, electrician, contracted out larger jobs, ordered and supervised work done by employees, qualifies as an interest in a closely held business for purposes of IRC Section 6166.

Letter Ruling 8529026: Commercial warehouse, as to which the decedent owned the land on which it stood and negotiated leases with the tenants; carried out routine inspections of the property to determine necessary maintenance; carried out all maintenance and repair work; hired others to carry out additional maintenance; dealt with bankruptcy proceedings of two tenants and with subsequent lawsuits over a sublease; negotiated with tenants, attorneys, architects, and contractors with respect to modifications to the warehouse to suit tenants' needs; maintained an office in his home from which he performed all bookkeeping, paid monthly expenses, and maintained all correspondence concerning the warehouse; decedent's sons helped him with all aspects of the warehouse business. Held that the decedent's activity was not sufficient to qualify as an interest in a closely held business for purposes of IRC Section 6166.

Technical Advice Memorandum (TAM) 8601005: Interest in a general partnership leasing ranchland on a net-lease basis to a limited partnership actively engaged in ranching and in which the decedent was a limited partner. The Service said the land was not held simply as a passive income producing investment, but rather was used as an integral part of the trade or business of ranching. Accordingly, it was held that the decedent's interest in the general partnership was an interest in the business enterprise and not simply a passive investment.

Revenue Ruling 2006-34[2] provides that, for purposes of determining whether a decedent's interest in real estate is an interest in an asset used in an active trade or business, the Service will consider all facts and circumstances, including the activities of agents and employees, the activities of management companies or other third parties, and the decedent's ownership interest in any management company or other third party. The Service will consider the following nonexclusive list of factors (no single factor is dispositive):

- The amount of time the decedent devoted to the trade or business;
- Whether an office was maintained from which the activities of the decedent were conducted or coordinated, and whether the decedent maintained regular business hours for that purpose;
- The extent to which the decedent was actively involved in finding new tenants and negotiating and executing leases;

1. 1975-2 CB 472.
2. 2006-26 IRB 1171, Let. Rul. 200842012.

- The extent to which the decedent provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;
- The extent to which the decedent personally made, arranged for, performed, or supervised repairs and maintenance to the property; and
- The extent to which the decedent handled tenant repair requests and complaints;

For purposes of this list of factors, the term decedent generally includes agents and employees of the decedent, partnership, LLC, or corporation.

For purposes of IRC Section 6166, at the executor's election, the portion of the stock of any holding company which represents direct ownership (or indirect ownership through one or more other holding companies) by such company in a "business company" (i.e., a corporation carrying on a trade or business) is deemed to be stock in such business company. However, as to such holding company stock, the five-year delay and the 2 percent or 4 percent interest provisions (see above) will not apply.[1]

The value included in the computations necessary to determine if the estate qualifies for an IRC Section 6166 extension is the value determined for purposes of the estate tax.[2] Thus, in the case of a farm or other business as to which the executor elected special use valuation (see Q 760), the special use valuation is treated as the value of the property as to which it applies, for purposes of IRC Section 6166.[3]

Also, for purposes of such valuation, the value of passive assets held by the business is not includable. In general, the term "passive asset" includes any stock held in another corporation. However, holding company stock included in the executor's election, explained just above, is not considered a passive asset. Also, if a corporation owns 20 percent or more in value of the voting stock of another corporation, or such other corporation has 45 (15 for decedents dying before 2002) or fewer stockholders, and 80 percent or more of the value of the assets of each such corporation is attributable to active assets, then such corporations are treated as one corporation. In other words, if the foregoing conditions are met, then for purposes of the passive asset rule, the corporation is not considered to hold stock in another corporation.[4]

For purposes of IRC Section 6166, interests in two or more closely held businesses, with respect to each of which there is included in determining the value of the decedent's gross estate 20 percent or more of the total value of each such business, are treated as an interest in a single closely held business. For purposes of this 20 percent requirement, an interest in a closely held business which represents the surviving spouse's interest in property held by the decedent and the surviving spouse as community property or as joint tenants, tenants by the entirety, or tenants in common is treated as having been included in determining the value of the decedent's

1. IRC Sec. 6166(b)(8).
2. IRC Sec. 6166(b)(4).
3. House Report No. 94-1380, pages 32-33.
4. IRC Sec. 6166(b)(9).

gross estate.[1] However, an interest so attributed will not qualify for the 5-year deferral or the special 2 percent or 4 percent interest rates.[2]

The IRS is permitted to require a bond or a lien to guarantee payment of future installments.[3] However, the IRS abuses its discretion by arbitrarily requiring a bond or lien in all cases to secure payment of estate tax deferred under IRC Section 6166.[4] The IRS will determine on a case by case basis whether security will be required when an estate elects to defer estate tax on a closely held business under IRC Section 6166.[5]

In general, if any payment of principal or interest is not paid when due, the whole of the unpaid portion of the tax payable in installments must be paid upon notice and demand from the district director. However, if the full amount of the delinquent payment (principal and all accrued interest) is paid within six months of the original due date, the remaining tax balance is not accelerated. Rather, the payment loses eligibility for the special interest rates (see above) and a penalty is imposed, equal to 5 percent per month based on the amount of the payment.[6]

The IRC Section 6166 election terminates and the whole of the unpaid portion of the tax payable in installments becomes due and is payable upon notice and demand from the district director if (1) any portion of the business interest is distributed, sold, exchanged, or otherwise disposed of, or money and other property attributable to such an interest is withdrawn from the business, and (2) the aggregate of such distributions, sales, exchanges, or other dispositions and withdrawals equals or exceeds 50 percent of the value of such interest.[7] A sale of business assets by the estate to satisfy unpaid mortgages encumbering the business property is not considered a disposition for purposes of the IRC Section 6166 election; however, to the extent proceeds from such a sale exceed the amount used to satisfy the mortgages, the transaction is considered a disposition.[8] Distributions in redemption of stock under IRC Section 303 (distributions in redemption of stock held by a decedent at death in an amount not in excess of death taxes and settlement costs under special income tax rules that treat the redemption as a capital transaction rather than as a dividend) are not counted as withdrawals or as disposals of decedent's interest in the business if an amount equal to any such distribution is paid in estate tax on or before the due date of the first installment of tax due after the distribution, or, if earlier, within one year after the distribution. However, an IRC Section 303 redemption does reduce the value of the business (as of the applicable valuation date) by the amount redeemed, for purposes of determining whether other withdrawals, distributions, sales, exchanges, or disposals meet the applicable 50 percent test.[9]

1. IRC Sec. 6166(c).
2. IRC Sec. 6166(b)(7).
3. IRC Secs. 6166(k), 6165, 6324A.
4. *Est. of Roski v. Comm.*, 128 TC 113 (2007).
5. Notice 2007-90, 2007-46 IRB 1003.
6. IRC Sec. 6166(g)(3).
7. IRC Sec. 6166(g)(1)(A).
8. Let. Rul. 8441029.
9. IRC Sec. 6166(g)(1)(B).

721. Can the time for paying the estate tax be extended if the estate includes a reversionary or remainder interest?

If the gross estate includes a reversionary or remainder interest, the executor may elect to postpone payment of the portion of the tax attributable to that interest until six months after termination of the precedent interest in the property. Notice of the election to exercise postponement, together with supporting documents and information, must be filed with the District Director before the due date for payment of the tax. The IRS may, for "reasonable cause," extend payment of the tax postponed because of the reversionary or remainder interest for up to an additional three years beyond the postponement period referred to above.[1]

Generation-Skipping Transfer Tax

722. What is the federal generation-skipping transfer tax?

The federal generation-skipping transfer (GST) tax is a tax on the right to transfer property to a skip person (a person two or more generations (see Q 735) younger than the transferor).[2] The GST tax was repealed for one year in 2010 but, while the GST tax was technically zero for 2010, it was reinstated thereafter. For 2011 and 2012, the maximum GST tax rate was 35 percent. ATRA increased this maximum GST tax rate to 40 percent and made the provision permanent.[3] TRA 2010 unified the estate, gift and GST tax lifetime exemption amounts and increased the exemption to $5 million for 2010-2011. This $5 million base amount is adjusted annually for inflation and increased to $5.12 million for 2012. The $5 million lifetime exemption was scheduled to sunset (expire) after 2012, but ATRA repealed the sunset provisions to maintain the current exemption amount and permanently unify the estate, gift and GST taxes. The exemption level was adjusted for inflation to $5.25 million in 2013 and $5.34 million in 2014.[4]

Depending on the transfer, a generation-skipping transfer is reported on either a gift tax return or an estate tax return. The person required to file the return (Q 738) and pay the tax (Q 739) also depends on the type of transfer.

Generation-skipping transfers (Q 723) include direct skips, taxable terminations, and taxable distributions. Taxable terminations and taxable distributions apply to certain terminations of interests in trusts or distributions from trusts. A husband and wife can elect to have all generation-skipping transfers made by either spouse during the year treated as made one-half by each spouse (Q 736).

Value is generally the value of the taxable amount at the time of the transfer (Q 724).

A couple of exclusions are available from GST tax. In 2013 and 2014, a $14,000 annual exclusion (up from $13,000 in 2011 and 2012) is available for certain present interest gifts on a

1. IRC Sec. 6163.
2. IRC Sec. 2601.
3. American Taxpayer Relief Act of 2012, Pub. Law No. 112-240.
4. Rev. Proc. 2013-15, 2013-5 IRB 444.

per donor/donee basis.[1] An unlimited exclusion is available for qualified transfers for educational and medical purposes. See Q 724.

As a discussed above, a $5,000,000 ($5.34 million in 2014 and $5.25 million in 2013) GST exemption is available to each transferor.[2] Great flexibility is available to allocate or not allocate GST exemption to transfers. An inclusion ratio is derived from allocations of GST exemption to, in effect; determine the amount subject to GST tax. See Q 724.

Planning Point: Taxpayers should consider whether a "by-pass trust" or a trust that contains assets that will be excluded from a surviving spouse's estate is a viable option to maximize the estate tax and GST exemptions.

Again, tax is imposed on generation-skipping transfers. The tax rate (40 percent for tax years beginning after 2012 and 35 percent in 2011 and 2012, see Appendix D) is a flat rate equal to the top estate tax rate. The tax is calculated by multiplying the tax rate by the inclusion ratio and then multiplying this figure by the amount of the generation skipping transfer (Q 724).

723. What is a generation-skipping transfer (GST) on which a generation-skipping transfer tax is imposed?

In general, it is a transfer to a person two or more generations younger than the transferor (called a "skip person"; see Q 735 regarding generation assignments), and can take any one of three forms: (1) a taxable distribution; (2) a taxable termination; and (3) a direct skip. A trust is also a skip person if the trust can benefit only persons two or more generations younger than the transferor.[3] The GST tax is zero percent for one year in 2010 with a top 35 percent rate in 2011 and 2012.[4] ATRA increased the maximum GST tax rate to 40 percent for tax years beginning after 2012.[5]

Transferor

A "transferor," in the case of any property subject to the federal estate tax, is the decedent. In the case of any property subject to the federal gift tax, the transferor is the donor.[6] Thus, to the extent that a lapse of a general power of appointment (including a right of withdrawal) is subject to gift or estate tax, the powerholder becomes the transferor with respect to such lapsed amount.[7] Thus, a *Crummey* powerholder should not be treated as a transferor with respect to the lapse of a withdrawal power if the amount lapsing in any year is no greater than (1) $5,000, or (2) 5 percent of the assets out of which exercise of the power could be satisfied.[8]

If there is a generation-skipping transfer of any property and immediately after the transfer such property is held in trust, a different rule (the "multiple skip" rule) applies to subsequent

1. Rev. Proc. 2012-41, 2012-45 IRB 539.
2. See Rev. Proc. 2013-15, above, Rev. Proc. 2013-35, 2013-47 IRB 537.
3. IRC Secs. 2611(a), 2613.
4. IRC Sec. 2664.
5. American Taxpayer Relief Act of 2012, Pub. Law No. 112-240, Sec. 101.
6. IRC Sec. 2652(a)(1).
7. Treas. Reg. §26.2652-1(a).
8. Let. Rul. 9541029.

transfers from that trust. In such case, the trust is treated as if the transferor (for purposes of subsequent transfers) were assigned to the first generation above the highest generation of any person having an "interest" (see below) in the trust immediately after the transfer.[1] If no person holds an interest immediately after the GST, then the transferor is assigned to the first generation above the highest generation of any person in existence at the time of the GST who may subsequently hold an interest in the trust.[2]

For the effect of making a "reverse QTIP election," see Q 724.

Direct Skip

A direct skip is a transfer subject to federal gift or estate tax to a skip person. However, with respect to transfers before 1998, such a transfer was not a direct skip if the transfer was to a grandchild of the transferor or of the transferor's spouse or former spouse, and the grandchild's parent who was the lineal descendant of the transferor or his spouse or former spouse was dead at the time of the transfer. In other words, a person could be stepped-up in generations because a parent who had been in the line of descent predeceased such person. This rule could be reapplied to lineal descendants below that of a grandchild. Persons assigned to a generation under this rule were also assigned to such generation when such persons received transfers from the portion of a trust attributable to property to which the step-up in generation rule applied.[3] For purposes of this predeceased child rule, a living descendant who died no later than 90 days after a transferor was treated as predeceasing the transferor if he or she was treated as predeceased under the governing instrument or state law.[4] For a discussion of the more expansive predeceased parent rule after 1997, see Q 735.

In some circumstances, whether a step-up in generation was available could depend on whether a QTIP or a reverse QTIP marital election was made for GSTT purposes (see Q 724). If the parent of a grandchild-distributee died after the transfer by a grandparent to a generation-skipping trust, but before the distribution from the trust to the grandchild, and a reverse QTIP election had been made, the distribution was a taxable termination and the "step-up in generation" rule was not available. However, if the reverse QTIP election had not been made, the distribution was eligible for the "step-up in generation" exception from treatment as a direct skip and was not subject to GSTT.[5]

Also, for purposes of the GST tax, the term "direct skip" did not include any transfer before January 1, 1990 from a transferor to a grandchild of the transferor to the extent that the aggregate transfers from such transferor to such grandchild did not exceed $2 million. This $2 million exemption was available with respect to a transfer in trust only if (1) during the life of such individual no portion of the trust corpus or income could be distributed to or for the benefit of any other person, (2) the trust would be included in such individual's estate if such

1. IRC Sec. 2653(a).
2. Treas. Reg. §26.2653-1.
3. IRC Sec. 2612(c)(2), prior to amendment by TRA '97.
4. Treas. Reg. §26.2612-1(a)(2)(i).
5. Rev. Rul. 92-26, 1992-2 CB 314.

individual were to die before the trust terminated, and (3) all of the income of the trust had to be distributed at least annually to the grandchild once he reached 21. Requirement (3) applied only to transfers after June 10, 1987. However, the Committee Report indicated that this requirement was not satisfied by a *Crummey* demand power.[1]

The $2 million per grandchild exemption applied to transfers to grandchildren only; the step-up in generation rule for a predeceased parent did not apply. A transfer which would have been a direct skip were it not for the $2 million exemption was likewise exempted from being treated as a taxable termination or taxable distribution. However, the rules which apply to the taxation of multiple skips will apply to subsequent transfers from such trust.

Taxable Termination

A taxable termination occurs when an "interest in property" (see below) held in trust (or some arrangement having substantially the same effect as a trust) for a skip person is terminated by an individual's death, lapse of time, release of a power, or otherwise, unless either (1) a non-skip person has an interest in the trust immediately after such termination, or (2) at no time after the termination may a distribution be made from the trust to a skip person, other than a distribution the probability of which occurring is so remote as to be negligible (i.e., less than a 5 percent actuarial probability). If upon the termination of an interest in a trust by reason of the death of a lineal descendant of the transferor, a portion of the trust is distributed to skip persons (or to trusts for such persons), such partial termination is treated as taxable. If a transfer subject to estate or gift tax occurs at the time of the termination, the transfer is not a taxable termination (but it may be a direct skip).[2]

Taxable Distribution

A taxable distribution is any distribution from a trust to a skip person (other than a taxable termination or a direct skip).[3]

Generation-Skipping Transfer Exceptions

However, the following are not considered generation-skipping transfers:

(1) Any transfer which, if made during life by an individual, would be a "qualified transfer" (see Q 753); and

(2) Any transfer to the extent (a) the property transferred was subject to a prior GST tax, (b) the transferee in the prior transfer was in the same generation as the current transferee or a younger generation, and (c) the transfers do not have the effect of avoiding the GST tax.[4]

1. TRA '86, Sec. 1433(b)(3), as amended by TAMRA '88, Sec. 1014(h)(3).
2. IRC Sec. 2612(a); Treas. Reg. §26.2612-1(b).
3. IRC Sec. 2612(b).
4. IRC Sec. 2611(b).

Interest in Property

A person has an "interest in property" held in trust if (at the time the determination is made) such person–

(1) has a present right to receive income or corpus from the trust (Ex: a life income interest);

(2) is a permissible current recipient of income or corpus from the trust (Ex: a beneficiary entitled to distribution of income or corpus, but only in the discretion of the trustee) and is not a charitable organization (specifically, one described in IRC Section 2055(a)); or

(3) is such a charitable organization and the trust is a charitable remainder annuity trust (see Q 7979), a charitable remainder unitrust (see Q 7980), or a pooled income fund (see Q 7988).

In determining whether a person has an interest in a trust, the fact that income or corpus may be used to satisfy a support obligation is disregarded if such use is discretionary or made pursuant to the Uniform Gifts to Minors Act (or similar state statute). In other words, a parent is not treated as having an interest in a trust merely because the parent acts as guardian for a child. However, a parent would be treated as having an interest in the trust if support obligations are mandatory.[1]

An interest may be disregarded if it is used *primarily* to postpone or avoid the GST tax.[2] The regulations provide that an interest is disregarded if *a significant purpose* for the creation of the interest is the postponement or avoidance of the GST tax.[3]

Effective Date and Transitional Rules

The rules explained here and in the succeeding questions apply generally to any generation-skipping transfer (GST) made after October 22, 1986. Also, any lifetime transfer after September 25, 1985, and on or before October 22, 1986, is treated as if made on October 23, 1986. These rules will not, however, apply to the following:

(1) Any GST under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus (or income attributable to such corpus) added to the trust after September 25, 1985;

(2) Any GST under a will or revocable trust executed before October 22, 1986, if the decedent died before January 1, 1987; and

(3) Any GST–

1. IRC Sec. 2652(c)(3).
2. IRC Sec. 2652(c)(2).
3. Treas. Reg. §26.2612-1(e)(2)(ii).

(a) under a trust to the extent such trust consists of property included in the gross estate of a decedent (other than property transferred by the decedent during his life after October 22, 1986), or reinvestments thereof, or

(b) which is a direct skip that occurs by reason of the death of any decedent;

but only if such decedent was, on October 22, 1986, under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of his death.[1] It appears that Congress does not intend for the third grandfathering rule to apply with respect to property transferred after August 3, 1990 to an incompetent person, or to a trust of such a person.[2]

724. How is the amount of tax on a GST determined?

The amount of tax is the "taxable amount" (based on the kind of GST involved–see Q 723) multiplied by the "applicable rate."[3] The applicable rate of tax applied to the taxable amount is itself a product. It is a product of the maximum federal estate tax rate in effect at the time of the GST (35 percent in 2011 and 2012 and 40 percent for tax years beginning after 2012. See Appendix D for earlier years) and the "inclusion ratio" with respect to the transfer.[4] The inclusion ratio, in turn, depends on allocations of the "GST exemption."[5] The GST tax was zero percent for one year in 2010.[6]

Taxable Amount

In the case of a taxable distribution, the taxable amount is the value of the property received by the transferee reduced by any expense incurred by the transferee with respect to the GST tax imposed on the distribution. If any portion of the GST tax with respect to a taxable distribution is paid out of the trust, the taxable distribution is increased by such an amount.[7]

In the case of a taxable termination, the taxable amount is the value of all property with respect to which the taxable termination has occurred, reduced by the expenses, similar to those allowed as a deduction under IRC Section 2053 in determining the taxable estate for estate tax purposes (see Q 701), with respect to which the taxable termination has occurred.[8]

In the case of a direct skip, the taxable amount is the value of the property received by the transferee.[9] Where a life estate was given to a skip person and a remainder interest was given to a non-skip person, the value of the entire property (and not just the actuarial value of the life estate) was subject to GST tax.[10]

1. TRA '86, Sec. 1433(a), (b), as amended by TAMRA '88, Sec. 1014(h)(2).
2. OBRA '90, Sec. 11703(c)(3).
3. IRC Sec. 2602.
4. IRC Sec. 2641.
5. IRC Sec. 2642.
6. IRC Sec. 2664; EGTRRA 2001 Sec. 901.
7. IRC Sec. 2621.
8. IRC Sec. 2622.
9. IRC Sec. 2623.
10. TAM 9105006.

725. What is the GST exemption and how is it applied in determining the GST tax?

For purposes of determining the inclusion ratio, every individual is allowed a GST exemption of $5 million and (the $5 million base figure is adjusted annually for inflation. The amount is $5.25 million in 2013 and $5.34 million in 2014. For other years, see Appendix D)[1] which may be allocated irrevocably by the individual (or his executor) to any property with respect to which he is the transferor.

In 2004 to 2009, the GST exemption was equal to the estate tax unified credit equivalent (applicable exclusion amount) rather than to $5 million, as indexed (see Appendix D). Any indexing increase in the GST exemption is available for all generation-skipping transfers occurring in the year of the increase and subsequent years in which the GST exemption is equal to $5 million, as indexed, up to the year of the decedent's death.[2]

The GST tax was repealed (zero percent) for one year in 2010. The Tax Relief Act of 2010 revived the GST tax and included a $5 million GST exemption that was scheduled to last for two years, 2011 and 2012, with indexing for 2012 (to $5.12 million). ATRA made the $5 million (as indexed) GST exemption permanent for tax years beginning after 2012.

In general, an individual or the individual's executor may allocate the GST exemption at any time from the date of the transfer until the time for filing the individual's federal estate tax return (including extensions actually granted), regardless of whether a return is required (see Q 717).[3]

The GST exemption is automatically allocated to lifetime direct skips unless otherwise elected on a timely filed federal gift tax return (see Q 759).[4]

In addition, any unused GST exemption is automatically allocated to indirect skips to a GST trust (see Q 726), effective 2001 to 2009 and after 2010.[5] An indirect skip is a transfer (other than a direct skip) to a GST trust that is subject to gift tax. A transferor can elect to have the automatic allocation not apply to (1) an indirect skip, or (2) to any or all transfers made by the individual to a particular trust. The transferor can also elect to treat a trust as a GST trust with respect to any or all transfers made by the individual to the trust. Nevertheless, an allocation still cannot be made until the end of any estate tax inclusion period (see below).

Regulations generally permit elections to allocate or not allocate GST exemption to individual transfers or to all current or future transfers to a trust, or any combination of these. An election with regard to all transfers to a trust can later be revoked with respect to future transfers to the trust. The regulations also permit elections with regard to individual transfers to a trust even where an election is in place with regard to all transfers to a trust.[6]

1. Rev. Proc. 2013-15, 2013-5 IRB 444, Rev. Proc. 2013-35, 2013-47 IRB 537.
2. IRC. Sec. 2631, as amended by EGTRRA 2001.
3. IRC Sec. 2632.
4. IRC Sec. 2632(b).
5. IRC Sec. 2632(c), as added by EGTRRA 2001.
6. Treas. Reg. §26.2632-1.

Planning Point: Grantors should make elections to allocate or not allocate GST exemption with respect to all transfers to a particular trust. GST exemption can be allocated to trusts benefiting skip persons; while allocations are not made to trusts benefiting non-skip persons.

A retroactive allocation of the GST exemption can be made when certain non-skip beneficiaries of a trust predecease the transferor, effective 2001 to 2009. The non-skip beneficiary must (1) have an interest or a future interest (for this purpose, a future interest means that the trust may permit income or corpus to be paid to such person on a date or dates in the future) in the trust to which any transfer has been made, (2) be a lineal descendant of a grandparent of the transferor or of a grandparent of the transferor's spouse or former spouse, (3) be assigned to a generation lower than that of the transferor, and (4) predecease the transferor. In such a case, an allocation of the transferor's unused GST exemption (determined immediately before the non-skip person's death) can be made to any previous transfer or transfers to the trust (value of transfer is its gift tax value at the time of the transfer) on a chronological order. The allocation is made by the transferor on the gift tax return for the year of the non-skip person's death. The allocation is treated as effective immediately before the non-skip person's death.[1]

> *Example*: Grandparent creates a trust for the primary benefit of Child, with Grandchild as contingent remainder beneficiary. Grandparent doesn't expect Grandchild will receive anything, or that the trust will be generation-skipping; so he doesn't allocate GST exemption to the trust. (Or, perhaps, allocation of the GST exemption was simply overlooked). Child dies unexpectedly before Grandparent. There is a GST taxable termination at Child's death. Grandparent can make a retroactive allocation of GST exemption to the trust to reduce or eliminate the GST tax on the taxable termination.

With regard to lifetime transfers other than a direct skip, an allocation is made on the federal gift tax return. An allocation can use a formula (e.g., the amount necessary to produce an inclusion ratio of zero). An allocation on a timely filed gift tax return is generally effective as of the date of the transfer. An allocation on an untimely filed gift tax return is generally effective as of the date the return is filed and is deemed to precede any taxable event occurring on such date. (For certain retroactive allocations, see above). An allocation of the GST exemption is irrevocable after the due date. However, an allocation of GST exemption to a trust (other than a charitable lead annuity trust, see Q 729) is void to the extent the amount allocated exceeds the amount needed to produce an inclusion ratio of zero (See Q 727).[2]

An executor can make an allocation of the transferor's unused GST exemption on the transferor's federal estate tax return. An allocation with respect to property included in the transferor's estate is effective as of the date of death. A late allocation of the GST with respect to a lifetime transfer can be made by the executor on the estate tax return and is effective as of the date the allocation is filed. A decedent's unused GST exemption is automatically and irrevocably allocated on the due date for the federal estate tax return to the extent not otherwise allocated by the executor. The automatic allocation is made to nonexempt property: first to direct skips occurring at death, and then to trusts with potential taxable distributions or taxable terminations.[3]

1. IRC Sec. 2632(d), as added by EGTRRA 2001.
2. Treas. Reg. §26.2632-1(b).
3. IRC Sec. 2632(e), as redesignated by EGTRRA 2001, Treas. Reg. §26.2632-1(d).

726. What is a GST trust?

A GST trust is a trust that could have a generation-skipping transfer with respect to the transferor unless:

1. The trust provides that more than 25 percent of the trust corpus must be distributed to, or may be withdrawn by, one or more individuals who are non-skip persons, either (a) before the individual's 46th birthday, (b) on or before a date prior to such birthday, or (c) upon the occurrence of an event that may reasonably be expected to occur before such birthday.

2. The trust provides that more than 25 percent of the trust corpus must be distributed to, or may be withdrawn by, one or more individuals who are non-skip persons and who are living on the date of death of an individual identified in the trust (by name or class) who is more than 10 years older than such individual(s).

3. The trust provides that, if one or more individuals who are non-skip persons die before a date or event described in (1) or (2), more than 25 percent of the trust corpus must either (a) be distributed to the estate(s) of one or more of such individuals, or (b) be subject to a general power of appointment exercisable by one or more of such individuals.

4. Any portion of the trust would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer.

5. The trust is a charitable lead annuity trust (CLAT), charitable remainder annuity trust (CRAT), charitable remainder unitrust (CRUT), or a charitable lead unitrust (CLUT) with a non-skip remainder person.

For purposes of these GST trust rules, the value of transferred property is not treated as includable in the gross estate of a non-skip person nor subject to a power of withdrawal if the withdrawal right does not exceed the amount of the gift tax annual exclusion ($14,000 in 2013 and 2014) with respect to the transfer. It is also assumed that a power of appointment held by a non-skip person will not be exercised.

727. What is the inclusion ratio and how is it used for purposes of the GST tax?

In general, the inclusion ratio with respect to any property transferred in a GST is the excess of one minus (a) the "applicable fraction" for the trust from which the transfer is made, or (b) in the case of a direct skip, the applicable fraction determined for the skip.[1]

The "applicable fraction" is a fraction (a) the numerator of which is the amount of the GST exemption allocated to the trust (or to the property transferred, if a direct skip), and (b) the denominator of which is the value of the property transferred reduced by (i) the sum

1. Sec. 2642(a)(1).

of any federal estate or state death tax actually recovered from the trust attributable to such property, (ii) any federal gift tax or estate tax charitable deduction allowed with respect to such property, and (iii) with respect to a direct skip, the portion that is a nontaxable gift (see below). The fraction should be rounded to the nearest one-thousandth, with five rounded up (i.e., .2345 is rounded to .235). If the denominator of the applicable fraction is zero, the inclusion ratio is zero.[1]

Example: For illustrative purposes, in the year 2014, G transfers irrevocably in trust for his grandchildren $20 million and allocates all his $5,340,000 GST exemption to the transfer. The applicable fraction is 5,340,000/20,000,000, or .267. The inclusion ratio is 1 minus .267, or .733. The maximum estate tax rate, 40 percent, is applied against the inclusion ratio, .733. The resulting percentage, 29.3 percent, is applied against the value of the property transferred, $20,000,000, to produce a GST tax of $5,860,000. The tax is paid by G, the transferor, because this is a direct skip (other than a direct skip from a trust) (see Q 723).

Example: Same facts as in preceding example, except that for federal gift tax purposes G's wife consented to a split gift of the $20 million (see Q 736). Thus, for GST tax purposes as well, the gift is considered split between the spouses. If they both elect to have their respective GST exemptions allocated to the transfer, the applicable fraction for each is 5,340,000/10,000,000, or .534. The inclusion ratio is 1 minus .534, or .466. The maximum estate tax rate, 40 percent, is applied against the inclusion ratio, .466. The resulting percentage, 18.6 percent, is applied against the value of the property transferred, $10,000,000, to produce a GST tax of $1,860,000 for each, or a total GST tax of $3,720,000 on the $20 million transfer. The tax is paid 1/2 each by G and G's wife, the transferors, because each gift is a direct skip (other than a direct skip from a trust) (see Q 723).

Example: In 2014, G transfers $100,000 to a trust and allocates $100,000 GST exemption to the trust. The trust has an inclusion ratio of zero, and taxable distributions and taxable terminations can be made free of GST tax.

Example: In 2014, G transfers $100,000 to a trust and allocates no GST exemption to the trust. If all the trust beneficiaries are grandchildren of G, G has made a direct skip fully subject to GST tax. The GST tax is $40,000 ($100,000 transfer × 40 percent GST tax rate in 2014) and is payable by G. If the trust beneficiaries are children and grandchildren of G, the trust has an inclusion ratio of one, and GST transfers are fully subject to tax at the GST tax rate at the time of any later transfer.

If there is more than one transfer in trust the applicable fraction must be recomputed at the time of each transfer. Thus, if property is transferred to a preexisting trust, the "recomputed applicable fraction" is determined as follows: The numerator of such fraction is the sum of (1) the amount of the GST exemption allocated to the property involved in such transfer and (2) the nontax portion of the trust immediately before the transfer. (The nontax portion of the trust is the value of the trust immediately before the transfer multiplied by the applicable fraction in effect before such transfer). The denominator of such fraction is the value of the trust immediately after the transfer reduced by (i) the sum of any federal estate or state death tax actually recovered from the trust attributable to such property, (ii) any federal gift tax or estate tax charitable deduction allowed with respect to such property, and (iii) with respect to a direct skip, the portion that is a nontaxable gift (see below).[2]

1. IRC Sec. 2642(a)(2), Treas. Reg. §26.2642-1.
2. IRC Sec. 2642(d)(2), Treas. Reg. §26.2642-4.

Example: In the year 1995, G transfers irrevocably in trust for his children and grandchildren $4 million and allocates all his $1 million GST exemption to the transfer. The applicable fraction is 1,000,000/4,000,000, or .250. The inclusion ratio is 1 minus .250, or .750.

In 2001, the trust makes a taxable distribution to the grandchildren of $100,000. The maximum estate tax rate, 55 percent in 2001, is applied against the inclusion ratio, .750. The resulting percentage, 41.25 percent, is multiplied by the $100,000 transfer, resulting in a GST tax of $41,250. GST taxes in this example are paid by the grandchildren, the transferees, because the transfers are taxable distributions (see Q 739).

In 2014, the trust makes a taxable distribution to the grandchildren of $100,000. The maximum estate tax rate, 40 percent in 2014, is applied against the inclusion ratio, .750. The resulting percentage, 30 percent, is multiplied by the $100,000 transfer, resulting in a GST tax of $30,000.

Later in 2014, when the trust property has grown to $6 million, G transfers an additional $5 million to the trust. An additional $4,340,000 of GST exemption is available to G in 2014 ($5,340,000 GST exemption in 2014 minus $1,000,000 exemption already used). The numerator of the recomputed fraction is the value of the nontax portion of the trust immediately before the transfer, or $1.5 million (value of the trust, $6 million, multiplied by the applicable fraction of .250), plus $4,340,000 additional exemption, or $5,840,000. The denominator of the recomputed fraction is $11 million (the sum of the transferred property, $5 million, and the value of all the property in the trust immediately before the transfer, $6 million). The applicable fraction is 5,840,000/11,000,000, or .531. The inclusion ratio is 1 minus .531, or .469.

Later in 2014, the trust makes a taxable distribution to the grandchildren of $100,000. The maximum estate tax rate, (40 percent in 2014), is applied against the inclusion ratio, .469. The resulting percentage, 18.8 percent, is multiplied by the $100,000 transfer, resulting in a GST tax of $18,800.

Planning Point: Trusts are usually created with an inclusion ratio of either one (GST transfers, if any, with respect to trust are fully taxable) or zero (fully exempt from GST tax). A trust has an inclusion ratio of zero if GST exemption is allocated to any transfer to the trust that is not a nontaxable gift (an allocation of GST exemption is not needed for a direct skip nontaxable gift (see below); it has an inclusion ratio of zero). For information on severing a trust to create separate trusts with inclusion ratios of zero and one, see "Separate Trusts," Q 731.

728. How is property valued for purposes of the GST tax?

"Value" of the property is its value at the time of the transfer. In the case of a direct skip of property that is included in the transferor's gross estate, the value of the property is its estate tax value. In the case of a taxable termination with respect to a trust occurring at the same time as and as a result of the death of an individual, an election may be made to value at the alternate valuation date (see Q 761). In any case, the value of the property may be reduced by any consideration given by the transferee.[1]

For purposes of determining the GST inclusion ratio, certain other valuation rules may apply in some instances. For purposes of determining the denominator of the applicable fraction (see above), the value of property transferred during life is its fair market value as of the effective date of the GST exemption allocation (See Q 727). However, with respect to late allocations of the GST exemption to a trust, the transferor may elect (solely for purpose of determining the fair market value of trust assets) to treat the allocation as made on the first day of the month in which the allocation is made. This election is not effective with respect to a life insurance

1. IRC Sec. 2624.

policy, or a trust holding a life insurance policy, if the insured individual has died. For purposes of determining the denominator of the applicable fraction, the value of property included in the decedent's gross estate is its value for estate tax purposes. However, special use valuation (see Q 645) is not available unless the recapture agreement under IRC Section 2032A specifically refers to the GST tax. There are special rules in the regulations concerning the allocation of post-death appreciation or depreciation with respect to pecuniary payments and residuary payments made after a pecuniary payment.[1]

729. Are Charitable Lead Annuity Trusts treated differently than other types of trusts for GST tax purposes?

With respect to property transferred after October 13, 1987, the GST tax exemption inclusion ratio for any charitable lead annuity trust (see Q 7996) is to be determined by dividing the amount of exemption allocated to the trust by the value of the property in the trust following the charitable term. For this purpose, the exemption allocated to the trust is increased by interest determined at the interest rate used in determining the amount of the estate or gift tax charitable deduction with respect to such a trust over the charitable term. With respect to a late allocation of the GST exemption (See Q 728), interest accrues only from the date of the late allocation. The amount of GST exemption allocated to the trust is not reduced even though it is determined at a later time that a lesser amount of GST exemption would have produced a zero inclusion ratio.[2]

730. What is the Estate Tax Inclusion Period (ETIP) for GST Tax purposes?

With respect to inter vivos transfers subject at some point in time to the GST tax, the allocation of any portion of the GST tax exemption to such a transfer is postponed until the earlier of (a) the expiration of the period (not to extend beyond the transferor's death) during which the property being transferred would be included in the transferor's estate (other than by reason of the gifts within three years of death rule of IRC Section 2035) if he died, or (b) the GST. For purposes of determining the inclusion ratio with respect to such exemption, the value of such property is: (a) its estate tax value if it is included in the transferor's estate (other than by reason of the three year rule of IRC Section 2035), or (b) its value determined at the end of the ETIP. However, if the allocation of the exemption under the second valuation method is not made on a timely filed gift tax return for the year in which the ETIP ends, determination of value is postponed until such allocation is filed.[3]

> *Example*: Grantor sets up an irrevocable trust: income retained for 10 years, then life estate for children, followed by remainder to grandchildren. The valuation of property for purpose of the inclusion rule is delayed until the earlier of the expiration of the 10-year period or the transferor's death. If the grantor were to die during such time the property would be included in the grantor's estate under IRC Section 2036(a) (see Q 679). However, if the grantor survived the 10-year period and failed to make an allocation of the exemption on a timely filed gift tax return, the determination of value is postponed until the earlier of the time an allocation is filed or death.

1. IRC Sec. 2642(b)(2)(A), Treas. Reg. §26.2642-2.
2. IRC Sec. 2642(e), Treas. Reg. §26.2642-3.
3. IRC Sec. 2642(f).

Except as provided in regulations, for purpose of the GST tax exemption allocation rules, any reference to an individual or a transferor is generally treated as including the spouse of such individual or transferor.[1] Thus, an ETIP includes the period during which, if death occurred, the property being transferred would be included in the estate (other than by reason of the gifts within three years of death rule of IRC Section 2035) of the transferor or the spouse of the transferor. The property is not considered as includable in the estate of the transferor or the spouse of the transferor if the possibility of inclusion is so remote as to be negligible (i.e., less than a 5 percent actuarial probability). The property is not considered as includable in the estate of the spouse of the transferor by reason of a withdrawal power limited to the greater of $5,000 or 5 percent of the trust corpus if the withdrawal power terminates no later than 60 days after the transfer to trust. Apparently, the ETIP rules do not apply if a reverse QTIP election (see Q 733) is made. The ETIP terminates on the earlier of (1) the death of the transferor; (2) the time at which no portion would be includable in the transferor's estate (other than by reason of IRC Section 2035) or, in the case of the spouse who consents to a split-gift, the time at which no portion would be includable in the other spouse's estate; (3) the time of the GST (but only with respect to property involved in the GST); or (4) in the case of an ETIP arising because of an interest or power held by the transferor's spouse, at the earlier of (a) the death of the spouse, or (b) the time at which no portion would be includable in the spouse's estate (other than by reason of IRC Section 2035).[2]

> *Example*: Grantor sets up an irrevocable trust: income retained for the shorter of nine years or life, remainder to grandchild. Grantor and spouse elect to split the gift. If spouse dies during trust term, spouse's executor can allocate GST exemption to spouse's deemed one-half of the trust. However, the allocation is not effective until the earlier of the expiration of grantor's income interest or grantor's death.

The regulations provide that the election out of automatic allocation of GST exemption for either a direct skip or an indirect skip can be made at any time up until the due date for filing the gift tax return for the year the ETIP ends. If the transfer subject to an ETIP occurred in an earlier year, the election must specify the particular transfer. An affirmative allocation of GST exemption cannot be revoked after the due date for filing the gift tax return for the year the affirmative election is made (or after the allocation is made in the case of a late allocation), even where actual allocation is not effective until the end of an ETIP.[3]

731. When are portions of a severed trust treated as separate trusts for GST tax purposes?

In general, portions of a trust are not to be treated as separate trusts. However, portions attributable to different transferors, substantially separate and independent shares of different beneficiaries of a trust, and trusts treated as separate trusts under state law are to be treated as separate trusts for GST tax purposes.[4] However, treatment of a single trust as separate shares for purposes of the GST tax does not permit treatment as separate trusts for purposes of filing or payment of tax, or for purposes of any other tax. Additions to, or distributions from, such a

1. IRC Sec. 2642(f)(4).
2. Treas. Reg. §26.2632-1(c).
3. Treas. Reg. §26.2632-1.
4. IRC Sec. 2654(b).

trust are allocated pro-rata among all shares unless expressly provided otherwise. In general, a separate share is not treated as such unless it exists at all times from and after creation of the trust.

Trusts created from a qualified severance are treated as separate trusts for GST tax purposes, effective for 2001 to 2009 and for tax years beginning after 2010. A qualified severance means the division of a single trust into two or more trusts under the trust document or state law if (1) the single trust is divided on a fractional basis, and (2) in the aggregate, the terms of the new trusts provide for the same succession of interests of beneficiaries as are provided in the original trust. In the case of a trust with a GST inclusion ratio of greater than zero and less than one (i.e., the trust is partially protected from the GST by allocations of the GST exemption), a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional amount equal to the GST applicable fraction multiplied by the single trust's assets. The trust receiving the fractional amount receives an inclusion ratio of zero (i.e., it is not subject to GST tax), and the other trust receives an inclusion ratio of one (i.e., it is fully subject to GST tax).[1]

Otherwise, severance of a trust included in the taxable estate (or created in the transferor's will) into single shares will be recognized for GST purposes if (1) the trusts are severed pursuant to the governing instrument or state law, (2) such severance occurs (or a reformation proceeding is begun and is indicated on the estate tax return) prior to the date for filing the estate tax return (including extensions actually granted), and (3) the trusts are funded using (a) fractional interests or (b) pecuniary amounts for which appropriate adjustments are made.[2]

Regulations provide that a qualified severance must be done on a fractional or percentage basis; a severance based on a specific pecuniary amount is not permitted. The terms of the new trusts must provide in the aggregate for the same succession of beneficiaries. With respect to trusts from which discretionary distributions may be made on a non pro rata basis, this requirement can be satisfied even if each permissible beneficiary might be a beneficiary of only one of the separate trusts, but only if no beneficial interest is shifted to a lower generation and the time for vesting of any beneficial interest is not extended.[3]

The regulations provide that the separate trusts must be funded with property from the severed trust with either a pro rata portion of each asset or on a non pro rata basis. If funded on a non pro rata basis, the separate trusts must be funded by applying the appropriate severance fraction or percentage to the fair market value of all the property on the date of severance. The date of severance is either the date selected by the trustee or a court-imposed date of funding. The funding of the separate trusts must commence immediately, and occur within a reasonable period of time (not more than 90 days) after the date of severance.

A qualified severance is deemed to occur before a taxable termination or a taxable distribution that occurs by reason of the qualified severance. For example, a trust provides for trust income to be paid annually to grantor's child (C) and grandchild (GC) for 10 years, remainder

1. IRC Sec. 2642(a), as added by EGTRRA 2001.
2. Treas. Reg. §26.2654-1.
3. Treas. Reg. §26.2642-6.

to C and GC or their descendants. If either dies during the trust term, income is payable to that person's then-living descendants. The inclusion ratio for the trust is .50. The trust is severed into one trust for C and C's descendants and one for GC and GC's descendants. The trustee designates the trust for C as having an inclusion ratio of one, and the trust for GC as having an inclusion ratio of zero. The severance causes either a taxable termination of C's interest in, or a taxable distribution to, GC's trust (which is a skip person). However, the severance is deemed to occur before the GST and GC's trust has an inclusion ratio of zero; therefore, there is no GST tax due.[1]

A trust that is partly grandfathered from GST tax can be severed into a grandfathered and a nongrandfathered trust under these rules.

Regulations provide that, for purpose of funding the separate trusts, assets must be valued without taking into consideration any discount or premium arising from the severance.[2] For example, if the severance creates a minority interest when the separate trust receives less than the interest owned by the original trust, such a minority discount is disregarded for funding purposes.

Regulations provide that, with respect to a qualified severance of a trust with an inclusion ratio greater than zero and less than one, one or more resulting trusts must be funded with an amount equal to the GST applicable fraction (used to determine the GST inclusion ratio for the original trust immediately before the severance) times the value of the original trust on the date of severance. Each such resulting trust receives an inclusion ratio of zero. All other resulting trusts receive an inclusion ratio of one. If two or more trusts receive an amount equal to the applicable fraction of the original trust, the trustee can select which of the resulting trusts has an inclusion ratio of zero, and which has the inclusion ratio of one. For example, if the original trust has an applicable percentage of .50 and the trust is severed into two trusts, the trustee can select which of the two resulting trusts has an inclusion ratio of zero, and which has an inclusion ratio of one.[3]

Regulations provide that, where a trust is severed and the severance is not qualified, the resulting trusts each receive an inclusion ratio equal to the inclusion ratio of the original trust.[4]

Regulations provide that, for purposes of the requirements that a separate share is not treated as such unless it exists at all times from and after creation of the trust, a trust is treated as created on the date of death of the grantor if the trust is fully includable in the gross estate of the grantor for estate tax purposes. Also, if the trust document requires the mandatory severance of a trust upon the occurrence of an event (not within the discretion of any person), the resulting trusts will be treated as separate trusts for GST tax purposes. The resulting trusts each receive an inclusion ratio equal to the inclusion ratio of the original trust.[5]

1. Treas. Reg. §26.2642-6(j), Ex. 8.
2. Treas. Reg. §26.2642-6(d)(4).
3. Treas. Reg. §26.2642-6(d)(7).
4. Treas. Reg. §26.2642-6(h).
5. Treas. Reg. §26.2654-1(a).

Planning Point: The advantage of having portions or shares of a trust treated as separate trusts is that the transferor can decide whether or not to allocate a portion of his GST tax exemption to each separate trust and the trustee can make distributions from the separate trusts in a way which minimizes GST tax.

732. How is the GST tax applied to nontaxable gifts?

In the case of any direct skip which is a nontaxable gift, the inclusion ratio is zero. For this purpose, a nontaxable gift means any transfer of property to the extent the transfer is not treated as a taxable gift by reason of the gift tax annual exclusion (taking into account the split gift provision for married couples–see Q 753) or the "qualified transfer" exclusion (see Q 753). In other words, there is no GST tax imposed on direct skip gifts that come within the gift tax annual exclusion or that are "qualified transfers." However, with respect to transfers after March 31, 1988, a nontaxable gift which is a direct skip to a trust for the benefit of an individual has an inclusion ratio of zero only if (1) during the life of such individual no portion of the trust corpus or income may be distributed to or for the benefit of any other person, and (2) the trust would be included in such individual's estate if the trust did not terminate before such individual died.[1]

733. What is a Reverse QTIP Election and how is it made for GST tax purposes?

A qualified terminable interest property (QTIP) election can be made to qualify property for the estate tax (see Q 700) and gift tax (see Q 756) marital deductions. A reverse QTIP election may be made for such property under the GST tax. The effect of making the reverse QTIP election is to have the decedent or the donor treated as the transferor (see Q 723) for GST tax purposes. If a reverse QTIP election is made for property in a trust, the election must be made for all of the property in the trust. However, the Committee Report states that if the executor indicates on the federal estate tax return that separate trusts will be created, such trusts will be treated as separate trusts. In other words, separate trusts can be created so that the QTIP and reverse QTIP election can be made for different amounts, and thus minimize all transfer taxes.[2] See "Separate Trusts," above regarding the creation of separate shares from a single trust.

> *Example*: For example (based on a $5 million exemption) decedent (who has made $500,000 of taxable gifts protected by the unified credit) with a $10,000,000 estate leaves $4,500,000 in a credit shelter trust and $5,500,000 to his surviving spouse in a QTIP trust, reducing his estate tax to zero. (Assume each trust would be subject to GST tax to the extent that the $5,000,000 exemption is not allocated to such trust.) The executor allocates $4,500,000 of the decedent's $5,000,000 GST tax exemption to the credit shelter trust and makes a reverse QTIP election as to $500,000 of the QTIP property so that the decedent's full $5,000,000 exemption can be used. The surviving spouse's $5,000,000 exemption amount may then be used to protect the remaining $5,000,000 of property, and the entire $10,000,000 has escaped GST tax (assuming separate QTIP trusts of $4,500,000 and $500,000 are created).

1. IRC Sec. 2642(c).
2. IRC Sec. 2652(a)(3). See Let. Ruls. 9133016, 9002014.

734. How are basis adjustments treated for GST tax purposes?

Where the basis of property subject to the GST tax is increased (or decreased) to fair market value because property transferred in a taxable termination occurs at the same time and as a result of the death of an individual, any increase (or decrease) in basis is limited by multiplying such increase (or decrease) by the inclusion ratio used in allocating the GST exemption.[1]

735. How are individuals assigned to generations for purposes of the GST tax?

An individual (and his spouse or former spouse) who is a lineal descendant of a grandparent of the transferor (or the transferor's spouse) is assigned to that generation which results from comparing the number of generations between the grandparent and such individual with the number of generations between the grandparent and the transferor (or the transferor's spouse). A relationship by legal adoption is treated as a relationship by blood, and a relationship by the half-blood is treated as a relationship of the whole blood.[2]

A person who could be assigned to more than one generation is assigned to the youngest generation. However, regulations provide that adopted individuals will be treated as one generation younger than the adoptive parent where: (1) a transfer is made to the adopted individual from the adoptive parent, the spouse or former spouse of the adoptive parent, or a lineal descendant of a grandparent of the adoptive parent; (2) the adopted individual is a descendant of the adoptive parent (or the spouse or former spouse of the adoptive parent); (3) the adopted individual is under age 18 at the time of adoption; and (4) the adoption is not primarily for the purpose of avoiding GST tax.[3]

However, with respect to terminations, distributions, and transfers occurring after 1997, where an individual's parent is dead at the time of a transfer subject to gift or estate tax upon which the individual's interest is established or derived, such individual will be treated as being one generation below the lower of (1) the transferor's generation, or (2) the generation of the youngest living ancestor of the individual who is also a descendant of the parents of the transferor or the transferor's spouse (or former spouse). This predeceased parent rule applies to collateral relatives (e.g., nieces and nephews) only if there are no living lineal descendants of the transferor at the time of the transfer.[4] For a narrower predeceased parent rule that applied to direct skips before 1998, see Q 723.

Regulations make clear that if the generation-skipping property is subject to gift tax or estate tax on more than one occasion, the time for determining application of the predeceased parent rule is on the first of such occasions. In the case of a qualified terminable interest property (QTIP) marital deduction election, the time for determining application of the predeceased parent rule can essentially wait until the surviving spouse dies or makes a gift of the QTIP property. However, where a reverse QTIP election is made, application of the predeceased parent rule is

1. IRC Sec. 2654(a)(2).
2. IRC Secs. 2651(a), 2651(b), 2651(c).
3. Treas. Reg. §26.2651-2.
4. IRC Sec. 2651(e).

made at the time of the first spouse's death. Also, at times property may be transferred to a trust before the predeceased parent rule is applicable. Later, the predeceased parent rule applies to additional property transferred to the trust. The additional property is treated as being held in a separate trust for GST tax purposes. Each portion has, in effect, a separate transferor.[1]

An individual who cannot be assigned to a generation under the foregoing rules is assigned to a generation on the basis of his date of birth. An individual born not more than 12½ years after the date of birth of the transferor is assigned to the transferor's generation. An individual born more than 12½ years but not more than 37½ years after the date of birth of the transferor is assigned to the first generation younger than the transferor. There are similar rules for a new generation every 25 years.[2]

736. Can married couples make a split gift for purposes of the GST tax?

Yes. If a split gift is made for gift tax purposes (see Q 753), such gift will be so treated for purposes of the GST tax.[3] Split gifts allow spouses to, in effect, utilize each other's annual exclusions and exemptions (see Q 724). One memorandum permitted a taxpayer to elect after his spouse's death to split gifts with his spouse and thus take advantage of his spouse's GST tax exemption where the gifts were made by the taxpayer shortly before the spouse's death.[4]

737. What credits are allowed against the GST tax?

For decedents dying before 2005, if a GST (other than a direct skip) occurs at the same time as and as a result of the death of an individual, a credit against the GST tax imposed is allowed in an amount equal to the GST tax paid to any state in respect to any property included in the GST, but the amount cannot exceed 5 percent of the GST tax.[5] The amendments made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA 2001) sunset after December 31, 2012 so that this provision is no longer applicable. Transfers made to estates of decedents, gifts, or GST transfers are treated as if the amendments were never enacted.[6] However, under 2010 TRA, the GST tax rate for 2010 is zero, 35 percent for 2011 and 2012 and 40 percent for 2013 and beyond. The GST exemption for 2010 and 2011 was $5 million, $5.12 million in 2012, $5.25 million in 2013 and $5.34 million in 2014.

738. What are the return requirements with respect to the GST tax?

The person required to file the return is the person liable for paying the tax (see Q 739). In the case of a direct skip (other than from a trust), the return must be filed on or before the due date for the gift or estate tax return with respect to the transfer. In all other cases, the return must be filed on or before the 15th day of the 4th month after the close of the taxable year of the person required to make the return.[7]

1. Treas. Reg. §26.2651-1.
2. IRC Sec. 2651(d).
3. IRC Sec. 2652(a)(2).
4. TAM 9404023.
5. IRC Sec. 2604.
6. IRC Secs. 2604(c), 2664, as added by EGTRRA 2001.
7. IRC Sec. 2662.

739. Who is liable for paying the GST tax?

In the case of a taxable distribution, the tax is paid by the transferee. In the case of a taxable termination or a direct skip from a trust, the tax is paid by the trustee. In the case of a direct skip (other than a direct skip from a trust), the tax is paid by the transferor. Unless the governing instrument of transfer otherwise directs, the GST tax is charged to the property constituting the transfer.[1]

Gift Tax

740. What is the federal gift tax?

The federal gift tax is an excise tax on the right to transfer property during life.[2] The donor is generally responsible for paying the gift tax. The payment of the gift tax by the donor is not treated as a gift. The gift tax is a cumulative tax and the tax rates are progressive. Gifts made in prior years are taken into account in computing the tax on gifts made in the current year with the result that later gifts are usually taxed in a higher bracket than earlier gifts (a drop in tax rates could obviate this result). Moreover, the tax is a *unified* tax; the same tax that is imposed on taxable gifts is imposed on taxable estates. For gifts made during 2012, the applicable exclusion amount is increased to $5 million (with a 2012 inflation adjustment statement to $5.12 million).[3] The maximum gift tax rate for 2011 and 2012 is 35 percent. Under the American Taxpayer Relief Act of 2013, the top estate and gift tax rate increased to 40 percent, and the exclusion amount is permanently set at the $5 million level, as indexed for inflation annually ($5.34 million in 2014).[4]

A gift tax return (Form 709), if required, must generally be filed by April 15 of the following year. A six month extension for filing is available. Tax is generally due by April 15, but certain extensions for payment may be available. See Q 759.

The Federal Gift Tax Worksheet, below, shows the steps for calculating the gift tax. Calculation starts with determining what a gift for gift tax purposes is (see Q 741). In general, gifts include gratuitous transfers of all kinds. A husband and wife can elect to have all gifts made by either spouse during the year treated as made one-half by each spouse (Q 752). A qualified disclaimer is not treated as a gift (Q 743).

Gifts are generally valued at fair market value on the date of the gift (Q 760). Special rules apply for a wide variety of investments and to net gifts (Q 748), and Chapter 14 special valuation rules apply to transfers to family members of certain interests in corporations, partnerships, or trusts (Q 777).

A couple of exclusions are available from gifts. A $14,000 (in 2013 and 2014, up from $13,000 for 2011 and 2012) annual exclusion is available for present interest gifts on a

1. IRC Sec. 2603.
2. IRC Sec. 2501.
3. Tax Relief, Unemployment Compensation Reauthorization and Job Creation Act of 2010 (2010 TRA) P.L. 111-312.
4. American Taxpayer Relief Act of 2012, Pub. Law No. 112-240, Sec. 101; Rev. Proc. 2013-15, 2013-5 IRB 444, Rev. Proc. 2013-35, 2013-47 IRB 537.

per donor/donee basis. An unlimited exclusion is available for qualified transfers for educational and medical purposes. See Q 753.

A couple of deductions are also available. Unlimited marital (Q 756) and charitable (Q 757) deductions are available for certain transfers to the donor's spouse and to charities.

The amount of taxable gifts subject to the federal gift tax equals gifts made during the year reduced by all exclusions and deductions.

The federal gift tax is imposed on taxable gifts. As discussed above, the federal gift tax rates (Appendix D) are generally progressive and the tax is based on cumulative taxable transfers during lifetime. To implement this, the tax is calculated on total taxable gifts, the sum of the taxable gifts made during the year (current taxable gifts) and prior taxable gifts, and the gift tax that would have been payable on prior taxable gifts (using the current tax rates) is then subtracted out. 2010 TRA provided that the amount of the unified credit is computed taking into account the credit for prior years' gifts using the gift tax rate for the current gift to determine the tentative tax.[1] Thus, a donor can make gifts equal to the applicable exemption amount ($5 million for 2011, $5.12 million in 2012, $5.25 million in 2013 and $5.34 million in 2014) and prior taxable gifts without incurring a gift tax liability.

Planning Point: A gift made after August 5, 1997, cannot be revalued, if the gift was adequately disclosed on a gift tax return and the gift tax statute of limitations (generally, three years from the date of filing) has passed.[2] Consider filing gift tax returns even for non-cash annual exclusion gifts.

The tentative tax is then reduced by the unified credit (Q 758) to produce gift tax payable.

Federal Gift Tax Worksheet

Current Year		
Current Gifts		Q 741
– Annual Exclusions	Q 753	
– Qualified Transfers Exclusion	Q 753	
– Marital Deduction	Q 756	
– Charitable Deduction	Q 757	
– Total Reductions		
Current Taxable Gifts		
+ Prior Taxable Gifts		
Total Taxable Gifts		
Tax on Total Taxable Gifts		Appendix D
– Tax on Prior Taxable Gifts		Appendix D
Tentative Tax		Appendix D
– Unified Credit		Q 758
Federal Gift Tax		

1. IRC Section 2505(a).
2. IRC Sec. 6501(c)(9).

741. Which types of transfers are subject to the federal gift tax?

The gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. For example, a taxable transfer may be effectuated by the creation of a trust; the forgiving of a debt (see Q 745); the assignment of a judgment; the transfer of cash, certificates of deposit, federal, state, municipal, or corporate bonds, or stocks.[1]

All transactions whereby property or property rights or interests are gratuitously passed or conferred upon another, regardless of the means or device employed, constitute gifts subject to tax.[2] Donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor.[3] Generally, if property is transferred gratuitously or for an inadequate consideration, a gift (of the full value of the property transferred or the portion in excess of the consideration given) will be considered a gift.[4]

Shareholders of nonparticipating preferred stock in profitable family held corporations have been held to have made gifts to the common stockholders (typically descendants of the preferred shareholder) by waiving payment of dividends or simply by failing to exercise conversion rights or other options available to a preferred stockholder to preserve his position.[5] The Tax Court has held that the failure to convert noncumulative preferred stock to cumulative preferred stock did not give rise to a gift, but that thereafter a gift was made each time a dividend would have accumulated. However, the failure to exercise a put option at par plus accumulated dividends plus interest was not treated as a gift of foregone interest.[6]

A transaction involving the nonexercise of an option by a son under a cross-purchase buy-sell agreement followed by the sale of the same stock by the father to a third party when the fair market value of the stock was substantially higher than the option price was treated as a gift from the son to the father.[7] Also, a father indirectly made a gift to his son to the extent that the fair market value of stock exceeded its redemption price when the father failed to exercise his right under a buy-sell agreement to have a corporation redeem all of the available shares held by his brother-in-law's estate and the stock passed to the son.[8]

With respect to a trust, the grantor/income beneficiary may be treated as making additional gifts of remainder interests in each year that the grantor fails to exercise his right to make nonproductive or underproductive property normally productive.[9] A mother made gifts to her children to the extent that the children were paid excessive trustee fees from the marital deduc-

1. Treas. Reg. §25.2511-1(a).
2. Treas. Reg. §25.2511-1(c).
3. Treas. Reg. §25.2511-1(g)(1).
4. *Hollingsworth v. Comm.*, 86 TC 91 (1986).
5. TAMs 8723007, 8726005.
6. *Snyder v. Comm.*, 93 TC 529 (1989).
7. Let. Rul. 9117035.
8. TAM 9315005.
9. Let. Rul. 8945006.

tion trust of which the mother was a beneficiary.[1] Where a trust was modified to add adopted persons as beneficiaries, the beneficiaries with trust interests prior to the modification were treated as making gifts to the newly added beneficiaries.[2]

Planning Point: However, a grantor of a trust does not make a gift to trust beneficiaries by paying the income tax on trust income taxable to the grantor under the grantor trust rules (see Q 664).[3] Therefore, trusts that are disregarded for income tax purposes but not for transfer tax purposes can provide a significant opportunity for trust principal to grow without the reduction of tax.

Letter Ruling 9113009 (withdrawn without comment by TAM 9409018) had ruled that a parent who guaranteed loans to his children made a gift to his children because, without the guarantees, the children could not have obtained the loans or, at the very least, would have paid a higher interest rate.

The gift tax is imposed only on completed gifts (see Q 742), which is a facts and circumstances analysis.

Where spouses enter into joint and mutual wills, the surviving spouse may be treated as making a gift of a remainder interest at the other spouse's death.[4]

The transfer of a qualifying income interest for life in qualified terminable interest property for which a marital deduction was allowed (see Q 700, Q 756) will be treated as a transfer of such property for gift tax purposes.[5] If a QTIP trust is severed into Trust A and Trust B and the spouse renounces her interest in Trust A, such renunciation will not cause the spouse to be treated as transferring Trust B under IRC Section 2519.[6]

The spouse is entitled to collect from the donee the gift tax on the transfer of a QTIP interest. The amount treated as a transfer for gift tax purposes is reduced by the amount of the gift tax the spouse is entitled to recover from the donee. Thus, the transfer is treated as a net gift (see Q 748). The failure of a spouse to exercise the right to recover gift tax from the donee is treated as a transfer of the unrecovered amount to the donee when the right to recover is no longer enforceable. If a written waiver of the right of recovery is executed before the right becomes unenforceable, the transfer of the unrecovered gift tax is treated as made on the later of (1) the date of the waiver, or (2) the date the tax is paid by the transferor. Any delay in exercise of the right of recovery is treated as an interest-free loan (see Q 744) for gift tax purposes.[7]

Where a surviving spouse acquires a remainder interest in QTIP marital deduction property in connection with a transfer of property or cash to the holder of the remainder interest, the surviving spouse makes a gift to the remainder person under both IRC Section 2519 (disposition of QTIP interest) and IRC Sections 2511 and 2512 (transfers and valuation of gifts). The amount

1. TAM 200014004.
2. Let. Rul. 200917004.
3. Rev. Rul. 2004-64, 2004-27 IRB 7.
4. *Grimes v. C.I.R.*, 851 F. 2d 1005, 88-2 USTC ¶13,774 (7th Cir. 1988).
5. IRC Sec. 2519.
6. Let. Ruls. 200116006, 200122036.
7. Treas. Regs. §§25.2207A-1(b), 25.2519-1(c)(4).

of the gift is equal to the greater of (1) the value of the remainder interest, or (2) the value of the property or cash transferred to the holder of the remainder interest.[1] On the other hand, children would be treated as making a gift if the children transfer their remainder interest in a QTIP marital deduction trust to the surviving spouse.[2]

Any subsequent transfer by the donor spouse of an interest in such property is not treated as a transfer for gift tax purposes, unless the transfer occurs after the donee spouse is treated as having transferred such property under IRC Section 2519 or after such property is includable in the donee spouse's estate under IRC Section 2044 (see Q 679).[3] Also, if property for which a QTIP marital deduction was taken is includable in the estate of the spouse who was given the QTIP interest and the estate of such spouse fails to recover from the person receiving the property any estate tax attributable to the QTIP interest being included in such spouse's estate, such failure is treated as a transfer for gift tax purposes unless (1) such spouse's will waives the right to recovery, or (2) the beneficiaries cannot compel recovery of the taxes (e.g., where the executor is given discretion to waive the right of recovery in such spouse's will).[4]

The gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth, or to ordinary business transactions (i.e., transactions which are bona fide, at arm's length, and free from any donative intent). A consideration not reducible to a value in money or money's worth (such as love and affection, promise of marriage, etc.) is wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift. Similarly, a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the spouse's property or estate, is not considered to any extent a consideration "in money or money's worth."[5]

Transfers of property or interests in property made under the terms of a written agreement between spouses in settlement of their marital or property rights are deemed to be for an adequate and full consideration in money or money's worth and, therefore, exempt from the gift tax (whether or not such agreement is approved by a divorce decree), if the spouses obtain a final decree of divorce from each other within the three-year period beginning on the date one year before the agreement is entered into.[6]

For recapture rules applicable where distributions are not timely made in connection with the transfer of an interest in a corporation or partnership which is subject to the Chapter 14 valuation rules, see Q 778. For deemed transfers upon the lapse of certain voting or liquidation rights in a corporation or partnership, see Q 786.

A gift may be made of foregone interest with respect to interest-free and bargain rate loans (see Q 744).

1. Rev. Rul. 98-8, 1998-1 CB 541.
2. Let. Rul. 199908033.
3. IRC Sec. 2523(f)(5).
4. Treas. Reg. §20.2207A-1(a).
5. Treas. Reg. §25.2512-8.
6. IRC Sec. 2516.

A United States citizen or resident who receives a covered gift from certain expatriates may owe gift tax on the transfer.[1]

742. When does a complete gift take place for purposes of the federal gift tax?

The gift is complete once the donor parts with dominion and control over the property or interest in the property he is giving, leaving him no power to change its disposition, whether for his own benefit or for the benefit of another.[2] In general, a transfer of an interest in a revocable trust is incomplete until the interest becomes irrevocable. However, if the interest becomes irrevocable at the grantor's death, it will generally be subject to estate tax (see Q 679) rather than to gift tax.

If a donor delivers a properly endorsed stock certificate to the donee or the donee's agent, the gift is completed for gift tax purposes on the date of delivery. If the donor delivers the certificate to his bank or broker as his agent, or to the issuing corporation or its transfer agent, for transfer into the name of the donee, the gift is completed on the date the stock is transferred on the books of the corporation.[3]

A transfer of a nonstatutory stock option which was not traded on an established market would be treated as a gift to a family member on the later of the following: (1) the transfer; or (2) the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor.[4]

The gratuitous transfer by the maker of a legally binding promissory note is a completed gift (the transfer of a legally unenforceable promissory note is an incomplete gift); if the note is unpaid at the donor's death, the gift is not treated as an adjusted taxable gift in computing the tentative estate tax (see Q 675), and no deduction is allowable from the gross estate for the promisee's claim with respect to the note (see Q 700).[5]

In the case of a gift by check, the following questions arise: (1) when is the gift complete?; (2) when is the check delivered?; and (3) when is the check cashed? In litigation to date, the courts initially appeared to make a distinction between gifts to charitable donees and gifts to noncharitable donees. In the former scenario, it has been held that at least where there is timely presentment and payment, payment of the check by the bank relates back to the date of delivery for purposes of determining completeness of the gift.[6] In the latter scenario, the courts have shown less of a willingness to apply the "relation back" doctrine.

In *Estate of Dillingham v. Commissioner*,[7] the noncharitable donees did not cash the checks until 35 days after the delivery date – the donor's death having intervened. The court said that this

1. IRC Sec. 2801.
2. Treas. Reg. §25.2511-2(b).
3. Treas. Reg. §25.2511-2(h); Rev. Rul. 54-554, 1954-2 CB 317; Rev. Rul. 54-135, 1954-1 CB 205.
4. Rev. Rul. 98-21, 1998-1 CB 975.
5. Rev. Rul. 84-25, 1984-1 CB 191.
6. *Est. of Spiegel v. Comm.*, 12 TC 524 (1942).
7. 903 F 2d 760, 90-1 USTC ¶60,021 (10th Cir. 1990).

delay casted doubt as to whether the checks were unconditionally delivered. Since the estate failed to prove unconditional delivery, the court declined to extend the relation back doctrine to the case before it. It then turned to local law to determine whether the decedent had parted with dominion and control upon delivery of the checks. It determined that under applicable local law (Oklahoma), the donor did not part with dominion and control until the checks were cashed.

However, in *Est. of Gagliardi v. Comm.*,[1] checks written by a brokerage firm and charged against the decedent's account prior to decedent's death were treated as completed gifts to the noncharitable donees, even though some checks were cashed after decedent's death.

Also, in *Est. of Metzger v. Comm.*,[2] the relation-back doctrine was applied to gifts made by check to noncharitable beneficiaries where the taxpayer was able to establish the following: (1) the donor's intent to make gifts; (2) unconditional delivery of the checks; (3) presentment of the check during the year for which a gift tax annual exclusion was sought and within a reasonable time after issuance; and (4) that there were sufficient funds to pay the checks at all relevant times. In *W. H. Braum Family Partnership v. Commissioner*,[3] the relation back doctrine was not applied where the taxpayer could not establish either (2) or (4). In response to *Metzger*, the Service issued a Revenue Ruling providing that a gift by check to a noncharitable beneficiary will be considered complete on the earlier of (1) when the donor has so parted with dominion and control under state law such that the donor can no longer change its disposition, or (2) when the donee deposits the check, cashes the check against available funds, or presents the check for payment if the following conditions are met: (a) the check must be paid by the drawee bank when first presented for payment to the drawee bank; (b) the donor must be alive when the check is paid by the drawee bank; (c) the donor must have intended a gift; (d) delivery of the check by the donor must have been unconditional; (e) the check must be deposited, cashed or presented in the calendar year for which the completed gift tax treatment is sought; and (f) the check must be deposited, cashed, or presented within a reasonable time of issuance.[4]

743. If a person refuses to accept an interest in property (a disclaimer), is he considered to have made a gift of the interest for federal gift tax purposes?

Not if he makes a *qualified disclaimer*. A "qualified disclaimer" is an irrevocable and unqualified refusal to accept an interest in property created in the person disclaiming by a taxable transfer made after 1976. With respect to inter vivos transfers, for the purpose of determining when a timely disclaimer is made (see condition (3) below), a taxable transfer occurs when there is a completed gift for federal gift tax purposes regardless of whether a gift tax is imposed on the completed gift. Thus, gifts qualifying for the gift tax annual exclusion are regarded as taxable transfers for this purpose.[5] Furthermore, a disclaimer of a remainder interest in a trust created prior to the enactment of the federal gift tax was subject to the gift tax where the disclaimer was

1. 89 TC 1207 (1987).
2. 38 F 3d 118, 94-2 USTC ¶60,179 (4th Cir. 1994), aff'g 100 TC 204 (1993).
3. TC Memo 1993-434.
4. Rev. Rul. 96-56, 1996-2 CB 161.
5. Treas. Reg. §25.2518-2(c)(3).

not timely and the disclaimer occurred after enactment of the gift tax.[1] In order to effectively disclaim property for transfer tax purposes, a disclaimer of property received from a decedent at death should generally be made within nine months of death rather than within nine months of the probate of the decedent's will.[2]

In general, the disclaimer must satisfy the following conditions: (1) the disclaimer must be irrevocable and unqualified; (2) the disclaimer must be in writing; (3) the writing must be delivered to the transferor of the interest, his legal representative, the holder of the legal title to the property, or the person in possession of the property, not later than nine months after the later of (a) the day on which the transfer creating the interest is made, or (b) the day on which the disclaimant reaches age 21; (4) the disclaimant must not have accepted the interest disclaimed or any of its benefits; and (5) the interest disclaimed must pass either to the spouse of the decedent or to a person other than the disclaimant without any direction on the part of the person making the disclaimer.[3] Acts indicative of acceptance include: (1) using the property or the interest in property; (2) accepting dividends, interest, or rents from the property; and (3) directing others to act with respect to the property or interest in property. However, merely taking delivery of title without more does not constitute acceptance.[4] A person cannot disclaim a remainder interest in property while retaining a life estate or income interest in the same property.[5] Under 2010 TRA, a disclaimant has up to nine months after the enactment of 2010 TRA (12/17/10) to disclaim property passing from a decedent who died between January 1, 2010 and December 16, 2010.

If a person makes a qualified disclaimer, for purposes of the federal estate, gift, and generation-skipping transfer tax provisions, the disclaimed interest in property is treated as if it had never been transferred to the person making the qualified disclaimer. Instead it is considered as passing directly from the transferor of the property to the person entitled to receive the property as a result of the disclaimer. Accordingly, a person making a qualified disclaimer is not treated as making a gift. Similarly, the value of a decedent's gross estate for purposes of the federal estate tax does not include the value of property with respect to which the decedent or his executor has made a qualified disclaimer.[6]

In the case of a joint tenancy with rights of survivorship or a tenancy by the entirety, the interest which the donee receives upon creation of the joint interest can be disclaimed within nine months of the creation of the interest and the survivorship interest received upon the death of the first joint tenant to die (deemed to be a one-half interest in the property) can be disclaimed within nine months of the death of the first joint tenant to die, *without regard to* the following: (1) whether either joint tenant can sever unilaterally under local law; (2) the portion of the property attributable to consideration furnished by the disclaimant; or (3) the portion of the property includable in the decedent's gross estate under IRC Section 2040. However, in the

1. *U.S. v. Irvine*, 114 S. Ct. 1473, 94-1 USTC ¶60,163 (U.S. 1994).
2. *Est. of Fleming v. Comm.*, 974 F. 2d 894, 92-2 USTC ¶60,113 (7th Cir. 1992).
3. IRC Sec. 2518(b); Treas. Reg. §25.2518-2(a).
4. Treas. Reg. §25.2518-2(d)(1).
5. *Walshire v. Comm.*, 288 F.3d 342, 2002-1 USTC ¶60,439 (8th Cir. 2002).
6. Treas. Reg. §25.2518-1(b).

case of a creation of a joint tenancy between spouses or tenancy by the entirety created after July 13, 1988 where the *donee spouse is not a U.S. citizen*, a surviving spouse can make a disclaimer within nine months of the death of the first spouse to die of any portion of the joint interest that is includable in the decedent's estate under IRC Section 2040. Also, in the case of a transfer to a *joint bank, brokerage, or other investment account* (e.g., mutual fund account) where the transferor can unilaterally withdraw amounts contributed by the transferor, the surviving joint tenant may disclaim amounts contributed by the first joint tenant to die within nine months of the death of the first joint tenant to die.[1]

For purposes of a qualified disclaimer, the mere act of making a surviving spouse's statutory election is not to be treated as an acceptance of an interest in the disclaimed property or any of its benefits. However, the disclaimer of a portion of the property subject to the statutory election must be made within nine months of the decedent spouse's death, rather than within nine months of the surviving spouse's statutory election.[2]

A power with respect to property is treated as an interest in such property.[3] The exercise of a power of appointment to any extent by the donee of the power is an acceptance of its benefits.[4]

A beneficiary who is under 21 years of age has until nine months after his 21st birthday in which to make a qualified disclaimer of his interest in property. Any actions taken with regard to an interest in property by a beneficiary or a custodian prior to the beneficiary's 21st birthday will not be an acceptance by the beneficiary of the interest.[5] This rule holds true even as to custodianship gifts in states which provide that custodianship ends when the donee reaches an age below 21.[6]

It is also important to check applicable state law to make certain that the disclaimer meets the requirements and is effective.

744. Are gifts made of foregone interest or interest-free and bargain rate loans subject to the federal gift tax?

An interest-free or low-interest loan within a family or in any other circumstances where the foregone interest is in the nature of a gift results in a gift subject to the federal gift tax. IRC Section 7872 applies in the case of term loans made after June 6, 1984, and demand loans outstanding after that date.

In general, IRC Section 7872 recharacterizes a below-market loan (an interest-free or low-interest loan) as an arm's length transaction in which the lender (1) made a loan to the borrower in exchange for a note requiring the payment of interest at a statutory rate, and (2) made a gift, distributed a dividend, made a contribution to capital, paid compensation, or made another payment to the borrower which, in turn, is used by the borrower to pay the interest. The difference

1. Treas. Reg. §25.2518-2(c)(4).
2. Rev. Rul. 90-45, 1990-1 CB 176.
3. IRC Sec. 2518(c)(2).
4. Treas. Reg. §25.2518-2(d)(1); Let. Rul. 8142008.
5. Treas. Reg. §25.2518-2(d)(3).
6. Treas. Reg. §25.2518-2(d)(4), Example 11.

between the statutory rate of interest and the rate (if any) actually charged by the lender, the "foregone interest," is thus either a gift to the borrower or income to him, depending on the circumstances. The income tax aspects of below-market loans are discussed in Q 582 and Q 583. The gift tax aspects of such loans are discussed here.

First, some definitions: The term "gift loan" means any below-market loan where the foregoing of interest is in the nature of a gift as defined under Chapter 12. The term "demand loan" means any loan which is payable in full at any time on the demand of the lender. The term "term loan" means any loan which is not a demand loan. The term "applicable federal rate" means: in the case of a demand loan or a term loan of up to three years, the federal short-term rate; in the case of a term loan over three years but not over nine years, the federal mid-term rate; in the case of a term loan over nine years, the federal long-term rate. In the case of a term loan, the applicable rate is compounded semiannually. These rates are reset monthly.[1] The "present value" of any payment is determined as follows: (1) as of the date of the loan; and (2) by using a discount rate equal to the applicable federal rate.[2] The term "below-market loan" means any loan if in the case of the following: (1) a demand loan, in which interest is payable on the loan at a rate less than the applicable federal rate; or (2) a term loan, in which the amount loaned exceeds the present value of all payments due under the loan. The term "foregone interest" means, with respect to any period during which the loan is outstanding, the excess of the following: (1) the amount of interest that would have been payable on the loan for the period if the interest accrued on the loan at the applicable federal rate and was payable annually on the last day of the appropriate calendar year; over (2) any interest payable on the loan properly allocable to the period.

In the case of a demand gift loan, the foregone interest is treated as transferred from the lender to the borrower and retransferred by the borrower to the lender as interest on the last day of each calendar year the loan is outstanding. In the case of a term gift loan, the lender is treated as having transferred on the date the loan was made, and the borrower is treated as having received on such date, cash in an amount equal to the excess of (1) the amount loaned, over (2) the present value of all payments which are required to be made under the terms of the loan. The provisions do not apply in the case of a gift loan between individuals (a husband and wife are treated as one person) that at no time exceeds $10,000 in the aggregate amount outstanding on *all* loans, whether below-market or not. The $10,000 de minimis exception does not apply, however, to loans attributable to acquisition of income-producing assets.

IRC Section 7872 does not apply to life insurance policy loans.[3] Neither does IRC Section 7872 apply to loans to a charitable organization if the aggregate outstanding amount of loans by the lender to that organization does not exceed $250,000 at any time during the tax year.[4]

The Tax Court has held that IRC Section 483 and safe harbor interest rates contained therein do not apply for gift tax purposes. Consequently, the value of a promissory note given

1. IRC Sec. 1274(d).
2. See Prop. Treas. Reg. §1.7872-14.
3. Prop. Treas. Reg. §1.7872-5(b)(4).
4. Temp. Treas. Reg. §1.7872-5T(b)(9).

in exchange for real property was discounted to reflect time value of money concepts under IRC Section 7282 (without benefit of IRC Section 483).[1]

Prior to the enactment of IRC Section 7872, the Supreme Court held that, in the case of an interest-free demand loan made within a family, a gift subject to federal gift tax is made of the value of the use of the money lent.[2] The court did not decide how to value such a gift, but implicit in the decision was the assumption that low-interest or interest-free loans within a family context have, since the first federal gift tax statute was enacted in 1924, resulted in gifts. Rev. Proc. 85-46[3] provided guidance in valuing and reporting gift demand loans not covered by IRC Section 7872.

745. What are the gift tax implications, if any, when an individual transfers property (or an interest in property) and takes back noninterest-bearing term notes covering the value of the property transferred, which notes the transferor intends to forgive as they come due?

If the transferor's receipt of the noninterest-bearing notes is characterized as a "term gift loan," the lender/transferor will be treated as having transferred on the date of the receipt, and the borrower/transferee will be treated as having received on such date, cash in an amount equal to the excess of the following: (1) the amount loaned; over (2) the present value of all payments required to be made under the terms of the loan (see Q 741).[4] If the receipt of the notes is not so characterized, then the discussion in the following paragraph, relating to transactions occurring before June 7, 1984, is pertinent.

The IRS takes the position that such a transfer is a gift of the entire value of the property or interest given at the time of the transfer and is not a sale. If the transfer is of a remainder interest in property, it is a future interest gift that does not qualify for the gift tax annual exclusion (see Q 753). The Service distinguishes between an intent to forgive the notes and donative intent (see Q 741) with respect to transfer of the property: "A finding of an intent to forgive the note relates to whether valuable consideration was received, and thus, to whether the transaction was in reality a bona fide sale or a disguised gift."[5] The Tax Court, however, makes a distinction based on the nature of the notes given, holding that if the notes are secured by valid vendor's liens, the transaction is to be treated as a sale; a gift occurs on each date a note is due and forgiven, the value of the gift being the amount due on the note.[6]

746. Are gratuitous transfers by individuals of federal, state, and municipal obligations subject to federal transfer taxes?

Yes. Gratuitous transfers of obligations that are exempt from federal income tax are not exempt from federal estate tax, gift tax, or generation-skipping transfer tax, as the case may

1. *Frazee v. Comm.*, 98 TC 554 (1992).
2. *Dickman v. Comm.*, 104 S. Ct. 1086 (1984).
3. 1985-2 CB 507.
4. IRC Secs. 7872(b)(1), 7872(d)(2).
5. Rev. Rul. 77-299, 1977-2 CB 343; *Deal*, 29 TC 730 (1958).
6. *Haygood v. Comm.*, 42 TC 936 (1964), nonacq. 1977-2 CB 2; *Est. of Kelley v. Comm.*, 63 TC 321 (1974), nonacq. 1977-2 CB 2.

be – at least as to estates of decedents dying, gifts made, and transfers made on or after June 19, 1984. In the case of any provision of law enacted after July 18, 1984, such provision is not treated as exempting the transfer of property from such transfer taxes unless it refers to the appropriate IRC provisions.[1] Also, the removal of transfer tax exemption applies in the case of any transfer of property (or interest in property) if at any time an estate or gift tax return was filed showing such transfer as subject to federal estate or gift tax.[2] Congress also added that no inference was to be drawn that transfers of such obligations occurring before such time were exempt from transfer taxation.

In *United States v.Wells Fargo*,[3] the United States Supreme Court determined that "tax-exempt" bonds have always been subject to transfer taxes unless specifically provided otherwise by statute (even before enactment of TRA '84, Section 641). This determination was based on the longstanding principle that tax exemption cannot be inferred. The differing language concerning project notes issued pursuant to Housing Acts, providing at one time for exemption from all taxation and at another for exemption from all taxation except surtax, estate, inheritance, and gift taxes, could be explained by the need to address a surtax in 1937, and not by a Congressional intent to exempt the project notes from estate taxation, the court concluded. The project notes were not exempt from transfer taxes, the court ruled, and included the notes in the decedent's estate.

747. What are the federal gift tax implications of taking title to investment property in joint names?

There may be a gift for federal gift tax purposes either at the time title is taken in joint names or at a later time when one of the joint owners reduces some or all of the property to his own possession. Consider the following examples:

"If A creates a joint bank account for himself and B (or a similar type of ownership by which A can regain the entire fund without B's consent), there is a gift to B when B draws upon the account for his own benefit, to the extent of the amount drawn without any obligation to account for a part of the proceeds to A. Similarly, if A purchases a United States savings bond, registered as payable to 'A or B,' there is a gift to B when B surrenders the bond for cash without any obligation to account for a part of the proceeds to A."[4] Likewise, "where A, with his separate funds, creates a joint brokerage account for himself and B, and the securities purchased on behalf of the account are registered in the name of a nominee of the firm, A has not made a gift to B, for federal gift tax purposes, unless and until B draws upon the account for his own benefit without any obligation to account to A. If B makes a withdrawal under such circumstances, the value of the gift by A would be the sum of money or the value of the property actually withdrawn from the account by B."[5] Thus, the creation of a joint account or similar type of ownership by itself, does not constitute a completed transfer from the creator and sole contributor if the creator and sole contributor can regain the existing account without the joint owner's consent.

1. TRA '84, Sec. 641.
2. TRA '84, Sec. 641(b)(2).
3. 485 US 351, 708 S. Ct. 1179, 88-1 USTC ¶13,759 (U.S. 1988).
4. Treas. Reg. §25.2511-1(h)(4).
5. Rev. Rul. 69-148, 1969-1 CB 226.

"If A with his own funds purchases property and has the title conveyed to himself and B as joint owners, with rights of survivorship (other than a joint ownership described in [the forego-ing paragraph]) but which rights may be defeated by either party severing his interest, there is a gift to B in the amount of half the value of the property."[1]

Where A purchases and registers U.S. Treasury notes in the names of "A or B or survivor" in a jurisdiction in which this registration creates a joint tenancy, there is a completed gift of the survivorship rights in the notes and an undivided one-half interest in the interest payments and redemption rights pertaining to the notes. In a jurisdiction in which a joint tenancy is not created by such registration, there is a gift of the survivorship rights in the interest payments and in the notes at maturity.[2] Computation of the value of the gifts in both situations is set forth in Revenue Ruling 78-215.

In the above examples, if A and B are husband and wife, any gift will be offset by the marital deduction to the extent available (see Q 756).[3]

748. What are the federal gift tax results if the donee agrees to pay the gift tax?

If a gift is made subject to the express or implied condition that the donee pay the gift tax, the donor may deduct the amount of tax from the gift in determining the value of the gift. In such a transaction, the donor receives consideration for the transfer in the amount of the gift tax paid by the donee. Thus, to the extent of the tax paid, the donee does not receive a gift.[4] Similarly, if the donor makes a gift in trust subject to an agreement that the trustee pay the gift tax, the value of the property transferred is reduced for gift tax purposes by the amount of the tax.[5]

The computation of the tax requires the use of an algebraic formula, since the amount of the tax is dependent on the value of the gift which in turn is dependent on the amount of the tax. The formula is as follows:

$$\frac{\text{Tentative Tax}}{\text{1 plus Rate of Tax}} = \text{True Tax}$$

Examples illustrating the use of this formula, with the algebraic method, to determine the tax in a net gift situation are contained in IRS Publication 904 (Rev. May 1985). Three of the examples show the effect of a state gift tax upon the computation.

Although the donee pays the tax, it is the *donor's* unified credit that is used in computing the gift tax, not the donee's.[6]

1. Treas. Reg. §25.2511-1(h)(5).
2. Rev. Rul. 78-215, 1978-1 CB 298.
3. Treas. Reg. §25.2523(d)-1.
4. Rev. Rul. 75-72, 1975-1 CB 310; *Diedrich v. Comm.*, 102 S. Ct. 2414 (1982).
5. *Lingo*, 13 TCM 436 (1959); *Harrison*, 17 TC 1350 (1952), acq. 1952-2 CB 2.
6. Let. Rul. 7842068.

749. How is a gift of property under either the Uniform Gifts to Minors Act or under the Uniform Transfers to Minors Act treated for federal gift tax purposes?

Any transfer of property to a minor under either of the Uniform Acts constitutes a complete gift for federal gift tax purposes to the extent of the full fair market value of the property transferred. Generally, such a gift qualifies for the gift tax annual exclusion (see Q 753).[1] The allowance of the exclusion is not affected by the amendment of a state's Uniform Act lowering the age of majority and thus requiring that property be distributed to the donee at age 18.[2] These rulings base the allowance of the exclusion on the assumption that gifts under the Uniform Acts come within the purview of IRC Section 2503(c). Gifts to minors under IRC Section 2503(c) must pass to the donee on his attaining age 21. If a state statute varies from the Uniform Act by providing that under certain conditions custodianship may be extended past the donee's age 21, gifts made under those conditions would not qualify for the exclusion. For tables of state laws concerning the Uniform Acts, see Appendix D of *Tax Facts on Investments*.

750. When is a gift made with respect to an education savings account?

Contributions to an education savings account are treated as completed gifts to the beneficiary of a present interest in property which can qualify for the gift tax and generation-skipping transfer (GST) tax annual exclusion. The contributions must be in cash and prior to the beneficiary's 18th birthday. If the contribution is made for a beneficiary designated with special needs, the age limit does not apply.[3] If contributions for a year exceed the gift tax annual exclusion, the donor can elect to prorate the gifts over a five year period beginning with such year. A contribution to an education savings account does not qualify for the gift tax or GST tax exclusion for qualified transfers for educational purposes.[4] Distributions from an education savings account are not treated as taxable gifts. Also, if the designated beneficiary of the education savings account is changed, or if funds in the education savings account are rolled over to a new beneficiary, such a transfer is subject to the gift tax or GST tax only if the new beneficiary is a generation below the old beneficiary. Transfers within the same generation do not trigger a gift tax liability.[5]

See Q 695 for the estate tax treatment and Q 592 for the income tax treatment of education savings accounts.

751. When is a gift made with respect to a qualified tuition program?

For gift tax and generation-skipping transfer (GST) tax purposes, a contribution to a qualified tuition program on behalf of a designated beneficiary is not treated as a qualified transfer for purposes of the gift tax and GST tax exclusion for educational expenses, but is treated as a completed gift of a present interest to the beneficiary which qualifies for the annual exclusion

1. Rev. Rul. 56-86, 1956-1 CB 449; Rev. Rul. 59-357, 1959-2 CB 212.
2. Rev. Rul. 73-287, 1973-2 CB 321.
3. IRC Section 530(b)(1).
4. IRC Secs. 530(d)(3), 529(c)(2).
5. IRC Secs. 530(d)(3), 529(c)(5).

(see Q 753). If a donor makes contributions to a qualified tuition program in excess of the gift tax annual exclusion, the donor may elect to take the donation into account ratably over a five-year period.[1] Distributions from a qualified tuition program are not treated as taxable gifts. Also, if the designated beneficiary of a qualified tuition program is changed, or if funds in a qualified tuition program are rolled over to the account of a new beneficiary, such a transfer is subject to the gift tax or generation-skipping transfer tax only if the new beneficiary is a generation below the old beneficiary.[2]

See Q 696 for the estate tax treatment and Q 595 for the income tax treatment of qualified tuition programs.

752. When is the "split-gift" provision available?

When a husband or wife makes a gift to a *third* person, it may be treated as having been made one-half by each if the other spouse consents to the gift.[3]

Planning Point: The split-gift provision enables a spouse who owns most of the property to take advantage of the other spouse's annual exclusions (see Q 753) and unified credit (see Q 758). Thus, a spouse, with the other spouse's consent, can give up to $28,000 (2 × $14,000 annual exclusion in 2013 and 2014, see Appendix D) a year to each donee free of gift tax, and, in addition, will have both their unified credits to apply against gift tax imposed on gifts in excess of the annual exclusion. Moreover, by splitting the gifts between husband and wife, they will fall in lower gift tax brackets.

Where spouses elect to use the "split-gift" provision, the consent applies to all gifts made by either spouse to third persons during the calendar year.[4] The consent must be made on the Form 709. By consenting to gift splitting, a spouse may assume joint and several liability for any gift tax assessed on the gift.[5] A technical advice memorandum permitted a taxpayer to elect after his spouse's death to split gifts with his spouse where the gifts were made by the taxpayer shortly before the spouse's death.[6]

753. What is the gift tax annual exclusion and when is it available to a donor?

The gift tax annual exclusion is an exclusion of $10,000 as indexed ($14,000 in 2013 and 2014, see Appendix D for the amount in other years) per calendar year per donee applied to gifts of a present interest in property. The $10,000 amount is adjusted for inflation, rounded down to the next lowest multiple of $1,000, after 1998. The exclusion is not cumulative; that is, an exclusion unused in one year cannot be carried over and used in a future year. A gift of a present interest is one in which the donee has the right to immediate possession, use, and enjoyment of the property.

1. IRC Sec. 529(c)(2).
2. IRC Sec. 529(d)(5)(B).
3. IRC Sec. 2513; Treas. Reg. §25.2513-1.
4. IRC Sec. 2513(a)(2).
5. *Williams v. U.S.*, 378 F.2d 693 (Ct. Cl. 1967).
6. TAM 9404023.

The exclusion does not apply to gifts of a future interest in property, i.e., the right to use and enjoy the property only in the future. For example, if G transfers income producing property in trust, the terms of which provide that the income from the trust property will be paid to A for his lifetime and upon A's death the trust property will be paid to B free of trust, A's life income interest would be a present interest gift and B's remainder interest would be a future interest gift. G would be allowed to exclude from the value of gifts reported on his gift tax return the value of A's life income interest up to $14,000 (in 2014, assuming G made no other present interest gifts to A during the calendar year), but he would not be able to exclude any of the value of B's remainder interest. If the trustee were given discretion to withhold payments of income to A and add such amounts to the trust corpus, A's income interest would not be a present interest, and G would not be allowed to claim any exclusion.

A gift of property to a trust which directs the trustee to distribute the trust income annually to the beneficiary is a present interest gift of an income interest qualifying for the annual exclusion. However, a gift of property to a trust which directs the trustee to distribute from the trust annually a certain dollar amount to the beneficiary is a gift of a future interest not qualifying for the exclusion.

A gift of property in trust will qualify for the gift tax annual exclusion if the trust terms (1) provide that the trust beneficiary (or beneficiaries) be given timely written notice (notice given within 10 days after the transfer has been held timely) that the beneficiary has a reasonable period (45 days has been held reasonable) within which to demand immediate withdrawal (usually the trust specifies that the withdrawal right is limited to the amount of the exclusion), and (2) give the trustee the power to convert property in the trust to cash to the extent necessary to meet withdrawal demands. Such trusts are popularly known as Crummey trusts, after the name of a leading case that upheld them.[1]

The IRS has ruled with respect to Crummey trusts that the annual exclusion could not be applied to trust contributions on behalf of trust beneficiaries who had withdrawal rights as to the contributions (except to the extent they exercised their withdrawal rights) but who had either no other interest in the trust (a naked power) or only remote contingent interests in the remainder.[2] However, the Tax Court has rejected the IRS's argument that a power holder must hold rights other than the withdrawal right to obtain the annual exclusion. The withdrawal right (assuming there is no agreement to not exercise the right) is sufficient to obtain the annual exclusion.[3] (Language in *Cristofani* appears to support use of naked powers, although case did not involve naked powers). The Tax Court recently held the donor does not have to give the beneficiaries of a trust notice of the gift in certain circumstances.[4]

In an Action On Decision, the Service stated that, applying the substance over form doctrine, the annual exclusions should not be allowed where the withdrawal rights are not in substance

1. *Crummey v. Comm.*, 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 CB 321; Rev. Rul. 81-7, 1981-1 CB 474; Rev. Rul. 83-108, 1983-2 CB 167; Let. Ruls. 8022048, 8134135, 8118051, 8134135, 8445004, 9625031.
2. TAMs 9141008, 9045002, 8727003.
3. *Est. of Cristofani v. Comm.*, 97 TC 74 (1991), acq. in result, 1996-2 CB 1.
4. *Estate of Clyde W. Turner v. Commissioner*, T.C. Memo 2011-209.

what they purport to be in form. If the facts and circumstances show an understanding that the power is not meant to be exercised or that exercise would result in undesirable consequences, then creation of the withdrawal right is not a bona fide gift of a present interest and an annual exclusion should not be allowed.[1] In TAM 9628004, annual exclusions were not allowed where transfers to trust were made so late in the first year that *Crummey* withdrawal powerholders had no opportunity to exercise their rights, most powerholders had either no other interest in the trust or discretionary income or remote contingent remainder interests, and withdrawal powers were never exercised in any year. However, annual exclusions were allowed where the IRS was unable to prove that there was an understanding between the donor and the beneficiaries that the withdrawal rights should not be exercised.[2] In TAM 9731004, annual exclusions were denied where eight trusts were created for eight primary beneficiaries, but *Crummey* withdrawal powers were given to 16 or 17 persons who never exercised their powers and most powerholders held either a remote contingent interest or no interest other than the withdrawal power in the trusts in which the powerholder was not the primary beneficiary.

The annual exclusion was not allowed where the beneficiaries waived their right to receive notice of contributions to trust with respect to which their withdrawal rights could be exercised. Furthermore, the annual exclusion was not allowed because the grantor set up a trust which provided that notice was to be given to the trustee as to whether a beneficiary could exercise a withdrawal power with respect to a transfer to trust and the grantor never notified the trustee that the withdrawal powers could be exercised with respect to any of the transfers to trust.[3]

Substance over form analysis may be applied to deny annual exclusions where indirect transfers are used in an attempt to obtain inappropriate annual exclusions for gifts to intermediate recipients.[4] For example, suppose A transfers $14,000 to each of B, C, and D in 2014. By arrangement, B, C, and D each immediately transfer $14,000 to E. The annual exclusion for A's indirect transfers to E is limited to $14,000 and A has made taxable gifts of $28,000 to E.

An outright gift of a bond, note (though bearing no interest until maturity), or other obligation which is to be discharged by payments in the future is a gift of a present interest. Normally, a direct gift of shares of corporate stock is a present interest gift. However, if the gift is made subject to a stock transfer restriction agreement under which the donee is prohibited for a period of time from selling or pledging the stock, it has been held that the gift is one of a future interest which does not qualify for the gift tax annual exclusion.

It has been held that the gift of a portion of the donor's interest in real property, if under the terms of the transfer the donee receives the present unrestricted right to the immediate use, possession, and enjoyment of an ascertainable interest in the property, qualifies for the gift tax annual exclusion.

1. AOD 1996-010.
2. *Est. of Kohlsaat v. Comm.*, TC Memo 1997-212; *Est. of Holland v. Comm.*, TC Memo 1997-302.
3. TAM 9532001.
4. *Heyen v. U.S.*, 945 F2d 359, 91-2 USTC ¶60,085 (10th Cir. 1991).

If a donor transfers a specified portion of real property subject to an "adjustment clause" (i.e., under terms that provide that if the IRS subsequently determines that the value of the specified portion exceeds the amount of the annual exclusion, the portion of property given will be reduced accordingly, or the donee will compensate the donor for the excess), the IRS has ruled the adjustment clause will be disregarded for federal tax purposes.[1]

A gift of property to a minor, whether in trust or otherwise, is not considered a gift of a future interest in property if the terms of the transfer satisfy all the following conditions:

(1) Both the property itself and its income may be expended by or for the benefit of the donee before he attains the age of 21 years;

(2) Any portion of the property and its income not disposed of under (1) will pass to the donee when he attains the age of 21 years; and

(3) Any portion of the property and its income not disposed of under (1) will be payable either to the estate of the donee or as he may appoint under a general power of appointment if he dies before attaining the age of 21 years.[2]

A gift to a minor under the Uniform Gifts to Minors Act or under the Uniform Transfers to Minors Act generally is a gift of a present interest and qualifies for the annual exclusion.[3] Most states in recent years have adopted the later Uniform Transfers to Minors Act, which allows for any kind of property, real or personal, tangible or intangible, to be transferred under the Act. Other states have amended their Uniform Gifts to Minors Act to provide for gifts of various kinds of property ranging from real estate to partnership interests and other tangible and intangible interests in property. Originally, the Uniform Act provided for gifts of only money or securities. The allowance of the exclusion is not affected by the amendment of a state's Uniform Act lowering the age of majority and thus requiring that property be distributed to the donee at age 18.[4] The revenue rulings cited in this paragraph base the allowance of the exclusion on the assumption that gifts under the Uniform Act come within the purview of IRC Section 2503(c). Gifts to minors under IRC Section 2503(c) must pass to the donee on his attaining age 21. If a state statute varies from the Uniform Act by providing that under certain conditions custodianship may be extended past the donee's age 21, gifts made under those conditions would not qualify for the exclusion. For a state-by-state summary of the types of property which can be given under, and the adult age for purposes of, the Uniform Act, see www.TaxFactsUpdates.com.

A gift of property to a corporation generally represents a gift of a future interest in the property to the individual shareholders to the extent of their proportionate interests in the

1. Rev. Rul. 86-41, 1986-1 CB 300.
2. IRC Sec. 2503(c); Treas. Reg. §25.2503-4(a).
3. Rev. Rul. 59-357, 1959-2 CB 212; Rev. Rul. 73-287, 1973-2 CB 321.
4. Rev. Rul. 73-287, 1973-2 CB 321.

corporation.[1] Also a gift for the benefit of a corporation is a gift of a future interest in the property to its shareholders and does not qualify for the annual exclusion.[2] In contrast, gifts made to individual partnership capital accounts have been treated as gifts of a present interest which qualify for the annual exclusion where the partners were free to make immediate withdrawals of the gifts from their capital accounts.[3] However, annual exclusions were denied for gifts of limited partnership interests where (1) the general partner could retain income for any reason whatsoever, (2) limited partnership interests could not be transferred or assigned without the permission of a supermajority of other partners, and (3) limited partnership interests generally could not withdraw from the partnership or receive a return of capital contributions for many years into the future.[4] Similarly, annual exclusions were denied for gifts of business interests where the beneficiaries were not free to withdraw from the business entity, could not sell their interests, and could not control whether any income would be distributed (and no immediate income was expected).[5]

A donor's gratuitous payment of the monthly amount due on the mortgage on a house owned in joint tenancy by others has been held a present interest gift to the joint tenants in proportion to their ownership interests.[6]

754. How does the splitting of gifts between spouses affect the gift tax annual exclusion?

By means of the "split gift" provision (see Q 752), a married couple can effectively use each other's annual exclusions. Thus, if, in 2014, A makes a $28,000 gift of securities to his child, C, and A's wife, B, joins in making the gift (by signifying her consent on the gift tax return), the gift would be considered as having been made one-half by each, the exclusion is effectively doubled, and no gift tax would have to be paid (assuming neither A nor B made any other gifts to C during the calendar year).[7] However, if A and B join in making the same gift to F, child of A's brother D and wife E, while at the same time D and E make similar gifts to C and F, the scheme does not effectively again double the exclusion.[8]

If the spouse of the donor is not a United States citizen, the annual exclusion for a transfer from the donor spouse to the non-citizen spouse is increased from $10,000 (as indexed) to $100,000 as indexed ($136,000 in 2011, $139,000 for 2012, $143,000 for 2013, and $145,000 for 2014, see Appendix D) (provided the transfer would otherwise qualify for the marital deduction if the donee spouse were a United States citizen). The $100,000 amount is adjusted for inflation, as is the $10,000 amount (see above).[9] However, the marital deduction is not available for a transfer to a spouse who is not a United States citizen (see Q 756).

1. Treas. Reg. §25.2511-1(h)(1); Rev. Rul. 71-443, 1971-2 CB 337; *Stinson v. U.S.*, 2000-1 USTC ¶60,377 (7th Cir. 2000); *Hollingsworth v. Comm.*, 86 TC 91 (1986).
2. Let. Rul. 9114023.
3. *Wooley v. U.S.*, 736 F. Supp. 1506, 90-1 USTC ¶60,013 (S.D. Ind. 1990).
4. TAM 9751003.
5. *Hackl v. Comm.*, 335 F. 3d 664, 2003-2 USTC ¶60,465 (7th Cir. 2003), aff'g 118 TC 279 (2002).
6. Rev. Rul. 82-98, 1982-1 CB 141.
7. IRC Sec. 2513; Treas. Reg. §25.2513-1.
8. TAM 8717003; *Sather v. Comm.*, 251 F.3d 1168 (8th Cir. 2001); *Schuler v. Comm.*, 282 F. 3d 575, 2002-1 USTC ¶60,432 (8th Cir. 2002).
9. IRC Sec. 2523(i).

755. What gift tax exclusion applies, if any, for gifts made for education or medical expenses?

A "qualified transfer" is not considered a gift for gift tax purposes. A "qualified transfer" means any amount paid on behalf of an individual–

(A) as tuition to an educational organization[1] for the education or training of such individual, or

(B) to any person who provides medical care[2] with respect to such individual as payment for such medical care.[3] A technical advice memorandum treated tuition payments for future years as qualified transfers where the payments were nonrefundable.[4]

756. What is the gift tax marital deduction?

The gift tax marital deduction is a deduction for the entire value of gifts made between spouses.[5] The deduction does not apply, however, to a gift of a "nondeductible terminable interest" in property.[6] A "terminable interest" in property is an interest which will terminate or fail on the lapse of time or on the occurrence or failure to occur of some contingency. Life estates, terms for years, annuities, patents, and copyrights are therefore terminable interests. However, a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity or term for years, is not a terminable interest.[7]

In general, if a donor transfers a terminable interest in property to the donee spouse, the marital deduction is disallowed with respect to the transfer if the donor spouse also (1) transferred an interest in the same property to another donee, *or* (2) retained an interest in the same property in himself, *or* (3) retained a power to appoint an interest in the same property, *and* (4) gave the other donee, himself, or the possible appointee the right to possess or enjoy any part of the property after the termination or failure of the interest transferred to the donee spouse.[8] *However*, a terminable interest in property qualifies for the marital deduction (referred to as "QTIP") if the donee spouse is given (1) a right to the income from the property for life and a general power of appointment over the principal; or (2) a "qualifying income interest for life" in property transferred by the donor spouse as to which the donor must make an election (on or before the date, including extensions, for filing a gift tax return with respect to the year in which the transfer was made–see Q 759) to have the marital deduction apply. The QTIP regulations provide an exception to the estate tax inclusion issues that arise under Sections 2036 and 2038.[9]

1. IRC Section 170(b)(1)(A)(ii).
2. As defined in IRC Section 213(d).
3. IRC Sec. 2503(e); Rev. Rul. 82-98, 1982-1 CB 141.
4. Let. Rul. 200602002; TAM 199941013.
5. IRC Sec. 2523(a).
6. IRC Sec. 2523(b); Treas. Regs. §§25.2523(a)-1(b)(2), 25.2523(b)-1.
7. Treas. Reg. §25.2523(b)-1(a)(3).
8. Treas. Reg. §25.2523(b)-1(a)(2).
9. Treas. Reg. §25.2523(f)-1(d)(1).

The donee spouse has a "qualifying income interest for life" if (1) the donee spouse is entitled to all the income from the property, payable annually or at more frequent intervals, and (2) no person has a power to appoint any part of the property to any person other than the donee spouse during the donee spouse's lifetime.[1] Also, the interest of a donee spouse in a joint and survivor annuity in which only the donor and donee spouses have a right to receive payments during such spouses' joint lifetimes is treated as a "qualifying income interest for life" unless the donor spouse irrevocably elects otherwise within the time allowed for filing a gift tax return.[2]

In the two exceptions to the nondeductible terminable interest rule explained above, income producing property is contemplated. If a gift of non-income producing property in a form to comply with either of the two exceptions is proposed, Treasury Regulation Section 25.2523(e)-1(f) should be read carefully. A marital deduction has been disallowed for a transfer to an irrevocable trust where state law provided that the interest given the spouse would be revoked upon divorce and the grantor had not provided in the trust instrument that the trust would not be revoked upon divorce.[3]

If the spouse of the donor is not a United States citizen, the marital deduction is not available for a transfer to such a spouse. However, in such a case, the annual exclusion (see Q 753) for the transfer from the donor spouse to the non-citizen spouse is increased from $10,000 as indexed ($14,000 in 2013 and 2014, up from $13,000 in 2011 and 2012) to $100,000 as indexed ($145,000 in 2014, up from $143,000 in 2013, see Appendix D) (provided the transfer would otherwise qualify for the marital deduction if the donee spouse were a United States citizen). The $100,000 amount is adjusted for inflation, as is the $10,000 amount (see Q 753).[4]

757. Is a gift tax deduction allowed for gifts to charity?

Yes. In general, a deduction is allowed for the entire value of gifts to qualified charitable organizations.[5]

Where a donor makes a gift of an interest in property (other than a remainder interest in a personal residence or farm or an undivided portion of the donor's entire interest in property or certain gifts of property interests exclusively for conservation purposes) to a qualified charity, and an interest in the same property is retained by the donor or is given to a donee that is not a charity, no charitable deduction is allowed for the interest given the charity unless:

(1) in the case of a remainder interest, such interest is in a trust which is a *charitable remainder annuity trust* (see Q 7979) or a *charitable remainder unitrust* (see Q 7980) or a pooled income fund (see Q 7988); or

1. IRC Secs. 2523(e), 2523(f).
2. IRC Sec. 2523(f)(6).
3. TAM 9127005.
4. IRC Sec. 2523(i).
5. IRC Secs. 2522(a), 2522(b).

(2) in the case of any other interest (such as an interest in the income from a short term trust), such interest is in the form of a guaranteed annuity or is a fixed percentage of the fair market value of the property distributed yearly (to be determined yearly).[1]

A charitable contribution deduction is allowable for a gift to charity of a legal remainder interest in the donor's personal residence even though the interest conveyed to charity is in the form of a tenancy in common with an individual.[2]

If an individual creates a qualified charitable remainder trust in which his spouse is the only non-charitable beneficiary other than certain ESOP remainder beneficiaries, the grantor will receive a charitable contributions deduction for the value of the remainder interest.[3]

758. What is the gift tax unified credit?

It is a dollar amount ($2,081,800 in 2014) that is credited against the gift tax computed as shown in Q 740 (see Appendix D for amounts in other years).[4] In 2010, the credit exempted $1,000,000 of taxable gifts from the gift tax (the dollar amount exempted referred to as the "gift tax applicable exclusion amount"). For 2011, the amount increased to $5,000,000, and was adjusted for inflation to $5,120,000 in 2012, $5,250,000 in 2013 and $5,340,000 in 2014. Any gifts made over the gift tax applicable exclusion amount are taxed at a 40 percent rate (in 2013 and thereafter, up from 35 percent in 2011 and 2012). (For application of the unified credit to the federal estate tax, see Q 711). The credit is referred to as "unified" because the current $5.34 million credit applies to the gift tax (section 2505), the GST tax (section 2641) or the estate tax (section 2010).

The amount of unified credit allowed against the tax on gifts made in any calendar year cannot exceed the dollar amount of credit applicable to the period in which the gifts were made, reduced by the sum of the amounts of unified credit allowed the donor against gifts made in all prior calendar periods, and reduced further by the rule explained in the next paragraph (but in no event can the allowable credit exceed the amount of the tax). The unused exemption of a deceased spouse may be transferred to the surviving spouse to increase the gift or estate applicable exclusion amount for the surviving spouse.[5]

The unified credit was enacted by the Tax Reform Act of 1976. Under prior law, separate exemptions were provided for estate and gift taxes. The gift tax specific exemption was $30,000 for each donor (or $60,000 if the donor's spouse joined in making the gift). The exemption was not applied automatically, as in the case of the unified credit, but had to be elected by the donor, and once used was gone. The law provides that as to gifts made after September 8, 1976, and before January 1, 1977, if the donor elected to apply any of his lifetime exemption to such gifts, his unified credit is reduced by an amount equal to 20 percent of the amount allowed as

1. IRC Sec. 2522(c); Rev. Rul. 77-275, 1977-2 CB 346.
2. Rev. Rul. 87-37, 1987-1 CB 295, revoking Rev. Rul. 76-544, 1976-2 CB 288.
3. IRC Sec. 2522(c)(2).
4. IRC Sec. 2505, as amended by EGTRRA 2001.
5. IRC Secs. 2505(a)(i); 2010.

a specific exemption.[1] (The unified credit is not reduced by any amount allowed as a specific exemption for gifts made prior to September 9, 1976).

Under 2010 TRA, a donor can make gifts, without incurring a gift tax liability, up to the difference between the current year's applicable exclusion amount and the prior taxable gifts.

By means of the "split gift" provision (see Q 752), a married couple can effectively use each other's unified credit.

759. What are the requirements for filing the gift tax return and paying the tax?

A donor need not file a gift tax return if the only gifts made during the calendar year are covered by the annual exclusion (Q 753) or the marital deduction (Q 756), or are gifts to charity of the donor's entire interest in the property transferred where the donor does not (and has not) transferred any interest in the property to a noncharitable beneficiary. (Amounts paid on behalf of an individual as tuition to an educational organization or to a person providing medical care for him are not considered gifts for gift tax purposes).[2] However, in the case of a split gift (where the donor's spouse joins in making a gift to a third party), a gift tax return must be filed even though the amount of the gift comes within the spouses' annual exclusions.

The return (Form 709) is due on or before April 15 following close of the calendar year for which the return is made; however, if the donor is given an extension of time for filing his income tax return, the same extension applies to filing the gift tax return. Where a gift is made during the calendar year in which the donor dies, the time for filing the gift tax return is not later than the time (including extensions) for filing the estate tax return.[3] However, should the time for filing the estate tax return fall later than the 15th day of April following the close of the calendar year, the time for filing the gift tax return is on or before the 15th day of April following the close of the calendar year, unless an extension (not extending beyond the time for filing the estate tax return) was granted for filing the gift tax return. If no estate tax return is required to be filed, the time for filing the gift tax return is on or before the 15th day of April following the close of the calendar year, unless an extension was given for filing the gift tax return.[4]

The penalty for failure to timely file a federal tax return is 5 percent of the tax for each month the return is past due, up to a maximum of 25 percent. The penalty can be avoided only if "it is shown that such failure is due to reasonable cause and not due to willful neglect."[5] The regulations say that "reasonable cause" means that the taxpayer filing a late return must show that he "exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time."[6] In *United States v. Boyle*,[7] the Supreme Court held that a taxpayer's

1. IRC Sec. 2505(c).
2. IRC Sec. 2503(e); IRC Sec. 6019.
3. IRC Sec. 6075.
4. IRC Sec. 6075; Treas. Reg. §25.6075-1(b)(2).
5. IRC Sec. 6651(a)(1).
6. Treas. Reg. §301.6651-1(c)(1).
7. 105 S. Ct. 687 (1985).

reliance on an agent who says he will file the appropriate tax return does not avoid the penalty tax for failure to make a timely filing. However, the Court was careful to distinguish the case where the taxpayer relies on his tax advisor to determine whether a return should be filed at all. In *Estate of Buring v. Commissioner*,[1] the estate avoided the penalty tax because the Court found that the decedent had relied upon her accountant's advice in failing to file gift tax returns for substantial advances of cash the decedent made to her son, even though the accountant apparently had not actually advised her that it was not necessary to file gift tax returns.

The gift tax is payable by the donor on the date the gift tax return is due to be filed (April 15). An extension of time given to file the return does not act as an extension of time to pay the tax.[2] If the donor does not pay the tax when it is due, the donee is liable for the tax to the extent of the value of the gift.[3] If an extension of time for payment of the tax is granted, interest compounded daily is charged at an annual rate adjusted quarterly so as to be three percentage points over the short term federal rate.[4] The underpayment rate for the first quarter of 2014 is 3 percent.[5]

Valuation

760. How is investment property valued for federal transfer tax purposes?

"Fair market value" is the measure, defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." In the case of the estate tax, fair market value is determined as of the date of the decedent's death, except that if the executor elects the alternate valuation method, fair market value is determined in accordance with the rules explained at Q 761. In the case of the gift tax, fair market value is determined as of the date of the gift. Property is not to be valued at the value at which it is assessed for local tax purposes unless that value represents the fair market value as of the applicable valuation date.

Planning Point: The property is generally valued based on its highest and best use, which may be inconsistent with how the property is used at the time of the gift or at the time of death. All relevant facts and elements of value as of the applicable valuation date are to be considered in every case.[6]

In the case of any taxable gift which is a direct skip within the meaning of the generation-skipping transfer tax (GST tax) (see Q 723 et seq.), the amount of such gift is increased by the amount of the GST tax imposed on the transfer.[7] See Q 724 for special GST tax valuation rules.

Special rules apply to the valuation of particular kinds of investment property, such as stocks and bonds (Q 762), notes (Q 764), mutual fund shares (Q 768), certain kinds of business

1. TC Memo 1985-610.
2. IRC Secs. 2502(c), 6151(a).
3. IRC Sec. 6324(b); *Comm. v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958).
4. IRC Secs. 6601(a), 6621(a)(2).
5. Rev. Rul. 2013-6.
6. Treas. Regs. §§20.2031-1(b), 25.2512-1.
7. IRC Sec. 2515.

interests (Q 770). See Q 773 on the valuation of real estate. The principle of blockage discounting, applied in the valuation of a sizeable block of shares of corporate stock (see Q 762), can also be applied in valuing artwork.[1] Special rules also apply where, under certain conditions spelled out in IRC Section 2032A, an executor may elect to value, for federal estate tax purposes, real property (called "qualified real property") devoted to farming or other trade or business (called "qualified use") by the decedent or a member of the decedent's family on the date of the decedent's death, on the basis of its actual use rather than by taking into account the "highest and best" use to which the property could be put. See also Q 7955. Revenue Ruling 59-60[2] is the most often-cited authority for the basic principles of valuing closely-held stock or other business interest for tax purposes.

Assets in a restricted management account (RMA) are valued at fair market value, without regard to any RMA restrictions.[3]

Property includable in a surviving spouse's estate as qualified terminable interest property (see Q 700) under IRC Section 2044 (see Q 679) is not aggregated with other property includable in the estate for estate tax valuation purposes.[4] However, property included in the gross estate because of a general power of appointment under IRC Section 2041 (see Q 679) should be aggregated with property owned outright by the powerholder for estate tax valuation purposes.[5]

With respect to gift and estate tax returns, 20 percent of an underpayment attributable to a substantial gift or estate tax valuation understatement is added to tax.[6] There is a substantial gift or estate tax valuation understatement if (1) the value claimed was 65 percent or less of the correct amount; and (2) the underpayment exceeds $5,000. If the value claimed was 40 percent or less of the correct amount (and the underpayment exceeds $5,000), 40 percent of an underpayment attributable to such a gross gift or estate tax valuation understatement is added to tax.[7] The 20 percent or 40 percent penalty is not imposed with respect to any portion of the underpayment for which it is shown that there was reasonable cause and the taxpayer acted in good faith.[8]

A gift which is disclosed on a gift tax return in a manner adequate to apprise the Service of the nature of the item may not be revalued after the statute of limitations (generally, three years after the return is filed) has expired.[9]

See Q 777 for Chapter 14 special valuation rules.

1. *Calder v. Comm.*, 85 TC 713 (1985).
2. 1959-1 CB 237.
3. Rev. Rul. 2008-35, 2008-29 IRB 116.
4. *Est. of Bonner v. U.S.*, 84 F. 3d 196, 96-2 USTC ¶60,237 (5th Cir. 1996), rev'g an unpublished decision (S.D. Tex.); *Est. of Mellinger v. Comm.*, 112 TC 26 (1999), acq. AOD 1999-006.
5. FSA 200119013; *Est. of Fontana v. Comm.*, 118 TC 318 (2002).
6. IRC Sec. 6662.
7. IRC Sec. 6662(g)(2).
8. IRC Sec. 6664(c)(1).
9. IRC Sec. 6501(c)(9).

761. How does the executor's election of the alternate valuation method affect the valuation of property for federal estate tax purposes?

The law permits the executor to elect an alternate valuation method if the election will decrease the value of the gross estate and the sum of the amount of the federal estate tax and generation-skipping transfer tax payable by reason of the decedent's death with respect to the property includable in the decedent's gross estate.[1] If the alternate valuation method is elected, the property will be valued under the following rules:

Any property distributed, sold, exchanged or otherwise disposed of within six months after decedent's death is valued as of the date of such distribution, sale, exchange, or other disposition. The phrase "distributed, sold, exchanged, or otherwise disposed of" includes all possible ways by which property ceases to form a part of the gross estate. For example, money on hand at the date of the decedent's death which is thereafter used in the payment of funeral expenses, or which is thereafter invested, falls within the term "otherwise disposed of." The term also includes the surrender of a stock certificate for corporate assets in complete or partial liquidation of a corporation pursuant to IRC Section 331. The term does not, however, extend to transactions which are mere changes in form. Thus, it does not include a transfer of assets to a corporation controlled by the transferor in exchange for its stock in a transaction with respect to which no gain or loss would be recognized for income tax purposes under IRC Section 351. Nor does it include an exchange of stock or securities in a corporation for stock or securities in the same corporation or another corporation in a transaction, such as a merger, recapitalization, reorganization, or other transaction described in IRC Section 368(a) or IRC Section 355, with respect to which no gain or loss is recognizable for income tax purposes under IRC Section 354 or IRC Section 355.[2]

In *Estate of Smith v. Commissioner*,[3] the decedent's stock in X corporation was exchanged for stock and warrants in Y corporation pursuant to a plan of merger. The court held that the warrants were received in exchange for the estate's stock in X and were to be valued as of the date of the merger. The Commissioner conceded that the transaction should not be treated as an "exchange" with respect to the receipt of *stock* in Y, and that even though the value of the Y stock had declined substantially between the decedent's date of death and the alternate valuation date, the stock should be valued as of the alternate valuation date. The court's decision, however, was limited to the controverted issue as to the proper valuation date of the warrants. Apparently, the IRS soon changed its mind. In Revenue Ruling 77-221,[4] on substantially similar facts, the Service concluded that the exchange of X stock for Y stock and warrants constitutes an "exchange" and held that the X stock given in exchange was to be valued as of the date of the exchange.

If the property is listed stock and is sold in an arm's length transaction, the stock is valued at the actual selling price.[5] An exercise of stock rights is a "disposition" thereof; their value is

1. IRC Sec. 2032; Treas. Reg. §20.2032-1(b)(1).
2. Treas. Reg. §20.2032-1(c)(1).
3. 63 TC 722 (1975).
4. 1977-1 CB 271.
5. Rev. Rul. 70-512, 1970-2 CB 192; *Est. of Van Horne v. Comm.*, 720 F. 2d 1114, 83-2 USTC ¶13,548 (9th Cir. 1983), aff'g 78 TC 728 (1982).

equal to the excess, if any, of the fair market value of the stock acquired by such rights at the time the rights are exercised over the subscription price.[1]

Any property not distributed, sold, exchanged, or otherwise disposed of within six months after decedent's death is valued as of the date six months after death. When shares of stock in the estate are sold at a discount between the date of death and the alternate valuation date, such sales and the number of shares sold cannot be taken into account in determining whether the shares remaining in the estate at the alternate valuation date are eligible for "blockage" valuation (see Q 762).[2]

Any property interest whose value is affected by mere lapse of time is valued as of the date of decedent's death. But an adjustment is made for any change in value during the six-month period (or during the period between death and distribution, sale, or exchange) which is not due to mere lapse of time.[3] The phrase "affected by mere lapse of time" has no reference to obligations for the payment of money, whether or not interest bearing, the value of which changes with the passage of time.[4]

Proposed regulations would provide that the election to value property includable in the gross estate on the alternate valuation date applies only to the extent that the change in value is a result of market conditions.[5]

If the alternate valuation method is elected, it must be applied to all the property included in the gross estate, and cannot be applied to only a portion of the property.[6]

The election to value property using the alternate valuation method must be made by the executor on the Form 706, and no later than one year after the due date (including extensions) for filing the estate tax return. The election is irrevocable, unless it is revoked no later than the due date (including extensions) for filing the estate tax return. If use of the alternate valuation method would not result in a decrease in both the value of the gross estate and the amount of estate tax and generation-skipping transfer tax on a filed return, a protective election can be made to use the alternate valuation method if it is later determined that such a decrease would occur. A request for an extension of time to make the election or protective election may be made if the estate tax return was filed no later than one year after the due date (including extensions) for filing the estate tax return but an election or protective election was not made on the return.[7]

Property earned or accrued (whether received or not) after the date of the decedent's death and during the alternate valuation period with respect to property included in the gross estate

1. Rev. Rul. 58-576, 1958-2 CB 256.
2. *Est. of Van Horne v. Comm.*,720 F. 2d 1114, 83-2 USTC ¶13,548 (9th Cir. 1983), aff'g 78 TC 728 (1982).
3. IRC Sec. 2032(a).
4. Treas. Reg. §20.2032-1(f).
5. Prop. Treas. Reg. §20. 2032-1(f).
6. Treas. Reg. §20.2032-1(b)(2).
7. IRC Sec. 2032(d); Treas. Reg. §20.2032-1(b).

is excluded in valuing the gross estate under the alternate valuation method, and is referred to as "excluded property."[1]

Thus, as to *interest-bearing obligations* included in the gross estate ("included property"), interest accrued after the date of death and before the subsequent valuation date constitutes "excluded property." However, any part payment of principal made between the date of death and the subsequent valuation date, or any advance payment of interest for a period after the subsequent valuation date made during the alternate valuation period which has the effect of reducing the value of the principal obligation as of the subsequent valuation date, will be included in the gross estate, and valued as of the date of such payment.[2]

The same principles applicable to interest-bearing obligations also apply to *leased realty or personalty* which is included in the gross estate and with respect to which an obligation to pay rent has been reserved. Both the realty or personalty itself and the rents accrued to the date of death constitute "included property," and each is to be separately valued as of the applicable valuation date. Any rent accrued after the date of death and before the subsequent valuation date is "excluded property." Similarly, the principle applicable with respect to interest paid in advance is equally applicable with respect to advance payments of rent.[3]

Assets sold continue as included property "even though they change in form."[4] Where royalty and working interests in oil and gas property were included property, the proceeds from the sale of oil and gas extracted from this property between the date of the decedent's death and the alternate valuation date were held to be included property (merely the translation of the decedent's interest in the in-place reserves the decedent owned at the time of her death into cash). As for the portion of proceeds to be included in the gross estate, the appropriate value was held to be the in-place value of the oil and gas on the date of its severance.[5]

In the case of *noninterest-bearing obligations sold at a discount*, such as savings bonds, the principal obligation and the discount amortized to the date of death are property interests existing at the date of death and constitute "included property." The obligation itself is to be valued at the subsequent valuation date without regard to any further increase in value due to amortized discount. The additional discount amortized after death and during the alternate valuation period is the equivalent of interest accruing during that period and is, therefore, not to be included in the gross estate under the alternate valuation method.[6]

Shares of stock in a corporation and dividends declared to stockholders of record on or before the date of the decedent's death and not collected at the date of death constitute "included property" of the estate. On the other hand, ordinary dividends out of earnings and profits (whether in cash, shares of the corporation, or other property) declared to stockholders of record after the date of the decedent's death are "excluded property" and are not to be valued under the alternate

1. Treas. Reg. §20.2032-1(d).
2. Treas. Reg. §20.2032-1(d)(1).
3. Treas. Reg. §20.2032-1(d)(2).
4. Treas. Reg. §20.2032-1(d).
5. *Est. of Johnston v. U.S.*, 86-1 USTC ¶13,655 (5th Cir. 1986), rev'g and remanding 84-2 USTC ¶13,591 (N.D. Tex. 1984), cert. den. 6-23-86.
6. Treas. Reg. §20.2032-1(d)(3).

valuation method. If, however, dividends are declared to stockholders of record after the date of the decedent's death with the effect that the shares of stock at the subsequent valuation date do not reasonably represent the same "included property" of the gross estate as existed at the date of the decedent's death, the dividends are "included property," except to the extent that they are paid out of earnings of the corporation after the date of the decedent's death.

For example, if a corporation makes a distribution in partial liquidation to stockholders of record during the alternate valuation period which is not accompanied by a surrender of a stock certificate for cancellation, the amount of the distribution received on stock included in the gross estate is itself "included property," except to the extent that the distribution was out of earnings and profits since the date of the decedent's death. Similarly, if a corporation, in which the decedent owned a substantial interest and which possessed at the date of the decedent's death accumulated earnings and profits equal to its paid-in capital, distributed all of its accumulated earnings and profits as a cash dividend to shareholders of record during the alternate valuation period, the amount of the dividends received on stock includable in the gross estate will be included in the gross estate under the alternate valuation method. Likewise, a stock dividend distributed under such circumstances is "included property."[1]

"Included property" also includes the following:

(1) nontaxable stock rights and proceeds from the sale of such rights occurring after decedent's death but before the alternate valuation date, where the rights are issued subsequent to the decedent's death in respect of stock owned by the decedent at death;

(2) a nontaxable stock dividend received subsequent to decedent's death but before the alternate valuation date; and

(3) payments on the principal of mortgages received between the date of death and the alternate valuation date.[2]

But where an estate owned mutual fund shares, and between the date of the decedent's death and the alternate valuation date capital gains dividends attributable solely to gains on stocks held by the companies at decedent's death were declared and paid, it was held that the dividends were not "included property."[3]

When determining the value of a decedent's gross estate, dividends declared before death, on stock includable in the gross estate, payable to stockholders of record after the date of the decedent's death, must be considered in making an adjustment in the ex-dividend quotation of the stock at the date of the decedent's death. Such dividends may not be included in the gross estate under the alternate method of valuing the gross estate either as a separate asset or as an adjustment of the ex-dividend quoted value of the stock as of the alternate valuation date or as of some intermediate date.

1. Treas. Reg. §20.2032-1(d)(4).
2. Rev. Rul. 58-576, 1958-2 CB 625.
3. Rev. Rul. 76-234, 1976-1 CB 271.

Under the alternate method of valuing the gross estate, stock includable in the gross estate and selling ex-dividend is to be valued at its ex-dividend quoted selling price as of the alternate valuation date or at any intermediate valuation date, increased by the amount of dividends declared on the stock during the alternate valuation period payable to stockholders of record subsequent to the alternate valuation date or such intermediate date. No part of the value so determined is deemed to be excluded property in determining the value of the gross estate.[1]

762. How are stocks and bonds listed on an exchange or in an over-the-counter market valued for federal transfer tax purposes?

In general, their value is the fair market value per share or bond on the applicable valuation date (see Q 760). If there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market, or otherwise, the mean between the highest and lowest quoted selling prices on the valuation date is the fair market value per share or bond. (Listed securities and Treasury bonds must be reported and valued in dollar fractions smaller than eighths or thirty-seconds, respectively, if the mean selling price on the applicable valuation date results in a smaller fraction).[2]

Restricted securities (sometimes referred to as "unregistered securities," "investment letter stock," "control stock," or "private placement stock") are securities that cannot lawfully be distributed to the general public until a registration statement relating to the corporation underlying the securities has been filed and made effective by the SEC. Information and guidance in the valuation of these securities is contained in Revenue Ruling 77-287.[3]

If there were no sales on the valuation date but there were sales on dates within a reasonable period both before and after the valuation date, the fair market value is determined by taking a weighted average of the means between the highest and lowest sales on the nearest date before and the nearest date after the valuation date. The average is to be weighted inversely by the respective numbers of trading days between the selling dates and the valuation date. If the stocks or bonds are listed on more than one exchange, the records of the exchange where the stocks or bonds are principally dealt in should be employed if such records are available in a generally available listing or publication of general circulation. In the event that such records are not so available and such stocks or bonds are listed on a composite listing of combined exchanges in a generally available listing or publication of general circulation, the records of such combined exchanges should be employed.[4]

If it is established with respect to bonds for which there is a market on a stock exchange, that the highest and lowest selling prices are not available for the valuation date in a generally available listing or publication of general circulation, but that closing selling prices are so available, the fair market value per bond is the mean between the quoted closing selling price on the valuation date and the quoted closing selling price on the trading day before the valuation date.

1. Rev. Rul. 60-124, 1960-1 CB 368.
2. Rev. Rul. 68-272, 1968-1 CB 394.
3. 1977-2 CB 319. See *Est. of Stratton v. Comm.*, TC Memo 1982-744; *Est. of Sullivan v. Comm.*, TC Memo 1983-185; *Est. of Gilford v. Comm.*, 88 TC 38 (1987).
4. Treas. Regs. §§20.2031-2(a), 20.2031-2(b)(1), 25.2512-2(a), 25.2512-2(b)(1).

If there were no sales on the trading day before the valuation date but there were sales on a date within a reasonable period before the valuation date, the fair market value is determined by taking a weighted average of the quoted closing selling price on the valuation date and the quoted closing selling price on the nearest date before the valuation date. The closing selling price for the valuation date is to be weighted by the number of trading days between the previous selling date and the valuation dates. If there were no sales within a reasonable period before the valuation date but there were sales on the valuation date, the fair market value is the closing selling price on such valuation date. If there were no sales on the valuation date but there were sales on dates within a reasonable period both before and after the valuation date, the fair market value is determined by taking a weighted average of the quoted closing selling prices on the nearest date before and the nearest date after the valuation date. The average is to be weighted inversely by the respective numbers of trading days between the selling dates and the valuation date. If the bonds are listed on more than one exchange, the records of the exchange where the bonds are principally dealt in should be employed.[1]

If the above measures are inapplicable because actual sales are not available during a reasonable period beginning before and ending after the valuation date, the fair market value may be determined by taking the mean between the bona fide bid and asked prices on the valuation date, or if none, by taking a weighted average of the means between the bona fide bid and asked prices on the nearest trading date before and the nearest trading date after the valuation date, if both such nearest dates are within a reasonable period. The average is to be determined in the manner described above.[2]

If the foregoing measures are inapplicable because no actual sale prices or bona fide bid and asked prices are available on a date within a reasonable period before the valuation date, but such prices are available on a date within a reasonable period after the valuation date, or vice versa, then the mean between the highest and lowest available sale prices or bid and asked prices may be taken as the value.[3]

If it is established that the value of any bond or share of stock determined on the basis of selling or bid and asked prices as provided above does not reflect the fair market value thereof, then some reasonable modification of that basis or other relevant facts and elements of value are considered in determining the fair market value.

To quote the Tax Court: "In general, property is valued as of the valuation date on the basis of market conditions and facts available on that date *without regard to hindsight*...The rule that has developed, and which we accept, is that subsequent events are not considered in fixing fair market value, except to the extent that they were reasonably foreseeable at the date of valuation."[4] Generally, post-valuation date events should be ignored when valuing property for gift tax or estate tax purposes.

1. Treas. Regs. §§20.2031-2(b)(2); 25.2512-2(b)(2).
2. Treas. Regs. §§20.2031-2(c); 25.2512-2(c).
3. Treas. Regs. §§20.2031-2(d); 25.2512-2(d).
4. *Est. of Gilford v. Comm.*, 88 TC 38 (1987).

Where sales at or near the date of death or gift are few or of a sporadic nature, such sales alone may not indicate fair market value. In certain exceptional cases, the size of the block of stock to be valued in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the executor or donor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations.[1] "[W]here a security is actively traded on the market and the block in question represents, let's say, less than three months' average market trading, any blockage claim should be given careful examination before a discount is approved."[2]

The IRS has held that, in the estate tax setting, underwriting fees that are necessarily incurred in marketing a large block of stock are deductible as administration expenses under IRC Section 2053(a)(2), and are not considered in determining the blockage discount to be accorded in valuing the stock under IRC Section 2031 (see Q 700). Where a blockage discount is allowed, says the Service, the relevant valuation figure is the price that the public would pay to the underwriter for the stock, not the price the underwriter would pay to the estate.[3] For a discussion of the blockage discount issue, see *Est. of Sawade v. Comm.*[4]

If actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

(1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and

(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" referred to in (1) and (2) above are the following: the good will of the business, the economic outlook in the particular industry, the company's position in the industry and its management, the degree of control of the business represented by the block of stock to be valued, and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case.[5] In addition to the relevant factors described above, consideration is also given to nonoperating assets, including the proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity.[6]

1. Treas. Regs. §§20.2031-2(e); 25.2512-2(e).
2. *IRS Valuation Guide for Income, Estate and Gift Taxes*, page 194 (published by Commerce Clearing House on May 11, 1982).
3. Rev. Rul. 83-30, 1983-1 CB 224.
4. TC Memo 1984-626, aff'd 86-2 USTC ¶13,672 (8th Cir. 1986).
5. See, e.g., *Est. of Cook v. U.S.*, 86-2 USTC ¶13,678 (W.D. Mo. 1986).
6. Treas. Regs. §§20.2031-2(f); 25.2512-2(f).

Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.[1] For a case applying this regulation, see *Dorn v. the United States*.[2] In any event, an option or a contract to purchase securities which fails to meet the Chapter 14 valuation rules test for such options or agreements (see Q 785) will be disregarded.[3]

In any case where a dividend is declared on a share of stock before the decedent's death but payable to stockholders of record on a date after his death and the stock is selling "ex-dividend" on the date of the decedent's death, the amount of the dividend is added to the ex-dividend quotation in determining the fair market value of the stock as of the date of the decedent's death.[4]

763. What effect does it have on valuation of shares of stock for federal transfer tax purposes if they are pledged as security?

The full value of securities pledged to secure an indebtedness of the decedent is included in the gross estate. If the decedent had a trading account with a broker, all securities belonging to the decedent and held by the broker at the date of death must be included at their fair market value as of the applicable valuation date. Securities purchased on margin for the decedent's account and held by a broker must also be returned at their fair market value as of the applicable valuation date. The amount of the decedent's indebtedness to a broker or other person with whom securities were pledged is allowed as a deduction from the gross estate.[5] The deduction is taken under IRC Section 2053.

If the shares of stock are pledged to secure a debt that was not the decedent's debt at his death, the shares' value that is includable in the gross estate is reduced to reflect the encumbrance. The amount of the reduction depends upon such factors as the decedent's right to receive dividends, the size of the debt, and the outlook for timely repayment of the debt.[6]

1. Treas. Reg. §20.2031-2(h).
2. 828 F2d 177, 87-2 USTC ¶13,732 (3rd Cir. 1987), reversing 86-2 USTC ¶13,701 (W.D. Pa. 1986).
3. IRC Sec. 2703.
4. Treas. Reg. §20.2031-2(i); Rev. Rul. 54-399, 1954-2 CB 279.
5. Treas. Reg. §20.2031-2(g).
6. *Est. of Hall v. Comm.*, TC Memo 1983-355.

764. How are notes, mortgages, and mortgage participation certificates valued for federal transfer tax purposes?

The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death or gift, unless the executor or the donor establishes that the value is lower or that the notes are worthless. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.[1]

Mortgages and mortgage participation certificates are treated similarly. The presumption that their face value is their true value governs unless the representative of the estate submits convincing evidence to the contrary.

If it is contended that the actual value of mortgages or mortgage participation certificates is less than their face value, pertinent factors to be taken into consideration in fixing the correct value include the valuation of real estate and any collateral covered by the mortgages, arrears in taxes and interest, gross and net rentals, foreclosure proceedings, assignment of rents, prior liens or encumbrances, present interest yield, over-the-counter sales, bid and asked quotations, etc. The existence of an over-the-counter market for such securities and the quotations and opinions of value furnished by brokers and real estate appraisers cannot be accepted as conclusive evidence of the value of such securities. Such sales and bid and asked quotations are merely items to be considered with other evidence in fixing values.

In valuing unit mortgages, consideration will be given first to the value of the property securing the mortgages, applying the same factors as are used in fixing the valuation of real estate owned in fee. Where the mortgage is amply secured, the value will be determined to be its face value plus accrued interest to the date of death. Where the security is insufficient, the mortgage will be valued upon the basis of the fair market value of the property less back taxes, estimated foreclosure expenses, and, where justified, the expense of rehabilitation. If the mortgage is not affected by moratorium laws, the mortgagee's recourse against the mortgagor personally will be taken into consideration.

Planning Point: The valuation of such assets is a question of fact and the IRS contends that the burden of proof is upon the estate to overcome the presumption that the face value is the true value where a lower value is sought to be established.[2]

765. How are life estates, remainders, and private annuities valued?

Life estates, estates for a term of years, remainder interests, and private annuities are generally valued by use of the government's valuation tables (see below).[3] However, it has been held

1. Treas. Regs. §§20.2031-4; 25.2512-4.
2. Rev. Rul. 67-276, 1967-2 CB 321.
3. *Fehrs v. U.S.*, 45 AFTR 2d 80-1695, 79-2 USTC ¶13,324 (Ct. Cl. 1979).

that the tables are only *presumptively* correct, and that in exceptional cases where there is strong evidence at the date of valuation that the life by which an interest is measured has an expectation of life longer or shorter than the tables indicate, that interest may be valued according to the facts at hand rather than according to the tables.[1] On the other hand, the government tables must be used even though the life tenant or life annuitant is in poor health at the date of valuation if the tenant's or annuitant's time of death is neither predictable nor imminent.[2] Account may not be taken of facts later coming to light but not available at the date of valuation; i.e., the interest may not be valued through the aid of hindsight.[3]

Planning Point: Life annuitants should seek a medical evaluation and receive a written report at the time a private annuity contract or similar arrangement is executed to establish the individual's health status.

Regulations provide that the standard valuation tables are not to be used where the individual who is a measuring life is terminally ill (defined as a person with an incurable illness or other deteriorating physical condition and at least a 50 percent probability of dying within one year). However, if an individual survives for 18 months after the transaction, the individual is presumed to have not been terminally ill at the time of the transaction unless the contrary is established by clear and convincing evidence.[4]

The estate and gift tax valuation tables are based on an assumed interest rate. Departure from strict application of the tables is permissible in exceptional cases where use of the tables would violate reason and fact. For example, where transferred property may yield no income at all or the income is definitely determinable by other means.[5] However, the IRS will not allow such departure on a mere showing that past income yield from trust assets has been substantially lower than the rate assumed in the tables.[6] Nor will departure be allowed simply because the property transferred as a gift in trust is nonincome producing if the trustee has power to convert it to income producing property.[7]

Regulations provide that the standard valuation tables are not to be used to value an annuity if, considering the assumed interest rate, the trust is expected to exhaust the fund before the last possible annuity payment is made in full (measuring life survival to age 110 is assumed for this purpose). For a fixed annuity (i.e., annuity amount is payable for a term certain, or for one or two lives) payable annually at the end of the year, the corpus is assumed to be sufficient to make all payments if the assumed interest rate is greater than or equal to the annuity payment percentage (i.e., the amount of the annual annuity payment divided by the initial value of the corpus). If the annuity payment percentage exceeds the assumed interest rate and the annuity

1. *Est. of Carter v. U.S.*, 921 F. 2d 63, 91-1 USTC ¶60,054 (5th Cir. 1991); *Dunigan v. U.S.*, 434 F.2d 892 (5th Cir. 1970); *Est. of Hoelzel v. Comm.*, 28 TC 384 (1957), acq. 1957-2 CB 5; *Est. of Jennings v. Comm.*, 10 TC 323 (1948), nonacq. 1953-1 CB 5; *Ellis Sarasota Bank & Trust Co. v. U.S.*, 77-2 USTC ¶13,204 (M.D. Fla. 1977).
2. *Miami Beach First Nat'l Bank v. U.S.*, 443 F.2d 116 (5th Cir. 1971); *Bank of Cal. (Est. of Manning) v. U.S.*, 82-1 USTC ¶13,461 (C.D. Cal. 1980); *Est. of Fabric v. Comm.*, 83 TC 932 (1984).
3. *U.S. v. Provident Trust Co.*, 291 U.S. 272 (1934); *Est. of Van Horne v. Comm.*, 720 F. 2d 1114, 83-2 USTC ¶13,548 (9th Cir. 1983), aff'g 78 TC 728 (1982), *cert. den.*
4. Treas. Regs. §§1.7520-3(b)(3), 20.7520-3(b)(3), 25.7520-3(b)(3).
5. *Morgan v. Comm.*, 42 TC 1080 (1964), aff'd 353 F.2d 209 (4th Cir. 1965); *Hanley v. U.S.*, 63 F. Supp. 73 (Ct. Cl. 1945).
6. Rev. Rul. 77-195, 1977-1 CB 295.
7. Rev. Rul. 79-280, 1979-2 CB 340.

is for a term certain, multiply the annual annuity payment by the term certain annuity factor (derived from the Term Certain Remainder Factors Table found in Appendix C). If the annuity payment percentage exceeds the assumed interest rate and the annuity is for one or two lives, multiply the annual annuity payment by the term certain annuity factor (derived from the Term Certain Remainder Factors Table found in Appendix C) for a term equal to 110 minus the age of the youngest measuring life. If the present value for a term certain annuity, as derived in either of the two preceding sentences, exceeds the fund from which the annuity is to be paid, a special IRC Section 7520 valuation factor may be required to take into account the exhaustion of the fund. Adjustments in the computations described above would be required if payment terms differ from those described.[1]

> *Example*: Donor, age 60, transfers $1,000,000 to a trust. The trust will pay $100,000 a year to charity for the life of donor, with remainder to the donor's child. The IRC Section 7520 interest rate for the transfer is 6.8 percent. Since the annuity payment percentage of 10 percent ($100,000 annual payment divided by $1,000,000 initial value of trust fund) exceeds the 6.8 percent assumed interest rate, it cannot be assumed the annuity payments will not exhaust the trust. Therefore, subtract donor's age 60 from 110, resulting in a term of 50 years. The remainder factor for a term of 50 years at 6.8 percent interest is .037277 (Term Certain Remainder Factors Table). The life income factor equals one minus the remainder factor of .037277, or .962723. The annuity factor equals the life income factor of .962723 divided by the assumed interest rate of 6.8 percent, or 14.1577. The present value of a term certain annuity equals $1,415,770 ($100,000 annual payment multiplied by 14.1577 annuity factor). Since this exceeds the value of the trust fund of $1,000,000, special IRC Section 7520 valuation factors will be required to take into account the exhaustion of the fund.[2]

The Regulations provide that the standard valuation tables are not to be used to value an income interest, unless the income beneficiary is given an income interest which, in light of the trust, will, or other instrument, or state law, is in accord with an income interest which the principles of the laws of trust would provide consistent with the value of the trust corpus and its preservation. Also, the standard valuation tables are not to be used to value a use interest, unless the beneficiary is given a use interest which, in light of the trust, will, or other instrument, or state law, is in accord with an interest given to a life tenant or term holder. Standard valuation tables are not to be used for an income interest if (1) income or other enjoyment can be withheld, diverted, or accumulated for another's use without the consent of the income beneficiary, or (2) corpus can be withdrawn for another's use without the consent of the income beneficiary or accountability to such beneficiary. Thus, special factors may be required in conjunction with unproductive property, if the beneficiary has no right to require that the trustee make the trust income producing, and with Crummey withdrawal powers, if the power permits a diversion of income or principal to a person other than the income beneficiary during the income term.[3]

A remainder or reversionary interest is to be valued using the standard valuation factors only if the preceding interest (e.g., an income or annuity interest) adequately preserves and protects the remainder or reversionary interest (e.g., from erosion, invasion, depletion, or damage) until the interest takes effect.[4]

1. Treas. Regs. §§1.7520-3(b)(2)(i), 20.7520-3(b)(2)(i), 25.7520-3(b)(2)(i).
2. See Treas. Reg. §25.7520-3(b)(2)(v)(Ex. 5).
3. Treas. Regs. §§1.7520-3(b)(2)(ii), 20.7520-3(b)(2)(ii), 25.7520-3(b)(2)(ii).
4. Treas. Regs. §§1.7520-3(b)(2)(iii), 20.7520-3(b)(2)(iii), 25.7520-3(b)(2)(iii).

There is a split in the courts regarding lottery winnings includable in the gross estate as to whether they should be valued as an annuity under the standard valuation tables or whether a discount is available where state law prohibited the assignment of state lottery winnings.[1] Structured settlement payments should be valued as an annuity under the standard valuation tables without discount for lack of marketability.[2] Taxpayers wishing to challenge use of such tables to value lottery winnings will need to establish a market value as an alternative to the tables and that such value departs substantially from Section 7520 tables.[3]

Valuation Tables

Valuation tables using up-to-date interest and mortality factors must be used where the valuation date occurs on or after May 1, 1989. The value of an annuity, an interest for life or term of years, or a reversionary or remainder interest, is determined using tables and an interest rate (rounded to the nearest 2/10ths of 1 percent) equal to 120 percent of the federal midterm rate in effect for the month in which the valuation date occurs.[4] An interest rate falling midway between any 2/10ths of a percent is rounded up.[5] However, the valuation tables are not to be used with respect to any of the income tax provisions relating to qualified pension plans (including tax sheltered annuities and IRAs) contained in IRC Sections 401 to 419A.[6] The Section 7520 interest rate for each month is published at http://pro.nuco.com/Pages/default.aspx.

See Appendix C for valuation tables. (See also, Tax Facts on Investments, Appendix A, for unitrust tables (other than two-life factors or unitrust factors)). IRS Publications 1457 and 1458 contain examples of use of the valuation table and sources for the tables. Where the standard valuation table is to be used but the interest rate or payout rate to be used is between rates in the table, interpolation (an algebraic calculation of a number falling between table factors) is required.[7]

If an income, estate, or gift tax charitable deduction is allowable with respect to the property transferred, the taxpayer can elect to use the interest rate for either of the two months preceding the month in which the valuation date occurs. However, if a transfer of more than one interest in the same property is made with respect to which the taxpayer could use the same interest rate, such interest rate is to be used with respect to each such interest.[8]

766. How are Series E/EE and H/HH United States Savings Bonds valued for federal transfer tax purposes?

Apparently, they are valued at their redemption value on the applicable valuation date. In Revenue Ruling 55-278,[9] A, in 1948, bought Series E bonds with his own funds and had them

1. *Est. of Shackelford v. U.S.*, 2001-2 USTC ¶60,417 (9th Cir. 2001), aff'g 99-2 USTC ¶60,356 (E.D. Calif. 1999); *Est. of Cook v. Comm.*, 349 F. 3d 850, 2003-2 USTC ¶60,471 (5th Cir. 2003), aff'g TC Memo 2001-170; *Est. of Gribauskas v. Comm.*, 342 F. 3d 85, 2003-2 USTC ¶60,466 (2nd Cir. 2003), rev'g 116 TC 142 (2001); *Est. of Donovan v. Comm.*, 2005-1 USTC ¶60,500 (DC Mass. 2005); *Negron v. U.S.*, 553 F. 3d 1013, 2009-1 USTC ¶60,571 (6th Cir. 2009), rev'g 502 F. Supp. 682, 2007-1 USTC ¶60,541 (ND OH 2007).
2. *Est. of Anthony v. U.S.*, 2008-1 USTC ¶60,558 (5th Cir. 2008), aff'g 2005-1 USTC ¶60,504 (M.D. La. 2005).
3. *Davis v. U.S.*, 491 F. Supp. 2d 192, 2007-1 USTC ¶60,542 (DC NH 2007).
4. IRC Sec. 7520(a).
5. Treas. Reg. §20.7520-1(b)(1).
6. IRC Sec. 7520(b).
7. Treas. Regs. §§1.642(c)-6(e)(5), 1.664-4(e)(4).
8. IRC Sec. 7520(a).
9. 1955-1 CB 471.

registered in the names of A and B in the alternative as co-owners. In 1953, A had the bonds reissued in the name of B alone in order to effect a gift to him of A's co-ownership therein. The IRS held that the value of the gift made by A to B in 1953 was the redemption value of the bonds at the time they were reissued. The Service found that, "since Series E United States savings bonds are generally nonnegotiable and nontransferable, they are nonmarketable and, accordingly, have no particular 'market' value. Although ownership therein is transferable by death and by reissue in certain cases…, their only definitely indicated or ascertainable value is the amount at which they are redeemable by the United States Treasury." Presumably, the same would be true of Series H/HH bonds, since they are likewise nonnegotiable and nontransferable.

767. How is a non-negotiable savings certificate issued without discount by a Federal Reserve member bank valued for federal estate tax purposes when death occurs between interest periods?

Federal regulations provide that a time deposit, or the portion thereof requested, must be paid before maturity without a forfeiture of interest, where requested, upon the death of any owner of the time deposit funds.[1] Accordingly, the savings certificate is valued at the principal amount plus unpaid interest attributable to the period between the last interest payment date preceding death and the date of death.[2]

768. How are mutual fund shares valued for federal transfer tax purposes?

The fair market value of a share in an open-end investment company (commonly known as a "mutual fund") is the public redemption price of a share. In the absence of an affirmative showing of the public redemption price in effect at the time of death or gift, the last public redemption price quoted by the company for the date of death or gift shall be presumed to be the applicable public redemption price. If the estate tax alternate valuation method under IRC Section 2032 is elected, the last public redemption price quoted by the company for the alternate valuation date is the applicable redemption price. If there is no public redemption price quoted by the company for the applicable valuation date (e.g., the valuation date is a Saturday, Sunday, or holiday), the fair market value of the mutual fund share is the last public redemption price quoted by the company for the first day preceding the applicable valuation date for which there is a quotation. In any case where a dividend is declared on a share in an open-end investment company before the decedent's death but payable to shareholders of record on a date after his death and the share is quoted "ex-dividend" on the date of the decedent's death, the amount of the dividend is added to the ex-dividend quotation in determining the fair market value of the share as of the date of the decedent's death. As used in this paragraph, the term "open-end investment company" includes only a company which on the applicable valuation date was engaged in offering its shares to the public in the capacity of an open-end investment company.[3] Participating agreement shares in mutual funds are valued at the liquidation value and not at the public offering price on the date of death (following *Cartwright*).[4]

1. 12 CFR §204.2.
2. Rev. Rul. 79-340, 1979-2 CB 320.
3. Treas. Regs. §§20.2031-8(b); 25.2512-6(b); *U.S. v. Cartwright*, 411 U.S. 546 (1973).
4. *Est. of Sparling v. Comm.*, 60 TC 330 (1973), nonacq. 1978-2 CB 4.

769. How are United States silver coins valued for federal estate tax purposes?

If they have a fair market value which exceeds their face value, they are valued at their fair market value.[1] The applicable revenue ruling says that the same conclusion would apply to paper currency owned by the decedent and having a fair market value in excess of its face value.[2]

770. How are interests in a closely-held business valued for federal transfer tax purposes?

The fair market value of any interest in a unmarketable business, whether a partnership, corporation, limited liability company, or a proprietorship, is the net amount which a willing purchaser, whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. The net value is determined on the basis of all relevant factors, including the following:

(1) The value of all the assets of the business, tangible and intangible, including good will;

(2) The demonstrated earning capacity of the business; and

(3) The other factors set forth in the regulations[3] relating to the valuation of corporate stock, to the extent applicable (see Q 772).

Special attention should be given to determining an adequate value of the good will of the business. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of examinations of the business made by accountants, engineers, or any technical experts as of or near the applicable valuation date.[4]

For additional special valuation rules contained in IRC Chapter 14, see Q 777 to Q 786.

Approach of the Courts

The appraisal community, courts, taxpayers, and the IRS generally follow the principles laid out in Revenue Ruling 59-60 when valuing the stock of a closely-held corporation or the stock of corporations where market quotations are not available. Rev. Rul. 59-60 can also apply to value interests in closely-held partnerships or LLCs for gift tax or estate tax purposes. However, Rev. Rul. 59-60 does not discuss in detail valuation discounts for lack of control or lack of marketability. Thus, other sources must be relied upon for these critical components of valuation.

1. Rev. Rul. 78-360, 1978-2 CB 228.
2. Rev. Rul. 78-360, above.
3. See Treas. Regs. §§20.2031-2(f), 20.2031-2(h), 25.2512-2(f).
4. Treas. Regs. §§20.2031-3, 25.2512-3.

Historically, in valuation cases, the courts have tended to strike a compromise between the values asserted by the contending parties. But in many cases, courts are more willing to adopt one party's value. The credit for this "winner take all" approach must be given to former Chief Judge of the Tax Court, Theodore Tannenwald. After years of experience, Judge Tannenwald found that the "compromise the difference" approach of the courts merely encouraged the parties to assert extreme values. In a 1980 valuation decision, *Buffalo Tool & Die Manufacturing Company, Inc. v. Commissioner*,[1] Judge Tannenwald took the occasion to admonish the parties thus:

> "We are convinced that the valuation issue is capable of resolution by the parties themselves through an agreement which will reflect a compromise Solomon-like adjustment, thereby saving the expenditure of time, effort, and money by the parties and the court–a process not likely to produce a better result. Indeed, each of the parties should keep in mind that, in the final analysis, the court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other, rather than a middle-of-the-road compromise which we suspect each of the parties expects the court to reach." (At page 452).

This approach is reflected in a number of valuation decisions.[2]

771. How does the existence of a buy-sell agreement impact valuation of interests in a closely-held business for federal transfer tax purposes?

The value of any interest shall be determined without regard to any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to the option, agreement, or other restrictions) or any restriction on the right to sell or use the property (i.e., buy-sell agreement), unless the agreement (1) is a bona fide business arrangement, (2) is not a device to transfer the property to members of the decedent's family for less than full or adequate consideration in money or money's worth, and (3) has terms comparable to those entered into by persons in an arm's length transaction.[3] See Q 785.

Planning Point: Any buy-sell arrangement should take into account IRC Section 2703, and the drafter of the agreement should discuss Section 2703 with the parties to ensure they understand such agreement may not impact the estate tax valuation.

Assuming the requirements of IRC Section 2703 are met, or that IRC Section 2703 does not apply, it is possible that the *estate tax* value of a business interest (including closely held stock) may be controlled by the price or formula contained in a business purchase (buy-sell) agreement. The facts of each case must be examined to determine whether the agreement price will be accepted for estate tax purposes.[4] Case law has established, however, that if the following conditions are

1. 74 TC 441.
2. *Est. of McGill v. Comm.*, TC Memo 1984-292 (voting trust certificates); *Est. of Gallo v. Comm.*, TC Memo 1985-363 (closely held stock); *Est. of Gillet v. Comm.*, TC Memo 1985-394 (closely held stock); *Est. of Rubish v. Comm.*, TC memo 1985-406 (ranch); *Est. of Watts v. Comm.*, TC Memo 1985-595 (partnership interest).
3. IRC Sec. 2703.
4. Treas. Regs. §§20.2031-2(h), 20.2031-3; Rev. Rul. 59-60, 1959-1 CB 237.

met, the agreement price will hold for estate tax purposes, even though the fair market value of the business interest may be substantially more at the valuation date than the agreement price:

(1) The estate must be obligated to sell at death (under either a mandatory purchase agreement or an option held by the designated purchaser);

(2) The agreement must prohibit the owner from disposing of his interest during his lifetime at a price higher than the contract or option price;

(3) The price must be fixed by the terms of the agreement or the agreement must contain a formula or method for determining the price; and

(4) The agreement must be an arm's length business transaction and not a gift. Thus, the purchase price must be fair and adequate at the time the agreement is made, particularly if the parties are closely related.[1]

In a number of cases, the price set in the agreement was held to control the estate tax value of the business interest.[2]

For gift tax purposes, an agreement restricting lifetime sale will be considered with all other pertinent factors, and may tend to lower the value of the business interest.[3]

772. How are shares of stock in closely held corporations valued for federal transfer tax purposes?

IRC Section 2031(b) deals with the valuation, for estate tax purposes, of unlisted stocks and securities. It says: "In the case of stock and securities of a corporation the value of which, by reason of their not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices or with reference to sales prices, the value thereof shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange."

Rev. Rul. 59-60[4] contains a broad discussion of factors that the IRS believes should be considered in valuing shares of stock in closely held corporations or in corporations where market quotations are either lacking or too scarce to be recognized. The Service says that in these cases, "all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all-inclusive, are fundamental and require careful analysis in each case:

1. *Slocum v. U.S.*, 256 F. Supp. 753 (S.D.N.Y. 1966).
2. *Brodrick v. Gore*, 224 F.2d 892 (10th Cir. 1955); *May v. McGowan*, 194 F.2d 396 (2nd Cir. 1952); *Comm. v. Child's Estate*, 147 F.2d 368 (2nd Cir. 1952);.*Comm. v. Bensel*, 100 F.2d 639 (3rd Cir. 1939); *Lomb v. Sugden*, 82 F.2d 166 (2nd Cir. 1936); *Wilson v. Bowers*, 57 F.2d 682 (2nd Cir. 1932); *Mandel v. Sturr*, 266 F.2d 321 (2nd Cir. 1959); *Fiorito v. Comm.*, 33 TC 440, acq. 1960-1 CB 4; *Est. of Littick*, 31 TC 181, acq. in result, 1984-2 CB 1; *Est. of Weil*, 22 TC 1267, acq. 1955-2 CB 10; *Est. of Salt*, 17 TC 92, acq. 1952-1 CB 4; *Est. of Maddock*, 16 TC 324, acq. 1951-2 CB 3. See also Treas. Regs. §§20.2031-2(h), 20.2031-3.
3. *Est. of James v. Comm.*, 148 F.2d 236 (2nd Cir. 1945); *Kline v. Comm.*, 130 F.2d 742 (3rd Cir. 1942); *Krauss v. U.S.*, 140 F.2d 510 (5th Cir. 1944); *Comm. v. McCann*, 146 F.2d 385 (2nd Cir. 1944); *Spitzer v. Comm.*, 153 F.2d 967 (8th Cir. 1946); Rev. Rul. 189, 1953-2 CB 294.
4. 1959-1 CB 237.

(a) The nature of the business and the history of the enterprise from its inception;

(b) The economic outlook in general and the condition and outlook of the specific industry in particular;

(c) The book value of the stock and the financial condition of the business;

(d) The earning capacity of the company;

(e) The dividend-paying capacity;

(f) Whether or not the enterprise has good-will or other intangible value;

(g) Sales of the stock and the size of the block of stock to be valued; and

(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter."[1]

Planning Point: Taxpayers should go over in detail all the facts with the business appraiser relating to the business that would impact the appraiser's analysis of the facts laid out in Rev. Rul. 59-60.

If a block of stock represents a controlling interest in a corporation, a "control premium" generally adds to the value of the stock. If, however, the shares constitute a minority ownership interest, a "minority discount" is often applied to the value. See, e.g., *Martin v. Commissioner*,[2] which deals with discounts applied to shares of stock representing a minority interest in a holding company that, in turn, held minority interests in seven operating companies. A premium may also attach for swing vote attributes where one block of stock may exercise control by joining with another block of stock.[3] One memorandum valued stock included in the gross estate at a premium as a controlling interest, while applying a minority discount to the marital deduction (see Q 700) portion which passed to the surviving spouse.[4] Just because an interest being valued is a minority interest does not mean that a minority discount is available.[5] However, one case valued stock with voting rights at no more than stock without voting rights.[6]

If a donor transfers shares in a corporation to each of the donor's children, the Service will no longer consider family control when valuing the gift under IRC Section 2512. Thus, a minority discount will not be disallowed solely because a transferred interest would be part of a controlling interest if such interest were aggregated with interests held by family members.[7] Indeed, a minority discount was allowed even when the person to whom the interest was transferred was already a controlling shareholder.[8]

1. Rev. Rul. 59-60, Sec. 4.01.
2. TC Memo 1985-424.
3. TAM 9436005.
4. TAM 9403005.
5. *Godley v. Comm.*, 286 F. 3d 210, 2002-1 USTC ¶60,436 (4th Cir. 2002) (partnerships held housing projects subject to long-term government contracts).
6. *Est. of Simplot v. Comm.*, 249 F. 3d 1191, 2001-1 USTC ¶60,405 (9th Cir. 2001).
7. Rev. Rul. 93-12, 1993-1 CB 202, revoking Rev. Rul. 81-253, 1981-2 CB 187.
8. TAM 9432001.

The Tax Court has determined that an estate would not be allowed a minority discount where the decedent transferred a small amount of stock immediately prior to death for the sole purpose of reducing her interest from a controlling interest to a minority interest for valuation purposes.[1] Also, a partnership or LLC may be included in the gross estate under IRC Section 2036 without the benefit of discounts if a decedent puts everything he owns into the partnership or LLC and retains complete control over the income of the partnership or LLC.[2]

For a case discussing the valuation of voting trust certificates representing the decedent's beneficial interest in stock of a closely held corporation, see *Estate of McGill v. Commissioner*.[3]

In general, when valuing an operating company that sells goods and services, primary consideration is given to earnings, and when valuing a company that merely holds investments, primary consideration is given to asset values. However, if a company is not easily characterized as one or the other, appropriate weight should be given to both earnings and assets.[4]

For the effect of a buy-sell agreement on the valuation of closely held stock, see Q 771.

For additional special valuation rules contained in IRC Chapter 14, see Q 777 to Q 786.

773. How is real estate valued for federal transfer tax purposes?

There are three basic approaches appraisers use to arrive at the fair market value of real estate: (1) the market data, or comparable sales approach; (2) the capitalization of income approach; and (3) the reproduction cost less depreciation approach.[5] The real estate may be valued at its highest and best use with limited exceptions.

(1) *Market data*. An arm's length sale of the property in question on the valuation date would, of course, determine its fair market value. Lacking such a circumstance, the next best indication of value would be the price for which a reasonably comparable piece of property was sold on or near the valuation date. This approach is particularly useful in the valuation of unimproved real estate.[6]

(2) *Capitalization of income*. The projected net income from the property, either before or after depreciation, interest, and income taxes, from the highest and best use of the property is estimated and then capitalized at a rate which represents a fair return on the particular investment at the particular time, considering the risks involved. This approach is particularly useful in the appraisal of business properties.

(3) *Reproduction cost*. This approach requires an estimate of the cost of replacing a structure, an estimate of the depreciation and obsolescence that has taken place in the existing structure, and an appraisal of the land involved. Use of this method is extremely limited for ordinary federal tax valuation purposes.

1. *Est. of Murphy v. Comm.*, TC Memo 1990-472.
2. *Est. of Strangi v. Comm.*, TC Memo 2003-145; *Kimbell v. U.S.*, 2003-1 USTC ¶60,455 (N.D. Tex. 2003).
3. *Estate of McGill v. Commissioner*, TC Memo 1984-292.
4. *Martin v. Comm.*, TC Memo 1985-424.
5. IRS Valuation Guide, pages 18-19.
6. Rev. Proc. 79-24, 1979-1 CB 565.

An undivided fractional interest in property is normally determined to be a proportionate part of the value of the whole property. If any discount is allowed, the taxpayer must produce evidence that partial interests in real property in the locality sell for less than their proportionate shares of the whole.[1]

774. How are mineral properties valued for federal transfer tax purposes?

Treasury Regulation Section 1.611-2(d) provides, for income tax purposes, the following:

(d) Determination of fair market value of mineral properties, and improvements, if any. –

(1) If the fair market value of the mineral property and improvements at a specified date is to be determined for the purpose of ascertaining the basis (see Q 598), such value must be determined, subject to approval or revision by the district director, by the owner of such property and improvements in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments or subsequent improvements in methods of extraction and treatment of the mineral product. The district director will give due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties and improvements, bona fide offers, market value of stocks or shares, royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property and improvements was in question, the amount at which the property and improvements may have been inventoried or appraised in probate or similar proceedings, and disinterested appraisals by approved methods.

(2) If the fair market value must be ascertained as of a certain date, analytical appraisal methods of valuation, such as the present value method will not be used:

(i) If the value of a mineral property and improvements, if any, can be determined upon the basis of cost or comparative values and replacement value of equipment, or

(ii) If the fair market value can reasonably be determined by any other method."

Lambert v. U.S.,[2] concerned the federal estate tax valuation of an estate's one-half interest in a coal mining business operated as a partnership. The parties agreed that the Treasury Regulations on cost depletion provided guidance as to the valuation of coal properties. Citing Treasury Regulation Section 1.611-2(d)(2), above, the court found that the estate's witness had properly determined the value of the intangible assets, including the coal reserves and good will, upon the basis of comparative values, and that for that reason, the analytical methods applied by the government and its witness were not appropriate. Accordingly, the court found that the estate

1. *Est. of Iacono*, TC Memo 1980-520.
2. 85-2 USTC ¶13,637 (W.D. Va. 1985).

had met its burden of showing that the government's valuation of $3,772,326 for the coal company was excessive and that the fair market value, as determined by the estate, was $2,126,000.

Treasury Regulation Section 1.611-2(e) provides, for income tax purposes, the following:

(e) Determination of the fair market value of mineral property by the present value method. –

(1) To determine the fair market value of a mineral property and improvements by the present value method, the essential factors must be determined for each mineral deposit. The essential factors in determining the fair market value of mineral deposits are:

(i) The total quantity of mineral in terms of the principal or customary unit (or units) paid for in the product marketed,

(ii) The quantity of mineral expected to be recovered during each operating period,

(iii) The average quality or grade of the mineral reserves,

(iv) The allocation of the total expected profit to the several processes or operations necessary for the preparation of the mineral for market,

(v) The probable operating life of the deposit in years,

(vi) The development cost,

(vii) The operating cost,

(viii) The total expected profit,

(ix) The rate at which this profit will be obtained, and

(x) The rate of interest commensurate with the risk for the particular deposit.

(2) If the mineral deposit has been sufficiently developed, the valuation factors specified in subparagraph (1) of this paragraph may be determined from past operating experience. In the application of factors derived from past experience, full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, cost of development, production, interest rate, and selling price of the product marketed during the expected operating life of the mineral deposit. Mineral deposits for which these factors cannot be determined with reasonable accuracy from past operating experience may also be valued by the present value method; but the factors must be deduced from concurrent evidence, such as the general type of the deposit, the characteristics of the district in which it occurs, the habit of the mineral deposits, the intensity of mineralization, the oil-gas ratio, the rate at which additional

mineral has been disclosed by exploitation, the stage of the operating life of the deposit, and any other evidence tending to establish a reasonable estimate of the required factors.

(3) Mineral deposits of different grades, locations, and probable dates of extraction should be valued separately. The mineral content of a deposit shall be determined in accordance with paragraph (c) of this section. In estimating the average grade of the developed and prospective mineral, account should be taken of probable increases or decreases as indicated by the operating history. The rate of exhaustion of a mineral deposit should be determined with due regard to the limitations imposed by plant capacity, by the character of the deposit, by the ability to market the mineral product, by labor conditions, and by the operating program in force or reasonably to be expected for future operations. The operating life of a mineral deposit is that number of years necessary for the exhaustion of both the developed and prospective mineral content at the rate determined as above. The operating life of oil and gas wells is also influenced by the natural decline in pressure and flow, and by voluntary or enforced curtailment of production. The operating cost includes all current expense of producing, preparing, and marketing the mineral product sold (due consideration being given to taxes) exclusive of allowable capital additions, as described in §§1.612-2 and 1.612-4 (see Q 7798 through Q 7801), and deductions for depreciation and depletion (see Q 7802 through Q 7816), but including cost of repairs. This cost of repairs is not to be confused with the depreciation deduction by which the cost of improvements is returned to the taxpayer free from tax. In general, no estimates of these factors will be approved by the district director that are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods.

(4) The value of each mineral deposit is measured by the expected gross income (the number of units of mineral recoverable in marketable form multiplied by the estimated market price per unit) less the estimated operating cost, reduced to a present value as of the date for which the valuation is made at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at that date of the improvements and of the capital additions, if any, necessary to realize the profits. The degree of risk is generally lowest in cases where the factors of valuation are fully supported by the operating record of the mineral enterprise before the date for which the valuation is made. On the other hand, higher risks ordinarily attach to appraisals on any other basis."

775. How is timber valued for federal transfer tax purposes?

The estate tax regulations offer little guidance in the selection of an appropriate method for valuing timber property. However, Treasury Regulation Section 1.611-3(f), covering the depletion allowance deduction for income tax purposes, contains the following useful information:

(f) Determination of fair market value of timber property.

(1) If the fair market value of the property at a specified date is the basis for depletion deductions, such value shall be determined, subject to approval or revision by the district director upon audit, by the owner of the property in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, and methods of exploitation, in degree of utilization, etc. Such factors as the following will be given due consideration:

(i) Character and quality of the timber as determined by species, age, size, condition, etc.;

(ii) The quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber;

(iii) Accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation and the climate and the state of industrial development of the locality); and

(iv) The freight rates by common carrier to important markets.

(2) The timber in each particular case will be valued on its own merits and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned in this paragraph, will be consistent with that of other similar timber in the region. The district director will give weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost of production and the price realized for timber products, market value of stock or shares, royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried or appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors."

In a case involving estate tax valuation of undivided minority interests in timberland, the Tax Court, quoting from paragraph (2) of the foregoing regulation, added that, where available, the use of comparative sales is the method of valuation most preferred by that court and by the Ninth Circuit (to which appeal lay). As the Court found, few sales exist of undivided minority interests in timberland based on the inability of the owner to control the timberland, which should impact the overall value as no market may exist.

In that case, the government's appraisers based their valuation on 24 sales of "stumpage" believed by them to be the most comparable because of their similar characteristics and their proximity in time to the valuation date and in location to the subject property. In addition, the appraisers used seven other transactions involving timber and land in the same general vicinity. The prices of the sales considered comparable were adjusted by the appraisers for differences in timber, quality, accessibility and other logging costs, volume, species mix, and time of sale. The government's appraisers concluded that the total value of the timber on the land in which decedent had an undivided interest was $29,500,000 at the date of her death. With one exception, the government's appraisers used the same sales as comparables to determine that the value of the underlying land supporting the timber at decedent's death was $9,500,000.

The executor, however, contended that the sales upon which the government's appraisers relied involved timber that was not comparable to the timber in which the decedent had an undivided interest. He also contended that the sales used as comparables by the government's appraisers were not properly adjusted to bring them into comparability. With respect to the government's land valuation, the executor contended that the appraisal failed to adjust for acreage in the subject land that was barren, or to adjust adequately for differences in steepness of terrain.

The court examined the points of difference between the parties, found merit in several of the executor's contentions, and concluded that the government's valuation should be reduced by 20 percent, i.e., to $31,200,000.

The final issue in the case was the issue of a minority discount to be applied to the decedent's undivided aliquot portion of the $31,200,000 valuation. The government contended that no minority discount should be allowed. The executor contended that a discount of at least 60 percent was warranted. On this issue the estate's witnesses were persuasive. The court was convinced from their testimony of the disabilities associated with a minority undivided interest in timber property, including lack of marketability, lack of management, lack of general control, lack of liquidity, and potential partitionment expenses, that a minority discount of 60 percent was reasonable, and the court so held.[1] See also *Harwood v. Comm.*,[2] which concerned valuation of a minority interest in a limited partnership engaged in the timber business.

776. How are annuity, unitrust, and income (or use) interests retained by a grantor in a trust valued for estate tax purposes?

If a grantor retains an annuity, unitrust, or income (or use) interest in an irrevocable trust and dies before such retained interest terminates, the retained interest is includable in the decedent's gross estate for estate tax purposes. While a retained annuity or unitrust (which is a variable annuity) interest in a trust could be included in the estate under either IRC Section 2036 as a retained life estate or under IRC Section 2039 as an annuity, regulations state that IRC Section 2036, rather than IRC Section 2039, will be applied to such interests.[3] A retained income (or use) interest in an irrevocable trust would be includable under IRC Section 2036. A revocable trust is includable in a grantor's estate under IRC Section 2038. A gift within three

1. *Est. of Sels v. Comm.*, TC Memo 1986-501.
2. 82 TC 239 (1980), aff'd per order (9th Cir. March 18, 1986).
3. Treas. Reg. §20.2039-1(e)(1).

years of death of an IRC Section 2036, 2038, or 2039 interest is includable in the estate under IRC Section 2035.

Planning Point: If the grantor dies after the retained interest terminates, the interest is generally not includable in the grantor's estate. Setting the trust term can be a balancing act. If the trust with a retained interest is for life, it will be includable in the grantor's estate. In general, the longer the term of years the grantor retains the interest, the lower is the value of gifts to others; but longer terms increase the risk that the grantor with a retained interest will die during the trust term and that the trust will be includable in the grantor's estate.

Such retained annuity, unitrust, and income (or use) interests are generally found in GRITs, GRATs, GRUTs, PRTs, QPRTs, CRATs, and CRUTs, but can be found in other trusts as well. The valuation rules discussed below apply only to valuing the retained interest includable in the grantor's estate. The regular rules under IRC Section 2702 (see Q 781) and IRC Section 7520 (see Appendix A of *Tax Facts on Investments*) apply for valuing gifts in such trusts and for determining charitable deductions (see Q 7990). In general, the rules below include an amount in the gross estate that represents the amount of trust assets needed to yield the payments to the grantor from the trust.

Planning Point: The IRS is required by IRC Section 7520 (c)(3) to update the actuarial tables to reflect the new mortality data produced by each U.S. census. In that regard, the IRS has produced tables to reflect the 2000 census and regulations under Section 7520 reflecting the data. The data reflects an increased life expectancy for all persons under age 95. The result is that Table 2000 C.M. increases the value of lifetime interests and decreases the value of remainders or reversions following lifetime interests. This makes CRTs and QPRTs slightly less desirable while CLTs, private annuities and self-cancelling installment notes (SCINs) are slightly more desirable. Generally, the new tables apply to transfers for which the valuation date is on or after May 1, 2009.

An includable retained *income* interest would be valued based on the percentage of income retained by the grantor. The right to use trust property is valued similarly to an income interest.

> *Examples*: If the grantor retained the right to all the trust income, 100 percent of the trust corpus would be includable. If the grantor retained the right to 60 percent of the income, 60 percent would be includable. If the grantor retained the right to 50 percent of the income, which increased to 100 percent when the other income beneficiary died before the grantor, 100 percent would be includable. If a grantor retained use of a personal residence in a QPRT, 100 percent of the QPRT is includable.[1]

An includable retained *annuity* interest would be valued by dividing the annual annuity (adjusted for frequency of payment and whether payments are made at the beginning or the end of each period) by the IRC Section 7520 rate at the date of death (or alternate valuation date).[2] For this purpose, Annuity Adjustment Factors Table A is used for payments made at the end of each period, and Annuity Adjustment Factors Table B is used for payments made at the beginning of each period (see Appendix C). Presumably, if the value of the annuity calculated in this fashion exceeds the value of the trust assets, the amount includable would be limited to the value of the trust assets.

1. Treas. Reg. §20.2036-1(c)(1)(ii); Treas. Reg. §20.2036-1(c)(2)(ii).
2. Treas. Reg. §20.2036-1(c)(2).

Example: Grantor created a GRAT with an annuity of $1,000 ($12,000 annual) payable at the end of each month to Grantor for 10 years, with remainder to Grantor's child. Grantor died during the 10 year term. At grantor's death, the value of the GRAT assets was $300,000 and the Section 7520 interest rate was 6 percent. The annuity adjustment factor (monthly, payments at the end of each period, 6 percent) is 1.0272 (from Annuity Adjustment Factors Table A). The amount of property includable under IRC Section 2036 is $205,440 [($12,000 × 1.0272) / 6%].

An includable retained *unitrust* interest would be valued by multiplying the value of the trust assets by an inclusion ratio. The inclusion ratio is determined by dividing the trust's equivalent income interest rate by the IRC Section 7520 rate at the date of death (or alternate valuation date). The equivalent income interest rate is determined by dividing the trust's adjusted payout rate by the excess of 1 over the adjusted payout rate. The adjusted payout rate is determined by multiplying the payout rate by the Unitrust Payout Adjustment Factor (see Appendix C). If the inclusion ratio is greater than 100 percent, it is reduced to 100 percent.[1]

Example: Grantor created a CRUT with a 6 percent unitrust payout rate payable (in equal installments at the end of each quarter) to Grantor for life, then to Grantor's child for life, with remainder to charity. At grantor's death, the value of the CRUT assets was $300,000, the Section 7520 interest rate was 6 percent, and Grantor's child was age 55. The unitrust payout adjustment factor (6 percent Section 7520 rate, quarterly, 3 months to payout) is 0.964365. The adjusted payout rate equals 5.786 percent [6% payout rate × 0.964365]. The equivalent income interest rate equals 6.141 percent [5.786% / (1 – 5.786%)]. The inclusion ratio equals 102.35 percent [6.141% / 6% Section 7520 rate]. Since the inclusion ratio exceeds 100 percent, it is reduced to 100 percent. The amount includable under IRC Section 2036 is $300,000 [$300,000 × 100%]. The charitable deduction for the estate would be calculated under the regular rules for CRUTs (see Q 7990), as a CRUT with a unitrust payable to Grantor's child for life, and would be $84,759.

Graduated Retained Interests

A graduated retained interest is an annuity, unitrust, or other payment, payable at least annually, that increases at a regular rate over time, but not more often than annually. If the grantor dies during the trust term with a graduated retained interest, the amount includable in the gross estate for estate tax purposes includes the sum of the following: (1) the amount of corpus needed to generate the annuity, unitrust, or other payment for the year of the grantor's death (the base amount); and (2) the discounted value of the amounts of corpus needed to generate the periodic additions starting in each of the remaining years of the trust term.[2]

Example: Grantor created a five-year grantor retained annuity trust (GRAT). The GRAT pays Grantor an annual annuity at the end of each trust year, on October 31st. The first annuity payment equals $100,000 and the annuity payment increases by 20 percent each year. If Grantor dies during the trust term, payments continue to Grantor's estate. At the end of the trust term, the corpus is to be distributed to Grantor's child.

Grantor dies on January 31 of the third year of the GRAT term. The value of the trust corpus is $3,200,000 on the date of death. The Section 7520 interest rate for the month of death equals 6.8 percent. The alternate valuation date is not elected. The table shows calculation of the $2,973,868 includable in Grantor's gross estate as a graduated retained interest.[3]

1. Treas. Reg. §20.2036-1(c)(2).
2. Prop. Treas. Reg. §20.2036-1(c)(2)(ii).
3. Prop. Treas. Reg. §20.2036-1(c)(2)(iii)(Ex. 7).

A GRAT Year	B Annual Annuity	C Periodic Addition	D Required Principal	E Deferral Period	F PV Factor	G Corpus Amount
1	100,000					
2	120,000	20,000				
3	144,000	24,000	2,117,647			2,117,647
4	172,800	28,800	423,529	0.747945	0.951985	403,194
5	207,360	34,560	508,235	1.747945	0.891372	453,027
Total						2,973,868

D = (B or C × Ann. Adj. Factor) ÷ Sec. 7520 Rate
E = 273 {days from January 31 to October 31} ÷ 365 [for year 4]
F = 1 ÷ (1 + Sec. 7520 Rate)E
G = D × F

Contingent Retained Interests

If the grantor retained the right to receive an annuity, unitrust, or other payment from transferred property after the death of another person who was enjoying the annuity, unitrust, or other payment at the time of grantor's death, then the amount includable in grantor's gross estate is the amount of trust assets needed to yield the payments to the grantor from the trust. But this amount is reduced by the present value of the other person's interest. However, the amount includable cannot be less than the amount of trust assets needed to yield the trust payments the grantor was entitled to at grantor's death. In any event, however, the amount includable cannot exceed the fair market value of the trust corpus on the date of grantor's death.[1]

Example: Grantor created an irrevocable trust. The trust provides that 50 percent of trust income is to be paid each to Grantor and Grantor's child during their joint lives. On the death of the first to die of Grantor or Grantor's child, 100 percent of trust income is to be paid to the survivor for life. On the death of the survivor, the remainder is to be paid to a third person.

Grantor dies survived by child. Fifty percent of the trust corpus is includable in Grantor's gross estate because Grantor retained the right to 50 percent of trust income for life. In addition, the value of the remaining 50 percent of trust corpus, less the present value of the child's life estate, is includable in Grantor's estate because Grantor retained the right to 100 percent of trust income if Grantor survived child. [If child had predeceased Grantor, 100 percent of trust corpus would be includable in Grantor's gross estate.][2]

Example: Grantor created an irrevocable trust. The trust provides that an annuity of $5,000 is to be paid each to Grantor and Grantor's child during their joint lives. On the death of the first to die of Grantor or Grantor's child, an annuity of $10,000 is to be paid to the survivor for life. On the death of the survivor, the remainder is to be paid to a third person.

Grantor dies survived by child. The value of the trust corpus is $120,000 on the date of death. The Section 7520 interest rate for the month of death equals 7.0 percent. Assume the present value of child's $5,000 annuity for life is $40,000. The table shows calculation of the $102,857 includable in Grantor's gross

1. Prop. Treas. Reg. §20.2036-1(b)(1)(ii).
2. Prop. Treas. Reg. §20.2036-1(c)(1)(ii)(Ex. 1(i)).

estate. [If child had predeceased Grantor, $120,000 would be includable in Grantor's gross estate (Step 4 would be $0, and $120,000 is less than $142,857).][1]

Step 1: Fair market value of corpus	$120,000
Step 2: Corpus needed to produce Grantor's annuity ($5,000 ÷ 7%)	$71,429
Step 3: Corpus needed to produce survivor's annuity ($10,000 ÷ 7%)	$142,857
Step 4: Present value of child's annuity	$40,000
Step 5: Step 3 minus Step 4 (but not less than Step 2)	$102,857
Step 6: Lesser of Step 1 or Step 5	$102,857

777. What are the Chapter 14 special valuation rules?

Special valuation rules are contained in IRC Chapter 14. Chapter 14 generally focuses on establishing the value of various interests transferred to family members at the time of the transfer when the transferor retains certain interests in the property being transferred or restrictions are placed on the property that allow the property to be acquired at less than fair market value (measured without the restrictions). Special rules apply to certain transfers of interests in corporations and partnerships (see Q 778), to certain transfers of interests in trusts and even remainder and joint purchase transactions (see Q 781), to certain agreements, options, rights or restrictions exercisable at less than fair market value (see Q 785), and to various lapsing rights and restrictions (see Q 786).

778. What special valuation rules apply to the transfer of an interest in a corporation or partnership under Chapter 14?

As a general rule, the value of a transferred residual interest is equal to the value of the transferor's entire interest prior to the transfer reduced by the value of the interest retained by the transferor. For the purpose of determining whether a transfer of an interest in a corporation or partnership to (or for the benefit of) a "member of the transferor's family" is a gift (and the value of the transfer), the value of any "applicable retained interest" (see below) that is held by the transferor or an "applicable family member" (see below) immediately after the transfer is treated as being zero unless the applicable retained interest is a "distribution right" which consists of the right to receive a "qualified payment."[2] Where an applicable retained interest consists of a distribution right which consists of the right to receive a qualified payment and there are one or more liquidation, put, call, or conversion rights with respect to such interest, the value of all such rights is to be determined by assuming that each such liquidation, put, call, or conversion right is exercised in a manner which results in the lowest value.[3] IRC Section 2701 does not apply to distribution rights with respect to qualified payments where there is no liquidation, put, call, or conversion right with respect to the distribution right.[4] If the transfer subject to these rules is of a junior equity interest in a corporation or partnership, the transfer must be assigned a minimum value under the "junior equity rule."[5]

1. Prop. Treas. Reg. §20.2036-1(c)(1)(ii)(Ex. 1(ii)).
2. IRC Secs. 2701(a)(1), 2701(a)(3)(A).
3. IRC Sec. 2701(a)(3)(B).
4. IRC Sec. 2701(a)(3)(C).
5. IRC Sec. 2701(a)(4).

These rules do not apply if, for either the transferred interest or the applicable retained interest, market quotations are readily available (as of the date of transfer) on an established securities market. Also, the rules do not apply if the applicable retained interest is of the same class as the transferred interest, or if the applicable retained interest is proportionally the same as the transferred interest (disregarding nonlapsing differences with respect to voting in the case of a corporation, or with respect to management and limitations on liability in the case of a partnership).[1] An exception from the rules is also provided for a transfer of a vertical slice of interests in an entity (defined as a proportionate reduction of each class of equity interest held by the transferor and applicable family members in the aggregate).[2]

Definitions and Rules

Transfers

The rules apply to transfers with respect to new, as well as existing, entities.[3] Transfers may be either direct or indirect. Furthermore, except as provided in regulations, a contribution to capital, a redemption, a recapitalization, or other change in capital structure of a corporation or partnership is treated as a transfer if the taxpayer or an applicable family member receives an applicable retained interest in the transaction, or as provided under regulations, holds such an interest immediately after the transfer.[4] Any termination of an interest is also treated as a transfer.[5]

Applicable Retained Interests

An "applicable retained interest" is any interest in an entity with respect to which there is (1) a distribution right and the transferor and applicable family members control the entity immediately before the transfer, or (2) a liquidation, put, call, or conversion right.[6] (Regulations or rulings may provide that any applicable retained interest be treated as two or more interests.[7]) A "distribution right" is any right to a distribution from a corporation with respect to its stock, or from a partnership with respect to a partner's interest in the partnership, other than (1) a distribution with respect to any interest if such right is junior to the rights of the transferred interest, (2) any right to receive a guaranteed payment of a fixed amount from a partnership under IRC Section 707(c), or (3) a liquidation, put, call, or conversion right.[8]

For these purposes, a liquidation, put, call, or conversion right is treated as a distribution right rather than as a liquidation, put, call, or conversion right if (1) it must be exercised at a specific time and at a specific amount, or (2) the liquidation, put, call, or conversion right: (a) can be converted into a fixed amount or fixed percentage of the same class of shares of stock as the transferred shares; (b) is nonlapsing; (c) is subject to proportionate adjustments for splits, combinations, reclassifications, and similar changes in the capital stock; and (d) is subject to

1. IRC Sec. 2701(a)(2).
2. Treas. Reg. §25.2701-1(c)(4).
3. Treas. Reg. §25.2701-1(b)(2)(i).
4. IRC Sec. 2701(e)(5).
5. IRC Sec. 2701(d)(5).
6. IRC Sec. 2701(b).
7. IRC Sec. 2701(e)(7); Treas. Reg. §25.2701-7.
8. IRC Sec. 2701(c)(1).

adjustments for accumulated but unpaid distributions. (Similar rules apply to liquidation, put, call, or conversion rights in a partnership.) Where a liquidation, put, call, or conversion right is treated as exercised in a manner which produces the lowest value in the general rule above, such a right is treated as a distribution right which must be exercised at a specific time and at a specific amount.[1]

Regulations provide that applicable retained interests consist of (1) extraordinary payment rights, and (2) distribution rights held in a controlled entity.[2] The term "extraordinary payment rights" is used to refer to liquidation, put, call, or conversion rights, the exercise or nonexercise of which affects the value of the transferred interests.[3] The following are treated as neither extraordinary payment rights nor distribution rights: (1) mandatory fixed payment rights; (2) liquidation participation rights (other than ones in which the transferor, members of the transferor's family, and applicable family members have the ability to compel liquidation); and (3) non-lapsing conversion rights subject to proportionate adjustments for changes in equity and to adjustments to take account of accumulated but unpaid qualified payments.[4]

Qualified Payments

A "qualified payment" means any dividend payable on a periodic basis at a fixed rate (including rates tied to specific market rates) on any cumulative preferred stock (or comparable payment with respect to a partnership). With respect to the transferor, an otherwise qualified payment is to be treated as such unless the transferor elects otherwise. With respect to applicable family members, an otherwise qualified payment is not to be treated as such unless the applicable family member so elects. A transferor or an applicable family member can make an irrevocable election to treat any distribution right (which is otherwise not a qualified payment) as a qualified payment, payable at such times and in such amounts as provided in the election (such times and amounts not to be inconsistent with any underlying legal instruments creating such rights).[5] The value assigned to a right for which an election is made cannot exceed fair market (determined without regard to IRC Section 2701).[6]

Attribution

A "member of the transferor's family" includes the transferor's spouse, lineal descendants of the transferor or transferor's spouse, and the spouse of any such descendant.[7] An "applicable family member" with respect to a transferor includes the transferor's spouse, an ancestor of the transferor or transferor's spouse, and the spouse of any such ancestor.[8] An individual is treated as holding interests held indirectly through a corporation, partnership, trust, or other entity.[9] In the case of a corporation, "control" means 50 percent ownership (by vote or value) of the

1. IRC Sec. 2701(c)(2).
2. Treas. Reg. §25.2701-2(b)(1).
3. Treas. Reg. §25.2701-2(b)(2).
4. Treas. Reg. §25.2701-2(b)(4).
5. IRC Sec. 2701(c)(3).
6. Treas. Reg. §25.2701-2(c)(2).
7. IRC Sec. 2701(e)(1).
8. IRC Sec. 2701(e)(2).
9. IRC Sec. 2701(e)(3).

stock. In the case of a partnership, "control" means 50 percent ownership of the capital or profits interests, or in the case of a limited partnership, the ownership of any interest as a general partner.[1] When determining control, an individual is treated as holding any interest held by an applicable family member (see above), including (for this purpose) any lineal descendant of any parent of the transferor or the transferor's spouse.[2]

Minimum Value/Junior Equity Rule

If the transfer subject to these rules is of a junior equity interest in a corporation or partnership, the value of the transferred interest cannot be less than the amount which would be determined if the total value of all junior equity interests in the entity were equal to 10 percent of the sum of (1) the total value of the equity interests in the entity, and (2) the total amount of debt the entity owes to the transferor or an applicable family member.[3] For this purpose, indebtedness does not include (1) short term indebtedness incurred for the current conduct of trade or business, (2) indebtedness owed to a third party solely because it is guaranteed by the transferor or an applicable family member, and (3) amounts set aside for qualified deferred compensation to the extent such amounts are not available to the entity. While a properly structured lease is not treated as indebtedness, arrearages with respect to a lease are indebtedness.[4]

Valuation Method

For purposes of IRC Section 2701, the amount of a gift is determined as follows: (1) determine the fair market value of all family-held equity interests in the entity (treat as if held by one individual); (2) subtract out the sum of (a) the fair market value of all family-held senior equity interests in the entity other than applicable retained interests (treat as if held by one individual), and (b) the value of applicable retained interests as valued under IRC Section 2701; (3) allocate the remaining value among the transferred interests and other family-held subordinate interests; (4) reduce the value allocated to the transferred interests to adjust for a minority or similar discount or for consideration received for the transferred interest.[5]

779. When may additional estate or gift taxes be due when an interest is valued using the Chapter 14 special valuation rules?

Recapture

If "qualified payments" are valued under the rules discussed in Q 778, additional estate or gift tax may be due at the time of a later taxable event to reflect cumulative but unpaid distributions. The amount of an increase in estate or gift tax is equal to the excess (if any) of (1) the value of the qualified payments as if each payment had been timely made during the period beginning with the transfer subject to these rules and ending with the taxable event and each payment were reinvested at the (capitalization or discount) interest rate used to value the applicable retained transfer at the time of the transfer; over (2) the value of the qualified payments actually made

1. IRC Sec. 2701(b)(2).
2. IRC Sec. 2701(b)(2)(C).
3. IRC Sec. 2701(a)(4).
4. Treas. Reg. §25.2701-3.
5. Treas. Reg. §25.2701-3(b).

adjusted to reflect reinvestment as in (1). For this purpose, any payment made within four years of its due date is treated as made on its due date.[1] The due date is the date specified in the governing interest as the date on which the payment is to be made (or if no date is specified, the last day of each calendar year).[2] A transfer of a debt obligation bearing compound interest at a rate not less than the appropriate IRC Section 7520 discount rate from the due date of the payment and with a term of no more than four years is treated as payment.[3]

Regulations limit the amount of the increase in gift or estate tax attributable to recapture in order to prevent double inclusion of the same transfer in the transfer tax system. The mitigation provisions include reduction of the amount recaptured by the sum of (1) the portion of the fair market value of the qualified payment interest which is attributable to cumulative but unpaid distributions; (2) to the extent held by the individual at the time of a taxable event, the fair market value of any equity interest received by the individual in lieu of qualified payments; and (3) the amount by which the individual's aggregate taxable gifts were increased to reflect failure of the individual to enforce his rights to qualified payments.[4]

As an overall limitation, the amount of any increase in tax due to cumulative but unpaid distributions will not exceed the applicable percentage of the excess (if any) of (1) the value (determined as of the date of the taxable event) of all equity interests in the entity which are junior to the applicable retained interest (see Q 778), over (2) the value of such interests (determined as of the date of the earlier transfer subject to these rules). The numerator of the applicable percentage is equal to the number of shares in the corporation held (as of the date of the taxable event) by the transferor which are applicable retained interests of the same class. The denominator of the applicable percentage is equal to the total number of shares in the corporation (as of the date of the taxable event) which are of the same class as the shares used in the numerator. (A similar rule applies to partnerships.)[5] The applicable percentage equals the largest ownership percentage interest in any preferred interest held by the interest holder.[6] The appreciation limitation does not apply if the interest holder elects to treat the late payment of a qualified payment as a taxable event (see below).[7]

For purposes of an increase in tax due to cumulative but unpaid distributions, a "taxable event" includes (1) the death of the transferor if the applicable retained interest is included in the transferor's estate, (2) the transfer of an applicable retained interest, and (3) at the election of the taxpayer, the payment of a qualified payment which is made after its four-year grace period.[8] Also, a termination of a qualified payment interest is treated as a taxable event. Thus, a taxable event occurs with respect to an individual indirectly holding a qualified payment interest held by a trust on the earlier of (1) the termination of the individual's interest in the trust, or (2) the termination of the trust's interest in the qualified payment interest. However, if the value of

1. IRC Sec. 2701(d).
2. Treas. Reg. §25.2701-4(c)(2).
3. Treas. Reg. §25.2701-4(c)(5).
4. Treas. Reg. §25.2701-4(c)(1).
5. IRC Sec. 2701(d)(2)(B).
6. Treas. Reg. §25.2701-4(c)(6)(iii).
7. Treas. Reg. §25.2701-4(d)(2).
8. IRC Sec. 2701(d)(3)(A).

the qualified payment interest would be included in the individual's federal gross estate if the individual were to die immediately after the termination, the taxable transfer does not occur until the earlier of (1) the time the interest would no longer be includable in the individual's estate (other than by reason of the gifts within three years of death rule of IRC Section 2035), or (2) such individual's death.[1]

A "taxable event" does not include an applicable retained interest includable in the transferor's estate and passing under the marital deduction. Nor does a "taxable event" include a lifetime gift to a spouse which does not result in a taxable gift because the marital deduction is taken, or the spouse pays consideration for the transfer. However, such a spouse is thereafter treated in the same manner as the transferor.[2]

An applicable family member (see Q 778) is treated the same as the transferor with respect to any applicable retained interest retained by such family member. Also, if the transferor transfers an applicable retained interest to an applicable family member (other than the transferor's spouse), the applicable family member is treated the same as the transferor with respect to distributions accumulating after the time of the taxable event. In the case of a transfer of an applicable retained interest from an applicable family member to the transferor, IRC Section 2701 continues to apply as long as the transferor holds the interest.[3]

Adjustment to Mitigate Double Taxation

As provided in regulations, if there is a later transfer or inclusion in the gross estate of property which was subject to IRC Section 2701, adjustments are to be made for gift, estate, and generation-skipping transfer tax purposes to reflect any increase in valuation of a prior taxable gift or any recapture under IRC Section 2701.[4]

IRC Section 2701 interests transferred after May 4, 1994. An individual (the initial transferor) who has previously made a transfer subject to IRC Section 2701 (the initial transfer) may be permitted a reduction in his taxable gifts for gift tax purposes or adjusted taxable gifts for estate tax purposes. If the holder of the IRC Section 2701 interest (i.e., the applicable retained interest, see Q 778) transfers the interest to an individual other than the initial transferor or an applicable family member of the initial transferor in a transfer subject to estate or gift tax during the lifetime of the initial transferor, then the initial transferor can reduce the amount upon which his tentative tax is calculated for gift tax purposes in the year of the transfer. The amount of the reduction is generally equal to the lesser of (1) the amount by which the initial transferor's taxable gifts were increased by reason of IRC Section 2701, or (2) the amount by which the value of the IRC Section 2701 interest at the time of the subsequent transfer exceeds its value at the time of the initial transfer (the duplicated amount). Any unused reduction can be carried over and applied in succeeding years; any reduction remaining at death can be applied in the initial transferor's estate. The amount upon which the initial transferor's tentative tax is calculated for

1. Treas. Regs. §§25.2701-4(b)(1), 25.2701-4(b)(2).
2. IRC Sec. 2701(d)(3)(B).
3. IRC Sec. 2701(d)(4).
4. IRC Sec. 2701(e)(6).

estate tax purposes may also be reduced (generally occurs if the IRC Section 2701 interest is retained until the initial transferor's death or if there is a carryover of any unused reduction).

If the holder of the IRC Section 2701 interest transfers the interest to an individual other than the initial transferor or an applicable family member of the initial transferor in an exchange for consideration during the lifetime of the initial transferor, then the reduction is taken by the initial transferor's estate and calculated as if the value of the consideration were included in the estate at its value at the time of the exchange. Property received in a nonrecognition exchange for an IRC Section 2701 interest is thereafter treated as the IRC Section 2701 interest for adjustment purposes. Reductions are calculated separately for each class of IRC Section 2701 interests. If spouses elected to treat the initial transfer as a split gift (see Q 753), then (1) each spouse may be entitled to reductions if there is a transfer of the IRC Section 2701 interest during their joint lives; and (2) if there is a transfer of the IRC Section 2701 interest at or after the death of either spouse, then (a) the donor spouse's estate may be entitled to reductions; and (b) the consenting spouse's aggregate sum of taxable gifts and gift tax payable on prior gifts are reduced to eliminate any remaining effect of IRC Section 2701 if the consenting spouse survives the donor spouse. In any event, no reduction is available to the extent that double taxation has otherwise been avoided.[1]

IRC Section 2701 interests transferred before May 5, 1994. The initial transferor can use the final regulations (see above), the proposed regulations (see below), or any other reasonable interpretation of the statute.[2]

A person who has previously made a transfer subject to IRC Section 2701 is permitted a reduction in his adjusted taxable gifts for estate tax purposes. Whether a person is a transferor is determined without regard to the split-gift provisions for spouses (see Q 753). If any portion of the transferor's IRC Section 2701 interest is transferred to the transferor's spouse in a nontaxable event (e.g., the marital deduction), any reduction in adjusted taxable gifts is taken by such spouse rather than the transferor.[3]

The amount of the reduction is equal to the lesser of (1) the amount by which the transferor's taxable gifts were increased by reason of IRC Section 2701, or (2) the amount of the excess estate tax value of such interest multiplied by a fraction. The excess estate tax value equals the estate value of the IRC Section 2701 interest reduced by the value of such interest under IRC Section 2701 at the time of the transfer. In the case of an IRC Section 2701 interest transferred during life, the estate tax value equals the sum of (1) the increase in taxable gifts resulting from the transfer of the IRC Section 2701 interest, and (2) consideration received in exchange for the transfer. The numerator of the fraction above equals the value allocated under step 3 of the "Valuation Method" (see Q 778); the numerator of the fraction equals the value allocated under step 2 of the "Valuation Method."[4] However, no reduction is available to the extent that double taxation has otherwise been avoided.[5]

1. Treas. Reg. §25.2701-5.
2. Treas. Reg. §25.2701-5(h).
3. Treas. Reg. §25.2701-5(a).
4. Treas. Reg. §25.2701-5(b).
5. Treas. Reg. §25.2701-5(c).

Miscellaneous

These provisions apply to transfers after October 8, 1990. However, with respect to property transferred before October 9, 1990, any failure to exercise a right of conversion, to pay dividends, or to exercise other rights to be specified in regulations, is not to be treated as a subsequent transfer.[1]

With respect to gifts made after October 8, 1990, the gift tax statute of limitations on a transfer subject to these provisions does not run unless the transaction is disclosed on a gift tax return in a manner adequate to apprise the IRS of the nature of the retained and transferred interests.[2]

780. How are corporate and partnership transactions, such as recapitalizations, transfers and other changes in capital structure impacted by the Chapter 14 special valuation rules?

Effect on Corporate and Partnership Transactions

Recapitalizations and Transfers of Stock

If a parent recapitalizes a corporation into common and preferred stock and gives the common stock to his children, the value of the common stock is determined by subtracting from the value of the entire corporation the value of the preferred stock as determined under IRC Section 2701. If the parent treats the preferred stock's right to dividends as qualified payments, the right to such payments is assigned a present value. However, the value assigned to the common stock must be at least equal to the value determined under the junior equity rule (See Q 778). If the parent does not receive the preferred dividends within four years of their due dates, the parent may be treated as making additional transfers of the accumulated, but undistributed dividends, at the time of a subsequent transfer of the preferred stock. On the other hand, if the parent does not treat the right to dividends as qualified payments; such a right is assigned a value of zero.

Similarly, if a parent owns 80 percent of a corporation and a child owns 20 percent of the same corporation and the parent's common stock is exchanged for preferred stock, the value of what the parent has transferred and what the parent has retained are determined under IRC Section 2701.

Even if the child pays consideration for the common stock, whether the parent has made a transfer (and the value of such transfer) is determined under IRC Section 2701.

If a parent and a child each contribute to the startup of a new business and the parent receives preferred stock while the child receives common stock, the parent is treated as if he received common stock and preferred stock and then exchanged the common stock for the balance of the

1. OBRA '90, Sec. 11602(e)(1).
2. IRC Sec. 6501(c)(9); OBRA '90, Sec. 11602(e)(2).

preferred stock. The value of what the parent has transferred and what the parent has retained are determined under IRC Section 2701.

However, a gift or a sale of stock to a child is not subject to IRC Section 2701 if the stock is of the same class as that retained by the parent. Also, a gift or a sale of stock to a child is not subject to IRC Section 2701 if the stock is proportionately the same as that retained by the parent (e.g., retained stock is entitled to $2 of dividends for every $1 of dividends paid to transferred stock), without regard to nonlapsing voting rights (i.e., parent can retain control with nonlapsing voting right).

If applicable family members receive or retain applicable retained interests at the time of a gift or a sale of stock to a child, the transaction may be subject to IRC Section 2701 even though the parent is willing to terminate his equity relationship with the corporation.

IRC Section 2701 could be avoided by selling the common stock to a nonfamily member, such as a valuable employee. Proceeds of the sale could then be distributed to the children.

Of course, IRC Section 2701 does not apply if either the transferred interest (common stock) or retained interest (preferred stock) is publicly traded. Also, with regard to retained distribution rights, IRC Section 2701 does not apply if the transferor and applicable family members do not control the corporation immediately before the transfer. However, with regard to liquidation, put, call, or conversion rights (other than those treated as distribution rights, see Q 778), IRC Section 2701 can apply even if the transferor and applicable family members do not control the corporation.

If the typical recapitalization is reversed (i.e., the parent retains the common stock and transfers the preferred stock), IRC Section 2701 should not apply (assuming no retention of applicable retained interests by parent or applicable family members).

Partnership Freezes

The traditional partnership freeze worked similarly to the traditional estate freeze recapitalization. It too is caught by the IRC Section 2701 special valuation rules. Most of the techniques employed to reduce the effect of, or to avoid, the valuation rules with respect to a recapitalization will also work with a partnership. Examination of the partnership agreement will be required to determine which partners hold which rights. Note that in the case of a limited partnership, "control" includes the holding of any interest as a general partner. Also, any right to receive a guaranteed payment of a fixed amount from a partnership under IRC Section 707(c) is not treated as a distribution right.

Other Changes in Capital Structure

Other changes in capital structure may also be caught by the IRC Section 2701 special valuation rules. Except as provided in regulations, a contribution to capital, a redemption, a recapitalization, or other change in capital structure of a corporation or partnership is treated as a transfer if the taxpayer or an applicable family member receives an applicable retained interest in the transaction, or as provided under regulations, holds such an interest immediately after the transfer.

Nonequity Interests

The IRC Section 2701 special valuation rules apply only to equity interests. Thus, none of the following should be treated as a retained interest for purposes of IRC Section 2701: an installment sale of an interest in a corporation or partnership, an exchange of an interest in a corporation or partnership for a private annuity, an employment contract or deferred compensation, or debt owed by a corporation or partnership to a transferor or applicable family member.[1] However, the total amount of debt owed the transferor or an applicable family member by the entity is a factor in the junior equity rule (See Q 778).

781. What special valuation rules apply to the transfer of an interest in trust under Chapter 14?

As a general rule, the value of a transferred remainder interest is equal to the value of the transferor's entire interest prior to the transfer reduced by the value of the interest retained by the transferor. For purposes of determining whether a transfer of an interest in a trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of the transfer), the value of any interest retained by the transferor or an applicable family member (Q 778) is treated as being zero unless the retained interest is a qualified interest. This rule does not apply to an incomplete gift (a transfer that would not be treated as a gift whether or not consideration was received), to a transfer to a trust if the only property to be held by the trust is a residence to be used as a personal residence by persons holding term interests in the trust, or to the extent that the Regulations provide that a transfer is not inconsistent with IRC Section 2702.[2]

Also, IRC Section 2702 does not apply to the following:

(1) certain charitable remainder trusts;

(2) pooled income funds;

(3) charitable lead trusts in which the only interest in the trust other than the remainder interest or a qualified annuity or unitrust interest is the charitable lead interest;

(4) the assignment of a remainder interest if the only interest retained by the transferor or an applicable family member is as a permissible recipient of income in the sole discretion of an independent trustee; and

(5) a transfer in trust to a spouse for full and adequate consideration in connection with a divorce if any remaining interests in the trust are retained by the other spouse.[3]

For transfers to a trust made after May 17, 1997, regulations exempt charitable remainder unitrusts (CRUTs) from IRC Section 2702 only if the trust provides for simple unitrust payments, or in the case of a CRUT with a lesser of trust income or the unitrust amount provision,

1. See TAM 9436006.
2. IRC Sec. 2702(a).
3. Treas. Reg. §25.2702-1(c).

the grantor and/or the grantor's spouse (who is a citizen of the U.S.) are the only noncharitable beneficiaries.[1] Modified rules apply to certain qualified tangible property.

For these purposes, a transfer in trust does not include (1) the exercise, release, or lapse of a power of appointment over trust property that would not be a transfer for gift tax purposes, or (2) the exercise of a qualified disclaimer. An interest in trust includes a power with respect to a trust which would cause any portion of the transfer to be incomplete for gift tax purposes.[2]

Retained Interests

"Retained" is defined as the same person holding an interest both before and after the transfer in trust. Thus, a transfer of an income interest for life in trust to an applicable family member in conjunction with the transfer of a remainder interest in trust to a member of the transferor's family is not subject to IRC Section 2702. However, with respect to the creation of a term interest (e.g., a joint purchase creating a term and remainder interest), any interest held by the transferor immediately after the transfer is treated as held both before and after the transfer.[3] A negotiable note received in exchange for publicly traded stock sold to a trust was not treated as a retained interest in a trust.[4]

Qualified Interests

A "qualified interest" is an annuity or unitrust interest, or, if all other interests in the trust are annuity or unitrust interests, a noncontingent remainder interest. A *qualified annuity interest* means a right to receive fixed amounts (or a fixed fraction or percentage of the property transferred to the trust) not less frequently than annually. A *qualified unitrust interest* means a right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually).[5] A qualified annuity interest can provide for an annuity amount (or fixed fraction or percentage) which increases by not more than 120 percent of the stated dollar amount (or fixed fraction or percentage) payable in the preceding year.[6] A qualified unitrust interest can provide for a unitrust percentage which increases by not more than 120 percent of the fixed percentage payable in the preceding year.[7]

The retention of a power to revoke a qualified annuity or unitrust interest of the transferor's spouse is treated as retention of the qualified annuity or unitrust interest.[8] Contingent annuity interests retained by the grantor or given to the grantor's spouse were not qualified interests.[9] Regulations treat an interest with the following characteristics as a qualified interest retained by the grantor: an annuity or unitrust interest that is (1) given to the spouse of the grantor;

1. Treas. Reg. §25.2702-1(c)(3).
2. Treas. Reg. §25.2702-2(a).
3. Treas. Reg. §25.2702-2(a)(3).
4. TAM 9436006.
5. IRC Sec. 2702(b).
6. Treas. Reg. §25.2702-3(b)(1)(ii).
7. Treas. Reg. §25.2702-3(c)(1)(ii).
8. Treas. Reg. §25.2702-2(a)(5).
9. TAMs 9707001, 9717008, 9741001; *Cook v. Comm.*, 269 F.3d 854 (7th Cir. 2001), *aff'g* 115 TC 15 (2000).

and (2) contingent only on (a) the spouse surviving, or (b) that the grantor does not revoke the spouse's interest.[1] The grantor makes an additional gift to the remainder person when the spouse's interest is revoked or the grantor survives the trust term without having revoked the interest.

A right to receive each year the *lesser of* an annuity interest or a unitrust interest is not treated as a qualified interest. The right to receive each year the *greater of* an annuity interest or a unitrust interest is treated as a qualified interest. However, the qualified interest is valued at the greater of the two interests.[2] A right of withdrawal, whether or not cumulative, is not a qualified annuity or unitrust interest.[3]

A qualified annuity or unitrust interest may permit the payment of income in excess of the annuity or unitrust amount to the transferor or applicable family member with the retained annuity or unitrust interest. However, the annuity or unitrust interest is valued without regard to the right to excess income (which is not a qualified annuity or unitrust interest).[4] Also, a qualified annuity interest may permit the payment of an amount sufficient to reimburse the grantor for any income tax due on income in excess of the annuity amount; the annuity interest is valued without regard to such reimbursement right.[5] Distributions from the trust cannot be made to anyone other than the transferor or applicable family member who holds the qualified annuity or unitrust interest.[6]

The term of the annuity or unitrust interest must be for the life of the transferor or applicable family member, for a specified term of years, or for the shorter of the two periods.[7] There is a split of authority as to whether valuation may be based on two lives, or just one life.[8] Regulations permit certain revocable spousal interests (see above), but value the retained grantor and spouse's interests separately as for a single life.[9]

An example in the regulations had provided that where a grantor retained the right to annuity payments for 10 years and the payments continued to his estate if he died during the 10-year term, the annuity was valued as for 10 years or until the grantor's prior death (i.e., as a temporary annuity).[10] The Tax Court ruled that the example was invalid, that the annuity should be valued as for 10 years (i.e., as a term annuity).[11] The IRS has changed the regulations so as to follow *Walton*.[12] Note that if the trust property reverted to grantor's estate if the grantor died during the 10-year term, the annuity is valued as for 10 years or until the grantor's prior death.[13] These results should apply likewise to unitrust payments.

1. Treas. Reg. §25.2702-3(d)(2).
2. Treas. Reg. §25.2702-3(d)(1).
3. Treas. Regs. §§25.2702-3(b)(1)(i), 25.2702-3(c)(1)(i).
4. Treas. Regs. §§25.2702-3(b)(1)(iii), 25.2702-3(c)(1)(iii).
5. Let. Ruls. 9441031, 9345035.
6. Treas. Reg. §25.2702-3(d)(2).
7. Treas. Reg. §25.2702-3(d)(3).
8. *Schott v. Comm.*, 2003-1 USTC 60,457 (9th Cir. 2003), rev'g TC Memo 2001-110; *Cook v. Comm.*, 269 F.3d 854 (7th Cir. 2001), *aff'g* 115 TC 15 (2000).
9. Treas. Reg. §25.2702-3(e)(Ex. 8).
10. Treas. Reg. §25.2702-3(e)(Ex. 5).
11. *Walton v. Comm.*, 115 TC 589 (2000).
12. Treas. Reg. §25.2702-3(e)(Ex. 5).
13. Treas. Reg. §25.2702-3(e)(Ex. 1).

Planning Point: A grantor retained annuity trust (GRAT) can be zeroed out (i.e., the value of the gift of the remainder reduced to zero) using an annuity payable to the grantor for a term of years with payments continuing to the grantor's estate for the balance of the term of years if the grantor dies during the term. In general, the GRAT is zeroed out if the annuity payment is made to equal the value of the property transferred to the trust divided by the appropriate annuity factor (including adjustments for frequency of payment).

The IRS will not issue rulings or determination letters on whether annuity interests are qualified interests under IRC Section 2702 where (1) the amount of the annuity payable annually is more than 50 percent of the initial fair market value of the property transferred to trust, or (2) the value of the remainder interest is less than 10 percent of the initial fair market value of the property transferred to trust. For purposes of the 10 percent test, the value of the remainder interest is determined under IRC Section 7520 without regard to the possibility that the grantor might die during the trust term, or that the trust property might revert to the grantor or the grantor's estate.[1]

Commutation (generally, an actuarially based acceleration or substitution of benefits) of a qualified annuity or unitrust interest is not permitted.[2] Additional contributions are not permitted with qualified annuity interests.[3]

The use of notes, other debt instruments, options or similar financial arrangements in satisfaction of the annuity or unitrust requirements under IRC Section 2702 is prohibited.[4]

A remainder (or reversion) interest is treated as a *qualified remainder interest* if: (1) all interests in the trust (other than non-contingent remainder interests) are either qualified annuity interests or qualified unitrust interests (thus, an excess income provision is not permitted for this purpose); (2) each remainder interest is entitled to all or a fractional share of the trust property when all or a fractional share of the trust terminates (a transferor's right to receive the original value of the trust property, or a fractional share, would not qualify); and (3) the remainder is payable to the beneficiary or the beneficiary's estate in all events (i.e., it is non-contingent).[5]

A qualified interest is to be valued using the valuation tables prescribed by IRC Section 7520.[6] For valuation rules for certain qualified tangible property, see below.

782. What special valuation rules apply to the transfer of qualified tangible property under Chapter 14?

If the nonexercise of rights under a term interest in tangible property would not have a substantial effect on the valuation of the remainder interest, the interest is valued at the amount for which it could be sold to an unrelated third person (i.e., market value is used instead of the

1. Rev. Proc. 2009-3, Sec. 4.51, 2009-1 IRB 107 and Rev. Proc. 2010-3, 2010-1 IRB 110, superseded by Rev. Proc. 2014-3, 2014-7 IRB 513.
2. Treas. Reg. §25.2702-3(d)(4).
3. Treas. Reg. §25.2702-3(b)(4).
4. Treas. Reg. §25.2702-3.
5. Treas. Reg. §25.2702-3(f).
6. IRC Sec. 2702(a)(2)(B).

valuation tables or zero valuation).[1] *Qualified tangible property* is tangible property (1) for which a depreciation or depletion allowance would not be allowable if the property were used in a trade or business or held for the production of income, and (2) as to which the nonexercise of any rights under the term interest would not affect the value of the property passing to the remainderperson. A de minimis exception is provided at the time of the transfer to trust for improvements to the property which would be depreciable provided such improvements do not exceed 5 percent of the fair market value of the entire property.[2]

Term interests in qualified tangible property are valued using 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 given appraisals in the absence of comparables. Tables used in valuing annuity, unitrust, estate, and remainder interests under IRC Section 7520 are not evidence of what a willing buyer would pay a willing seller for an interest in qualified tangible property.[3] If the taxpayer cannot establish the value of the term interest, the interest is valued at zero.[4]

If, during the term, the term interest is converted into property other than qualified tangible property, the conversion is treated as a transfer of the unexpired portion of the term interest (valued as of the time of the original transfer) unless the trust is converted to a qualified annuity interest (see Q 781).[5] If an addition or improvement is made to qualified tangible property such that the property would no longer be treated as qualified tangible property, the property is subject to the conversion rule above. If the addition or improvement would not change the nature of the qualified tangible property, the addition or improvement is treated as an additional transfer subject to IRC Section 2702.[6]

783. What special valuation rules apply to the transfer of an interest in a personal residence trust or qualified personal residence trust under Chapter 14?

IRC Section 2702 does not apply to the transfer of an interest in a personal residence trust or a qualified personal residence trust.[7] However, a person is limited to holding a term interest in only two such trusts.[8] A personal residence trust or a qualified personal residence trust which does not meet the requirements in the regulations may be modified (by judicial modification or otherwise, so long as the modification is effective under state law), if the reformation commences within 90 days of the due date (including extensions) for filing the gift tax return and is completed within a reasonable time after commencement. In the case of a trust created before 1997, the reformation must commence within 90 days after December 23, 1997, and be completed within a reasonable time after commencement.[9]

1. IRC Sec. 2702(c)(4).
2. Treas. Reg. §25.2702-2(c)(2).
3. Treas. Reg. §25.2702-2(c)(3).
4. Treas. Reg. §25.2702-2(c)(1).
5. Treas. Reg. §25.2702-2(c)(4).
6. Treas. Reg. §25.2702-2(c)(5).
7. IRC Sec. 2702(a)(3)(A)(ii); Treas. Reg. §25.2702-5(a).
8. Treas. Reg. §25.2702-5(a).
9. Treas. Reg. §25.2702-5(a)(2).

A *personal residence* is defined as either (1) the principal residence of the term holder, (2) a residence of the term holder which the term holder uses for personal use during the year for a number of days which exceeds the greater of 14 days or 10 percent of the days during the year that the residence is rented at fair market value, or (3) an undivided fractional interest in either (1) or (2). A personal residence includes appurtenant residential structures and a reasonable amount of land (taking into account the residence's size and location). Personal property, such as household furnishings, is not included in a personal residence. A personal residence is treated as such as long as it is not occupied by any other person (other than the spouse or a dependent) and is available at all times for use by the term holder as a personal residence. A personal residence can be rented out if the rental use is secondary to the primary use as a personal residence (but see above). Use of the residence as transient lodging is not permitted if substantial services are provided (e.g., a hotel or a bed and breakfast). Spouses may hold interests in the same personal residence or qualified personal residence trust.[1]

A *personal residence trust* is a trust which is prohibited for the entire term of the trust from holding any property other than one residence to be used as the personal residence of the term holder(s). A personal residence trust cannot permit the personal residence to be sold, transferred, or put to any other use. Expenses of the trust can be paid by the term holder. A personal residence trust can hold proceeds payable as a result of damage to, or destruction or involuntary conversion of, the personal residence for reinvestment in a personal residence within two years of receipt of such proceeds.[2] Also, with respect to trusts created after May 16, 1996, a personal residence trust must be prohibited from selling or transferring, directly or indirectly, the residence to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse, at any time after the original term interest during which the trust is a grantor trust. A distribution upon or after the expiration of the original duration of the trust term to another grantor trust of the grantor or the grantor's spouse pursuant to the trust terms will not be treated as a sale or transfer to the grantor or grantor's spouse if the second trust prohibits 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. This prohibition against a transfer to the grantor or the grantor's spouse does not apply to a transfer pursuant to the trust document or a power retained by the grantor in the event the grantor dies prior to the expiration of the original duration of the trust term. Nor does this prohibition apply to a distribution (for no consideration) of the residence to the grantor's spouse pursuant to the trust document at the expiration of the original duration of the trust term.[3]

A *qualified personal residence trust* is generally prohibited for the entire term of the trust from holding any property other than one residence to be used as the personal residence of the term holder(s), but certain exceptions are available. Thus, a qualified personal residence trust is permitted to hold cash in a separate account, but not in excess of the amount needed (1) for payment of trust expenses (including mortgage payments) currently due or expected within the next six months, (2) for improvements to the residence to be paid within the next six months,

1. Treas. Regs. §§25.2702-5(b), 25.2702-5(c)(2).
2. Treas. Reg. §25.2702-5(b).
3. Treas. Regs. §§25.2702-5(b)(1), 25.2702-7.

and (3) for purchase of a personal residence either (a) within three months of the creation of the trust, or (b) within the next three months pursuant to a previously entered into contract to purchase. Improvements to the personal residence which meet the personal residence requirements are permitted.[1]

Generally, sales proceeds (including income thereon) may be held in a qualified personal residence trust in a separate account until the earlier of (1) two years from the date of sale, (2) termination of the term holder's interest, or (3) purchase of a new residence. Insurance proceeds (including, for this purpose, certain amounts received upon an involuntary conversion) paid to a qualified personal residence trust for damage or destruction to the personal residence may also be held in the trust in a separate account for a similar period of time.[2] However, with respect to trusts created after May 16, 1996, a qualified personal residence trust must be prohibited from selling or transferring, directly or indirectly, the residence to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse, during the original trust term and at any time after the original term interest during which the trust is a grantor trust. A distribution upon or after the expiration of the original duration of the trust term to another grantor trust of the grantor or the grantor's spouse pursuant to the trust terms will not be treated as a sale or transfer to the grantor or grantor's spouse if the second trust prohibits 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. This prohibition against a transfer to the grantor or the grantor's spouse does not apply to a transfer pursuant to the trust document or a power retained by the grantor in the event the grantor dies prior to the expiration of the original duration of the trust term. Nor does this prohibition apply to a distribution (for no consideration) of the residence to the grantor's spouse pursuant to the trust document at the expiration of the original duration of the trust term.[3]

Cash held by a qualified personal residence trust in excess of the amounts permitted above must be distributed to the term holder at least quarterly. Furthermore, upon termination of the term holder's interest, any cash held by a qualified personal residence trust for payment of trust expenses must be distributed to the term holder within 30 days.[4]

The qualified personal residence trust must provide that any trust income be distributed at least annually to the term holder.[5] Distributions from a qualified personal residence trust cannot be made to anyone other than the term holder during any term interest.[6] Commutation (generally, an actuarially based acceleration or substitution of benefits) of a qualified personal residence trust is not permitted.[7]

A qualified personal residence trust ceases to be a qualified personal residence trust if the residence ceases to be used or held for use as the personal residence of the term holder. A

1. Treas. Reg. §25.2702-5(c)(5).
2. Treas. Regs. §§25.2702-5(c)(5)(ii), 25.2702-5(c)(7).
3. Treas. Regs. §§25.2702-5(c)(9), 25.2702-7.
4. Treas. Reg. §25.2702-5(c)(5)(ii)(A)(2).
5. Treas. Reg. §25.2702-5(c)(3).
6. Treas. Reg. §25.2702-5(c)(4).
7. Treas. Reg. §25.2702-5(c)(6).

residence is held by the trust for use as the 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. A sale of a personal residence is not treated as a cessation of use as a personal residence if the personal residence is replaced by another within two years of the sale. The trust must provide that if damage to or destruction of the residence renders it unusable as a residence, the trust ceases to be a qualified personal residence trust unless the residence is repaired or replaced within two years.[1]

A qualified personal residence trust must provide that within 30 days of ceasing to be a qualified personal residence trust with respect to any assets, either (1) the assets must be distributed to the term holder; (2) the assets must be put into a separate share of the trust for the balance of the term holder's interest as a qualified annuity interest; or (3) the trustee may elect either (1) or (2). The amount of such an annuity must be no less than the amount determined by dividing the lesser of the original value of all interests retained by the term holder or the value of all the trust assets by an annuity valuation factor reflecting the valuation table rate on the date of the original transfer and the original term of the term holder's interest. If only a portion of the trust continues as a qualified personal residence trust, then the annuity determined in the preceding sentence is reduced in proportion to the ratio that assets which still qualify as a personal residence trust bear to total trust assets.[2]

784. What special valuation rules apply to remainder interests and joint purchase transactions under Chapter 14?

The transfer of an interest in property with respect to which there are one or more term interests (e.g., transfer of a remainder interest) is to be treated as a transfer of an interest in trust.[3] A leasehold interest in property is not treated as a term interest provided a good faith effort is made to set the lease at a fair rental value.[4] If a person acquires a term interest in property in a joint purchase (or series of related transactions) with members of his family, then such person is treated as though he acquired the entire property and then transferred the interests acquired by the other persons in the transaction to such persons in return for consideration furnished by such persons.[5] For this purpose, the amount considered transferred by such individual is not to exceed the amount which such individual furnished for such property.[6] Special rules apply to "qualified tangible property" (see above).

Attribution

A "member of the family" with respect to an individual includes such individual's spouse, any ancestor or lineal descendant of such individual or such individual's spouse, any brother or sister of the individual, and any spouse of the above.[7] An "applicable family member" with respect to a

1. Treas. Reg. §25.2702-5(c)(7).
2. Treas. Reg. §25.2702-5(c)(8).
3. IRC Sec. 2702(c)(1).
4. Treas. Reg. §25.2702-4(b).
5. IRC Sec. 2702(c)(2).
6. Treas. Reg. §25.2702-4(c).
7. IRC Sec. 2702(e).

transferor includes the transferor's spouse, an ancestor of the transferor or transferor's spouse, and the spouse of any such ancestor.[1]

Adjustment to Mitigate Double Taxation

A gift tax and estate tax adjustment is provided to mitigate the double taxation of retained interests previously valued under IRC Section 2702. In the case of a transfer by gift of a retained interest previously valued under IRC Section 2702 using the zero valuation rule or the qualified tangible property rule, a reduction in aggregate taxable gifts is available in calculating gift tax. If a retained interest previously valued under IRC Section 2702 using the zero valuation rule or using the qualified tangible property rule is later included in the gross estate, a reduction in adjusted taxable gifts is available in calculating estate tax. The amount of the reduction in aggregate taxable gifts or adjusted taxable gifts is equal to the lesser of (1) the increase in the taxable gifts resulting from the retained interest being initially valued under the zero valuation rule or the qualified tangible property rule, or (2) the increase in taxable gifts or gross estate resulting from the subsequent transfer of the interest. For purposes of (2), the annual exclusion is applied first to transfers other than the transfer valued under the zero valuation rule or the qualified tangible property rule. One-half of the amount of reduction may be assigned to a consenting spouse if gifts are split under IRC Section 2513.[2]

Miscellaneous

These provisions apply to transfers after October 8, 1990. However, with respect to property transferred before October 9, 1990, any failure to exercise a right of conversion, to pay dividends, or to exercise other rights to be specified in regulations, is not to be treated as a subsequent transfer.[3]

With respect to gifts made after October 8, 1990, the gift tax statute of limitations on a transfer subject to these provisions does not run unless the transaction is disclosed on a gift tax return in a manner adequate to apprise the IRS of the nature of the retained and transferred interests.[4]

Effect on Trust, Remainder Interest, and Joint Purchase Transactions

GRITs, GRATs, and GRUTs

Generally, a grantor retained income trust (GRIT) should no longer be used unless the only property to be held by the trust is a residence to be used as a personal residence by persons holding term interests in the trust. Under IRC Section 2702, the grantor is treated as though he transferred the entire property to the remainderperson at the time of the creation of the GRIT since his retained income interest is valued at zero (except with respect to the personal residence exception or unless the remainderperson is not a member of the transferor's family).[5]

1. IRC Secs. 2702(a)(1), 2701(e)(2).
2. Treas. Reg. §25.2702-6.
3. OBRA '90, Sec. 11602(e)(1).
4. IRC Sec. 6501(c)(9); OBRA '90, Sec. 11602(e)(2).
5. Let. Rul. 9109033.

Instead, grantor retained annuity trusts (GRATs) and grantor retained unitrusts (GRUTs) can be used to leverage gifts. The retained annuity or unitrust interest is valued using the government valuation tables provided under IRC Section 7520. Notes, other debt instruments, options or similar financial arrangements cannot be used in satisfaction of the annuity or unitrust requirements. The value of the transferred remainder interest is equal to the value of the entire property reduced by the value of the retained interest. A reversion or general power of appointment retained by the grantor which is contingent upon the grantor dying during the trust term will no longer reduce the value of the transferred property. However, the value of the retained interest is reduced by such a contingency.

Charitable Trusts

Transfers to charitable remainder annuity trusts (CRATs), certain charitable remainder unitrusts (CRUTs), and pooled income funds are not subject to IRC Section 2702. Also, IRC Section 2702 does not apply to a charitable lead trust in which the only interest in the trust other than the remainder interest or a qualified annuity or unitrust interest is the charitable lead interest. For transfers to a trust made after May 17, 1997, regulations exempt CRUTs from IRC Section 2702 only if the trust provides for simple unitrust payments, or in the case of a CRUT with a lesser of trust income or the unitrust amount provision, the grantor and/or the grantor's spouse (who is a citizen of the U.S.) are the only noncharitable beneficiaries.[1]

Irrevocable Life Insurance Trusts

Irrevocable life insurance trusts should not be affected by IRC Section 2702. Generally, the full value of transfers to an irrevocable life insurance trust are already treated as gifts (except to the extent that annual exclusions are available).

Other Trusts

If a term interest (whether for life or term of years) is given to the transferor's spouse, an ancestor of the transferor or transferor's spouse, or the spouse of any such ancestor, and a remainder interest is given to any member of the transferor's family, IRC Section 2702 should not apply because the grantor has not retained a term interest.

Remainder Interest Transaction (RIT)

In general, if a person retains a term interest (whether for life or term of years) in property and sells or give a remainder interest in the property to another family member, the value of the transferred property will be equal to the full value of the property unless the transferor retained an annuity or unitrust interest in the property (i.e., the value of a retained income interest is valued at zero).

However, if the nonexercise of rights under a term interest in tangible property would not have a substantial effect on the valuation of the remainder interest, the interest is valued at the amount for which it could be sold to an unrelated third person (i.e., market value is used instead of the valuation tables or zero valuation). The Senate Committee Report to OBRA '90

1. Treas. Reg. §25.2702-1(c)(3).

gives a painting, or undeveloped real estate, as examples of such tangible property. Depletable property is given as an example of property which would not qualify for this special rule. See "Qualified Tangible Property," Q 782.

Split Purchases (Splits)

If a person acquires a term interest in property in a joint purchase (or series of related transactions) with members of his family, then such person is treated as though he acquired the entire property and then transferred the interests acquired by the other persons in the transaction to such persons in return for consideration furnished by such persons. Thus, if a father and son purchase rental property and the father receives an interest for life and the son receives a remainder interest; the father is treated as though he sold the remainder interest to his son for the consideration furnished by the son. The transaction is then essentially treated as a sale of a remainder interest (see above).

785. What special valuation rules apply to certain agreements, options, rights, or restrictions exercisable at less than fair market value under Chapter 14?

For estate, gift, and generation-skipping transfer tax purposes, the value of any property is to be determined without regard to any restriction on the right to sell or use such property, or any option, agreement, or other right to acquire or use the property at less than fair market value (determined without regard to such an option, agreement, or right). However, the previous sentence is not to apply if the option, agreement, right, or restriction: (1) is a bona fide business arrangement, (2) is not a device to transfer the property to members of the decedent's family for less than full and adequate consideration in money or money's worth, and (3) has terms comparable to those entered into by persons in an arm's length transaction.[1] The three prongs of the test must be independently satisfied.[2] All three prongs of the test are considered met if more than 50 percent of the value of the property subject to the right or restriction is owned by persons who are not members of the transferor's family or natural objects of the transferor's bounty. The property owned by such other persons must be subject to the right or restriction to the same extent as the property owned by the transferor.[3]

To determine whether a buy-sell agreement or other restrictive agreement has terms comparable to those entered into by persons in an arm's length transaction, the following factors are to be considered: (1) "the expected term of the agreement, (2) the current fair market value of the property, anticipated changes in value during the term of the agreement, and (3) the adequacy of any consideration given in exchange for the rights granted."[4] The terms of a buy-sell agreement or other restrictive agreement must be comparable to those used as a general practice by unrelated persons under negotiated agreements in the same business. Isolated comparables do not meet this requirement. More than one recognized method may be acceptable. Where

1. IRC Sec. 2703.
2. Treas. Reg. §25.2703-1(b)(2).
3. Treas. Reg. §25.2703-1(b)(3).
4. Treas. Reg. §25.2703-1(b)(4)(i).

comparables are difficult to find because the business is unique, comparables from similar businesses may be used.[1]

In the case of a partnership (or LLC) created on a decedent's deathbed, the IRS has stated that the partnership was the agreement for purposes of IRC Section 2703, and the partnership should be ignored because the partnership was not a valid business arrangement and the partnership was a device to transfer the underlying property to the family members for less than adequate consideration. Even if the partnership was not ignored, the Service stated that it would ignore the restrictions on use of the property contained in the partnership's agreement; such restrictions also would fail IRC Section 2703.[2] A couple of courts have rejected the idea that the partnership can be ignored for purposes of IRC Section 2703.[3]

The Tax Court has applied IRC Section 2703 to certain gifts of family limited partnership interests.[4]

Certain restrictions on the sale or use of property in a restricted management account are disregarded for transfer tax purposes under IRC Section 2703.[5]

For more information on valuing a closely held business interest, see Q 770, Q 772.

Effective Date and Transition Rules

This provision applies to agreements, options, rights, or restrictions entered into or granted after October 8, 1990, and agreements, options, rights, or restrictions substantially modified after October 8, 1990.[6] Any discretionary modification of an agreement that results in other than a de minimis change in the quality, value, or timing of the agreement is a substantial modification. Generally, a modification required by the agreement is not considered a substantial modification. However, if the agreement requires periodic modification, the failure to update the agreement is treated as a substantial modification unless the updating would not have resulted in a substantial modification. The addition of a family member as a party to a right or restriction is treated as a substantial modification unless (1) the addition is mandatory under the terms of the right or restriction, or (2) the added family member is in a generation (using the generation-skipping transfer tax definitions of generations) no lower than the lowest generation of any individuals already party to the right or restriction. The modification of a capitalization rate in a manner that bears a fixed relationship to a specified market rate is not treated as a substantial modification. Furthermore, a modification that results in an option price that more closely approximates fair market value is not treated as a substantial modification.[7]

1. Treas. Reg. §25.2703-1(b)(4)(ii).
2. TAMs 9723009, 9725002, 9730004, 9735003, 9736004, 9842003.
3. *Est. of Strangi v. Comm.*, 2002-2 USTC ¶60,441 (5th Cir. 2002), aff'g 115 TC 478 (2000); *Church v. U.S.*, 2000-1 USTC ¶60,369 (W.D. Tex. 2000).
4. *Holman v. Comm.*, 130 TC 170 (2008).
5. Rev. Rul. 2008-35, 2008-29 IRB 116.
6. OBRA '90, Sec. 11602(e)(1)((A)(ii).
7. Treas. Reg. §25.2703-1(c).

Effect on Options and Buy-sell Agreements

In order to help fix values for estate, gift, and generation-skipping transfer tax purposes, newly executed or substantially modified options and buy-sell agreements exercisable at less than fair market value between persons who are the natural objects of each other's bounty will generally have to meet all three of IRC Section 2703's requirements. Otherwise, such agreement will be disregarded in valuing the property. Old options and buy-sell agreements which are not substantially modified after October 8, 1990 are not affected by IRC Section 2703. IRC Section 2703's provisions apply to agreements involving either business or non-business property.

786. What special valuation rules apply to certain lapsing rights and restrictions under Chapter 14?

In general, IRC Section 2704(a) provides that the lapse of certain voting or liquidation rights in a family owned business results in a taxable transfer by the holder of the lapsing right. IRC Section 2704(b) provides generally that certain restrictions on liquidating a family owned business are ignored in valuing a transferred interest. These provisions apply to restrictions or rights (or limitations on rights) created after October 8, 1990.[1]

For more information on valuing a closely held business interest, see Q 770, Q 772.

Lapse of Certain Rights

For estate, gift, and generation-skipping transfer tax purposes, if there is a lapse of a voting or liquidation right in a corporation or partnership and the individual holding such right (the "holder") immediately before the lapse and members of the holder's family control the entity (both before and after the lapse), then the holder is treated as if making a transfer. The value of the transfer is equal to the amount (if any) by which the value of all interests in the entity held by the holder immediately prior to the lapse (determined as if all voting and liquidation rights were nonlapsing) exceeds the sum of (1) the value of such interests immediately after the lapse (determined as if held by one individual), and (2) in the case of a lapse during the holder's life, any consideration in money or money's worth received by the holder with respect to such lapse.[2]

A *voting right* is defined as a right to vote with respect to *any* matter of the entity. Also, with respect to a partnership, the right of a general partner to participate in partnership management is treated as a voting right. A *liquidation right* is the right to compel (including by aggregate voting power) the entity to acquire *all or a portion* of the holder's equity interest in the entity.[3] A lapse of a voting or liquidation right occurs when a presently exercisable right is restricted or eliminated.[4]

The transfer of an interest which results in the lapse of a liquidation right is not subject to IRC Section 2704(a) if the rights with respect to the transferred interest are not restricted or

1. OBRA '90, Sec. 11602(e)(1)(A)(iii).
2. IRC Sec. 2704(a); Treas. Regs. §§25.2704-1(a), 25.2704-1(d).
3. Treas. Reg. §25.2704-1(a)(2).
4. Treas. Regs. §§25.2704-1(b), 25.2704-1(c)(1).

eliminated. However, a transfer that results in the elimination of the transferor's right to compel the entity to acquire an interest of the transferor which is subordinate to the transferred interest is treated as a lapse of a liquidation right with respect to the subordinate interest. The lapse rule does not apply to the lapse of a liquidation right with respect to (1) a transfer that was previously valued in the hands of the holder as a transfer of an interest in a corporation or partnership under IRC Section 2701 (see Q 778), or (2) the lapse of a liquidation right to the extent that immediately after the lapse the holder (or the holder's estate) and members of the holder's family cannot liquidate an interest that the holder could have liquidated prior to the lapse. Whether an interest can be liquidated immediately after the lapse is determined under state law or, if the governing instruments are less restrictive than the state law which would apply in the absence of such instruments, the governing instruments. For this purpose, any applicable restriction under IRC Section 2704(b) (see below) is disregarded.[1]

If a lapsed right may be restored only upon the occurrence of a future event not within the control of the holder or the holder's family, the lapse is deemed to occur at the time the lapse becomes permanent with respect to the holder (e.g., upon the transfer of the interest).[2]

For attribution rules, see below.

Transfers Subject to Applicable Restrictions

If there is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family and the transferor and members of transferor's family control the entity (immediately before the transfer), any applicable restriction is to be disregarded in valuing the transferred interest for estate, gift, or generation-skipping transfer tax purposes.[3] If an applicable restriction is disregarded under this rule, the rights of the transferor are valued under the state law that would apply but for the limitation (which is treated as if it did not exist).[4]

"Applicable restriction" means any restriction which effectively limits the ability of the corporation or partnership to liquidate if either (1) the restriction lapses (in whole or in part) after the transfer, or (2) the transferor or any member of the transferor's family, acting alone or collectively, can remove the restriction (in whole or in part) after the transfer.[5] Applicable restriction treatment was avoided where the consent of all parties was required and a charity (a nonfamily member) had become a partner.[6]

However, any restriction imposed or required by any federal or state law is not treated as an applicable restriction.[7] Thus, the definition of an applicable restriction has been limited to a restriction which is more restrictive than the limitations which would apply under state law if there were no restriction. Also, whether there is the ability to remove a restriction is determined

1. Treas. Reg. §25.2704-1(c).
2. Treas. Reg. §25.2704-1(a)(3).
3. IRC Sec. 2704(b)(1).
4. Treas. Reg. §25.2704-2(c).
5. IRC Sec. 2704(b)(2).
6. *Kerr v. Comm.*, 292 F. 3d 490, 2002-1 USTC ¶60,440 (5th Cir. 2002).
7. IRC Sec. 2704(b)(3)(B).

under the state law which would apply in the absence of the restrictive provision in the governing instruments.[1]

An applicable restriction does not include any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either.[2] Regulations provide that an applicable restriction does not include any commercially reasonable restriction which arises as a result of any unrelated person providing capital in the form of debt or equity to the corporation or partnership for the entity's trade or business operations. For this purpose, the regulations apply the relationship rules of IRC Section 267(b), except that the term "fiduciary of a trust" under the relationship rules is modified to generally exclude banks, trust companies, and building and loan associations.[3]

Furthermore, an applicable restriction does not include an option, right to use property, or other agreement subject to IRC Section 2703 (see Q 785).[4]

With respect to a partnership (or LLC) created on a decedent's deathbed, the IRS has disregarded restrictions where the partnership provided that a partner could not liquidate his interest, while state law provided a less restrictive provision.[5] A few cases have held that partnership liquidation provisions were no more restrictive than state law and should not be ignored under IRC Section 2704(b).[6]

Attribution

The following attribution rules or definitions generally apply for purposes of the rules which apply to certain lapsing rights and applicable restrictions under IRC Section 2704:

In the case of a corporation, "control" means 50 percent ownership (by vote or value) of the stock. In the case of a partnership, "control" means 50 percent ownership of the capital or profits interests, or in the case of a limited partnership, the ownership of any interest as a general partner.[7]

A "member of the family" with respect to an individual includes such individual's spouse, any ancestor or lineal descendant of such individual or such individual's spouse, any brother or sister of the individual, and any spouse of the above.[8]

An individual is treated as holding interests held indirectly through a corporation, partnership, trust, or other entity.[9] Thus, transfers may be either direct or indirect.

1. Treas. Reg. §25.2704-2(b).
2. IRC Sec. 2704(b)(3)(A).
3. Treas. Reg. §25.2704-2(b).
4. Treas. Reg. §25.2704-2(b).
5. TAMs 9723009, 9725002, 9730004, 9735003, 9736004, 9842003.
6. *Kerr v. Comm.*, 113 TC 449 (1999); *Knight v. Comm.*, 115 TC 506 (2000).
7. IRC Secs. 2704(c)(1), 2701(b)(2).
8. IRC Sec. 2704(c)(2).
9. IRC Secs. 2704(c)(3), 2701(e)(3).