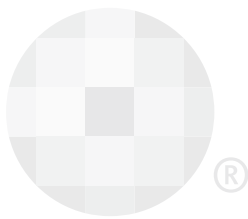


Unpacking the Myths and Mysteries of Chapter 14: Part I—Code Secs. 2701 and 2702

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Christine Quigley and Nathan Brown examine Code Sec. 2701 and Code Sec. 2702 in Part I of their two-part series exploring Chapter 14.



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I. Introduction

Chapter 14 of the Code,¹ consisting of Code Secs. 2701 through 2704, was enacted in 1990 in an effort to prevent certain estate freeze techniques that Congress and the IRS viewed as abusive. Code Sec. 2701 provides special valuation rules for transfers of interests in closely-held entities. Code Sec. 2702 provides special valuation rules for transfers of interests in trust and for transfers and joint purchase of term interests. Code Sec. 2703 provides special rules for disregarding certain rights or restrictions on the ability to acquire or use property. Code Sec. 2704 provides special rules with respect to certain lapsing rights and restrictions. Part I of this article analyzes Code Sec. 2701 and Code Sec. 2702 in detail. Part II of this article will analyze Code Sec. 2703 and Code Sec. 2704 in detail.

II. Code Sec. 2701

Generally, Code Sec. 2701 applies any time an individual “transfers” an equity interest in a privately-held entity to a “member of the transferor’s family,” if, immediately after such transfer, the transferor or one or more “applicable family members” holds an equity interest in the entity that is classified as an “applicable retained interest.”²

If Code Sec. 2701 applies, the transfer tax value of the transferred equity interest is determined under the so-called “subtraction method.”³ In its simplest form, the subtraction method determines the value of the transferred equity interest by subtracting the aggregate value of all equity interests in the entity held by the

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transferor (and applicable family members) immediately after the transfer from the aggregate value of all equity interests in the entity held by the transferor (and applicable family members) immediately before the transfer.

If the retained equity interest is classified as an applicable retained interest, its value for purposes of applying the subtraction method is zero.⁴ This is commonly referred to as the “zero value rule.” The result of the zero value rule is that, for gift tax purposes, the transferor is treated as transferring not only the actual gifted interest, but all applicable retained interests as well. This can result in a significant, unexpected transfer tax liability.

A. Getting into the Details

Code Sec. 2701 is one of the most technical transfer tax provisions. It is riddled with defined terms that must be fully understood before one can properly determine whether the section may apply to a particular transfer. What follows is a summary of some of the more important of those terms.

- i. *Transfer*—Code Sec. 2701 applies only if there has been a “transfer” of an equity interest in an entity. “Transfer” for purposes of Code Sec. 2701 is broadly defined and includes easily-identifiable transfers, such as gifts and sales, as well as certain “deemed” transfers, such as capital contributions to a new or existing entity, recapitalizations and changes in the capital structure of an entity.⁵ These deemed transfers are discussed in more detail below.
- ii. *Member of the Transferor’s Family*—Code Sec. 2701 applies only if the equity interest is transferred to an individual who falls within a limited defined group, referred to as a “member of the transferor’s family.” A member of the transferor’s family includes (a) the transferor’s spouse, (b) a lineal descendant of the transferor or the transferor’s spouse and (c) the spouse of any lineal descendant of the transferor or his or her spouse.⁶ Generally speaking, a “member of the transferor’s family” is a spouse or junior generation family member.
- iii. *Applicable Family Member*—Code Sec. 2701 applies only if after the transfer of an equity interest to a member of the transferor’s family, the transferor or an “applicable family member” holds an equity interest in the entity that constitutes an applicable retained interest. An applicable family member includes (a) the transferor’s spouse, (b) an ancestor of the transferor or of the transferor’s spouse and (c) the spouse of any ancestor of the transferor or of the transferor’s spouse.⁷ Generally speaking, an “applicable family

member” is the transferor’s spouse or a senior generation family member.

- iv. *Applicable Retained Interest*—Code Sec. 2701 applies only if the equity interest held by the transferor or applicable family member immediately after the transfer is classified as an “applicable retained interest.” An equity interest will be classified as an applicable retained interest if it confers upon its holder either an “extraordinary payment right” or a “distribution right” in a controlled entity.⁸

An extraordinary payment right is any liquidation, put, call or conversion right, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest.⁹ A call right includes any warrant, option or other right to acquire one or more equity interests.¹⁰ Extraordinary payment rights do not include any right that must be exercised at a specific time and at a specific amount.¹¹ Thus, a liquidation, put, call or conversion right will generally only be an extraordinary payment right when the holder of such right has discretion as to whether (or when) to exercise it. Extraordinary payment rights do not include certain nonlapsing rights to convert to a fixed number or percentage of units or shares of the same class as the transferred interest (or which would be of the same class but for nonlapsing differences in voting power).¹²

A distribution right is the right to receive discretionary distributions with respect to an equity interest in an entity that is “controlled” by the transferor or applicable family members.¹³ A distribution right does not include (a) a right to receive distributions in an entity that is junior to the rights of the transferred interest, (b) a liquidation, put, call, or conversion right, or (c) any right to receive a guaranteed payment described in Code Sec. 707(c) of a fixed amount.¹⁴

- v. *Qualified Payment Rights*—A “qualified payment right” is a different type of exception under Code Sec. 2701. It is a type of distribution right and so, with respect to an equity interest in a controlled entity, it would be an applicable retained interest. However, a qualified payment right is not subject to Code Sec. 2701’s zero value rule. Rather, a qualified payment right is valued under traditional valuation principles for purposes of Code Sec. 2701, unless it is combined with one or more extraordinary payment rights, in which case, the lower of rule applies.

A qualified payment right is a right to receive “qualified payments.”¹⁵ A “qualified payment” is a distribution that is (a) any dividend payable on a periodic basis (at least annually) under any

cumulative preferred stock, to the extent such dividend is determined at a fixed rate¹⁶; (b) any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount; or (c) any distribution right for which an election has been made to treat such distribution right as a qualified payment.¹⁷

An individual holding an equity interest which confers upon the holder a qualified payment right may elect to treat the qualified payment right as a distribution right that is not a qualified payment right¹⁸ and an individual holding an equity interest which confers upon the holder a distribution right that is not otherwise classified as a qualified payment right may elect to treat such distribution right as a qualified payment right.¹⁹ If the qualified payment right is held by an applicable family member, a special election must be made to treat the payment right as a qualified payment right, even if it otherwise qualifies as such.²⁰

An election assumes for purposes of Code Sec. 2701 that a fixed annual payment will be made to the holder of the interest (regardless of whether or not the partnership or corporation has adequate cash-flow) on a specified date. Failure to make the payments in accordance with the assumptions used in valuing the qualified payment right will trigger increases to the holder's taxable gifts (upon a subsequent transfer of the interest conferring the qualified payment right) or taxable estate (upon the death of the holder of the interest conferring the qualified payment right).

A qualified payment is due on the date specified in the governing instrument as the due date for such payment.²¹ If the governing instrument is silent, the qualified payment is due on the last day of each calendar year.²² Any qualified payment made within four years of such payment's due date is deemed to have been paid on the due date. The qualified payment may be satisfied with a debt obligation, provided that the debt obligation bears compound interest from the original due date at an appropriate discount rate and the term of the debt obligation does not exceed four years.²³ This effectively allows the qualified payment to be deferred for up to eight years without any adverse transfer tax consequences.

- vi. *The Control Requirement*—As noted above, a right to receive distributions with respect to an equity interest is a distribution right for purposes of Code Sec. 2701 only if the transferor or applicable family members control the entity immediately prior to the transfer.²⁴

For purposes of determining whether an entity is controlled, the attribution rules of Code Sec. 2701(e)(3) and Reg. Sec. 25.2701-6, discussed below, apply.²⁵

Control, in the case of a corporation, is defined as holding at least 50 percent of the total voting power or 50 percent of the fair market value of the equity interests in a corporation.²⁶ For this purpose, voting rights do not include the right to vote on a limited group of matters, such as liquidation, merger and similar events, or the right to vote upon the occurrence of a contingency that has not occurred (other

The winding nature of Code Secs. 2701 and 2702 demands that practitioners remain on alert.

than a contingency within the control of the holder of the right).²⁷ Control, in the case of a partnership, is defined as holding at least 50 percent of either the capital interest or the profits interest (without regard to any right to a guaranteed payment of a fixed amount under Code Sec. 707(c)).²⁸ Control, in the case of a limited partnership, means holding any interest in the limited partnership “as a general partner.”²⁹ The specific phrasing of this rule raises the question of whether an interest “in the general partner” of the limited partnership (*e.g.*, a membership interest in a limited liability company that is the general partner of the limited partnership) is the same as an interest “as a general partner” of the limited partnership. Many practitioners take the conservative position that an individual will be treated as controlling a limited partnership if he or she owns any equity interest in the general partner of the limited partnership.³⁰ Code Sec. 2701 and the current regulations thereunder do not contain a control test for limited liability companies. However, Proposed Reg. §25.2701-2(b)(5) would clarify that, in the case of a limited liability company, control means the holding of at least 50 percent of the capital or profits interest in the limited liability company or the holding of an equity interest with the ability to cause the liquidation of the entity in whole or in part.

- vii. *Certain Rights that are Not Extraordinary Payment Rights or Distribution Rights*—Certain rights may be retained by the transferor or an applicable family member in connection with preferred interests, which do not fall within the definition of an extraordinary payment right or a distribution right, and,

therefore, are not “applicable retained interests” that trigger the application of Code Sec. 2701. These rights include mandatory payment rights, liquidation participation rights, guaranteed payment rights and nonlapsing conversion rights. A mandatory payment right is a right to receive a payment required to be made at a specific time for a specific amount (e.g., mandatory redemption required at certain date at certain value).³¹ A liquidation participation right is a right to participate (in contrast to a right to compel) in a liquidating distribution.³² A guaranteed payment right is a right to a guaranteed fixed amount payment, without contingencies, under Code Sec. 707(c).³³ A nonlapsing conversion right is a nonlapsing right to convert an equity interest into a specific number or percentage of shares (if the entity is a corporation), or into a specified interest (if the entity is a partnership).³⁴

B. The Attribution Rules Under Code Sec. 2701

Code Sec. 2701 applies whether the interest is held directly or indirectly.³⁵ Indirect holdings are determined under Reg. Sec. 25.2701-6.

- i. *Attribution to Individuals*—An individual is treated as holding an equity interest to the extent the interest is held indirectly through a corporation, partnership, estate, trust or other entity.³⁶ If an equity interest is treated as held by an individual in more than one capacity, then it is treated as being held by the individual in the manner that attributes to the individual the largest total ownership of the equity interest.³⁷ If an entity holds an equity interest in another entity, the attributions rules apply a tiered attribution approach. For example, if an individual owns 50 percent of the preferred stock of corporation X, which in turn owns 50 percent of the preferred stock of corporation Y, 25 percent of the preferred stock of corporation Y is considered held by the individual under these rules.³⁸
- ii. *Interests Held by Corporations*—A person (as opposed to an individual) is considered to hold an equity interest held by or for a corporation in the proportion that the fair market value of the stock the person holds bears to the fair market value of all the stock in the corporation (determined as if each class of stock were held separately by one individual).³⁹ The Regulations imply that the proportion of equity attributable to an interest in a corporation is determined without regard to minority discounts and without regard to the special valuation rules of Chapter 14.⁴⁰
- iii. *Interests Held by Partnerships*—A person (as opposed to an individual) is considered to hold an equity interest held by or for a partnership or an entity classified as a partnership for federal income tax purposes in proportion that the fair market value of the larger of the person’s profits interest or capital interest in the partnership bears to the total fair market value of the corresponding profits interests or capital interests in the partnership, as the case may be (determined as if each class were held by one individual).⁴¹
- iv. *Interests Held by Estates and Trusts*—A person is considered to hold an equity interest held by or for an estate or trust to the extent the person’s beneficial interest therein may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, assuming the maximum exercise of discretion in favor of the person.⁴² If an equity interest is specifically bequeathed to one beneficiary, it will not be attributed to the residuary beneficiaries. A beneficiary of an estate or trust who cannot receive any distribution with respect to an equity interest held by the estate or trust is not considered the holder of the equity interest.⁴³ Nonetheless, any person who may receive distributions from a trust is considered to hold an equity interest held by the trust if the distributions may be made from current or accumulated income from or the proceeds from the disposition of the equity interest, even though under the terms of the trust the interest can never be distributed to that person.⁴⁴ Thus, even a person who has an income interest only may be deemed to own a share of the corpus of the trust.⁴⁵ In addition, these rules do not distinguish between a present and a future interest. As a result, even an individual who does not have a present right to distributions may be deemed to indirectly hold a share of the underlying equity interest.⁴⁶

If the trust at issue is a “grantor trust” for income tax purposes under Code Secs. 671–679, an individual will be treated as holding an equity interest held by or for a trust if the individual is considered an owner of the trust for income tax purposes (i.e., the trust is a grantor trust with respect to the individual).⁴⁷ If an individual is treated as the owner of only a fractional share of a grantor trust because there are multiple grantors, the individual holds each equity interest held by the trust, except to the extent that the fair market value of the interest exceeds the fair market value of the fractional share.⁴⁸

The grantor of an irrevocable grantor trust is often not a discretionary beneficiary of the trust

and, therefore, would not be attributed ownership of any portion of the equity interest held by such trust under the basic trust attribution rules. However, under an alternative reading of the Regulations, this special grantor trust attribution rule may broaden the attribution of equity interests to include those treated as grantors for income tax purposes—even if they are not permissible beneficiaries of the trust. This may result in both the trust beneficiaries and the grantor of the trust being attributed ownership of a particular interest.

- v. *The Multiple Attribution Rules under Code Sec. 2701*—If the attribution rules result in an equity interest being attributed to more than one person, ordering rules determine to whom ownership is attributable for purposes of applying Code Sec. 2701. The ordering rules differ depending on whether the equity interest in question is an applicable retained interest or a subordinate equity interest.⁴⁹

If ownership of an applicable retained interest is attributed to more than one of the transferor and applicable family members, it is attributed within that class in the following order: (a) if the interest is held in a grantor trust, to the individual treated as the owner of the trust assets under the grantor trust rules; (b) to the transferor; (c) to the transferor's spouse or (d) to each applicable family member on a *pro rata* basis.⁵⁰

If ownership of a subordinate equity interest is attributed to more than one individual in a class consisting of the transferor, applicable family members and members of the transferor's family, the interest is attributed within that class in the following order: (a) to the transferee; (b) to each member of the transferor's family on a *pro rata* basis; (c) if the interest is held in a grantor trust, to the individual treated as the owner of the trust assets under the grantor trust rules; (d) to the transferor; (e) to the transferor's spouse or (f) to each applicable family member on a *pro rata* basis.⁵¹

The existence of separate ordering rules appears to be motivated by two goals: (a) maximizing the chance that ownership of an applicable retained interest will be attributed to the transferor or an applicable family member and (b) maximizing the chance that ownership of a subordinate equity interest will be attributed to a member of the transferor's family.

It is important to note that the multiple attribution rules do not create attribution where there otherwise was none. In other words, the multiple attribution rules only apply if ownership of an equity interest is attributed to multiple persons under Reg. §25.2701-6(a).

C. Deemed and Indirect Transfers

As noted above, Code Sec. 2701 applies not only to traditional gifts, but to all transfers. For purposes of Code Sec. 2701, a transfer includes the following transactions:

- i. *Sale for Full and Adequate Consideration*—Code Sec. 2701 applies to a transfer that would not otherwise be a gift under general gift tax principles because it was a transfer for full and adequate consideration.⁵²
- ii. *Capital Contribution*—A contribution to the capital of a new or existing entity.⁵³

Because of the broad reach of Code Sec. 2701, even non-gift transfers for full and adequate consideration could potentially trigger a tax.

- iii. *Capital Structure Transaction*—A redemption, recapitalization or other change in the capital structure of an entity (a “capital structure transaction”), if—(a) the transferor or an applicable family member receives an applicable retained interest in the capital structure transaction; (b) the transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity that is junior to the applicable retained interest and receives property other than an applicable retained interest; or (c) the transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity (other than a subordinate equity interest) and the fair market value of the applicable retained interest is increased.⁵⁴
- iv. *Termination of Indirect Holding*—The termination of an indirect holding in an entity (or a contribution to the capital of an entity to the extent an individual indirectly holds an interest in the entity) if (a) the property is held in a trust as to which the indirect holder is treated as the owner under the grantor trust rules of Code Secs. 671–679⁵⁵ or, if the termination (or contribution) is not treated as a transfer under the preceding provision, to the extent that the value of the indirectly held interest would have been included in the value of the indirect holder's gross estate for federal estate tax purposes if the indirect holder died immediately prior to termination.⁵⁶

Certain transactions, however, are explicitly excluded from the definition of “transfer” for purposes of Code Sec. 2701. A capital structure transaction is not a transfer if the transferor, each applicable family member, and each member of the transferor’s family holds substantially the same interest after the transaction as that individual held before the transaction.⁵⁷ A shift of rights occurring upon the execution of a qualified disclaimer under Code Sec. 2518 is not a transfer.⁵⁸ Finally, a shift of rights occurring upon the release, exercise or lapse of a nongeneral power of appointment is not a transfer, except to the extent that it would otherwise be a transfer (a taxable gift) under chapter 12.⁵⁹

D. The Valuation Rules of Code Sec. 2701

If Code Sec. 2701 applies, the gift tax value of the transferred interest is determined under the so-called subtraction method. Generally speaking, the subtraction method determines the gift tax value of the transferred interest by subtracting the aggregate value of all equity interests in the entity held by the transferor immediately after the transfer from the aggregate value of all equity interests in the entity held by the transferor immediately before the transfer.

If the retained equity interest is an applicable retained interest, the zero value rule applies and assigns a zero value to any applicable retained interest.⁶⁰ The result of the zero value rule is that, for gift tax purposes, the transferor is treated as transferring not only the actual gifted interest but also all applicable retained interests as well.

The value of a qualified payment right is determined without regard to Code Sec. 2701 (*i.e.*, it is valued under traditional valuation principles), unless it is held in connection with an extraordinary payment right.⁶¹ If an applicable retained interest confers upon its holder both a qualified payment right (generally valued at fair market value) and an extraordinary payment right (valued at zero), the value of the applicable retained interest is determined as if each extraordinary payment right were exercised in the manner resulting in the lowest possible value being determined for all such rights.⁶² This is commonly referred to as the “lower of rule.”

EXAMPLE: P, an individual, holds all 1,000 shares of X Corporation’s \$1,000 par value preferred stock bearing an annual cumulative dividend of \$100 per share and holds all 1,000 shares of X’s voting common stock. P has the right to put all the preferred stock to X at any time for \$900,000. P transfers the common stock to P’s child and immediately

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

If Code Sec. 2701 applies to the transfer of an interest in an entity, the value of a junior equity interest shall not be less than its *pro rata* portion of 10 percent of the sum of (i) the total value of all equity interests in the entity, and (ii) the total amount of any indebtedness of the entity owed to the transferor and applicable family members.⁶³ For purposes of this 10-percent minimum value rule, junior equity interest means common stock, or, in the case of a partnership, any partnership interest under which the rights to income and capital are junior to the rights of all other classes of partnership interests.⁶⁴

E. Avoiding Double Taxation

Code Sec. 2701 contains a set of detailed rules to prevent double taxation of a retained equity interest that was subject to taxation under Code Sec. 2701. Under these mitigation rules, an individual making a transfer subject to Code Sec. 2701 is entitled to reduce his or her taxable gifts or adjusted taxable gifts if he or she subsequently transfers the interest that was subject to taxation under Code Sec. 2701 in a transaction that is subject to Federal estate or gift tax.⁶⁵ A detailed discussion of these rules is beyond the scope of this article.

F. Exceptions to Code Sec. 2701

Code Sec. 2701 is intended to prevent value from being ascribed to retained equity interests in situations where the rights associated with the retained interests are not mandatory or quantifiable at the time of the transfer. Code Sec. 2701 does not apply in the following situation because the potential for the transferor and his or her family to manipulate values does not exist:

- i. *Market Quotations Readily Available*: Code Sec. 2701 does not apply if market quotations are readily available (as of the date of the transfer) for the transferred or retained interest on an established securities market.⁶⁶
- ii. *Same Class*: Code Sec. 2701 does not apply if the retained interest is of the same class as the transferred interest,⁶⁷ meaning that the rights associated with the retained interest are identical (or proportional) to the rights associated with the transferred interests, except for nonlapsing differences in voting rights (or, for partnerships, nonlapsing differences with respect to management and limitations on liability). Nonlapsing provisions necessary to comply with partnership allocation requirements of the Code (e.g., Code Sec. 704(b)) are nonlapsing differences with respect to limitations on liability.⁶⁸ An interest in a partnership is not an interest in the same class as the transferred interest if the transferor or applicable family members have the right to alter the liability of the transferee.⁶⁹
- iii. *Proportionate Transfers*: Also known as the “Vertical Slice” approach, Code Sec. 2701 does not apply where the transfer results in a proportionate reduction of each class of equity interest held by the transferor and applicable family members immediately before the transfer.⁷⁰ For example, Code Sec. 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P’s child in a manner that reduces each interest held by P and any applicable family member, in the aggregate, by 10 percent even if the transfer does not proportionately reduce P’s interest in each class.⁷¹

III. Code Sec. 2702

Code Sec. 2702 may be the most familiar section of Chapter 14 to practitioners, as it provides that statutory basis for grantor retained annuity trusts and qualified personal residence trusts. Code Sec. 2702 is similar in concept to Code Sec. 2701 in that it determines the value of a transfer by a subtraction method of valuation which utilizes a zero-value rule. However, there is a fundamental difference in that Code Sec. 2702 is focused on the nature of the transfer itself and not on the nature of the assets transferred.

Code Sec. 2702 applies any time an individual makes a transfer “in trust” to or for the benefit of a “member of the transferor’s family”⁷² if the transferor or an “applicable family member”⁷³ of the transferor “retains” an interest in the trust. If Code Sec. 2702 applies to a

transfer, the amount of the gift, if any, is determined via a subtraction method of valuation similar to Code Sec. 2701. The subtraction method determines the amount of the gift by subtracting the value of the retained interest from the value of the property transferred. If the retained interest is not a “qualified interest” (discussed below), the retained interest is valued at zero and the amount of the gift is equal to the entire value of the transferred property. If the retained interest is a qualified interest, its value is determined actuarially and subtracted from the value of the transferred interest to determine the amount of the gift.

A. Getting into the Details

Similar to Code Sec. 2701, Code Sec. 2702 is riddled with defined terms that must be fully understood before one can properly determine whether Code Sec. 2702 applies to a particular transfer. What follows is a summary of some of the more important defined terms within Code Sec. 2702.

- i. *Transfer “In Trust”*—Code Sec. 2702 applies to transfers of property “in trust,” whether an actual transfer in trust or a deemed transfer in trust. For this purpose, any transfer of an interest in property with respect to which there are one or more term interests is treated as a transfer in trust.⁷⁴ A term interest is one of a series of successive interests.⁷⁵ For example, a life interest in property or an interest for a term of years is a term interest. The deemed transfer in trust rule can be a trap for the unwary and is discussed in greater detail below in the context of joint purchases.
- ii. *Member of the Family*—The term “member of the family” means, with respect to an individual transferor, such transferor’s spouse, any ancestor or lineal descendant of the transferor or the transferor’s spouse, any brother or sister of the transferor, and any spouse of the foregoing.⁷⁶
- iii. *Applicable Family Member*—The term “Applicable Family Member” means, with respect to the individual transferor, the transferor’s spouse, and any ancestor of the transferor or the transferor’s spouse and the spouse of any such ancestor.⁷⁷
- iv. *Retained*—An interest in property will be treated as being “retained” if it is held by the same individual both before and after the transfer in trust. In the case of the creation of a term interest, any interest in the property held by the transferor immediately after the transfer is treated as held both before and after the transfer.⁷⁸
- v. *Qualified Interest*—As discussed above, unless the retained interest is a qualified interest (or another

exception within Code Sec. 2701 applies), its value for purposes of determining the amount of the gift is zero. Accordingly, knowing what types of interests constitute qualified interests is imperative. There are three types of qualified interests—qualified annuity interests, qualified unitrust interests and qualified remainder interests.

A qualified annuity interest, which provides the statutory basis for grantor retained annuity trusts, is any interest which consists of the right to receive fixed amounts payable not less frequently than annually.⁷⁹ For this purpose, a fixed amount means either (i) a stated dollar amount, payable periodically (at least annually),

Similarly, under Code Sec. 2702, the expansive definition of a transfer “in trust” may cover a number of purchase and joint interest situations.

but only to the extent the dollar amount does not exceed 120 percent of the stated dollar amount payable in the preceding year⁸⁰ or (ii) a fixed fraction or percentage of the initial fair market value of the property transferred to the trust, payable periodically (at least annually), but only to the extent the fractional percentage does not exceed 120 percent of the fixed fractional percentage payable in the preceding year.⁸¹ A qualified unitrust interest is any interest which consists of the 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.⁸² A qualified remainder interest is any noncontingent remainder interest if all other interests are annuity interests or unitrust interests.⁸³

The annuity amount or unitrust amount may be payable based on either the anniversary date of the creation of the trust or the tax year of the trust.⁸⁴ If the annuity amount or the unitrust amount is payable based on the anniversary date of the creation of the trust, the annuity amount or the unitrust amount must be paid within 105 days following the anniversary date.⁸⁵ If the annuity amount or unitrust amount is payable based on the tax year of the trust, the annuity amount or unitrust amount must be paid no later than the date by which the trust is required to file its federal income tax return for the tax year (without regard to extensions).⁸⁶

The trust agreement conferring the qualified annuity or qualified unitrust must (1) fix the term of the annuity or unitrust, (2) prohibit distributions from the trust to or for the

benefit of any person other than the transferor, (3) prohibit the commutation (*i.e.*, prepayment) of the term interest and (4) prohibit the payment of the annuity or unitrust amount with a promissory note or other debt instrument.⁸⁷

B. Valuation Rules

If Code Sec. 2702 applies, the amount of the gift is determined by subtracting the value of the retained interest from the value of the transferred property. If the retained interest is not a qualified interest, it is assigned a zero value and the amount of the gift is the entire value of the transferred property. If the retained interest is a qualified annuity interest or a qualified remainder interest following a qualified annuity interest, the value of the retained interest is determined under Code Sec. 7520 and subtracted from the value of the transferred property.⁸⁸ If the retained interest is a qualified unitrust interest or a qualified remainder interest following a qualified unitrust interest, the value of the qualified unitrust interest is determined under Code Sec. 664 and subtracted from the value of the transferred property.⁸⁹

A special set of valuation rules apply if (a) the property transferred in trust is nondepreciable tangible personal property (TPP) and (b) the failure to exercise any rights under the term interest would not increase the value of the property passing at the end of the term interest (the “TPP exception”).⁹⁰ If the TPP exception applies, the value of the retained interest is equal to the amount that the transferor establishes as the fair market value of the term interest.⁹¹ If the transferor is not able to reasonably establish the fair market value of the term interest, the interest is valued at zero.⁹²

The TPP exception provides a planning opportunity for individuals who desire to transfer valuable TPP to younger generation family members, yet retain the right to use the property for a certain number of years.

EXAMPLE: A transfers a painting having a fair market value of \$2,000,000 to A’s child, B, retaining the use of the painting for 10 years. The painting does not possess an ascertainable useful life. Assume that the painting would not be depreciable if it were used in a trade or business or held for the production of income. Assume that the value of A’s term interest, determined under Code Sec. 7520, is \$1,220,000, and that A establishes that a willing buyer of A’s interest would pay \$500,000 for the interest. A’s term interest is not a qualified interest under Reg. Sec. 25.2702-3. However, because of the nature of the property, A’s failure to exercise A’s rights with regard to the painting would not be expected to cause the value of the painting to

be higher than it would otherwise be at the time it passes to B. Accordingly, A's interest is valued under Reg. Sec. 25.2702-2(c)(1) at \$500,000. The amount of A's gift is \$1,500,000, the difference between the fair market value of the painting and the amount determined under Reg. Sec. 25.2702-2(c)(1).⁹³

If the transferor's retained interest is valued under the TPP exception, and during the term the property is converted into property a term interest in which would not qualify for valuation under the TPP exception (e.g., the TPP is sold and reinvested in marketable securities), the transferor is deemed to have made a transfer of property having a value equal to the value of the unexpired portion of the term interest unless the interest held by the transferor after the conversion is a qualified annuity interest.⁹⁴ The value of the unexpired portion of the term interest is the amount that bears that same relation to the value of the term interest as of the date of conversion (determined under Code Sec. 7520 using the rate in effect under Code Sec. 7520 on the date of the original transfer and the fair market value of the property as of the date of the original transfer) as the value of the term interest bears to the value of the term interest as of the date of the original transfer (determined under Code Sec. 7520).⁹⁵

C. Exceptions to Code Sec. 2702

Code Sec. 2702 does not apply in the following situations, regardless of whether the retained interest is a qualified interest:

- i. *Incomplete Gifts*—A transfer that is an incomplete gift for federal gift tax purposes.⁹⁶
- ii. *Personal Residence Trusts*—A transfer to a trust that meets the requirements of a personal residence trust or a qualified personal residence trust (discussed below).⁹⁷
- iii. *Charitable Remainder Annuity Trusts*—A transfer to a charitable remainder annuity trust described in Code Sec. 664(d)(1).⁹⁸
- iv. *Charitable Remainder Unitrusts*—A transfer to a charitable remainder unitrust described in Code Sec. 664(d)(2) if under the terms of the governing instrument, the unitrust amount can be computed only under Code Sec. 664(d)(2)(A) or a transfer to a charitable remainder unitrust if under terms of the governing instrument the unitrust amount can be computed under Code Sec. 664(d)(2) or (3) and either there are only two consecutive noncharitable beneficial interests and the transferor holds the second of the two interests, or the only permissible recipients of the unitrust amount are the transferor,

the transferors spouse or both the transferor and the transferor's spouse.⁹⁹

- v. *Pooled Income Fund*—A transfer of property to a pooled income fund as defined in Code Sec. 642(c)(5).¹⁰⁰
- vi. *Charitable Lead Trusts*—A transfer in trust if the only interest in the trust, other than the remainder interest or a qualified annuity or unitrust interest, is an interest that qualifies for the gift tax charitable deduction under Code Sec. 2522, such as a charitable lead annuity trust or a charitable lead unitrust.¹⁰¹
- vii. *Assignment of Remainder Interest*—The assignment of a remainder interest if the only retained interest of the transferor or an applicable family member is as the permissible recipient of distributions of income in the sole discretion of an independent trustee, as defined in Code Sec. 674(c).¹⁰²
- viii. *Property Settlements*—A transfer in trust if the transfer of an interest to a spouse is deemed to be for full and adequate consideration by reason of Code Sec. 2516 and the remaining interests in the trust are retained by the other spouse.¹⁰³

D. Qualified Personal Residence Trusts

Even if the retained interest is not structured as a qualified interest, Code Sec. 2702 may nonetheless be avoided if the trust to which the property is transferred meets the requirements of a qualified personal residence trust. Generally speaking, a qualified personal residence trust is an irrevocable trust to which an individual transfers his or her personal residence and retains the right to occupy the residence for a term of years. The trust agreement must prohibit the trust from owning any asset other than one residence to be used or held for the use as a personal residence during the entire term.¹⁰⁴ A personal residence includes the transferor's principal residence and one other residence of the transferor,¹⁰⁵ provided that the primary use of such residence is as a residence of the transferor when occupied by the transferor.¹⁰⁶

Similar to the rules that apply with respect to qualified interests, the trust agreement must prohibit distributions to any person other than the transferor during the term and prohibit commutation of the term interest.¹⁰⁷ Additionally, the trust agreement must provide that the trust ceases to be a qualified personal residence trust if the residence ceases to be used or held for use as a personal residence of the term holder; provided, however, if the personal residence ceases to be used as a personal residence of the term holder as a result of the sale of the residence, the trust ceases to be a qualified personal residence trust only after two years from the date of the sale and only to the extent that the net sale

proceeds are not reinvested in a new personal residence.¹⁰⁸ In the event that the trust ceases to qualify as a qualified personal residence trust, the trust agreement must provide that, within 30 days of the date on which the trust ceases to so qualify, either (1) the asset be distributed to the term holder or (2) the assets be converted into a qualified annuity interest for the balance of the term.¹⁰⁹

E. Certain Property Interests Treated as Held in Trust Under Code Sec. 2702(c)

Code Sec. 2702(c) treats certain property interests as being held in trust, which will be subject to the zero value rule unless such property interests are structured as qualified interests. Specifically, Code Sec. 2702(c) can apply to joint purchases in which a family member retains a term interest, which, although not actually a transfer in trust, may be treated as a transfer in trust under Code Sec. 2702(c).

Solely for purposes of Code Sec. 2702, if an individual acquires a term interest in property and, in the same transaction or series of transactions, one or more members of the individual's family acquire an interest in the same property, the individual acquiring the term interest is treated as acquiring the entire property so acquired, and transferring to each of those family members the interests acquired by that family member in exchange for any consideration paid by that family member. The amount of the individual's gift will not exceed the amount of consideration furnished by that individual for all interests in the property.¹¹⁰

EXAMPLE: A purchases a 20-year interest in an apartment building and A's child purchases the remainder interest in the property. A and A's child each provide the portion of the purchase price equal to the value of their respective interests in the property determined actuarially under Code Sec. 7520. Solely for purposes of Code Sec. 2702, A is treated as buying the entire property and transferring the remainder interest to his child in exchange for the portion of the purchase price provided by A's child. To determine the amount of A's gift, A's retained interest is valued at zero because it is not a qualified interest.¹¹¹

In this example, if the entire value of the property is \$10 million, and A's child paid consideration of \$3,000,000, because A's retained interest is valued at zero, A would be deemed to have made a gift of \$7,000,000 to her child (\$10,000,000 – \$3,000,000).

EXAMPLE: K holds rental real estate valued at \$100,000. K sells a remainder interest in the property

to K's child, retaining the right to receive the income from the property for 20 years. Assume the purchase price paid by K's child for the remainder interest is equal to the value of the interest determined under Code Sec. 7520. K's retained interest is not a qualified interest and is therefore valued at zero. K has made a gift in the amount of \$100,000 less the consideration received from K's child.¹¹²

F. Mitigation of Double Taxation

If an individual subsequently transfers an interest in trust previously valued under Code Sec. 2702, or if such interest is included in an individual's gross estate, the individual is entitled to a reduction in his or her aggregate taxable gifts or adjustable taxable gifts, as the case may be.¹¹³ The amount of the reduction is equal to the lesser of (1) the increase in the individual's taxable gifts resulting from the interest being valued at the time of the initial transfer under Code Sec. 2702 or (2) the increase in the individual's taxable gifts (or gross estate) resulting from the subsequent transfer of the interest.¹¹⁴

EXAMPLE: In 2015, X transferred property to an irrevocable trust retaining the right to receive the trust income for life. On the death of X, the trust is to terminate and the trust corpus is to be paid to X's child, C. X's income interest had a value under Code Sec. 7520 of \$40,000 at the time of the transfer; however, because X's retained interest was not a qualified interest, it was valued at zero under Code Sec. 2702 for purposes of determining the amount of X's gift. X's taxable gifts in 2015 were therefore increased by \$40,000.

In 2016, X transfers the income interest to C for no consideration. Assume that the value under Code Sec. 7520 of the income interest on the subsequent transfer to C is \$30,000. If X makes no other gifts to C in 2016, X is entitled to a reduction in aggregate taxable gifts of \$16,000, the lesser of the amount by which X's taxable gifts were increased as a result of the income interest being valued at zero on the initial transfer (\$40,000) or the amount by which X's taxable gifts are increased as a result of the subsequent transfer of the income interest (\$30,000 minus \$14,000 annual exclusion).¹¹⁵

IV. Conclusion

The winding nature of Code Secs. 2701 and 2702 demands that practitioners remain on alert. Because of the broad reach of Code Sec. 2701, even nongift transfers for full and adequate consideration could

potentially trigger a tax. Similarly, under Code Sec. 2702, the expansive definition of a transfer “in trust” may cover a number of purchase and joint interest situations. In the next part of this article, we will examine Code Secs. 2703 and 2704, both of which take a slightly different turn. Rather than focusing merely

on whether a transfer has occurred, the latter two sections focus on the presence, absence or lapse of certain rights and restrictions. When taken together, the four sections comprising Chapter 14 of the Code provide a comprehensive-valuation system to combat potentially abusive intra-family transactions.

ENDNOTES

¹ All references herein to “Code” are to the Internal Revenue Code of 1986, as amended.
² Code Sec. 2701.
³ Reg. §25.2701-1(a)(2); Reg. §25.2701-3.
⁴ Code Sec. 2701(a)(3)(A).
⁵ Reg. §25.2701-1(b)(2).
⁶ Code Sec. 2701(e)(1); Reg. §25.2701-1(d)(1).
⁷ Code Sec. 2701(e)(2); Reg. §25.2701-1(d)(2).
⁸ Code Sec. 2701(b); Reg. §25.2701-2(b)(1).
⁹ Code Secs. 2701(b)(1)(B), 2701(c)(2)(A).
¹⁰ Reg. §25.2701-2(b)(2).
¹¹ Code Sec. 2701(c)(2)(B)(i).
¹² Code Sec. 2701(c)(2)(C).
¹³ Code Sec. 2701(b)(1)(A).
¹⁴ Code Sec. 2701(c)(1)(B)(i).
¹⁵ Code Sec. 2701(c)(3).
¹⁶ For purposes of Code Sec. 2701, a payment rate that bears a fixed relationship to a specified market interest rate is a payment determined at a fixed rate. Reg. §25.2701-2(b)(6)(i)(C).
¹⁷ Reg. §25.2701-2(b)(6).
¹⁸ Reg. §25.2701-2(c)(1).
¹⁹ Reg. §25.2701-2(c)(2). Such an election may not cause the value of the applicable retained interest conferring the distribution right to exceed the fair market value of the applicable retained interest (determined without regard to Code Sec. 2701).
²⁰ Reg. §2701-2(c)(4).
²¹ Reg. §2701-4(c)(2).
²² *Id.*
²³ Reg. §25.2701-4(c)(5).
²⁴ Code Sec. 2701(b)(2)(C); Reg. §25.2701-2(b)(5)(i). “Applicable family member” for purposes of determining whether an entity is controlled under Code Sec. 2701 is broadly defined in Code Sec. 2701(b)(1)(2)(C) to include any lineal descendant of any parent of the transferor or the transferor’s spouse.
²⁵ Code Sec. 2701(b)(1); Reg. §25.2701-2(b)(5)(ii)(B).
²⁶ Code Sec. 2701(b)(2)(A); Reg. §25.2701-2(b)(5)(ii)(A).
²⁷ Reg. §25.2701-2(b)(5)(ii)(B).
²⁸ Reg. §25.2701-2(b)(5)(iii).
²⁹ *Id.*
³⁰ LTR 9639054 (June 21, 1996) would support the position that an interest in the general partner is not necessarily equal to an interest as a

general partner for purposes of determining control of a limited partnership. However, such a position is merely implicit in the ruling.
³¹ Reg. §25.2701-2(b)(4)(i).
³² Reg. §25.2701-2(b)(4)(iii).
³³ Reg. §25.2701-2(b)(4)(iii).
³⁴ Reg. §25.2701-2(b)(4)(iv).
³⁵ Code Sec. 2701(e)(3).
³⁶ Reg. §25.2701-6(a)(1).
³⁷ *Id.*
³⁸ *Id.*
³⁹ Reg. §25.2701-6(a)(2).
⁴⁰ Reg. §25.2701-6(b), Example 2.
⁴¹ Reg. §25.2701-6(a)(3).
⁴² Reg. §25.2701-6(a)(4)(i).
⁴³ *Id.*
⁴⁴ *Id.*
⁴⁵ Reg. §25.2701-6(b), Examples 4 and 5.
⁴⁶ Reg. §25.2701-6(b), Examples 4 and 5.
⁴⁷ Reg. §25.2701-6(a)(4)(C).
⁴⁸ *Id.*
⁴⁹ Reg. §25.2701-3(a)(2)(iii).
⁵⁰ Reg. §25.2701-6(a)(5)(i).
⁵¹ Reg. §25.2701-6(a)(5)(ii).
⁵² Reg. §25.2701-1(b)(1).
⁵³ Reg. §25.2701-1(b)(2)(i)(A).
⁵⁴ Reg. §25.2701-1(b)(2)(i)(B).
⁵⁵ For example, an indirect transfer may occur when the transferor relinquishes the rights retained with respect to the property held in the grantor trust that caused the trust to be a grantor trust.
⁵⁶ Reg. §25.2701-1(b)(2)(i)(C).
⁵⁷ Reg. §25.2701-1(b)(3)(i).
⁵⁸ Reg. §25.2701-1(b)(3)(ii).
⁵⁹ Reg. §25.2701-1(b)(3)(iii).
⁶⁰ Code Sec. 2701(a)(3)(A).
⁶¹ Code Sec. 2701(a)(3)(C).
⁶² Code Sec. 2701(a)(3)(B).
⁶³ Code Sec. 2701(a)(4)(A); Reg. §25.2701-3(c)(1).
⁶⁴ Reg. §25.2701-3(c)(2).
⁶⁵ Code Sec. 2701(e)(6); Reg. §25.2701-5.
⁶⁶ Code Sec. 2701(a)(2)(A).
⁶⁷ Code Sec. 2701(a)(2)(B).
⁶⁸ Reg. §25.2701-1(c)(3).
⁶⁹ *Id.*
⁷⁰ Code Sec. 2701(a)(2)(C); Reg. §25.2701-1(c)(4).

⁷¹ *Id.*
⁷² Code Sec. 2704(e); Code Sec. 2704(c)(2); Reg. §25.2702-2(a)(1).
⁷³ Code Sec. 2701(e)(2); Reg. §25.2701-1(d)(2).
⁷⁴ Code Sec. 2702(c)(1).
⁷⁵ Reg. §25.2702-4(a).
⁷⁶ Code Sec. 2704(e); Code Sec. 2704(c)(2); Reg. §25.2702-2(a)(1).
⁷⁷ Code Sec. 2701(e)(2); Reg. §25.2701-1(d)(2).
⁷⁸ Reg. §25.2701-2(a)(3).
⁷⁹ Code Sec. 2702(b)(1); Reg. §25.2701-1(b)(1).
⁸⁰ Reg. §25.2702-3(b)(1)(ii)(A).
⁸¹ Reg. §25.2702-3(b)(1)(ii)(B).
⁸² Code Sec. 2702(b)(2); Reg. §25.2701-1(b)(2).
⁸³ Code Sec. 2702(b)(3); Reg. §25.2701-1(b)(3).
⁸⁴ Reg. §25.2702-3(b)(3).
⁸⁵ Reg. §25.2702-3(b)(4).
⁸⁶ *Id.*
⁸⁷ Reg. §25.2702-3(b)(3)-(6).
⁸⁸ Reg. §25.2702-2(b)(2).
⁸⁹ Reg. §25.2702-2(b)(2).
⁹⁰ Reg. §25.2702-2(b)(2).
⁹¹ *Id.*
⁹² *Id.*
⁹³ Reg. §25.2702-2(b)(2), Example 6.
⁹⁴ Reg. §25.2702(c)(4)(i), (iii).
⁹⁵ Reg. §25.2702(c)(4)(ii).
⁹⁶ Code Sec. 2702(3)(A)(i).
⁹⁷ Code Sec. 2702(3)(A)(ii).
⁹⁸ Reg. §25.2702-1(c)(3).
⁹⁹ *Id.*
¹⁰⁰ Reg. §25.2702-1(c)(4).
¹⁰¹ Reg. §25.2702-1(c)(5).
¹⁰² Reg. §25.2702-1(c)(6).
¹⁰³ Reg. §25.2702-1(c)(7).
¹⁰⁴ Reg. §25.2702-5(c)(5).
¹⁰⁵ Reg. §25.2702-5(c)(2).
¹⁰⁶ *Id.*
¹⁰⁷ Reg. §25.2702-5(c)(4), (6).
¹⁰⁸ Reg. §25.2702-5(c)(7).
¹⁰⁹ Reg. §25.2702-5(c)(8).
¹¹⁰ Reg. §25.2702-4(c).
¹¹¹ Reg. §25.2702-4(d), Example 1.
¹¹² Reg. §25.2702-4(d), Example 2.
¹¹³ Reg. §25.2702-6(a).
¹¹⁴ Reg. §25.2702-6(b).
¹¹⁵ Reg. §25.2702-6(c), Example 1.

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