

# Section 2702.—Special Valuation Rules in Case of Transfers of Interests in Trusts

26 CFR 25.2702–2: Definitions and valuation rules.

## T.D. 9181

### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 25

### Qualified Interests

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations amending the regulations under the gift tax special valuation rules to provide that a unitrust or annuity interest payable for a specified term of years to the grantor, or to the grantor's estate if the grantor dies prior to the expiration of the term, is a qualified interest for the specified term. The final regulations also clarify that the exception treating a spouse's revocable successor interest as a retained qualified interest applies only if the spouse's annuity or unitrust interest, standing alone, would constitute a qualified interest that meets the requirements of §25.2702–3(d)(3), but for the grantor's revocation power.

DATES: The regulations are effective July 26, 2004.

FOR FURTHER INFORMATION CONTACT: Juli Ro Kim (202) 622–3090 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

#### Background

On July 26, 2004, the IRS published in the **Federal Register** (69 FR 44476) a notice of proposed rulemaking (REG–163679–02, 2004–35 I.R.B. 390) conforming the gift tax regulations defining a qualified interest for purposes of section 2702 to the Tax Court's decision in *Walton v. Commissioner*, 115 T.C. 589 (2000), *acq. in result*, Notice 2003–72, 2003–2 C.B. 964. In *Walton*, the court declared *Example 5* of §25.2702–3(e) to

be invalid. The notice of proposed rule-making also clarifies those parts of the regulations under section 2702 addressing revocable spousal interests that were at issue in *Schott v. Commissioner*, 319 F.3d 1203 (9<sup>th</sup> Cir. 2003), *rev'g and remanding* T.C.M. 2001-110, and *Cook v. Commissioner*, 269 F.3d 854 (7<sup>th</sup> Cir. 2001), *aff'g* 115 T.C. 15 (2000).

No public hearing was requested or held, but one written comment and some telephone comments were received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision, and the corresponding proposed regulations are removed. The comments and revisions to the proposed regulations are discussed below.

## Summary of Comments

Generally, the commentators agreed with the amendments conforming the regulations to the *Walton* decision. Several commentators requested that the regulations address the amount includible in the grantor's gross estate with respect to a *Walton*-type grantor retained annuity trust (GRAT), if the grantor dies during the GRAT term, including the application of Rev. Rul. 82-105, 1982-1 C.B. 133. In addition, several commentators requested guidance regarding the application of section 2035 if the grantor dies within three years after termination of the term of the GRAT (or grantor retained unitrust (GRUT)). These suggestions were not adopted. The determination of the amount includible in the grantor's gross estate is an issue different from and governed by different Code sections than the definition of a qualified interest for purposes of section 2702, and is thus beyond the scope of this project. However, Treasury and IRS will consider addressing that issue in future guidance.

Regarding the proposed regulations addressing revocable spousal interests, commentators suggested that section 2702 was enacted to avoid valuation problems and that, because the value of the contingent revocable spousal interest at issue in *Schott v. Commissioner* is readily determinable using actuarial tables, such an interest should be a qualified interest (as the Ninth Circuit concluded in *Schott*).

Treasury and the IRS continue to believe that the proposed regulations properly implement section 2702 and the policy underlying the statute. Uncertainty in valuation is not the only valuation inaccuracy that the statute was intended to correct. A valuation inaccuracy is also present when the value of a retained interest is increased through the use of a joint and survivor (or two-life) annuity or unitrust interest if there is no certainty that the survivorship interest will ever be paid. The revocable spousal interest involved in *Schott* may best be described as speculative, because it takes effect, if at all, only if the grantor fails to survive the term of the trust, and the duration of the interest, if it takes effect at all, is dependent on the portion of the term remaining at the grantor's death. The existing regulations make it clear that the ability to actuarially determine an interest is not sufficient to secure recognition of that interest as a qualified interest for purposes of section 2702. Under *Example 1* of §25.2702-2(d)(1), neither a retained income interest for life nor a contingent reversionary interest in trust corpus payable to the grantor's estate if the grantor dies prior to the expiration of the trust term is a qualified interest, notwithstanding that the present value of both the income interest and the contingent reversion is readily determinable actuarially. Just as the contingent reversion in *Example 1* would increase the value of the retained interest without any certainty that the reversion would ever be paid, a revocable spousal interest of the kind at issue in *Schott* would similarly increase the value of the retained interest without any certainty that the spouse's survivorship interest would ever be paid.

Some commentators requested that the regulations also confirm the gift tax consequences of the lapse of the grantor's retained right to revoke the spouse's successor interest, for example when that revocation right lapses at the end of the GRAT term and the spouse's successor interest becomes operative. In response, language has been added to §25.2702-3(e), *Example 8*, to clarify that the grantor makes a completed gift to the spouse when the revocation right lapses on the expiration of the grantor's retained term (the grantor having survived the term and not having exercised the revocation right). See §25.2511-2(f).

Other commentators suggested that the regulations also address the treatment of a revocable spousal interest in a *Walton*-type GRAT when the grantor's spouse is given a revocable survivor interest in the annuity payments to be made during the balance of the fixed term of the GRAT remaining after the grantor's death. Specifically, if the grantor dies prior to the expiration of the fixed GRAT term, the annuity interest is payable to the spouse for the balance of that term, subject to the grantor's power to revoke the spousal interest or, if the spousal interest is revoked, then to the grantor's estate for the balance of the fixed term. The commentators suggested that regardless of whether the grantor dies during the stated term or survives, the annuity or unitrust interest will be paid for a fixed term of years either to the grantor, the surviving spouse, or the grantor's estate. Accordingly, the commentators suggested that the interest is payable in all events for a fixed term, and is therefore a qualified interest. The commentators' suggestion would extend the concept espoused by the Tax Court in *Walton* of an "undifferentiated unit" consisting of the grantor and the grantor's estate (see 115 T.C. at 603) to include the grantor, the grantor's estate, and the grantor's spouse. Treasury and the IRS do not believe that the Tax Court opinion supports this extension. The spouse's revocable successor interest is an interest separate and distinct from the interest of the grantor and the grantor's estate. Further, the use of the spouse's life expectancy in valuing the retained interest would increase the value of that interest without any guarantee that the spouse would actually receive any part of that interest. For these reasons, the spouse's revocable successor interest described above does not satisfy the requirements of a qualified interest. Accordingly, this suggestion was not adopted.

## Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because these regulations do not impose

on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the Notice of Proposed Rulemaking preceding these regulations was submitted to the Small Business Administration for comment on their impact on small business.

### Drafting Information

The principal author of these regulations is Juli Ro Kim, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. Other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 25 is amended as follows:

#### PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Paragraph 1. The authority citation for part 25 continues to read, in part, as follows:

Authority: 25 U.S.C. 7805 \* \* \*

Par. 2. In §25.2702-0, the table is amended as follows:

1. The entries for §25.2702-2(a)(5) through §25.2702-2(a)(9) are redesignated as §25.2702-2(a)(6) through §25.2702-2(a)(10), respectively.

2. A new entry for §25.2702-2(a)(5) is added.

3. The entries for §25.2702-3(d)(2) through §25.2702-3(d)(4) are redesignated as §25.2702-3(d)(3) through §25.2702-3(d)(5), respectively.

4. A new entry for §25.2702-3(d)(2) is added.

5. An entry for §25.2702-3(d)(6) is added.

The additions read as follows:

#### §25.2702-0 Table of contents.

\* \* \* \* \*

#### §25.2702-2 Definitions and valuation rules.

(a) \* \* \*

(5) Holder.

\* \* \* \* \*

#### §25.2702-3 Qualified interests.

\* \* \* \* \*

(d) \* \* \*

(2) Contingencies.

\* \* \* \* \*

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

\* \* \* \* \*

Par. 3. Section 25.2702-2 is amended as follows:

1. Paragraphs (a)(5) through (a)(9) are redesignated as paragraphs (a)(6) through (a)(10), respectively.

2. A new paragraph (a)(5) is added.

3. In newly designated paragraph (a)(6), the second sentence is removed and two sentences are added in its place.

4. In paragraph (d)(1), *Example 6* and *Example 7* are removed.

5. In paragraph (d)(2), introductory text, the language “*Examples 8–10*” is revised to read “*Examples 6 through 8*”.

6. In paragraph (d)(2), *Examples 8, 9 and 10* are redesignated *Examples 6, 7 and 8*, respectively.

The additions read as follows:

#### §25.2702-2 Definitions and valuation rules.

(a) \* \* \*

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

(6) \* \* \* If a transferor retains a power to revoke a qualified annuity interest or qualified unitrust interest of the transferor’s spouse, then the revocable qualified annuity or unitrust interest of the transferor’s spouse is treated as a retained qualified interest of the transferor. In order for the transferor to be treated as having retained a qualified interest under the preceding sentence, the interest of the transferor’s spouse (the successor holder) must be an interest that meets the requirements of a qualified annuity interest in accordance with §25.2702-3(b) and (d), or a qualified unitrust interest in accordance with §25.2702-3(c) and (d), but for

the transferor’s retained power to revoke the interest. \* \* \*

\* \* \* \* \*

Par. 4. Section 25.2702-3 is amended as follows:

1. Paragraphs (d)(2) through (d)(5) are redesignated as paragraphs (d)(3) through (d)(6), respectively.

2. A new paragraph (d)(2) is added.

3. In newly designated paragraph (d)(4), the first two sentences are revised.

4. Newly designated paragraph (d)(5) is revised.

5. In paragraph (e), *Example 5*, the last sentence is revised.

6. In paragraph (e), *Example 6*, the last sentence is removed and two new sentences are added in its place.

7. In paragraph (e), new *Example 8* and new *Example 9* are added.

The revisions and additions read as follows:

#### §25.2702-3 Qualified interests.

\* \* \* \* \*

(d) \* \* \*

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

\* \* \* \* \*

(4) *Term of the annuity or unitrust interest*. The governing instrument must fix the term of the annuity or unitrust and the term of the interest must be fixed and ascertainable at the creation of the trust. The term must be for the life of the holder, for a specified term of years, or for the shorter (but not the longer) of those periods. \* \* \*

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

\* \* \* \* \*

(e) \* \* \*

*Example 5*. \* \* \* The interest of A (and A’s estate) to receive the unitrust amount for the specified term of 10 years in all events is a qualified unitrust interest for a term of 10 years.

*Example 6.* \*\*\* As in *Example 5*, the interest of A (and A's estate) to receive the unitrust amount for a specified term of 10 years in all events is a qualified unitrust interest for a term of 10 years. However, the right of A's estate to continue to receive the unitrust amount after the expiration of the 10-year term if A dies within that 10-year period is not fixed and ascertainable at the creation of the interest and is not a qualified unitrust interest.

\*\*\*\*\*

*Example 8.* A transfers property to an irrevocable trust, retaining the right to receive an annuity equal to 6 percent of the initial net fair market value of the trust property for 10 years, or until A's prior death. At the expiration of the 10-year term, or on A's death prior to the expiration of the 10-year term, the annuity is to be paid to B, A's spouse, if then living, for 10 years or until B's prior death. A retains an *inter vivos* and testamentary power to revoke B's interest during the initial 10-year term. If not exercised by A during the initial 10-year term (whether during A's life or on A's death), A's right to revoke B's interest will lapse upon either A's death during the 10-year term, or the expiration of A's 10-year term (assuming A survives the term). Upon expiration of B's interest (or on the expiration of A's interest if A revokes B's interest or if B predeceases A), the trust terminates and the trust corpus is payable to A's child. Because A has made a completed gift of the remainder interest, the transfer of property to the trust is not incomplete as to all interests in the property and section 2702 applies. A's annuity interest (A's right to receive the annuity for 10 years, or until A's prior death) is a retained interest that is a qualified annuity interest under paragraphs (b) and (d) of this section. In addition, because A has retained the power to revoke B's interest, B's interest is treated as an interest retained by A for purposes of section 2702. B's successive annuity interest otherwise satisfies the requirements for a qualified interest contained in paragraph (d) of this section, but for A's power to revoke. The term of B's interest is specified in the governing instrument and is fixed and ascertainable at the creation of the trust, and B's right to receive the annuity is contingent only on B's survival, and A's power to revoke. Following the expiration of A's interest, the annuity is to be paid for a 10-year term or for B's (the successor holder's) life, whichever is shorter. Accordingly, A is treated as retaining B's revocable qualified annuity interest pursuant to §25.2702-2(a)(6). Because both A's interest and B's interest are treated as qualified interests retained by A, the value of the gift is the value of the property transferred to the trust less the value of both A's qualified interest and B's qualified interest (subject to A's power to revoke), each valued as a single-life annuity. If A survives the 10-year term without having revoked B's interest, then A's power to revoke lapses and A will make a completed gift to B at that time. Further, if A revokes B's interest prior to the commencement of that interest, A is treated as making an additional completed gift at that time to A's child. In either case, the amount of the gift would be the present value of B's interest determined under section 7520 and the applicable regulations, as of the date the revocation power lapses or the interest is revoked. See §25.2511-2(f).

*Example 9.* (i) A transfers property to an irrevocable trust, retaining the right to receive 6 percent of

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

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

\*\*\*\*\*

Par. 5. Section 25.2702-7 is amended by adding two sentences at the end of the section to read as follows:

*§25.2702-7 Effective dates.*

\*\*\* Section 25.2702-2(a)(5), the second and third sentences of §25.2702-2(a)(6), §25.2702-3(d)(2), the first two sentences of §25.2702-3(d)(4), the last sentence of §25.2702-3(e), *Example 5*, the last two sentences of §25.2702-3(e), *Example 6*, and §25.2702-3(e), *Examples 8 and 9*, apply for trusts created on or after July 26, 2004. However, the Internal Revenue Service will not challenge any prior application of the changes to *Examples 5 and 6* in §25.2702-3(e).

Mark E. Matthews,  
*Deputy Commissioner for  
Services and Enforcement.*

Approved February 15, 2005.

Eric Solomon,  
*Acting Deputy Assistant Secretary  
of the Treasury.*