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# SUBCHAPTER A—INCOME TAX (Continued)

## PART 2—MARITIME CONSTRUCTION RESERVE FUND

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AUTHORITY: Sec. 511(b), 49 Stat. 1985, as amended, sec. 7805, 68A Stat. 917; 26 U.S.C. 7805, 46 U.S.C. 1161(b).

SOURCE: T.D. 6820, 30 FR 6030, Apr. 29, 1965, unless otherwise noted.

EDITORIAL NOTE: The regulations contained in this part have been recodified in 46 CFR part 287.

### § 2.1 Statutory provisions; sections 511 and 905, Merchant Marine Act, 1936, and related statutes.

SEC. 511. [Merchant Marine Act, 1936] (a) When used in this section the term *new vessel* means any vessel (1) documented or agreed with the Commission to be documented under the laws of the United States; (2) constructed in the United States after December 31, 1939, or the construction of which has been financed under titles V or VII of this Act, as amended, or the construction of which has been aided by a mortgage insured under title XI of this Act as amended; and (3) either (A) of such type, size, and speed as the Commission shall determine to be suitable for use on the high seas or Great Lakes in carrying out the purposes of this Act, but not of less than 2,000 gross tons or of less speed than twelve knots, unless the Commission shall determine and certify in each case that a vessel of a specified lesser tonnage or speed is desirable for use by the United States in case of war or national emergency, or (B) constructed to replace a vessel or vessels requisitioned or purchased by the United States.

(b) For the purpose of promoting the construction, reconstruction, reconditioning, or acquisition of vessels, or for other purposes authorized in this section, necessary to carrying out the policy set forth in title I of this Act, any citizen of the United States who is operating a vessel or vessels in the foreign or domestic commerce of the United States or in the fisheries or owns in whole or in part a vessel or vessels being so operated, or who, at the time of purchase or requisition of the vessel by the Government, was operating a vessel or vessels so engaged or owned in whole or in part a vessel or vessels being so operated or had acquired or was having constructed a vessel or vessels for the purpose of operation in such commerce or in the fisheries, may establish a construction reserve fund, for the construction, reconstruction, reconditioning, or acquisition of new vessels, or for other purposes authorized in this section, to be composed of deposits of proceeds from sales of vessels, indemnities on account of losses of vessels, earnings from the operation of vessels documented under the laws of the United States and from services incident thereto, and receipts, in the form of interest or otherwise, with respect to amounts previously deposited. Such construction reserve fund shall be established, maintained, expended, and used in accordance with the provisions of this section and rules or regulations to be prescribed jointly by the Commission and the Secretary of the Treasury.

(c) In the case of the sale or actual or constructive total loss of a vessel, if the taxpayer deposits an amount equal to the net proceeds of the sale or to the net indemnity with respect to the loss in a construction reserve fund established under subsection (b), then—

(1) If the taxpayer so elects in his income-tax return for the taxable year in which the gain was realized, or

(2) In case a vessel is purchased or requisitioned by the United States, or is lost, in any taxable year beginning after December 31, 1939, and the taxpayer receives payment for the vessel so purchased or requisitioned, or receives from the United States indemnity on account of such loss, subsequent to the end of such taxable year, if the taxpayer so elects prior to the expiration of sixty days after the receipt of the payment or indemnity, and in accordance with a form of election to be prescribed by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury,

no gain shall be recognized to the taxpayer in respect of such sale or indemnification in the computation of net income for the purposes of Federal income or excess-profits taxes. If an election is made under subdivision (2) and if computation or recomputation in accordance with this subsection is otherwise allowable but is prevented, on the date of making such election or within six months thereafter, by any statute of limitation, such computation or recomputation nevertheless shall be made notwithstanding such statute if a claim therefor is filed within six months after the date of making such election.

For the purposes of this subsection no amount shall be considered as deposited in a construction reserve fund unless it is deposited within sixty days after it is received by the taxpayer.

As used in this subsection the term *net proceeds* and the term *net indemnity* mean the sum of (1) the adjusted basis of the vessel and (2) the amount of gain which would be recognized to the taxpayer without regard to this subsection.

(d) The basis for determining gain or loss and for depreciation, for the purposes of Federal income or excess profits taxes, of any new vessel constructed, reconstructed, reconditioned, or acquired by the taxpayer, or with respect to which purchase-money indebtedness is liquidated as provided in subsection (g), in whole or in part out of the construction reserve fund shall be reduced by that portion of the deposits in the fund expended in the construction, reconstruction, reconditioning, acquisition, or liquidation of purchase-money indebtedness of the new vessel which represents gain not recognized for tax purposes under subsection (c).

(e) For the purposes of this section, (1) if the net proceeds of a sale or the net indemnity in respect of a loss are deposited in more than one deposit, the amount consisting of the gain shall be considered as first deposited; (2) amounts expended, obligated, or otherwise withdrawn shall be applied against the amounts deposited in the fund in the order of deposit; and (3) if any deposit consists in part of gain not recognized under subsection (c), any expenditure, obligation, or withdrawal applied against such deposit shall be considered to consist of gain in the proportion that the part of the deposit consisting of gain bears to the total amount of the deposit.

(f) With respect to any taxable year, amounts on deposit on the last day of such year in a construction reserve fund in accordance with this section and with respect to which all the requirements of subsection (g) have been satisfied, to the extent that such requirements are applicable as of the last day of said taxable year, shall not constitute an accumulation of earnings or profits within the meaning of section 102 of the Internal Revenue Code [Part I (section 531 and following), Subchapter A, Chapter 1 of the Internal Revenue Code of 1954].

(g) The provisions of subsections (c) and (f) shall apply to any deposit in the construction reserve fund only to the extent that such deposit is expended or obligated for expenditure, in accordance with rules and regulations to be prescribed jointly by the Commission and the Secretary of the Treasury—

(1) Under a contract for the construction or acquisition of a new vessel or vessels (or in the discretion of the Commission, for a part interest therein), or, with the approval of the Commission, for the reconstruction or reconditioning of a new vessel or vessels, entered into within (i) two years from the date of deposit or the date of any extension thereof which may be granted by the Commission pursuant to the provisions of section 511(h), in the case of deposits made prior to the date [July 17, 1952] on which these amendatory provisions become effective, or (ii) three years from the date of such deposit in the case of a deposit made after such effective date, only if under such rules and regulations—

(A) Within such period not less than 12½ per centum of the construction or contract price of the vessel or vessels is paid or irrevocably committed on account thereof and the plans and specifications therefor are approved by the Commission to the extent by it deemed necessary; and

(B) In case of a vessel or vessels not constructed under the provisions of this title or not purchased from the Commission, (i) said construction is completed, within six months from the date of the construction contract, to the extent of not less than 5 per centum thereof (or in case the contract covers more than one vessel, the construction of the first vessel so contracted for is so completed to the extent of not less than 5 per centum) as estimated by the Commission and certified by it to the Secretary of the Treasury, and (ii) all construction under such contract is completed with reasonable dispatch thereafter;

(2) For the liquidation of existing or subsequently incurred purchase-money indebtedness to persons other than a parent company of, or a company affiliated or associated

with, the mortgagor on a new vessel or vessels within (i) two years from the date of deposit or the date of any extension thereof which may be granted by the Commission pursuant to the provisions of section 511(h), in the case of deposits made prior to the date [July 17, 1952] on which these amendatory provisions become effective, or (ii) three years from the date of such deposit in the case of a deposit made after such effective date.

(h) The Commission is authorized under rules and regulations to be prescribed jointly by the Secretary of the Treasury and the Commission to grant extensions of the period within which the deposits shall be expended or obligated or within which construction shall have progressed to the extent of 5 per centum of completion as provided herein, but such extension shall not be for an aggregate additional period in excess of two years with respect to the expenditure or obligation of such deposits or more than one year with respect to the progress of such construction: *Provided*, That until January 1, 1965, in addition to the extensions hereinbefore permitted, further extensions may be granted ending not later than December 31, 1965.

(i) Any such deposited gain or portion thereof which is not so expended or obligated within the period provided, or which is otherwise withdrawn before the expiration of such period, or with respect to which the construction has not progressed to the extent of 5 per centum of completion within the period provided, or with respect to which the Commission finds and certifies to the Secretary of the Treasury that, for causes within the control of the taxpayer, the entire construction is not completed with reasonable dispatch, if otherwise taxable income under the law applicable to the taxable year in which such gain was realized, shall be included in the gross income for such taxable year, except for the purpose of the declared value excess-profits tax and the capital stock tax. If any such deposited gain or portion thereof with respect to a deposit made in any taxable year ending on or before June 30, 1945, is so included in gross income for such taxable year, there shall (in addition to any other deficiency) be assessed, collected, and paid in the same manner as if it were a deficiency, an amount equal to 1.1 per centum of the amount of gain so included, such amount being in lieu of any adjustment with respect to the declared value excess-profits tax for such taxable year.

(j) Notwithstanding any other provision of law, any deficiency in tax for any taxable year resulting from the inclusion of any amount in gross income as provided by subsection (i), and the amount to be treated as a deficiency under such subsection in lieu of any adjustment with respect to the declared value excess-profits tax, may be assessed or a proceeding in court for the collection thereof may be begun without assessment, at any time: *Provided, however*, That interest on any such deficiency or amount to be treated as a deficiency shall not begin until the date the deposited gain or portion thereof in question is required under subsection (i) to be included in gross income.

(k) This section shall be applicable to a taxpayer only in respect of sales or indemnifications for losses occurring within a taxable year beginning after December 31, 1939, and only in respect of earnings derived during a taxable year beginning after December 31, 1939.

(l) For the purposes of this section a vessel shall be considered as constructed or acquired by the taxpayer if constructed or acquired by a corporation at a time when the taxpayer owns at least 95 per centum of the total number of shares of each class of stock of the corporation.

(m) The terms used in this section shall have the same meaning as in chapter 1 of the Internal Revenue Code.

(n) The terms *contract for the construction* and *construction contract*, as used in this section, shall include, in the case of a taxpayer who constructs a new vessel in a shipyard owned by such taxpayer, an agreement between such taxpayer and the Commission with respect to such construction and containing provisions deemed necessary or advisable by the Commission to carry out the purposes and policy of this section.

(o) The terms *reconstruction and reconditioning*, as used in this section, shall include the reconstruction, reconditioning, or modernization of a vessel for exclusive use on the Great Lakes, including the St. Lawrence River and Gulf, if the Commission determines that the objectives of this Act will be promoted by such reconstruction, reconditioning, or modernization, and, notwithstanding any other provisions of law, such vessel shall be deemed to be a ''new vessel'' within the meaning of this section for such reconstruction, reconditioning, or modernization.

[Sec. 511 as added by Act of October 10, 1940 (Pub. L. 840, 76th Cong., 54 Stat. 1106), as amended by Act of June 17, 1943 (Pub. L. 78, 78th Cong., 57 Stat. 157); Act of Dec. 23, 1944 (Pub. L. 552, 78th Cong., 58 Stat. 920); secs. 9–14, Act of July 17, 1952 (Pub. L. 586, 82d Cong., 66 Stat. 762); Act of Sept. 12, 1964 (Pub. L. 88–595, 78 Stat. 943)]

SEC. 905. [Merchant Marine Act, 1936.] When used in this Act—

(a) The words *foreign commerce* or *foreign trade* mean commerce or trade between the United States, its Territories or possessions,

or the District of Columbia, and a foreign country.

* * * * *

(c) The words *citizen of the United States* include a corporation, partnership, or association only if it is a citizen of the United States within the meaning of section 2 of the Shipping Act, 1916, as amended (U.S.C., title 46, sec. 802), and with respect to a corporation under title VI of this Act, all directors of the corporation are citizens of the United States, and, in the case of a corporation, partnership, or association operating a vessel on the Great Lakes, or on bays, sounds, rivers, harbors, or inland lakes of the United States the amount of interest required to be owned by a citizen of the United States shall be not less than 75 per centum.

* * * * *

(e) The terms *United States Maritime Commission* and *Commission* shall mean the Secretary of Commerce, the Maritime Administrator, or the * * * [Maritime Subsidy Board] as the context may require * * *.

[Sec. 905 (a), (c), and (e) (49 Stat. 2016), amended by sec. 39 (a) and (b), Act of June 23, 1938 (Pub. L. 705, 75th Cong., 52 Stat. 964); Act of July 17, 1952 (Pub. L. 586, 82d Cong., 66 Stat. 765); sec. 4, Act of Sept. 21, 1959 (Pub. L. 86–327, 73 Stat. 597)]

SEC. 2. [Shipping Act, 1916.] (a) That within the meaning of this Act no corporation, partnership, or association shall be deemed a citizen of the United States unless the controlling interest therein is owned by citizens of the United States, and, in the case of a corporation, unless its president or other chief executive officer and the chairman of its board of directors are citizens of the United States and unless no more of its directors than a minority of the number necessary to constitute a quorum are noncitizens and the corporation itself is organized under the laws of the United States or of a State, Territory, District, or possession thereof, but in the case of a corporation, association, or partnership operating any vessel in the coastwise trade the amount of interest required to be owned by citizens of the United States shall be 75 per centum.

(b) The controlling interest in a corporation shall not be deemed to be owned by citizens of the United States (a) if the title to a majority of the stock thereof is not vested in such citizens free from any trust or fiduciary obligation in favor of any person not a citizen of the United States; or (b) if the majority of the voting power in such corporation is not vested in citizens of the United States; or (c) if through any contract or understanding it is so arranged that the majority of the voting power may be exercised, directly or indirectly, in behalf of any person who is not a citizen of the United States; or (d) if by any other means whatsoever control of the corporation is conferred upon or permitted to be exercised by any person who is not a citizen of the United States.

(c) Seventy-five per centum of the interest in a corporation shall not be deemed to be owned by citizens of the United States (a) if the title to 75 per centum of its stock is not vested in such citizens free from any trust or fiduciary obligation in favor of any person not a citizen of the United States; or (b) if 75 per centum of the voting power in such corporation is not vested in citizens of the United States; or (c) if, through any contract or understanding it is so arranged that more than 25 per centum of the voting power in such corporation may be exercised, directly or indirectly, in behalf of any person who is not a citizen of the United States; or (d) if by any other means whatsoever control of any interest in the corporation in excess of 25 per centum is conferred upon or permitted to be exercised by any person who is not a citizen of the United States.

(d) The provisions of this Act shall apply to receivers and trustees of all persons to whom the Act applies, and to the successors or assignees of such persons.

[Sec. 2 (39 Stat. 729) as amended by Act of July 15, 1918 (Pub. L. 198, 65th Cong., 40 Stat. 900); sec. 38, Merchant Marine Act, 1920 (41 Stat. 1008); sec. 3, Act of Sept. 21, 1959 (Pub. L. 86–327, 73 Stat. 597)]

### § 2.1–1 Definitions.

(a) As used in the regulations in this part, except as otherwise expressly provided—

(1) *Act* means the Merchant Marine Act, 1936, as amended (46 U.S.C. 27).

(2) *Section* means one of the sections of the regulations in this part.

(3) *Administration* means the Maritime Administration of the Department of Commerce as created by Reorganization Plan No. 21 of 1950 (46 U.S.C. 1111 note).

(4) *Citizen* means a person who, if an individual, was born or naturalized as a citizen of the United States or, if other than an individual, meets the requirements of section 905(c) of the Act and section 2 of the Shipping Act, 1916, as amended (46 U.S.C. 802).

(5) *Taxpayer* means a citizen who has established or seeks to establish a construction reserve fund under the provisions of section 511 of the Act and the regulations in this part, and may include a partnership.

(6) *Corporation* includes associations, joint-stock companies and insurance companies.

(7) *Stock* includes the shares in an association, joint-stock company, or insurance company.

(8) *Affiliate* or *associate* means a person directly or indirectly controlling, controlled by, or under common control with, another person.

(9) *Control*, as used in subparagraph (8) of this paragraph, means the possession of the power to direct in any manner the management and policies of a person, and the terms ''controlling'' and ''controlled'' shall have the meanings correlative to the foregoing.

(10) *Person* means an individual, a corporation, a partnership, an association, an estate, a trust, or a company.

(11) *Partnership* includes a syndicate, group, pool, joint venture, or other unincorporated organization.

(12) *Construction*, if so determined by the Administration, shall include reconstruction and reconditioning.

(13) *Reconstruction and reconditioning* shall include the reconstruction, reconditioning, or modernization of a vessel for exclusive use on the Great Lakes, including the Saint Lawrence River and Gulf, if the Administration determines that the objectives of the Act will be promoted by such reconstruction, reconditioning, or modernization, and, notwithstanding any other provisions of law, such vessel shall be deemed to be a ''new vessel'' within the meaning of section 511 of the Act for such reconstruction, reconditioning, or modernization.

(14) *Purchase-money indebtedness* means any indebtedness, or evidence thereof, created as the result of the purchase of a vessel by the taxpayer.

(15) *Contract, contract for the construction*, and *construction contract* shall include, if so determined by the Administration, a contract for reconstruction or reconditioning and shall include, in the case of a taxpayer who constructs a new vessel in a shipyard owned by such taxpayer, an agreement, between such taxpayer and the Administration with respect to such construction, and containing provisions deemed necessary or advisable by the Administration to carry out the purposes and policy of section 511 of the Act.

(b) Insofar as the computation and collection of taxes are concerned, other terms used in the regulations in this part, except as otherwise provided, have the same meaning as in the Internal Revenue Code and the regulations thereunder.

### § 2.1–2 Scope of section 511 of the Act and the regulations in this part.

(a) *Applicability of regulations.* (1) The regulations prescribed in this part—

(i) Apply to gain realized from the sale or loss of vessels, earnings from the operation of vessels, and interest (or otherwise) with respect to amounts previously deposited in the construction reserve fund, for a taxable year beginning after December 31, 1964, and

(ii) Apply to the expenditure, obligation, or withdrawal, during a taxable year beginning after December 31, 1964, of any deposits of gain, earnings, and interest (or otherwise) of the character referred to in subdivision (i) of this subparagraph without regard to the taxable year in which the deposits were made.

(2) As to gain, earnings, or interest (or otherwise) described in subparagraph (1)(i) of this paragraph and as to an expenditure, obligation, or withdrawal described in subparagraph (1)(ii) of this paragraph, the regulations in this part supersede Treasury Decision 5330, as amended (26 CFR (1939) Part 32).

(b) *Nonrecognition and accumulation.* Section 511 of the Act provides, under conditions specified, for the nonrecognition, for income and excess-profits tax purposes, of the gain realized from the sale or indemnification for loss of certain vessels including certain vessels in the course of construction, or shares therein. It also permits the accumulation of the proceeds of such sales or indemnification and of certain earnings without liability under Part I (section 531 and following), Subchapter G, Chapter I of the Internal Revenue Code of 1954, and the regulations thereunder (§§ 1.531–1 through 1.537–3 of this chapter (Income Tax Regulations)).

(c) *Availability of benefits.* The benefits of section 511 of the Act are available to any citizen as defined in paragraph (a)(4) of § 2.1–1, who, during any

taxable year owns, in whole or in part, a vessel or vessels within the scope of § 2.1–3. A citizen operating such a vessel or vessels owned by any other person or persons can derive no benefit from the provisions relating to the nonrecognition of gain from the sale or loss of such vessel or vessels so owned, but may establish a construction reserve fund in which he may deposit earnings from the operation of such vessel or vessels.

(d) *Applicability of section 511.* Section 511 of the Act applies only with respect to sales or losses of vessels within the scope of § 2.1–3 or in respect of earnings derived from the operation of such vessels. A loss to be within section 511 of the Act must be an actual or constructive total loss. Whether there is a total loss, actual or constructive, will be determined by the Administration.

### § 2.1–3 Requirements as to vessel operations.

Section 511 of the Act applies with respect to vessels operated in the foreign or domestic commerce of the United States or in the fisheries of the United States and vessels acquired or being constructed for the purpose of such operation. The foreign commerce of the United States includes commerce or trade between the United States (including the District of Columbia), the territories and possessions which are embraced within the coastwise laws, and a foreign country or other territories and possessions of the United States. The domestic commerce of the United States includes commerce or trade between ports of the United States and its territories and possessions, embraced within the coastwise laws and on inland rivers. The fisheries include the fisheries of the United States and its territories and possessions. Section 511 of the Act does not apply to vessels operated in the foreign commerce or fisheries of any country other than the United States.

### § 2.1–4 Application to establish fund.

Any person claiming to be entitled to the benefits of section 511 of the Act may make application, in writing, to the Administration for permission to establish a construction reserve fund. The application shall be in such form and substance as the Administration may prescribe and shall designate, among other things, the depository or depositories with which the taxpayer proposes to establish the said fund. The original application shall be executed and verified by the taxpayer, or if the taxpayer is a corporation, by one of its principal officers, in triplicate, and shall be accompanied by eight conformed copies when filed with the Administration.

### § 2.1–5 Tentative authorization to establish fund.

Where the time between the receipt by the Administration of the application for permission to establish a construction reserve fund and the date prior to which an amount received from the sale or loss of a vessel must be deposited to come within the scope of section 511 of the Act is insufficient to permit a determination of the eligibility of the applicant, the Administration may tentatively authorize the establishment of a construction reserve fund and the deposit of such amount therein. Such tentative authorization shall be subject to rescission by the Administration if subsequently it is determined that the applicant is not entitled to the benefits of section 511 of the Act, or has not complied with the statutory requirements. For example, a tentative authorization will be rescinded if the Administration ascertains that the applicant is not a citizen. Upon such determination, the fund shall be closed and all amounts on deposit therein shall be withdrawn.

### § 2.1–6 Establishment of fund.

(a) *Authorization by the Administration.* If the application is approved by the Administration, the Administration will adopt Orders authorizing the establishment of a construction reserve fund with the depository or depositories designated by the taxpayer and approved by the Administration. The Orders will provide for joint control by the Administration and the taxpayer over such fund, will set forth the conditions governing the establishment and maintenance of the fund and the making of deposits therein and withdrawals

therefrom, and will designate the representatives authorized to execute instruments of withdrawal on behalf of the Administration.

(b) *Resolution or agreement of the taxpayer.* A certified copy of the Orders of the Administration will be furnished the taxpayer. If the taxpayer is a corporation, it shall promptly adopt, through its board of directors, a resolution satisfactory in form and substance to the Administration, authorizing the establishment and maintenance of the fund in conformity with the action of the Administration. If the taxpayer is not a corporation, it shall promptly execute an agreement with the depository satisfactory in form and substance to the Administration to conform to the action of the Administration as set forth in the Orders. Certified copies of the Orders of the Administration and of the resolution of the taxpayer (if it is a corporation) will be furnished to the depository by the Administration and the taxpayer, respectively, for its guidance in maintaining the fund and honoring instruments of withdrawal. The taxpayer, if a corporation, shall also furnish the Administration with a certified copy of its resolution, or if not a corporation, a duplicate original of its agreement with the depository.

(c) *Constructive action not recognized.* Constructive deposits, substitutions or withdrawals will not be recognized by the Administration in the establishment and maintenance of the fund.

(d) *Failure to make deposits as basis for termination of fund.* In the event no deposit is made into the fund for more than five years, any amounts remaining in the fund shall be removed from the fund at the discretion of the Administration and, if so removed, the fund shall be terminated. In the event of such termination, see § 2.1–23 for recognition of gain.

### § 2.1–7 Circumstances permitting reimbursement from a construction reserve fund.

(a) *Payments prior to establishment of fund.* If, prior to the establishment of a construction reserve fund under the regulations in this part, a taxpayer has made necessary payments under a contract which satisfies the provisions of the regulations in this part and section 511 of the Act for the construction or acquisition of a new vessel, such taxpayer may, if subsequently authorized to establish a construction reserve fund under the regulations in this part, draw against such fund as reimbursement for the amount, if any, of other funds which, with the approval or ratification of the Administration, the taxpayer used for making such necessary payments prior to the establishment of the fund.

(b) *Payments subsequent to establishment of fund.* If, subsequent to the establishment of a construction reserve fund under the regulations in this part, the taxpayer has made necessary payments under a contract which satisfies the provisions of the regulations in this part and section 511 of the Act for the construction or acquisition of a new vessel, such taxpayer may draw against such fund as reimbursement for the amount, if any, of other funds which, with the approval or ratification of the Administration, the taxpayer had used for the purpose of making such necessary payments.

### § 2.1–8 Investment of funds in securities.

(a) *Obligations of or guaranteed by the United States.* Interest-bearing direct obligations of the United States, or obligations fully guaranteed as to principal and interest by the United States, may be deposited in the construction reserve fund in lieu of cash, may be purchased with cash on deposit in the fund, or may be substituted for securities or commitment to finance in the fund, subject to the provisions of paragraph (b) of this section.

(b) *Other securities.* In cases where the taxpayer desires to deposit any securities in the fund in lieu of cash other than those of or guarantees by the United States or to purchase such other securities with cash on deposit in the fund, or to substitute such other securities for securities or commitment to finance in the fund, the taxpayer shall make written application to the Administration and shall not consummate the transaction until the written consent of the Administration shall have been received. The application shall describe the securities fully. Every approval by the Administration

of such application shall be conditioned upon agreement by the taxpayer forthwith to dispose of such securities upon subsequent request by the Administration. Immediately upon the purchase of any securities for deposit in the fund, the taxpayer shall advise the Administration, giving the date of purchase, a description of the securities, and the price paid therefor (net, brokerage and other charges, and gross). Ordinarily, the Administration will not approve the deposit in the fund in lieu of cash, or the purchase with cash on deposit in the fund or the substitution for securities in the fund of securities not actively traded in on exchanges registered under the Securities Exchange Act of 1934 (15 U.S.C. ch. 2B), or securities which are not legal for investment of trust funds. Whenever the Administration approves the substitution of other securities for securities in the fund, such substitution shall be effected only upon or after the deposit of the substituted securities into the fund.

(c) *Cash.* Cash may be substituted for amounts which are on deposit in the fund in any other form.

(d) *Devalued securities.* In the event the Administration determines that the market value at any date of any securities in the fund has decreased to a figure which is less than 90 percent of the market value at the time of deposit into the fund, then within 60 days after the taxpayer receives notice of such determination the taxpayer shall (except as otherwise provided in this paragraph) deposit into the fund cash or securities in an amount equal to the difference between the current market value of the devalued securities and the market value of such securities at the time of their original deposit. However if any securities in the fund are valued at the time of their deposit at less than the market value of such securities at the time of their deposit the taxpayer shall be required to deposit only an amount equal to that portion of the difference between the current market value of the devalued securities and the market value of such securities at the time of their original deposit which bears the same ratio to such total difference as the amount at which the securities were valued at the time of their deposit bears to the market value at the time of such deposit.

### § 2.1–9 Valuation of securities in fund.

(a) *Equivalent values.* In cases where securities are deposited in the fund in lieu of cash, or are purchased with cash on deposit in the fund, or are substituted for securities in the fund, the value of such securities must not be less than the amount of cash in lieu of which they are so deposited or with which they are so purchased, or the value at the time of deposit of the securities for which they were so substituted. If the securities on deposit in the fund are replaced by cash from the general funds of the taxpayer, the amount of cash to be deposited in the fund in lieu thereof shall be not less than the amount at which such securities were valued at the time of their deposit in the fund.

(b) *Determination of value.* (1) For the purpose of determining the amount in the fund, the value of securities shall be their ''market value'' (which shall be the basis for determining value, unless otherwise agreed to by the administration) and shall be determined in the following manner:

(i) In instances where no actual purchase is involved, such as the initial deposit of securities in the fund in lieu of cash, the last sales price thereof on the principal exchange on the day the deposit was made shall be deemed to be the ''market value'' thereof, or, if no such sales were made, the ''market value'' thereof will be determined by the Administration on such basis as it may deem to be fair and reasonable in each case.

(ii) In instances where the purchase of securities with cash on deposit in the fund is involved, ''market value'' shall be the gross price paid (adjusted for accrued interest): *Provided,* That if such securities are purchased otherwise than upon a registered exchange the price shall be within the range of transactions on the exchange on the date of such purchase, or, if there were no such transactions, then the ''market value'' thereof will be determined by the Administration on such basis as it may deem to be fair and reasonable in each case.

(2) Purchase-money obligations secured by mortgages on vessels sold or irrevocable commitments to finance the construction or acquisition of new vessels which are deposited in the construction reserve fund as provided in §2.1–13 ordinarily will be considered as equivalent to their face value.

**§2.1–10 Withdrawals from fund.**

(a) *Withdrawals for obligations or liquidation.* (1) Checks, drafts, or other instruments of withdrawal to meet obligations under a contract for the construction or acquisition of a new vessel or vessels or for the liquidation of existing or subsequently incurred purchase-money indebtedness, after having been executed by the taxpayer, shall be forwarded to the Administration in Washington, DC, with appropriate explanation of the purpose of the proposed withdrawal, including properly certified invoices or other supporting papers. Such instruments of withdrawal, if payable to the Administration, will be deposited by the Administration for collection, and the proceeds thereof, upon collection, will be credited to the appropriate contract with the Administration; but if drawn to the order of payees other than the Administration, after countersignature on behalf of the Administration, will ordinarily be forwarded to the payees.

(2) An amount obligated under a contract for the construction or acquisition of a new vessel or vessels or for the liquidation of existing or subsequently incurred purchase-money indebtedness, whether the obligor has the entire or a partial interest therein within the scope of section 511 of the Act, may not, so long as the contract or indebtedness continues in full force and effect, be withdrawn except to meet payments due or to become due under such contract or for such liquidation.

(b) *Other withdrawals.* Checks, drafts, or other instruments of withdrawal executed by the taxpayer for purposes other than to meet obligations under a contract for the construction or acquisition of a new vessel or vessels or for the liquidation of existing or subsequently incurred purchase-money indebtedness, whether the taxpayer has the entire or a partial interest therein, shall be drawn by the taxpayer to its own order and forwarded to the Administration in Washington, DC, with appropriate explanation of the purpose of the proposed withdrawal. Such withdrawals may occur by reason of a determination by the Administration that the taxpayer is not entitled to the benefits of section 511 of the Act (see §2.1–5), or that a particular deposit has been improperly made (see §2.1–13), or by reason of the election of the taxpayer to make such withdrawals. Upon receipt of such checks, drafts, or other instruments of withdrawal, the Administration will give notice thereof to the Commissioner of Internal Revenue. The Commissioner will advise the Administration of the receipt of the notice and the date it was received. The Administration shall not countersign such checks, drafts, or other instruments of withdrawal or transmit them to the taxpayer until the expiration of 30 days from the date of receipt of the notice by the Commissioner, unless the Commissioner or such official of the Internal Revenue Service as he may designate for the purpose consents in writing to earlier countersignature by the Administration and transmittal to the taxpayer. Upon the expiration of such 30-day period, or prior thereto if the aforesaid consent of the Commissioner has been obtained, the Administration will countersign the check, draft, or other instrument of withdrawal and forward it to the taxpayer.

(c) *Inapplicability to certain transactions.* The provisions of this section shall not be applicable to transactions deemed to be withdrawals by reason of the sale of securities held in the fund for an amount less than the market value thereof at the time of their deposit (see §2.1–23), nor to the cancellation of an irrevocable commitment deposited in the fund, upon proof satisfactory to the Administration that the terms of such commitment have been fully satisfied.

**§2.1–11 Time deposits.**

Deposits in the construction reserve fund not invested in securities may be placed in time deposits when, in the judgment of the taxpayer, it is desirable and feasible so to do. The taxpayer

shall promptly advise the Administration of any time deposit arrangements made with the depository. The Administration reserves the right at any time to require the termination or modification of any such arrangements. With prior approval of the Administration a time deposit may be made in a depository other than the one with which the construction reserve fund is established.

### § 2.1–12 Election as to nonrecognition of gain.

(a) *Election requirements.* As a prerequisite to the nonrecognition of gain on the sale or loss of a vessel (or of a part interest therein) for Federal income tax purposes, the taxpayer, after establishing a construction reserve fund, must make an election with respect to such vessel or interest in the manner set forth in this paragraph.

(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the election must be made in the taxpayer's Federal income tax return (or, in the case of a partnership, in the partnership return of income) for the taxable year in which the gain with respect to the sale or loss of the vessel is realized. The election as to the nonrecognition of gain shall be shown by a statement to that effect, submitted as a part of, and attached to, the return. The statement, which need not be on any prescribed form, shall set forth a computation of the amount of the realized gain, the identity of the vessel, the nature and extent of the taxpayer's interest therein, whether such vessel was sold or lost and the date of sale or loss, the full sale price or full amount of indemnity, and the amount and date of each payment thereof, the basis for tax purposes and any other data affecting the determination of the realized gain.

(2) *Certain Government payments.* In case a vessel is purchased or requisitioned by the United States, or is lost, in any taxable year and the taxpayer receives payment for the vessel so purchased or requisitioned, or receives from the United States indemnity on account of such loss, subsequent to the end of such taxable year, the taxpayer shall make his election by filing notice thereof with the Commissioner of Internal Revenue, Washington, DC, 20224, prior to the expiration of 60 days after receipt of the payment or indemnity. The taxpayer shall file a copy of the notice with the Secretary, Federal Maritime Board, Washington, DC, 20573. The form of the notice of election shall be prepared by the taxpayer and shall be substantially as follows:

ELECTION RELATIVE TO NONRECOGNITION OF GAIN UNDER SECTION 511(C)(2), MERCHANT MARINE ACT, 1936

Pursuant to the provisions of section 511(c)(2) of the Merchant Marine Act, 1936, as amended, notice is hereby given that the undersigned taxpayer elects that gain in respect of the sale to the United States, or indemnification received from the United States on account of the loss, of the vessel named below or share therein shall not be recognized. The circumstances involved in the computation of such gain are as follows:

Name and other identification of vessel ____
Nature and extent of the taxpayer's interest in the vessel _____
Nature of disposition, i.e., sale or loss _____
Date of disposition _____
Full sale price or full amount of indemnity received by taxpayer _____
Amount and date of each payment of sale price or indemnity received by taxpayer __
Amount and date of each previous deposit of such payments in construction reserve fund _____
_____
Identification of each check or other instrument by which payment made to taxpayer
_____
Tax basis of taxpayer's interest in vessel ____
Any other data affecting the determination of the realized gain _____
Amount of gain (submit computation) _____
_____
(Name of taxpayer)
By _____
_____
(Date of execution)

(b) [Reserved]

### § 2.1–13 Deposit of proceeds of sales or indemnities.

(a) *Manner of deposit.* The deposit required by section 511 of the Act must be made in a construction reserve fund established with a depository or depositories approved by the Administration and subject to the joint control of the Administration and the taxpayer. It is not necessary to establish a separate fund with respect to each vessel or share in a vessel sold or lost.

(b) *Amount of deposit.* With respect to any vessel sold or lost, or a share therein, the deposit must be in an amount equal to the ''net proceeds'' of the sale, or the ''net indemnity'' for the loss. By ''net proceeds'' and ''net indemnity'' is meant (1) the depositor's interest in the adjusted basis of the vessel plus (2) the amount of gain which would be recognized for tax purposes in the absence of section 511 of the Act. In determining ''net proceeds'', the amount necessarily paid or incurred for brokers' commissions is to be deducted from the gross amount of the sales price. In the event the taxpayer is an affiliate or associate of the buyer, the amount of the sales price shall not exceed the fair market value of the vessel or vessels sold as determined by the Administration. In such case the taxpayer shall furnish evidence sufficient, in the opinion of the Administration, to establish that the sales price is not in excess of the fair market value. In determining ''net indemnity'', the amount necessarily paid or incurred purely for collection, or rate of exchange discounts on the payment, of the indemnity is to be deducted from the gross amount of collectible indemnity. In case of the sale or loss of several vessels or share therein, a deposit of the ''net proceeds'' or ''net indemnity'' with respect to one or more of the vessels or shares is permissible. Where several vessels or shares are sold for a lump sum, the ''net proceeds'' allocated to each vessel or share shall be determined in accordance with any reasonable rule satisfactory to the Commissioner of Internal Revenue. The taxpayer must deposit the full amount of each payment (including cash, notes, or other evidences of indebtedness) as a single deposit in the construction reserve fund. A payment divided between two or more depositories will be regarded as a single deposit. Amounts received by the taxpayer prior to the date of consummation of the sale of the vessel shall be considered as having been received by the taxpayer at the time the sale is consummated.

(c) *Purchase-money obligations.* Where the proceeds from the sale of a vessel include purchase-money obligations, such obligations together with the entire collateral therefor, or, in the case of deposit of the proceeds of a share in the vessel, a proportionate part of the obligations and collateral as determined by the Administration, shall be deposited, with the remainder of the proceeds, in the construction reserve fund as a part of the ''net proceeds''. The depository shall receive payment of all amounts due on such purchase-money obligations and such amounts shall be placed in the fund in substitution for the portion of the obligations paid. All installments of purchase-money obligations shall be paid directly into the fund by the obligor. In the event any such installment is not so deposited, the Administration, at any time after the due date, may require the taxpayer to deposit an amount equal to such installment. If the taxpayer so desires, he may deposit in the construction reserve fund cash or approved securities in an amount equal to the face value of any purchase-money obligations in lieu of depositing such obligations.

(d) *Vessel subject to mortgage at time of sale or loss.* Where a vessel is subject to a mortgage or other encumbrance at the time of its sale or loss and the taxpayer actually receives only an amount representing the equity therein or a share in such equity corresponding to his share in the vessel, he shall deposit in the construction reserve fund such amount and concurrently therewith other funds in an amount equal to the difference between the amount received and the ''net proceeds'' or ''net indemnity''. Such other funds may be in the form of cash, or, subject to the approval of the Administration, (1) interest-bearing securities, or (2) an irrevocable and unconditional commitment to finance the construction or acquisition of a new vessel in whole or in part by an obligor approved by the Administration in an amount equal to the amount by which the ''net proceeds'' exceed the cash or securities deposited in the fund.

(e) *Unauthorized deposits.* A deposit which is not provided for by section 511 of the Act shall, without unreasonable delay, be withdrawn from the fund and tax liability will be determined as though such deposit had not been made. (See §§ 2.1–10 and 2.1–24.)

**§ 2.1–14 Deposit of earnings and receipts.**

(a) *Earnings.* A citizen may deposit all or any part of earnings derived from the operation, within the scope of § 2.1–3, of a vessel or vessels owned either by himself or any other person, if such earnings are intended for construction or acquisition of new vessels. Such earnings may include payments received by an owner, as compensation for use of his vessel, from other persons by whom it is so operated. Earnings from other sources may not be deposited. The earnings from operation of vessels which are eligible for deposit are the net earnings determined without regard to any deduction for depreciation, obsolescence, or amortization with respect to such vessels.

(b) *Receipts.* Receipts from deposited funds, in the form of interest or otherwise, may be deposited.

**§ 2.1–15 Time for making deposits.**

(a) *Proceeds of sale or indemnification.* Deposits of amounts representing proceeds of the sale or indemnification for loss of a vessel or share therein must be made within 60 days after receipt by the taxpayer.

(b) *Earnings and receipts.* Earnings and receipts for the taxable year may be deposited at any time. (See § 2.1–14.)

**§ 2.1–16 Tax liability as to earnings deposited.**

Deposit in the construction reserve fund of earnings from the operation of a vessel or vessels, or receipts, in the form of interest or otherwise, with respect to amounts previously deposited does not exempt the taxpayer from tax liability with respect thereto nor postpone the time such earnings or receipts are includible in gross income. Earnings and receipts deposited in a construction reserve fund established in accordance with the provisions of section 511 of the Act and the regulations in this part will be deemed to have been accumulated for the reasonable needs of the business within the meaning of Part 1 (section 531 and following), Subchapter G, Chapter I of the Internal Revenue Code of 1954, so long as the requirements of section 511 of the Act and the regulations in this part are satisfied relative to the use of the fund in the construction, reconstruction, reconditioning, or acquisition of new vessels, or for the liquidation of purchase-money indebtedness on such vessels. For incurrence of tax liability due to noncompliance with the requirements of section 511 of the Act and the regulations in this part with respect to deposits in the construction reserve fund, see the provisions of § 2.1–23.

**§ 2.1–17 Basis of new vessel.**

The basis for determining gain or loss and for depreciation for the purpose of the Federal income tax with respect to a new vessel constructed, reconstructed, reconditioned, or acquired by the taxpayer, or with respect to which purchase-money indebtedness is liquidated as provided in section 511(g) of the Act, with funds deposited in the construction reserve fund, is reduced by the amount of the unrecognized gain represented in the funds allocated under the provisions of the regulations in this part to the cost of such vessel. (See § 2.1–18.)

**§ 2.1–18 Allocation of gain for tax purposes.**

(a) *General rules of allocation.* As provided in § 2.1–17, if amounts on deposit in a construction reserve fund are expended, obligated, or withdrawn for construction, reconstruction, reconditioning, or acquisition of new vessels, or for the liquidation of purchase-money indebtedness of such vessels, the portion thereof which represents gain shall be applied in reduction of the basis of such new vessels. The rules set forth below in this paragraph shall apply in allocating the unrecognized gain to the amounts so expended, obligated, or withdrawn:

(1) If the ''net proceeds'' of a sale or ''net indemnity'' in respect of a loss are deposited in more than one deposit, the portion thereof representing unrecognized gain shall be considered as having been deposited first.

(2) Amounts expended, obligated, or withdrawn from the construction reserve fund shall be applied against amounts deposited in the order of deposit.

(3) If any deposit consists in part of gain not recognized under section 511(c)

of the Act, then any expenditure, obligation, or withdrawal applied against such deposit shall be considered to consist of gain in the same proportion that the part of the deposit which constitutes gain bears to the total amount of the deposit.

(b) *Date of obligation.* The date funds are obligated under a contract for the construction, reconstruction, reconditioning, or acquisition of new vessels, or for the liquidation of purchase-money indebtedness on such vessels, rather than the date of payment from the fund, will determine the order of application against the deposits in the fund. When a contract for the construction, reconstruction, reconditioning, or acquisition of new vessels, or for the liquidation of purchase-money indebtedness on such vessels is entered into, amounts on deposit in the construction reserve fund will be deemed to be obligated to the extent of the amount of the taxpayer's liability under the contract. Deposits will be deemed to be so obligated in the order of deposit, each new contract obligating the earliest deposit not previously expended, obligated, or withdrawn. If the liability under the contract exceeds the amount in the construction reserve fund, the contract will be deemed to obligate, to the extent of that part of such excess not otherwise satisfied, the earliest deposit or deposits thereafter made.

(c) *Illustration.* The foregoing rules are illustrated in the following example:

*Example.* (1) A taxpayer who makes his returns on the calendar year basis sells a vessel in 1963 for $1,000,000, realizing a gain of $400,000. Payment of $100,000 is received in March 1963 when the contract is signed, and the balance of $900,000 is received in June 1963 on delivery of the vessel. The $1,000,000 is deposited in a construction reserve fund in July 1963. In December 1963, the taxpayer also deposits $150,000, representing earnings of that year. In 1964, he sells another vessel for $1,000,000, realizing a gain of $250,000. The sale price of $1,000,000 is received on delivery of the vessel in February 1964, and deposited in the construction reserve fund in March 1964. In September 1964, the taxpayer purchases for cash out of the construction reserve fund a new vessel for $1,750,000. To the cost of this vessel must be allocated the 1963 deposits of $1,150,000 and $600,000 of the March 1964 deposit. This leaves in the fund $400,000 of the March 1964 deposit. The amount of the unrecognized gain to be applied against the basis of the new vessel is $550,000, computed as follows: Gain of $400,000 represented in the 1963 deposits, plus the same proportion of the $250,000 gain represented in the March 1964 deposit ($1,000,000) which the amount ($600,000) allocated to the vessel is of the amount of the deposit, i.e., $400,000 plus 600,000/1,000,000 of $250,000 or $150,000, a total of $550,000. This reduces the basis of the new vessel to $1,200,000 ($1,750,000 less $550,000).

(2) In 1965, the taxpayer sells a third vessel for $3,000,000, realizing a gain of $900,000. The $3,000,000 is received and deposited in the construction reserve fund in June 1965, making a total in the fund of $3,400,000. In December 1965, the taxpayer contracts for the construction of a second new vessel to cost a maximum of $3,200,000, thereby obligating that amount of the fund, and in June 1966, receives permission to withdraw the unobligated balance amounting to $200,000. To the cost of the second new vessel must be allocated the $400,000 balance of the March 1964 deposit and $2,800,000 of the June 1965 deposit. The unrecognized gain to be applied against the basis of such new vessel is that proportion of the gain represented in each deposit which the portion of the deposit allocated to the vessel bears to the amount of such deposit, i.e., 400,000/1,000,000 of $250,000, or $100,000 plus 2,800,000/3,000,000 of $900,000, or $840,000 making a total of $940,000. The $200,000 withdrawal is applied against the June 1965 deposit and the portion thereof which represents gain will be recognized as income for 1965, the year in which realized. The computation of the recognized gain is as follows: 200,000/3,000,000 of $900,000, or $60,000.

### § 2.1–19 Requirements as to new vessels.

(a) *Requirements.* For the purposes of section 511 of the Act and the regulations in this part, the new vessel must be—

(1) Documented under the laws of the United States when it is acquired by the taxpayer, or the taxpayer must agree that when acquired it will be documented under the laws of the United States;

(2)(i) Constructed in the United States after December 31, 1939, or (ii) its construction has been financed under Title V or Title VII of the Act, or (iii) its construction has been aided by a mortgage insured under Title XI of the Act; and

(3) Either (i) of such type, size, and speed as the Administration determines to be suitable for use on the high seas or Great Lakes in carrying out the

purposes of the Act, but of not less than 2,000 gross tons or of less speed than 12 knots, except that a particular vessel may be of lesser tonnage or speed if the Administration determines and certifies that the particular vessel is desirable for use by the United States in case of war or national emergency, or (ii) constructed to replace a vessel or vessels requisitioned or purchased by the United States, in which event it must be of such type, size, and speed as to constitute a suitable replacement for the vessel requisitioned or purchased, but if a vessel already built is acquired to replace a vessel or vessels requisitioned or purchased by the United States, such vessel must meet the requirements set forth in subdivision (i) of this subparagraph. Ordinarily, under subdivision (i) of this subparagraph, a vessel constructed more than five years before the date on which deposits in a construction reserve fund are to be expended or obligated for acquisition of such vessel will not be considered suitable for use in carrying out the purpose of the Act, except that the five-year age limitation provided above in this sentence shall not apply to a vessel to be reconstructed before being placed in operation by the taxpayer.

(b) *Time of construction.* A vessel will be deemed to be constructed after December 31, 1939, only if construction was commenced after that date. Subject to the provisions of this section, a new vessel may be newly built for the taxpayer, or may be acquired after it is built.

(c) *Replacement of vessels.* It is not necessary that vessels shall be replaced vessel for vessel. The new vessels may be more or less in number than the replaced vessels, provided the other requirements of this section are met.

**§ 2.1–20 Obligation of deposits.**

(a) *Time for obligation.* Within three years from the date of any deposit in a construction reserve fund, unless extension is granted as provided in § 2.1–22, such deposit must be obligated under a contract for the construction or acquisition of a new vessel or vessels (or in the discretion of the Administration for a share therein), with not less than 12½ percent of the construction or contract price of the entire vessel or vessels actually paid or irrevocably committed on account thereof or must be expended or obligated for the liquidation of existing or subsequently incurred purchase-money indebtedness to persons other than a parent company of, or a company affiliated or associated with, the mortgagor on a new vessel or vessels. Amounts on deposit in a construction reserve fund will be deemed to be obligated for expenditure when a binding contract of construction or acquisition has been entered into or when purchase-money indebtedness has been incurred and, if obligated under a contract of construction or acquisition, will be deemed to be irrevocably committed when due and payable in accordance with the terms of the contract of construction or acquisition.

(b) *Requirements for obligations.* Unless otherwise authorized by the Administration, contracts for the construction of new vessels must be for a fixed price, or provide for a base price that may be adjusted for changes in labor and material costs not exceeding 15 percent of the base price. The fixed or base price, as the case may be, shall be fair and reasonable as determined by the Maritime Administration. Any financial or other interests between the taxpayer and the contractor shall be disclosed to the Administration by the taxpayer. Plans and specifications for the new vessel or vessels must be approved by the Administration to the extent it deems necessary. A deposit in a construction reserve fund may be expended or obligated for expenditure for procurement under an acquisition or construction contract of a part interest in a new vessel or vessels only after obtaining the written consent of the Administration. The granting of such consent shall be entirely in the discretion of the Administration and it may impose such conditions with respect thereto as it may deem necessary or advisable for the purpose of carrying out the provisions of section 511 of the Act. Applications for such consent shall be executed in triplicate, and, together with eight conformed copies thereof, filed with the Administration.

**§ 2.1–21 Period for construction of certain vessels.**

A new vessel constructed otherwise than under the provisions of Title V of the Act, and not purchased from the Administration must, within six months from the date of the construction contract, or within the period of any extension, be completed to the extent of not less than 5 percent as estimated by the Administration and certified by it to the Secretary of the Treasury. In case of a contract covering more than one vessel it will be sufficient if one of the vessels is 5 percent completed within the six months' period from the date of the contract or within the period of any extension, and so certified. All construction must be completed with reasonable dispatch as determined by the Administration. If, for causes within the control of the taxpayer, the entire construction is not completed with reasonable dispatch, the Administration will so certify to the Secretary of the Treasury. For the effect of such certification, see § 2.1–23.

**§ 2.1–22 Time extensions for expenditure or obligation.**

(a) *Extensions.* The Administration, upon application and a showing of proper circumstances, (1) may allow an extension of time within which deposits shall be expended or obligated, not to exceed one year, and upon a second application received before the expiration of the first extension, may allow an additional extension not to exceed one year, and (2) may allow an extension or extensions of time within which five percent of the construction shall have been completed as provided in § 2.1–21 not to exceed one year in the aggregate, and (3) may allow any other extensions that may be provided by amendment to the Act.

(b) *Application required.* A taxpayer seeking an extension of time shall make application therefor, and transmit it with an appropriate statement of the circumstances, including the reasons justifying the requested extension or extensions, and appropriate documents in substantiation of the statement, to the Administration. The Administration will notify the Commissioner of Internal Revenue of any extension granted. In case an application for extension is denied, the taxpayer will be liable for delay as though no application had been made.

**§ 2.1–23 Noncompliance with requirements.**

(a) *Noncompliance.* The amount of the gain which is that portion of the construction reserve fund otherwise constituting taxable income under the law applicable to the taxable year in which such gain was realized shall be included in the taxpayer's gross income for such taxable year for income or excess-profits tax purposes, if—

(1) A portion of such fund is withdrawn for purposes other than—

(i) The construction, reconstruction, reconditioning, or acquisition of a new vessel; or

(ii) The liquidation of existing or subsequently incurred purchase-money indebtedness to persons other than a parent company of, or a company affiliated or associated with, the mortgagor on a new vessel or vessels; or

(2) The taxpayer fails to comply with the requirements of section 511 of the Act or the regulations in this part relating to the utilization of construction reserve funds in the construction, reconstruction, reconditioning, or acquisition of a new vessel, or the liquidation of purchase-money indebtedness on such a vessel.

If securities on deposit in a construction reserve fund are sold and the amount placed in the fund in lieu thereof is less than the value of the securities at the time of their deposit, the difference between such value and the amount placed in the fund in lieu of the securities will be deemed to have been withdrawn. With respect to the substitution of new financing in the case of an irrevocable commitment, see paragraph (d) of § 2.1–13.

(b) *Amount recognized.* In the event of noncompliance with the prescribed conditions relative to any contract for construction, reconstruction, reconditioning, or acquisition of new vessels, or for the liquidation of purchase-money indebtedness on such vessels, recognition will extend to the entire amount of the gain represented in that portion of the construction reserve fund obligated under such contract.

Thus, if the Administration determines and certifies to the Secretary of the Treasury that for causes within the control of the taxpayer construction under a contract is not completed with reasonable dispatch, the entire amount of the gain represented in the portion of the construction reserve fund obligated under the contract will be recognized even though all other conditions have been satisfied. In case of noncompliance with the requirements of section 511 of the Act or the regulations in this part, see the provisions of § 2.1–18 as to the allocation of gain.

(c) *Unreasonable accumulation.* Noncompliance with the provisions of section 511 of the Act or the regulations in this part relative to the utilization of the deposited amounts may also, inasmuch as the provision of section 511(f) of the Act is then inapplicable, warrant an examination to ascertain whether such amounts constitute an unreasonable accumulation of earnings and profits within the meaning of Part I (section 531 and following), Subchapter G, Chapter I of the Internal Revenue Code of 1954, or corresponding provisions of prior law. If amounts are deposited and the fund maintained in good faith for the purpose of construction, reconstruction, reconditioning, and acquisition of new vessels, or for the liquidation of purchase-money indebtedness on such vessels, such amounts will be deemed to have been accumulated for the reasonable needs of the business.

### § 2.1–24 Extent of tax liability.

(a) *Declared value excess-profits tax.* Gain which is includible in gross income under § 2.1–23 shall be included in gross income for all income and excess-profits tax purposes, but not for the purposes of the declared value excess-profits tax and the capital stock tax as provided in section 511(i) of the Act. In lieu of any adjustment with respect to such declared value excess-profits tax, there is imposed for any taxable year ending on or before June 30, 1945, in which the gain is realized an additional tax of 1.1 percent of the amount of the gain. No additional capital stock tax liability is incurred.

(b) *Improper deposits.* In the case of deposits in the construction reserve fund of amounts derived from sources other than those specified in section 511 of the Act, or in the case of failure to deposit an amount equal to the ''net proceeds'' or ''net indemnity'' within the period prescribed in section 511(c) of the Act and § 2.1–15, the taxpayer obtains no suspension or postponement of any tax liability and the tax is collectible without regard to the provisions of section 511(c) of the Act.

(c) *Time for filing claim subsequent to election under section 511(c)(2).* If an election is made under section 511(c)(2) of the Act and paragraph (a)(2) of § 2.1–12, and if computation or recomputation in accordance therewith is otherwise allowable but is prevented, on the date of filing of notice of such election, or within six months thereafter, by any statute of limitation; such computation or recomputation nevertheless shall be made notwithstanding such statute if a claim therefor is filed within six months after the date of making such election. If as the result of such computation or recomputation an overpayment is disclosed a claim for refund should be made in accordance with § 301.6402–3 within such six months' period. For other rules applicable to the filing of claims for credit or refund of an overpayment of tax, see § 301.6402–2 of this chapter (Regulations on Procedure and Administration), relating to claims for credit or refund.

[T.D. 6820, 30 FR 6030, Apr. 29, 1965, as amended by T.D. 7410, 41 FR 11020, Mar. 16, 1976]

### § 2.1–25 Assessment and collection of deficiencies.

Any additional tax, including the 1.1 percent amount imposed by section 511(i) of the Act, due on account of withdrawal from a construction reserve fund, or failure to comply with section 511 of the Act or the regulations in this part, is collectible as a deficiency. Interest upon such deficiency will run from the date the withdrawal or noncompliance occurs. The amount of any deficiency, including interest and additions to the tax, determined as a result of such withdrawal or noncompliance, may be assessed, or a proceeding in court for the collection thereof may be begun without assessment, at any time and without regard to any period of limitations or any other provisions of

law or rule of law, including the doctrine of res judicata.

**§2.1–26 Reports by taxpayers.**

(a) *Information required.* With each income tax return filed for a taxable year during any part of which a construction reserve fund is in existence the taxpayer shall submit a statement setting forth a detailed analysis of such fund. The statement, which need not be on any prescribed form, shall include the following information with respect to the construction reserve fund:

(1) The actual balance in the fund at the beginning and end of the taxable year;

(2) The date, amount, and source of each deposit during the taxable year;

(3) If any deposit referred to in subparagraph (2) of this paragraph consists of proceeds from the sale, or indemnification of loss, of a vessel or share thereof, the amounts of the unrecognized gain;

(4) The date, amount, and purpose of each expenditure or withdrawal from the fund; and

(5) The date and amount of each contract, under which deposited funds are deemed to be obligated during the taxable year, for the construction, reconstruction, reconditioning, or acquisition of new vessels, or for the liquidation of purchase-money indebtedness on such vessels, and the identification of such vessels.

(b) *Records required.* Taxpayers shall keep such records and make such additional reports as the Commissioner of Internal Revenue or the Administration may require.

**§2.1–27 Controlled corporation.**

For the purpose of section 511 of the Act and the regulations in this part a new vessel is considered as constructed, reconstructed, reconditioned, or acquired by the taxpayer if constructed, reconstructed, reconditioned, or acquired by a corporation at a time when the taxpayer owns not less than 95 percent of the total number of shares of each class of stock of the corporation.

**§2.1–28 Administrative jurisdiction.**

Sections 2.1–3 to 2.1–11, inclusive, §§2.1–13 to 2.1–15, inclusive, and §§2.1–19 to 2.1–22, inclusive, deal primarily with matters under the jurisdiction of the Administration. Sections 2.1–12, 2.1–16 to 2.1–18, inclusive, and §§2.1–23 to 2.1–27, inclusive, deal primarily with matters under the jurisdiction of the Commissioner of Internal Revenue. Generally, matters relating to the establishment, maintenance, expenditure, and use of construction reserve funds and the construction, reconstruction, reconditioning, or acquisition of new vessels are under the jurisdiction of the Administration; and matters relating to the determination, assessment, and collection of taxes are under the jurisdiction of the Commissioner of Internal Revenue. Correspondence should be addressed to the particular authority having jurisdiction in the matter.

## PART 3—CAPITAL CONSTRUCTION FUND

Sec.

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AUTHORITY: Sec. 21(a) of the Merchant Marine Act of 1970 (84 Stat. 1026); sec. 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

SOURCE: T.D. 7398, 41 FR 5812, Feb. 10, 1976, unless otherwise noted.

**§3.0 Statutory provisions; section 607, Merchant Marine Act, 1936, as amended.**

SEC. 607 (a) Agreement Rules.

Any citizen of the United States owning or leasing one or more eligible vessels (as defined in subsection (k)(1)) may enter into an agreement with the Secretary of Commerce under, and as provided in, this section to establish a capital construction fund (hereinafter in this section referred to as the ''fund'') with respect to any or all of such

vessels. Any agreement entered into under this section shall be for the purpose of providing replacement vessels, additional vessels, or reconstructed vessels, built in the United States and documented under the laws of the United States for operation in the United States, foreign, Great Lakes, or noncontiguous domestic trade or in the fisheries of the United States and shall provide for the deposit in the fund of the amounts agreed upon as necessary or appropriate to provide for qualified withdrawals under subsection (f). The deposits in the fund, and all withdrawals from the fund, whether qualified or nonqualified, shall be subject to such conditions and requirements as the Secretary of Commerce may by regulations prescribe or are set forth in such agreement; except that the Secretary of Commerce may not require any person to deposit in the fund for any taxable year more than 50 percent of that portion of such person's taxable income for such year (computed in the manner provided in subsection (b)(1)(A)) which is attributable to the operation of the agreement vessels.

(b) Ceiling on Deposits.

(1) The amount deposited under subsection (a) in the fund for any taxable year shall not exceed the sum of:

(A) That portion of the taxable income of the owner or lessee for such year (computed as provided in chapter 1 of the Internal Revenue Code of 1954 but without regard to the carryback of any net operating loss or net capital loss and without regard to this section) which is attributable to the operation of the agreement vessels in the foreign or domestic commerce of the United States or in the fisheries of the United States,

(B) The amount allowable as a deduction under section 167 of the Internal Revenue Code of 1954 for such year with respect to the agreement vessels,

(C) If the transaction is not taken into account for purposes of subparagraph (A), the net proceeds (as defined in joint regulations) from (i) the sale or other disposition of any agreement vessel, or (ii) insurance or indemnity attributable to any agreement vessel, and

(D) The receipts from the investment or reinvestment of amounts held in such fund.

(2) In the case of a lessee, the maximum amount which may be deposited with respect to an agreement vessel by reason of paragraph (1)(B) for any period shall be reduced by any amount which, under an agreement entered into under this section, the owner is required or permitted to deposit for such period with respect to such vessel by reason of paragraph (1)(B).

(3) For purposes of paragraph (1), the term ''agreement vessel'' includes barges and containers which are part of the complement of such vessel and which are provided for in the agreement.

(c) Requirements as to Investments.

Amounts in any fund established under this section shall be kept in the depository or depositories specified in the agreement and shall be subject to such trustee and other fiduciary requirements as may be specified by the Secretary of Commerce. They may be invested only in interest-bearing securities approved by the Secretary of Commerce; except that, if the Secretary of Commerce consents thereto, an agreed percentage (not in excess of 60 percent) of the assets of the fund may be invested in the stock of domestic corporations. Such stock must be currently fully listed and registered on an exchange registered with the Securities and Exchange Commission as a national securities exchange, and must be stock which would be acquired by prudent men of discretion and intelligence in such matters who are seeking a reasonable income and the preservation of their capital. If at any time the fair market value of the stock in the fund is more than the agreed percentage of the assets in the fund, any subsequent investment of amounts deposited in the fund, and any subsequent withdrawal from the fund, shall be made in such a way as to tend to restore the fund to a situation in which the fair market value of the stock does not exceed such agreed percentage. For purposes of this subsection, if the common stock of a corporation meets the requirements of this subsection and if the preferred stock of such corporation would meet such requirements but for the fact that it cannot be listed and registered as required because it is nonvoting stock, such preferred stock shall be treated as meeting the requirements of this subsection.

(d) Nontaxability for Deposits.

(1) For purposes of the Internal Revenue Code of 1954—

(A) Taxable income (determined without regard to this section) for the taxable year shall be reduced by an amount equal to the amount deposited for the taxable year out of amounts referred to in subsection (b)(1)(A),

(B) Gain from a transaction referred to in subsection (b)(1)(C) shall not be taken into account if an amount equal to the net proceeds (as defined in joint regulations) from such transaction is deposited in the fund,

(C) The earnings (including gains and losses) from the investment and reinvestment of amounts held in the fund shall not be taken into account,

(D) The earnings and profits of any corporation (within the meaning of section 316 of such Code) shall be determined without regard to this section, and

(E) In applying the tax imposed by section 531 of such Code (relating to the accumulated earnings tax), amounts while held in the fund shall not be taken into account.

(2) Paragraph (1) shall apply with respect to any amount only if such amount is deposited in the fund pursuant to the agreement

and not later than the time provided in joint regulations.

(e) Establishment of Accounts.

For purposes of this section—

(1) Within the fund established pursuant to this section three accounts shall be maintained:

(A) The capital account,

(B) The capital gain account, and

(C) The ordinary income account.

(2) The capital account shall consist of—

(A) Amounts referred to in subsection (b)(1)(B),

(B) Amounts referred to in subsection (b)(1)(C) other than that portion thereof which represents gain not taken into account by reason of subsection (d)(1)(B),

(C) 85 percent of any dividend received by the fund with respect to which the person maintaining the fund would (but for subsection (d)(1)(C)) be allowed a deduction under section 243 of the Internal Revenue Code of 1954, and

(D) Interest income exempt from taxation under section 103 of such Code.

(3) The capital gain account shall consist of—

(A) Amounts representing capital gains on assets held for more than 6 months and referred to in subsection (b)(1)(C) or (b)(1)(D), reduced by—

(B) Amounts representing capital losses on assets held in the fund for more than 6 months.

(4) The ordinary income account shall consist of—

(A) Amounts referred to in subsection (b)(1)(A),

(B)(i) Amounts representing capital gains on assets held for 6 months or less and referred to in subsection (b)(1)(C) or (b)(1)(D), reduced by—

(ii) Amounts representing capital losses on assets held in the fund for 6 months or less,

(C) Interest (not including any tax-exempt interest referred to in paragraph (2)(D)) and other ordinary income (not including any dividend referred to in subparagraph (E)) received on assets held in the fund,

(D) Ordinary income from a transaction described in subsection (b)(1)(C), and

(E) 15 percent of any dividend referred to in paragraph (2)(C).

(5) Except on termination of a fund, capital losses referred to in paragraph (3)(B) or in paragraph (4)(B)(ii) shall be allowed only as an offset to gains referred to in paragraph (3)(A) or (4)(B)(i), respectively.

(f) Purposes of Qualified Withdrawals.

(1) A qualified withdrawal from the fund is one made in accordance with the terms of the agreement but only if it is for:

(A) The acquisition, construction, or reconstruction of a qualified vessel,

(B) The acquisition, construction, or reconstruction of barges and containers which are part of the complement of a qualified vessel, or

(C) The payment of the principal on indebtedness incurred in connection with the acquisition, construction, or reconstruction of a qualified vessel or a barge or container which is part of the complement of a qualified vessel.

Except to the extent provided in regulations prescribed by the Secretary of Commerce, subparagraph (B), and so much of subparagraph (C) as relates only to barges and containers, shall apply only with respect to barges and containers constructed in the United States.

(2) Under joint regulations, if the Secretary of Commerce determines that any substantial obligation under any agreement is not being fulfilled, he may, after notice and opportunity for hearing to the person maintaining the fund, treat the entire fund or any portion thereof as an amount withdrawn from the fund in a nonqualified withdrawal.

(g) Tax Treatment of Qualified Withdrawals.

(1) Any qualified withdrawal from a fund shall be treated—

(A) First as made out of the capital account,

(B) Second as made out of the capital gain account, and

(C) Third as made out of the ordinary income account.

(2) If any portion of a qualified withdrawal for a vessel, barge, or container is made out of the ordinary income account, the basis of such vessel, barge, or container shall be reduced by an amount equal to such portion.

(3) If any portion of a qualified withdrawal for a vessel, barge, or container is made out of the capital gain account, the basis of such vessel, barge, or container shall be reduced by an amount equal to—

(A) Five-eighths of such portion, in the case of a corporation (other than an electing small business corporation, as defined in section 1371 of the Internal Revenue Code of 1954), or

(B) One-half of such portion, in the case of any other person.

(4) If any portion of a qualified withdrawal to pay the principal on any indebtedness is made out of the ordinary income account or the capital gain account, then an amount equal to the aggregate reduction which would be required by paragraphs (2) and (3) if this were a qualified withdrawal for a purpose described in such paragraphs shall be applied, in the order provided in joint regulations, to reduce the basis of vessels, barges, and containers owned by the person maintaining the fund. Any amount of a withdrawal remaining after the application of the preceding sentence shall be treated as a nonqualified withdrawal.

(5) If any property the basis of which was reduced under paragraph (2), (3), or (4) is disposed of, any gain realized on such disposition, to the extent it does not exceed the aggregate reduction in the basis of such property under such paragraphs, shall be treated as an amount referred to in subsection (h)(3)(A) which was withdrawn on the date of such disposition. Subject to such conditions and requirements as may be provided in joint regulations, the preceding sentence shall not apply to a disposition where there is a redeposit in an amount determined under joint regulations which will, insofar as practicable, restore the fund to the position it was in before the withdrawal.

(h) Tax Treatment of Nonqualified Withdrawals.

(1) Except as provided in subsection (i), any withdrawal from a fund which is not a qualified withdrawal shall be treated as a nonqualified withdrawal.

(2) Any nonqualified withdrawal from a fund shall be treated—

(A) First as made out of the ordinary income account,

(B) Second as made out of the capital gain account, and

(C) Third as made out of the capital account.

For purposes of this section, items withdrawn from any account shall be treated as withdrawn on a first-in-first-out basis; except that (i) any nonqualified withdrawal for research, development, and design expenses incident to new and advanced ship design, machinery and equipment, and (ii) any amount treated as a nonqualified withdrawal under the second sentence of subsection (g)(4), shall be treated as withdrawn on a last-in-first-out basis.

(3) For purposes of the Internal Revenue Code of 1954—

(A) Any amount referred to in paragraph (2)(A) shall be included in income as an item of ordinary income for the taxable year in which the withdrawal is made.

(B) Any amount referred to in paragraph (2)(B) shall be included in income for the taxable year in which the withdrawal is made as an item of gain realized during such year from the disposition of an asset held for more than 6 months, and

(C) For the period on or before the last date prescribed for payment of tax for the taxable year in which this withdrawal is made—

(i) No interest shall be payable under section 6601 of such Code and no addition to the tax shall be payable under section 6651 of such Code,

(ii) Interest on the amount of the additional tax attributable to any item referred to in subparagraph (A) or (B) shall be paid at the applicable rate (as defined in paragraph (4)) from the last date prescribed for payment of the tax for the taxable year for which such item was deposited in the fund, and

(iii) No interest shall be payable on amounts referred to in clauses (i) and (ii) of paragraph (2) or in the case of any nonqualified withdrawal arising from the application of the recapture provision of section 606(5) of the Merchant Marine Act of 1936 as in effect on December 31, 1969.

(4) For purposes of paragraph (3)(C)(ii), the applicable rate of interest for any nonqualified withdrawal—

(A) Made in a taxable year beginning in 1970 or 1971 is 8 percent, or

(B) Made in a taxable year beginning after 1971, shall be determined and published jointly by the Secretary of the Treasury and the Secretary of Commerce and shall bear a relationship to 8 percent which the Secretaries determine under joint regulations to be comparable to the relationship which the money rates and investment yields for the calendar year immediately preceding the beginning of the taxable year bear to the money rates and investment yields for the calendar year 1970.

(i) Certain Corporate Reorganizations and Changes in Partnerships.

Under joint regulations—

(1) A transfer of a fund from one person to another person in a transaction to which section 381 of the Internal Revenue Code of 1954 applies may be treated as if such transaction did not constitute a nonqualified withdrawal, and

(2) A similar rule shall be applied in the case of a continuation of a partnership (within the meaning of subchapter K of such Code).

(j) Treatment of Existing Funds.

(1) Any person who was maintaining a fund or funds (hereinafter in this subsection referred to as ''old fund'') under this section (as in effect before the enactment of this subsection) may elect to continue such old fund but—

(A) May not hold moneys in the old fund beyond the expiration date provided in the agreement under which such old fund is maintained (determined without regard to any extension or renewal entered into after April 14, 1970),

(B) May not simultaneously maintain such old fund and a new fund established under this section, and

(C) If he enters into an agreement under this section to establish a new fund, may agree to the extension of such agreement to some or all of the amounts in the old fund.

(2) In the case of any extension of an agreement pursuant to paragraph (1)(C), each item in the old fund to be transferred shall be transferred in a nontaxable transaction to the appropriate account in the new fund established under this section. For purposes of subsection (h)(3)(C), the date of the deposit of any item so transferred shall be July 1,

1971, or the date of the deposit in the old fund, whichever is the later.

(k) Definitions.

For purposes of this section—

(1) The term ''eligible vessel'' means any vessel—

(A) Constructed in the United States and, if reconstructed, reconstructed in the United States,

(B) Documented under the laws of the United States, and

(C) Operated in the foreign or domestic commerce of the United States or in the fisheries of the United States.

Any vessel which (i) was constructed outside of the United States but documented under the laws of the United States on April 15, 1970, or (ii) constructed outside the United States for use in the United States foreign trade pursuant to a contract entered into before April 15, 1970, shall be treated as satisfying the requirements of subparagraph (A) of this paragraph and the requirements of subparagraph (A) of paragraph (2).

(2) The term ''qualified vessel'' means any vessel—

(A) Constructed in the United States and, if reconstructed, reconstructed in the United States,

(B) Documented under the laws of the United States, and

(C) Which the person maintaining the fund agrees with the Secretary of Commerce will be operated in the United States foreign, Great Lakes, or noncontiguous domestic trade or in the fisheries of the United States.

(3) The term ''agreement vessel'' means any eligible vessel or qualified vessel which is subject to an agreement entered into under this section.

(4) The term ''United States,'' when used in a geographical sense, means the continental United States including Alaska, Hawaii, and Puerto Rico.

(5) The term ''United States foreign trade'' includes (but is not limited to) those areas in domestic trade in which a vessel built with construction-differential subsidy is permitted to operate under the first sentence of section 506 of this Act.

(6) The term ''joint regulations'' means regulations prescribed under subsection (1).

(7) The term ''vessel'' includes cargo handling equipment which the Secretary of Commerce determines is intended for use primarily on the vessel. The term ''vessel'' also includes an ocean-going towing vessel or an ocean-going barge or comparable towing vessel or barge operated on the Great Lakes.

(8) The term ''noncontiguous trade'' means (i) trade between the contiguous forty-eight States on the one hand and Alaska, Hawaii, Puerto Rico, and the insular territories and possessions of the United States on the other hand, and (ii) trade from any point in Alaska, Hawaii, Puerto Rico, and such territories and possessions to any other point in Alaska, Hawaii, Puerto Rico, and such territories and possessions.

(l) Records; Reports; Changes in Regulations.

Each person maintaining a fund under this section shall keep such records and shall make such reports as the Secretary of Commerce or the Secretary of the Treasury shall require. The Secretary of the Treasury and the Secretary of Commerce shall jointly prescribe all rules and regulations, not inconsistent with the foregoing provisions of this section, as may be necessary or appropriate to the determination of tax liability under this section. If, after an agreement has been entered into under this section, a change is made either in the joint regulations or in the regulations prescribed by the Secretary of Commerce under this section which could have a substantial effect on the rights or obligations of any person maintaining a fund under this section, such person may terminate such agreement.

## §3.1 Scope of section 607 of the Act and the regulations in this part.

(a) *In general.* The regulations prescribed in this part provide rules for determining the income tax liability of any person a party to an agreement with the Secretary of Commerce establishing a capital construction fund (for purposes of this part referred to as the ''fund'') authorized by section 607 of the Merchant Marine Act, 1936, as amended (for purposes of this part referred to as the ''Act''). With respect to such parties, section 607 of the Act in general provides for the nontaxability of certain deposits of money or other property into the fund out of earnings or gains realized from the operation of vessels covered in an agreement, gains realized from the sale or other disposition of agreement vessels or proceeds from insurance for indemnification for loss of agreement vessels, earnings from the investment or reinvestment of amounts held in a fund, and gains with respect to amounts or deposits in the fund. Transitional rules are also provided for the treatment of ''old funds'' existing on or before the effective date of the Merchant Marine Act of 1970 (see §3.10).

(b) *Cross references.* For rules relating to eligibility for a fund, deposits, and withdrawals and other aspects, see the regulations prescribed by the Secretary of Commerce in titles 46 (Merchant Marine) and 50 (Fisheries) of the *Code of Federal Regulations.*

(c) *Code.* For purposes of this part, the term ''Code'' means the Internal Revenue Code of 1954, as amended.

**§ 3.2 Ceiling on deposits.**

(a) *In general*—(1) *Total ceiling.* Section 607(b) of the Act provides a ceiling on the amount which may be deposited by a party for a taxable year pursuant to an agreement. The amount which a party may deposit into a fund may not exceed the sum of the following subceilings:

(i) The lower of *(a)* the taxable income (if any) of the party for such year (computed as provided in Chapter I of the Code but without regard to the carryback of any net operating loss or net capital loss and without regard to section 607 of the Act) or *(b)* taxable income (if any) of such party for such year attributable under paragraph (b) of this section to the operation of agreement vessels (as defined in paragraph (f) of this section) in the foreign or domestic commerce of the United States or in the fisheries of the United States (see section 607(b)(1)(A) of the Act).

(ii) Amounts allowable as a deduction under section 167 of the Code for such year with respect to the agreement vessels (see section 607(b)(1)(B) of the Act),

(iii) The net proceeds (if not included in subdivision (i) of this paragraph) from *(a)* the sale or other disposition of any agreement vessels or *(b)* insurance or indemnity attributable to any agreement vessels (see section 607(b)(1)(C) of the Act and paragraph (c) of this section), and

(iv) Earnings and gains from the investment or reinvestment of amounts held in such fund (see section 607(b)(1)(D) of the Act and paragraphs (d) and (g) of this section).

(2) *Overdeposits.* (i) If for any taxable year an amount is deposited into the fund under a subceiling computed under subparagraph (1) of this paragraph which is in excess of the amount of such subceiling for such year, then at the party's option such excess (or any portion thereof) may—

*(a)* Be treated as a deposit into the fund for that taxable year under another available subceiling, or

*(b)* Be treated as not having been deposited for the taxable year and thus, at the party's option, may be disposed of either by it being—

*(1)* Treated as a deposit into the fund under any subceiling available in the first subsequent taxable year in which a subceiling is available, in which case such amount shall be deemed to have been deposited on the first day of such subsequent taxable year, or

*(2)* Repaid to the party from the fund.

(ii)*(a)* When a correction is made for an overdeposit, proper adjustment shall be made with respect to all items for all taxable years affected by the overdeposit, such as, for example, amounts in each account described in § 3.4, treatment of nonqualified withdrawals, the consequences of qualified withdrawals and the treatment of losses realized or treated as realized by the fund. Thus, for example, if the party chooses to have the fund repay to him the amount of an overdeposit, amounts in each account, basis of assets, and any affected item will be determined as though no deposit and repayment had been made. Accordingly, in such a case, if there are insufficient amounts in an account to cover a repayment of an overdeposit (as determined before correcting the overdeposit), and the party had applied the proceeds of a qualified withdrawal from such account towards the purchase of a qualified vessel (within the meaning of § 3.11(a)(2)), then such account and the basis of the vessel shall be adjusted as of the time such withdrawal was made and proceeds were applied, and repayment shall be made from such account as adjusted. If a party chooses to treat the amount of an overdeposit as a deposit under a subceiling for a subsequent year, similar adjustments to affected items shall be made. If the amount of a withdrawal would have exceeded the amount in the fund (determined after adjusting all affected amounts by reason of correcting the overdeposit), the withdrawal to the extent of such excess shall be treated as a repayment made at the time the withdrawal was made.

*(b)* If the accounts (as defined in § 3.4) that were increased by reason of excessive deposits contain sufficient amounts at the time the overdeposit is

discovered to repay the party, the party may, at his option, demand repayment of such excessive deposits from such accounts in lieu of making the adjustments required by *(a)* of this subdivision (ii).

(iii) During the period beginning with the day after the date an overdeposit was actually made and ending with the date it was disposed of in accordance with subdivision (i)*(b)* of this subparagraph, there shall be included in the party's gross income for each taxable year the earnings attributed to any amount of overdeposit on hand during such a year. The earnings attributable to any amount of overdeposit on hand during a taxable year shall be an amount equal to the product of—

*(a)* The average daily earnings for each one dollar in the fund (as determined in subdivision (iv) of this subparagraph),

*(b)* The amount of overdeposit (as determined in subdivision (vi) of this subparagraph), and

*(c)* The number of days during the taxable year the overdeposit existed.

(iv) For purposes of subdivision (iii) *(a)* of this subparagraph, the average daily earnings for each dollar in the fund shall be determined by dividing the total earnings of the fund for the taxable year by the sum of the products of—

*(a)* Any amount on hand during the taxable year (determined under subdivision (v) of this subparagraph), and

*(b)* The number of days during the taxable year such amount was on hand in the fund.

(v) For purposes of this subparagraph—

*(a)* An amount on hand in the fund or an overdeposit shall not be treated as on hand on the day deposited but shall be treated as on hand on the day withdrawn, and

*(b)* The fair market value of such amounts on hand for purposes of this subparagraph shall be determined as provided in § 20.2031–2 of the Estate Tax Regulations of this chapter but without applying the blockage and other special rules contained in paragraph (e) thereof.

(vi) For purposes of subdivision (iii) *(b)* of this subparagraph, the amount of overdeposit on hand at any time is an amount equal to—

*(a)* The amount deposited into the fund under a subceiling computed under subparagraph (1) of this paragraph which is in excess of the amount of such subceiling, less

*(b)* The sum of—

*(1)* Amounts described in *(a)* of this subdivision (vi) treated as a deposit under another subceiling for the taxable year pursuant to subdivision (i) of this subparagraph,

*(2)* Amounts described in *(a)* of this subdivision (vi) disposed of (or treated as disposed of) in accordance with subdivision (i) or (ii) of this subparagraph prior to such time.

(vii) To the extent earnings attributed under subdivision (iii) of this subparagraph represent a deposit for any taxable year in excess of the subceiling described in subparagraph (1)(iv) of this paragraph for receipts from the investment or reinvestment of amounts held in the fund, such attributed earnings shall be subject to the rules of this subparagraph for overdeposits.

(3) *Underdeposit caused by audit adjustment.* [Reserved]

(4) *Requirements for deficiency deposits.* [Reserved]

(b) *Taxable income attributable to the operation of an agreement vessel*—(1) *In general.* For purposes of this section, taxable income attributable to the operation of an agreement vessel means the amount, if any, by which the gross income of a party for the taxable year from the operation of an agreement vessel (as defined in paragraph (f) of this section) exceeds the allowable deductions allocable to such operation (as determined under subparagraph (3) of this paragraph). The term ''taxable income attributable to the operation of the agreement vessels'' means the sum of the amounts described in the preceding sentence separately computed with respect to each agreement vessel (or share therein) or, at the party's option, computed in the aggregate.

(2) *Gross income.* (i) Gross income from the operation of agreement vessels means the sum of the revenues which are derived during the taxable year from the following:

*(a)* Revenues derived from the transportation of passengers, freight, or

mail in such vessels, including amounts from contracts for the charter of such vessels to others, from operating differential subsidies, from collections in accordance with pooling agreements and from insurance or indemnity net proceeds relating to the loss of income attributable to such agreement vessels.

*(b)* Revenues derived from the operation of agreement vessels relating to commercial fishing activities, including the transportation of fish, support activities for fishing vessels, charters for commercial fishing, and insurance or indemnity net proceeds relating to the loss of income attributable to such agreement vessels.

*(c)* Revenues from the rental, lease, or use by others of terminal facilities, revenues from cargo handling operations and tug and lighter operations, and revenues from other services or operations which are incidental and directly related to the operation of an agreement vessel. Thus, for example, agency fees, commissions, and brokerage fees derived by the party at his place of business for effecting transactions for services incidental and directly related to shipping for the accounts of other persons are includible in gross income from the operation of agreement vessels where the transaction is of a kind customarily consummated by the party for his own account at such place of business.

*(d)* Dividends, interest, and gains derived from assets set aside and reasonably retained to meet regularly occurring obligations relating to the shipping or fishing business directly connected with the agreement vessel which obligations cannot at all times be met from the current revenues of the business because of layups or repairs, special surveys, fluctuations in the business, and reasonably foreseeable strikes (whether or not a strike actually occurs), and security amounts retained by reason of participation in conferences, pooling agreements, or similar agreements.

(ii) The items of gross income described in subdivision (i) *(c)* and *(d)* of this subparagraph shall be considered to be derived from the operations of a particular agreement vessel in the same proportion that the sum of the items of gross income described in subdivision (i) *(a)* and *(b)* of this subparagraph which are derived from the operations of such agreement vessel bears to the party's total gross income for the taxable year from operations described in subdivision (i) *(a)* and *(b)* of this subparagraph.

(iii) In the case of a party who uses his own or leased agreement vessels to transport his own products, the gross income attributable to such vessel operations is an amount determined to be an arm's length charge for such transportation. The arm's length charge shall be determined by applying the principles of section 482 of the Code and the regulations thereunder as if the party transporting the product and the owner of the product were not the same person but were controlled taxpayers within the meaning of § 1.482–1(a)(4) of the Income Tax Regulations of this chapter. Gross income attributable to the operation of agreement vessels does not include amounts for which the party is allowed a deduction for percentage depletion under sections 611 and 613 of the Code.

(3) *Deductions.* From the gross income attributable to the operation of an agreement vessel or vessels as determined under subparagraph (2) of this paragraph, there shall be deducted, in accordance with the principles of § 1.861–8 of the Income Tax Regulations of this chapter, the expenses, losses, and other deductions definitely related and therefore allocated and apportioned thereto and a ratable part of any expenses, losses, or other deductions which are not definitely related to any gross income of the party. Thus, for example, if a party has gross income attributable to the operation of an agreement vessel and other gross income and has a particular deduction definitely related to both types of gross income, such deduction must be apportioned between the two types of gross income on a reasonable basis in determining the taxable income attributable to the operation of the agreement vessel.

(4) *Net operating and capital loss deductions.* The taxable income of a party attributable to the operation of agreement vessels shall be computed without regard to the carryback of any net

operating loss deduction allowed by section 172 of the Code, the carryback of any net capital loss deduction allowed by sections 165(f) of the Code, or any reduction in taxable income allowed by section 607 of the Act.

(5) *Method of accounting.* Taxable income must be computed under the method of accounting which the party uses for Federal income tax purposes. Such method may include a method of reporting whereby items of revenue and expense properly allocable to voyages in progress at the end of any accounting period are eliminated from the computation of taxable income for such accounting period and taken into account in the accounting period in which the voyage is completed.

(c) *Net proceeds from transactions with respect to agreement vessels.* [Reserved]

(d) *Earnings and gains from the investment or reinvestment of amounts held in a fund*—(1) *In general.* (i) Earnings and gains received or accrued by a party from the investment or reinvestment of assets in a fund is the total amount of any interest or dividends received or accrued, and gains realized, by the party with respect to assets deposited in, or purchased with amounts deposited in, such fund. Such earnings and gains are therefore required to be included in the gross income of the party unless such amount, or a portion thereof, is not taken into account under section 607(d)(1)(C) of the Act and § 3.3(b)(2)(ii) by reason of a deposit or deemed deposit into the fund. For rules relating to receipts from the sale or other disposition of nonmoney deposits into the fund, see paragraph (g) of this section.

(ii) Earnings received or accrued by a party from investment or reinvestment of assets in a fund include the ratable monthly portion of original issue discount included in gross income pursuant to section 1232(a)(3) of the Code. Such ratable monthly portion shall be deemed to be deposited into the ordinary income account of the fund, but an actual deposit representing such ratable monthly portion shall not be made. For basis of a bond or other evidence of indebtedness issued at a discount, see § 3.3(b)(2)(ii)*(b)*.

(2) *Gain realized.* (i) The gain realized with respect to assets in the fund is the excess of the amount realized (as defined in section 1001(b) of the Code and the regulations thereunder) by the fund on the sale or other disposition of a fund asset over its adjusted basis (as defined in section 1011 of the Code) to the fund. For the adjusted basis of nonmoney deposits, see paragraph (g) of this section.

(ii) Property purchased by the fund (including property considered under paragraph (g)(1)(iii) of this section as purchased by the fund) which is withdrawn from the fund in a qualified withdrawal (as defined in § 3.5) is treated as a disposition to which subdivision (i) of this subparagraph applies. For purposes of determining the amount by which the balance within a particular account will be reduced in the manner provided in § 3.6(b) (relating to order of application of qualified withdrawals against accounts) and for purposes of determining the reduction in basis of a vessel, barge, or container (or share therein) pursuant to § 3.6(c), the value of the property is its fair market value on the day of the qualified withdrawal.

(3) *Holding period.* Except as provided in paragraph (g) of this section, the holding period of fund assets shall be determined under section 1223 of the Code.

(e) *Leased vessels.* In the case of a party who is a lessee of an agreement vessel, the maximum amount which such lessee may deposit with respect to any agreement vessel by reason of section 607(b)(1)(B) of the Act and paragraph (a)(1)(ii) of this section (relating to depreciation allowable) for any period shall be reduced by the amount (if any) which, under an agreement entered into under section 607 of the Act, the owner is required or permitted to deposit for such period with respect to such vessel by reason of section 607(b)(1)(B) of the Act and paragraph (a)(1)(ii) of this section. The amount of depreciation depositable by the lessee under this paragraph is the amount of depreciation deductible by the lessor on its income tax return, reduced by the amount described in the preceding sentence or the amount set forth in the agreement, whichever is lower.

(f) *Definition of agreement vessel.* For purposes of this section, the term ''agreement vessel'' (as defined in

§ 3.11(a)(3) and 46 CFR 390.6) includes barges and containers which are the complement of an agreement vessel and which are provided for in the agreement, agreement vessels which have been contracted for or are in the process of construction, and any shares in an agreement vessel. Solely for purposes of this section, a party is considered to have a ''share'' in an agreement vessel if he has a right to use the vessel to generate income from its use whether or not the party would be considered as having a proprietary interest in the vessel for purposes of State or Federal law. Thus, a partner may enter into an agreement with respect to his share of the vessel owned by the partnership and he may make deposits of his distributive share of the sum of the four subceilings described in paragraph (a)(1) of this section. Notwithstanding the provisions of subchapter K of the Code (relating to the taxation of partners and partnerships), the Internal Revenue Service will recognize, solely for the purposes of applying this part, an agreement by an owner of a share in an agreement vessel even though the ''share'' arrangement is a partnership for purposes of the Code.

(g) *Special rules for nonmoney deposits and withdrawals*—(1) *In general.* (i) Deposits may be made in the form of money or property of the type permitted to be deposited under the agreement. (For rules relating to the types of property which may be deposited into the fund, see 46 CFR § 390.7(d), and 50 CFR part 259.) For purposes of this paragraph, the term ''property'' does not include money.

(ii) Whether or not the election provided for in subparagraph (2) of this paragraph is made—

*(a)* The amount of any property deposit, and the fund's basis for property deposited in the fund, is the fair market value of the property at the time deposited, and

*(b)* The fund's holding period for the property begins on the day after the deposit is made.

(iii) Unless such an election is made, deposits of property into a fund are considered to be a sale at fair market value of the property, a deposit of cash equal to such fair market value, and a purchase by the fund of such property for cash. Thus, in the absence of the election, the difference between the fair market value of such property deposited and its adjusted basis shall be taken into account as gain or loss for purposes of computing the party's income tax liability for the year of deposit.

(iv) For fund's basis and holding period of assets purchased by the fund, see paragraph (d) (2) and (3) of this section.

(2) *Election not to treat deposits of property other than money as a sale or exchange at the time of deposit.* A party may elect to treat a deposit of property as if no sale or other taxable event had occurred on the date of deposit. If such election is made, in the taxable year the fund disposes of the property, the party shall recognize as gain or loss the amount he would have recognized on the day the property was deposited into the fund had the election not been made. The party's holding period with respect to such property shall not include the period of time such property was held by the fund. The election shall be made by a statement to that effect, attached to the party's Federal income tax return for the taxable year to which the deposit relates, or, if such return is filed before such deposit is made, attached to the party's return for the taxable year during which the deposit is actually made.

(3) *Effect of qualified withdrawal of property deposited pursuant to election.* If property deposited into a fund, with respect to which an election under subparagraph (2) of this paragraph is made, is withdrawn from the fund in a qualified withdrawal (as defined in § 3.5) such withdrawal is treated as a disposition of such property resulting in recognition by the party of gain or loss (if any) as provided in subparagraph (2) of this paragraph with respect to nonfund property. In addition, such withdrawal is treated as a disposition of such property by the fund resulting in recognition of gain or loss by the party with respect to fund property to the extent the fair market value of the property on the date of withdrawal is greater or less (as the case may be) than the adjusted basis of the property to the fund on such date. For purposes of determining the amount by which

the balance within a particular account will be reduced in the manner provided in § 3.6(b) (relating to order of application of qualified withdrawals against accounts) and for purposes of determining the reduction in basis of a vessel, barge, or container (or share therein) pursuant to § 3.6(c), the value of the property is its fair market value on the day of the qualified withdrawal. For rules relating to the effect of a qualified withdrawal of property purchased by the fund (including deposited property considered under subparagraph (1)(iii) of this paragraph as purchased by the fund), see paragraph (d)(2)(ii) of this section.

(4) *Effect of nonqualified withdrawal of property deposited pursuant to election.* If property deposited into a fund with respect to which an election under subparagraph (2) of this paragraph is made, is withdrawn from the fund in a nonqualified withdrawal (as defined in § 3.7(b)), no gain or loss is to be recognized by the party with respect to fund property or nonfund property but an amount equal to the adjusted basis of the property to the fund is to be treated as a nonqualified withdrawal. Thus, such amount is to be applied against the various accounts in the manner provided in § 3.7(c), such amount is to be taken into account in computing the party's taxable income as provided in § 3.7(d), and such amount is to be subject to interest to the extent provided for in § 3.7(e). In the case of withdrawals to which this subparagraph applies, the adjusted basis of the property in the hands of the party is the adjusted basis on the date of deposit, increased or decreased by the adjustments made to such property while held in the fund, and in determining the period for which the party has held the property there shall be included, in addition to the period the fund held the property, the period for which the party held the property before the date of deposit of the property into the fund. For rules relating to the basis and holding period of property purchased by the fund (including deposited property considered under subparagraph (1)(ii) of this paragraph as purchased by the fund) and withdrawn in a nonqualified withdrawal see § 3.7(f).

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

*Example (1).* X Corporation, which uses the calendar year as its taxable year, maintains a fund described in § 3.1. X's taxable income (determined without regard to section 607 of the Act) is $100,000, of which $80,000 is taxable income attributable to the operation of agreement vessels (as determined under paragraph (b)(1) of this section). Under the agreement, X is required to deposit into the fund all earnings and gains received from the investment or reinvestment of amounts held in the fund, an amount equal to the net proceeds from transactions referred to in § 3.2(c), and an amount equal to 50 percent of its earnings attributable to the operation of agreement vessels provided that such 50 percent does not exceed X's taxable income from all sources for the year of deposit. The agreement permits X to make voluntary deposits of amounts equal to 100 percent of its earnings attributable to the operation of agreement vessels, subject to the limitation with respect to taxable income from all sources. The agreement also provides that deposits attributable to such earnings may be in the form of cash or other property. On March 15, 1973, X deposits, with respect to its 1972 earnings attributable to the operation of agreement vessels, stock with a fair market value at the time of deposit of $80,000 and an adjusted basis to X of $10,000. Such deposit represents agreement vessel income of $80,000. At the time of deposit, such stock had been held by X for a period exceeding 6 months. X does not elect under subparagraph (2) of this paragraph to defer recognition of the gain. Accordingly, under subparagraph (1)(iii) of this paragraph, the deposit is treated as a deposit of $80,000 and X realizes a long-term capital gain of $70,000 on March 15, 1973.

*Example (2).* The facts are the same as in example (1), except that X elects in accordance with subparagraph (2) of this paragraph not to treat the deposit as a sale or exchange. On July 1, 1974, the fund sells the stock for $85,000. The basis to the fund of the stock is $80,000 (see subparagraph (1)(ii) *(a)* of this paragraph). With respect to nonfund property, X recognizes $70,000 of long-term capital gain on the sale includible in its gross income for 1974. With respect to fund property, X realizes $5,000 of long-term capital gain (the difference between the amount received by the fund on the sale of the stock, $85,000, and the basis to the fund of the stock, $80,000), an amount equal to which is required to be deposited into the fund with respect to 1974, as a gain from the investment or reinvestment of amounts held in the

fund. Since the fund held the stock for a period exceeding 6 months, the $5,000 is allocated to the fund's capital gain account under § 3.4(c).

*Example (3).* The facts are the same as in example (2), except that the fund sells the stock on July 1, 1974, for $75,000. As the basis to the fund of the stock is $80,000, with respect to fund property, X realizes a long-term capital loss on the sale (the difference between the amount received by the fund on the sale of the stock, $75,000, and the basis to the fund of the stock, $80,000), of $5,000, an amount equal to which is required to be charged against the fund's capital gain account under § 3.4(e). Under subparagraph (2) of this paragraph, X recognizes $70,000 of long-term capital gain with respect to nonfund property on the sale which is includible in its gross income for 1974.

*Example (4).* The facts are the same as in example (2), except that on July 1, 1974, X makes a qualified withdrawal (as defined in § 3.5(a)) of the stock and uses it to pay indebtedness pursuant to § 3.5(b). On the disposition by X considered to occur under subparagraph (3) of this paragraph on the qualified withdrawal, X recognizes $70,000 of long-term capital gain with respect to nonfund property, which is includible in its gross income for 1974, and a long-term capital gain of $5,000 with respect to fund property, an amount equal to which is allocated to the fund's capital gain account under § 3.4(c). The fund is treated as having a qualified withdrawal of an amount equal to the fair market value of the stock on the day of withdrawal, $85,000 (see subparagraph (3) of this paragraph). In addition, $85,000 is applied against the various accounts in the order provided in § 3.6(b). The basis of the vessel with respect to which the indebtedness was incurred is to be reduced as provided in § 3.6(c).

*Example (5).* The facts are the same as in example (2), except that X withdraws the stock from the fund in a nonqualified withdrawal (as defined in § 3.7(b)). Under subparagraph (4) of this paragraph, X recognizes no gain or loss with respect to fund or nonfund property on such withdrawal. An amount equal to the basis of the stock to the fund ($80,000) is applied against the various accounts in the order provided in § 3.7(c), and is taken into account in computing X's taxable income for 1974 as provided in § 3.7(d). In addition, X must pay interest on the withdrawal as provided in § 3.7(e). The basis to X of the stock is $10,000 notwithstanding the fact that the fair market value of such stock was $85,000 on the day of withdrawal (see subparagraph (4) of this paragraph).

### § 3.3 Nontaxability of deposits.

(a) *In general.* Section 607(d) of the Act sets forth the rules concerning the income tax effects of deposits made with respect to ceilings described in section 607(b) and § 3.2. The specific treatment of deposits with respect to each of the subceilings is set forth in paragraph (b) of this section.

(b) *Treatment of deposits*—(1) *Earnings of agreement vessels.* Section 607(d)(1)(A) of the Act provides that taxable income of the party (determined without regard to section 607 of the Act) shall be reduced by an amount equal to the amount deposited for the taxable year out of amounts referred to in section 607(b)(1)(A) of the Act and § 3.2(a)(1)(i). For computation of the foreign tax credit, see paragraph (i) of this section.

(2) *Net proceeds from agreement vessels and fund earnings.* (i)(*a*) Section 607(d)(1)(B) provides that gain from a transaction referred to in section 607(b)(1)(C) of the Act and § 3.2(a)(1)(iii) (relating to ceilings on deposits of net proceeds from the sale or other disposition of agreement vessels) is not to be taken into account for purposes of the Code if an amount equal to the net proceeds from transactions referred to in such sections is deposited in the fund. Such gain is to be excluded from gross income of the party for the taxable year to which such deposit relates. Thus, the gain will not be taken into account in applying section 1231 of the Code for the year to which the deposit relates.

*(b)* [Reserved]

(ii)*(a)* Section 607(d)(1)(C) of the Act provides that the earnings (including gains and losses) from the investment and reinvestment of amounts held in the fund and referred to in section 607(b)(1)(D) of the Act and § 3.2(a)(1)(iv) shall not be taken into account for purposes of the Code if an amount equal to such earnings is deposited into the fund. Such earnings are to be excluded from the gross income of the party for the taxable year to which such deposit relates.

*(b)* However, for purposes of the basis adjustment under section 1232(a)(3)(E) of the Code, the ratable monthly portion of original issue discount included in gross income shall be determined without regard to section 607(d)(1)(C) of the Act.

(iii) In determining the tax liability of a party to whom subparagraph (1) of

this paragraph applies, taxable income, determined after application of subparagraph (1) of this paragraph, is in effect reduced by the portion of deposits which represent gain or earnings respectively referred to in subdivision (i) or (ii) of this subparagraph. The excess, if any, of such portion over taxable income determined after application of subparagraph (1) of this paragraph is taken into account in computing the net operating loss (under section 172 of the Code) for the taxable year to which such deposits relate.

(3) *Time for making deposits.* (i) This section applies with respect to an amount only if such amount is deposited in the fund pursuant to the agreement and not later than the time provided in subdivision (ii), (iii), or (iv) of this subparagraph for the making of such deposit or the date the Secretary of Commerce provides, whichever is earlier.

(ii) Except as provided in subdivision (iii) or (iv) of this subparagraph, a deposit may be made not later than the last day prescribed by law (including extensions thereof) for filing the party's Federal income tax return for the taxable year to which such deposit relates.

(iii) If the party is a subsidized operator under an operating-differential subsidy contract, and does not receive on or before the 59th day preceding such last day, payment of all or part of the accrued operating-differential subsidy payable for the taxable year, the party may deposit an amount equivalent to the unpaid accrued operating-differential subsidy on or before the 60th day after receipt of payment of the accrued operating-differential subsidy.

(iv) A deposit pursuant to § 3.2(a)(3)(i) (relating to underdeposits caused by audit adjustments) must be made on or before the date prescribed for such a deposit in § 3.2(a)(4).

(4) *Date of deposits.* (i) Except as otherwise provided in subdivisions (ii) and (iii) of this subparagraph (with respect to taxable years beginning after December 31, 1969, and prior to January 1, 1972), in § 3.2(a)(2)(i), or in § 3.10(b), deposits made in a fund within the time specified in subparagraph (3) of this paragraph are deemed to have been made on the date of actual deposit.

(ii)*(a)* For taxable years beginning after December 31, 1969, and prior to January 1, 1971, where an application for a fund is filed by a taxpayer prior to January 1, 1972, and an agreement is executed and entered into by the taxpayer prior to March l, 1972,

*(b)* For taxable years beginning after December 31, 1970, and prior to January 1, 1972, where an application for a fund is filed by a taxpayer prior to January 1, 1973, and an agreement is executed and entered into by the taxpayer prior to March l, 1973, and

*(c)* For taxable years beginning after December 31, 1971, and prior to January 1, 1975, where an agreement is executed and entered into by the taxpayer on or prior to the due date, with extensions, for the filing of his Federal income tax return for such taxable year,

deposits in a fund which are made within 60 days after the date of execution of the agreement, or on or before the due date, with extensions thereof, for the filing of his Federal income tax return for such taxable year or years, whichever date shall be later, shall be deemed to have been made on the date of the actual deposit or as of the close of business of the last regular business day of each such taxable year or years to which such deposits relate, whichever day is earlier.

(iii) Notwithstanding subdivision (ii) of this subparagraph, for taxable years beginning after December 31, 1970, and ending prior to January 1, 1972, deposits made later than the last date permitted under subdivision (ii) but on or before January 9, 1973, in a fund pursuant to an agreement with the Secretary of Commerce, acting by and through the Administrator of the National Oceanic and Atmospheric Administration, shall be deemed to have been made on the date of the actual deposit or as of the close of business of the last regular business day of such taxable year, whichever is earlier.

(c) *Determination of earnings and profits.* [Reserved]

(d) *Accumulated earnings tax.* As provided in section 607(d)(1)(E) of the Act amounts, while held in the fund, are

not to be taken into account in computing the ''accumulated taxable income'' of the party within the meaning of section 531 of the Code. Amounts while held in the fund are considered held for the purpose of acquiring, constructing, or reconstructing a qualified vessel or barges and containers which are part of the complement of a qualified vessel or the payment of the principal on indebtedness incurred in connection with any such acquisition, construction, or reconstruction. Thus, for example, if the reasonable needs of the business (within the meaning of section 537 of the Code) justify a greater amount of accumulation for providing replacement vessels than can be satisfied out of the fund, such greater amount accumulated outside of the fund shall be considered to be accumulated for the reasonable needs of the business. For a further example, although amounts in the fund are not taken into account in applying the tax imposed by section 531 of the Code, to the extent there are amounts in a fund to provide for replacing a vessel, amounts accumulated outside of the fund to replace the same vessel are not considered to be accumulated for the reasonable needs of the business.

(e) *Nonapplicability of section 1231.* If an amount equivalent to gain from a transaction referred to in section 607(b)(1)(C) of the Act and § 3.2(c) (1) and (5) is deposited into the fund and, therefore, such gain is not taken into account in computing gross income under the provisions of paragraph (b)(2) of this section, then such gain will not be taken into account for purposes of the computations under section 1231 of the Code.

(f) *Deposits of capital gains.* In respect of capital gains which are not included in the gross income of the party by virtue of a deposit to which section 607(d) of the Act and this section apply, the following provisions of the Code do not apply: the minimum tax for tax preferences imposed by section 56 of the Code; the alternative tax imposed by section 1201 of the Code on the excess of the party's net long-term capital gain over his net short-term capital loss; and, in the case of a taxpayer other than a corporation, the deduction provided by section 1202 of the Code of 50% of the amount of such excess. However, section 56 may apply upon a nonqualified withdrawal with respect to amounts treated under § 3.7(d)(2) as being made out of the capital gain account.

(g) *Deposits of dividends.* The deductions provided by section 243 of the Code (relating to the deductions for dividends from a domestic corporation received by a corporation) shall not apply in respect of dividends (earned on assets held in the fund) which are deposited into a fund, and which, by virtue of such deposits and the provisions of section 607(d) of the Act and this section, are not included in the gross income of the party.

(h) *Presumption of validity of deposit.* All amounts deposited in the fund shall be presumed to have been deposited pursuant to an agreement unless, after an examination of the facts upon the request of the Commissioner of Internal Revenue or his delegate, the Secretary of Commerce determines otherwise. The Commissioner or his delegate will request such a determination where there is a substantial question as to whether a deposit is made in accordance with an agreement.

(i) *Special rules for application of the foreign tax credit*—(1) *In general.* For purposes of computing the limitation under section 904 of the Code on the amount of the credit provided by section 901 of the Code (relating to the foreign tax credit), the party's taxable income from any source without the United States and the party's entire taxable income are to be determined after application of section 607(d) of the Act. Thus, amounts deposited for the taxable year with respect to amounts referred to in section 607(b)(1)(A) of the Act and § 3.2(a)(1)(i) (relating to taxable income attributable to the operation of agreement vessels) shall be treated as a deduction in arriving at the party's taxable income from sources without the United States (subject to the apportionment rules and subparagraph (2) of this paragraph) and the party's entire taxable income for the taxable year. Amounts deposited with respect to gain described in section 607(d)(1)(B) of the Act and § 3.2(c) (relating to net proceeds from the sale or other disposition of an

agreement vessel and net proceeds from insurance or indemnity) and amounts deposited with respect to earnings described in section 607(d)(1)(C) of the Act and paragraph (b)(2)(ii) (relating to earnings from the investment and reinvestment of amounts held in a fund) of this section are not taken into account for purposes of the Code and hence are not included in the party's taxable income from sources without the United States or in the party's entire taxable income for purposes of this paragraph.

(2) *Apportionment of taxable income attributable to agreement vessels.* For purposes of computing the overall limitation under section 904(a)(2) of the Code the amount of the deposit made with respect to taxable income attributable to agreement vessels pursuant to § 3.2(a)(1)(i) which is allocable to sources without the United States is the total amount of such deposit multiplied by a fraction the numerator of which is the gross income from sources without the United States from the operation of agreement vessels and the denominator of which is the total gross income from the operation of agreement vessels computed as provided in § 3.2(b)(2). For purposes of this paragraph, gross income from sources without the United States attributable to the operation of agreement vessels is to be determined under sections 861 through 863 of the Code and under the taxpayer's usual method of accounting provided such method is reasonable and in keeping with sound accounting practice. Any computation under the per-country limitation of section 904(a)(1) shall be made in the manner consistent with the provisions of the preceding sentences of this subparagraph.

### § 3.4 Establishment of accounts.

(a) *In general.* Section 607(e)(1) of the Act requires that three bookkeeping or memorandum accounts are to be established and maintained within the fund: the capital account, the capital gain account, and the ordinary income account. Deposits of the amounts under the subceilings in section 607(b) of the Act and § 3.2 are allocated among the accounts under section 607(e) of the Act and this section.

(b) *Capital account.* The capital account shall consist of:

(1) Amounts referred to in section 607(b)(1)(B) of the Act and § 3.2(a)(1)(ii) (relating to deposits for depreciation),

(2) Amounts referred to in section 607(b)(1)(C) of the Act and § 3.2(a)(1)(iii) (relating to deposits of net proceeds from the sale or other disposition of agreement vessels) other than that portion thereof which represents gain not taken into account for purposes of computing gross income by reason of section 607(d)(1)(B) of the Act and § 3.3(b)(2) (relating to nontaxability of gain from the sale or other disposition of an agreement vessel),

(3) Amounts representing 85 percent of any dividend received by the fund with respect to which the party would, but for section 607(d)(1)(C) of the Act and § 3.3(b)(2)(ii) (relating to nontaxability of deposits of earnings from investment and reinvestment of amounts held in a fund), be allowed a deduction under section 243 of the Code, and

(4) Amounts received by the fund representing interest income which is exempt from taxation under section 103 of the Code.

(c) *Capital gain account.* The capital gain account shall consist of amounts which represent the excess of (1) deposits of long-term capital gains on property referred to in section 607(b)(1) (C) and (D) of the Act and § 3.2(a)(1) (iii) and (iv) (relating respectively to certain agreement vessels and fund assets), over (2) amounts representing losses from the sale or exchange of assets held in the fund for more than 6 months (for purposes of this section referred to as ''long-term capital losses''). For purposes of this paragraph and paragraph (d)(2) of this section, an agreement vessel disposed of at a gain shall be treated as a capital asset to the extent that gain thereon is not treated as ordinary income, including gain which is ordinary income under section 607(g)(5) of the Act (relating to treatment of gain on disposition of a vessel with a reduced basis) and § 3.6(e) or under section 1245 of the Code (relating to gain from disposition of certain depreciable property). For provisions relating to the treatment of short-term capital gains on certain

transactions involving agreement vessels or realized by the fund, see paragraph (d) of this section. For rules relating to the treatment of capital losses on assets held in the fund, see paragraph (e) of this section.

(d) *Ordinary income account.* The ordinary income account shall consist of:

(1) Amounts referred to in section 607(b)(1)(A) of the Act and § 3.2(a)(1)(i) (relating to taxable income attributable to the operation of an agreement vessel),

(2) Amounts representing (i) deposits of gains from the sale or exchange of capital assets held for 6 months or less (for purposes of this section referred to as ''short-term capital gains'') referred to in section 607(b)(1) (C) or (D) of the Act and § 3.2(a)(1) (iii) and (iv) (relating respectively to certain agreement vessels and fund assets), reduced by (ii) amounts representing losses from the sale or exchange of capital assets held in the fund for 6 months or less (for purposes of this section referred to as ''short-term capital losses''). For rules relating to the treatment of certain agreement vessels as capital assets, see paragraph (c) of this section,

(3) Amounts representing interest (not including any tax-exempt interest referred to in section 607(e)(2)(D) of the Act and paragraph (b)(4) of this section) and other ordinary income received on assets held in the fund (not including any dividend referred to in section 607(e)(2)(C) of the Act and subparagraph (5) of this paragraph),

(4) Amounts representing ordinary income from a transaction (involving certain net proceeds with respect to an agreement vessel) described in section 607(b)(1)(C) of the Act and § 3.2(a)(1)(iii), including gain which is ordinary income under section 607(g)(5) of the Act and § 3.6(e) (relating to treatment of gain on the disposition of a vessel with a reduced basis) or under section 1245 of the Code (relating to gain from disposition of certain depreciable property), and

(5) Fifteen percent of any dividend referred to in section 607(e)(2)(C) of the Act and paragraph (b)(3) of this section received on any assets held in the fund.

(e) *Limitation on deduction for capital losses on assets held in a fund.* Except on termination of a fund, long-term (and short-term) capital losses on assets held in the fund shall be allowed only as an offset to long-term (and short-term) capital gains on assets held in the fund, but only if such gains are deposited into the fund, and shall not be allowed as an offset to any capital gains on assets not held in the fund. The net long-term capital loss of the fund for the taxable year shall reduce the earliest long-term capital gains in the capital gain account at the beginning of the taxable year and the net short-term capital loss for the taxable year shall reduce the earliest short-term capital gains remaining in the ordinary income account at the beginning of the taxable year. Any such losses that are in excess of the capital gains in the respective accounts shall reduce capital gains deposited into the respective accounts in subsequent years (without regard to section 1212, relating to capital loss carrybacks and carryovers). On termination of a fund, any net long-term capital loss in the capital gain account and any net short-term capital loss remaining in the ordinary income account is to be taken into account for purposes of computing the party's taxable income for the year of termination as a long-term or short-term (as the case may be) capital loss recognized in the year the fund is terminated. With respect to the determination of the basis to a fund of assets held in such fund, see § 3.2(g).

[T.D. 7398, 41 FR 5812, Feb. 10, 1976, as amended by T.D. 7831, 47 FR 39675, Sept. 9, 1982]

### § 3.5 Qualified withdrawals.

(a) *In general.* (1) A qualified withdrawal is one made from the fund during the taxable year which is in accordance with section 607(f)(1) of the Act, the agreement, and with regulations prescribed by the Secretary of Commerce and which is for the acquisition, construction, or reconstruction of a qualified vessel (as defined in § 3.11(a)(2)) or barges and containers which are part of the complement of a qualified vessel (or shares in such vessels, barges, and containers), or for the payment of the principal of indebtedness incurred in connection with the acquisition, construction, or reconstruction of such qualified vessel (or a

barge or container which is part of the complement of a qualified vessel).

(2) For purposes of this section the term *share* is used to reflect an interest in a vessel and means a proprietary interest in a vessel such as, for example, that which results from joint ownership. Accordingly, a share within the meaning of § 3.2(f) (relating to the definition of ''agreement vessel'' for the purpose of making deposits) will not necessarily be sufficient to be treated as a share within the meaning of this section.

(3) For purposes of this section, the term *acquisition* means any of the following:

(i) Any acquisition, but only to the extent the basis of the property acquired in the hands of the transferee is its cost. Thus, for example, if a party transfers a vessel and $1 million in an exchange for another vessel which qualifies for nonrecognition of gain or loss under section 1031 (a) of the Code (relating to like-kind exchange), there is an acquisition to the extent of $1 million.

(ii) With respect to a lessee's interest in a vessel, expenditures which result in increasing the amounts with respect to which a deduction for depreciation (or amortization in lieu thereof) is allowable.

(b) *Payments on indebtedness.* Payments on indebtedness may constitute qualified withdrawals only if the party shows to the satisfaction of the Secretary of Commerce a direct connection between incurring the indebtedness and the acquisition, construction, or reconstruction of a qualified vessel or its complement of barges and containers whether or not the indebtedness is secured by the vessel or its complement of barges and containers. The fact that an indebtedness is secured by an interest in a qualified vessel, barge, or container is insufficient by itself to demonstrate the necessary connection.

(c) *Payments to related persons.* Notwithstanding paragraph (a) of this section, payments from a fund to a person owned or controlled directly or indirectly by the same interests as the party within the meaning of section 482 of the Code and the regulations thereunder are not to be treated as qualified withdrawals unless the party demonstrates to the satisfaction of the Secretary of Commerce that no part of such payment constitutes a dividend, a return of capital, or a contribution to capital under the Code.

(d) *Treatment of fund upon failure to fulfill obligations.* Section 607(f)(2) of the Act provides that if the Secretary of Commerce determines that any substantial obligation under the agreement is not being fulfilled, he may, after notice and opportunity for hearing to the party, treat the entire fund, or any portion thereof, as having been withdrawn as a nonqualified withdrawal. In determining whether a party has breached a substantial obligation under the agreement, the Secretary will consider among other things, (1) the effect of the party's action or omission upon his ability to carry out the purposes of the fund and for which qualified withdrawals are permitted under section 607(f)(1) of the Act, and (2) whether the party has made material misrepresentations in connection with the agreement or has failed to disclose material information. For the income tax treatment of nonqualified withdrawals, see § 3.7.

### § 3.6 Tax treatment of qualified withdrawals.

(a) *In general.* Section 607(g) of the Act and this section provide rules for the income tax treatment of qualified withdrawals including the income tax treatment on the disposition of assets acquired with fund amounts.

(b) *Order of application of qualified withdrawals against accounts.* A qualified withdrawal from a fund shall be treated as being made: First, out of the capital account; second, out of the capital gain account; and third, out of the ordinary income account. Such withdrawals will reduce the balance within a particular account on a first-in-first-out basis, the earliest qualified withdrawals reducing the items within an account in the order in which they were actually deposited or deemed deposited in accordance with this part. The date funds are actually withdrawn from the fund determines the time at which withdrawals are considered to be made.

(c) *Reduction of basis.* (1) If any portion of a qualified withdrawal for the

acquisition, construction, or reconstruction of a vessel, barge, or container (or share therein) is made out of the ordinary income account, the basis of such vessel, barge, or container (or share therein) shall be reduced by an amount equal to such portion.

(2) If any portion of a qualified withdrawal for the acquisition, construction, or reconstruction of a vessel, barge, or container (or share therein) is made out of the capital gain account, the basis of such vessel, barge, or container (or share therein) shall be reduced by an amount equal to—

(i) Five-eighths of such portion, in the case of a corporation (other than an electing small business corporation, as defined in section 1371 of the Code), or

(ii) One-half of such portion, in the case of any other person.

(3) If any portion of a qualified withdrawal to pay the principal of an indebtedness is made out of the ordinary income account or the capital gain account, then the basis of the vessel, barge, or container (or share therein) with respect to which such indebtedness was incurred is reduced in the manner provided by subparagraphs (1) and (2) of this paragraph. If the aggregate amount of such withdrawal from the ordinary income account and capital gain account would cause a basis reduction in excess of the party's basis in such vessel, barge, or container (or share therein), the excess is applied against the basis of other vessels, barges, or containers (or shares therein) owned by the party at the time of withdrawal in the following order: (i) vessels, barges, or containers (or shares therein) which were the subject of qualified withdrawals in the order in which they were acquired, constructed, or reconstructed; (ii) agreement vessels (as defined in section 607(k)(3) of the Act and § 3.11(a)(3)) and barges and containers which are part of the complement of an agreement vessel (or shares therein) which were not the subject of qualified withdrawals, in the order in which such vessels, barges, or containers (or shares therein) were acquired by the party; and (iii) other vessels, barges, and containers (or shares therein), in the order in which they were acquired by the party. Any amount of a withdrawal remaining after the application of this subparagraph is to be treated as a nonqualified withdrawal. If the indebtedness was incurred to acquire two or more vessels, barges, or containers (or shares therein), then the basis reduction in such vessels, barges, or containers (or shares therein) is to be made pro rata in proportion to the adjusted basis of such vessels, barges, or containers (or shares therein) computed, however, without regard to this section and adjustments under section 1016(a) (2) and (3) of the Code for depreciation or amortization.

(d) *Basis for depreciation.* For purposes of determining the allowance for depreciation under section 167 of the Code in respect of any property which has been acquired, constructed, or reconstructed from qualified withdrawals, the adjusted basis for determining gain on such property is determined after applying paragraph (c) of this section. In the case of reductions in the basis of any property resulting from the application of paragraph (c)(3) of this section, the party may adopt a method of accounting whereby (1) payments shall reduce the basis of the property on the day such payments are actually made, or (2) payments made at any time during the first half of the party's taxable year shall reduce the basis of the property on the first day of the taxable year, and payments made at any time during the second half of the party's taxable year shall reduce the basis of the property on the first day of the succeeding taxable year. For requirements respecting the change of methods of accounting, see § 1.446–1(e)(3) of the Income Tax Regulations of this chapter.

(e) *Ordinary income treatment of gain from disposition of property acquired with qualified withdrawals.* [Reserved]

### § 3.7 Tax treatment of nonqualified withdrawals.

(a) *In general.* Section 607(h) of the Act provides rules for the tax treatment of nonqualified withdrawals, including rules for adjustments to the various accounts of the fund, the inclusion of amounts in income, and the payment of interest with respect to such amounts.

(b) *Nonqualified withdrawals defined.* Except as provided in section 607 of the Act and § 3.8 (relating to certain corporate reorganizations, changes in partnerships, and transfers by reason of death), any withdrawal from a fund which is not a qualified withdrawal shall be treated as a nonqualified withdrawal which is subject to tax in accordance with section 607(h) of the Act and the provisions of this section. Examples of nonqualified withdrawals are amounts remaining in a fund upon termination of the fund, and withdrawals which are treated as nonqualified withdrawals under section 607(f)(2) of the Act and § 3.5(d) (relating to failure by a party to fulfill substantial obligation under agreement) or under the second sentence of section 607(g)(4) of the Act and § 3.6(c)(3) (relating to payments against indebtedness in excess of basis).

(c) *Order of application of nonqualified withdrawals against deposits.* A nonqualified withdrawal from a fund shall be treated as being made: first, out of the ordinary income account; second, out of the capital gain account; and third, out of the capital account. Such withdrawals will reduce the balance within a particular account on a first-in-first-out basis, the earliest nonqualified withdrawals reducing the items within an account in the order in which they were actually deposited or deemed deposited in accordance with this part. Nonqualified withdrawals for research, development, and design expenses incident to new and advanced ship design, machinery, and equipment, and any amount treated as a nonqualified withdrawal under the second sentence of section 607(g)(4) of the Act and § 3.6(c)(3), shall be applied against the deposits within a particular account on a last-in-first-out basis. The date funds are actually withdrawn from the fund determines the time at which withdrawals are considered to be made. For special rules concerning the withdrawal of contingent deposits of net proceeds from the installment sale of an agreement vessel, see § 3.2(c)(6).

(d) *Inclusion in income.* (1) Any portion of a nonqualified withdrawal which, under paragraph (c) of this section, is treated as being made out of the ordinary income account is to be included in gross income as an item of ordinary income for the taxable year in which the withdrawal is made.

(2) Any portion of a nonqualified withdrawal which, under paragraph (c) of this section, is treated as being made out of the capital gain account is to be included in income as an item of long-term capital gain recognized during the taxable year in which the withdrawal is made.

(3) For effect upon a party's taxable income of capital losses remaining in a fund upon the termination of a fund (which, under paragraph (b) of this section, is treated as a nonqualified withdrawal of amounts remaining in the fund), see § 3.4(e).

(e) *Interest.* (1) For the period on or before the last date prescribed by law, including extensions thereof, for filing the party's Federal income tax return for the taxable year during which a nonqualified withdrawal is made, no interest shall be payable under section 6601 of the Code in respect of the tax on any item which is included in gross income under paragraph (d) of this section, and no addition to such tax for such period shall be payable under section 6651 of the Code. In lieu of the interest and additions to tax under such sections, simple interest on the amount of the tax attributable to any item included in gross income under paragraph (d) of this section is to be paid at the rate of interest determined for the year of withdrawal under subparagraph (2) of this paragraph. Such interest is to be charged for the period from the last date prescribed for payment of tax for the taxable year for which such item was deposited in the fund to the last date for payment of tax for the taxable year in which the withdrawal is made. Both dates are to be determined without regard to any extensions of time for payment. Interest determined under this paragraph which is paid within the taxable year shall be allowed as a deduction for such year under section 163 of the Code. However, such interest is to be treated as part of the party's tax for the year of withdrawal for purposes of collection and in determining any interest or additions to tax for the year of withdrawal under section 6601 or 6651, respectively, of the Code.

(2) For purposes of section 607(h)(3)(C)(ii) of the Act, and for purposes of certain dispositions of vessels constructed, reconstructed, or acquired with qualified withdrawals described in § 3.6(e), the applicable rate of interest for any nonqualified withdrawal—

(i) Made in a taxable year beginning in 1970 and 1971 is 8 percent.

(ii) Made in a taxable year beginning after 1971, the rate for such year as determined and published jointly by the Secretary of the Treasury or his delegate and the Secretary of Commerce. Such rate shall bear a relationship to 8 percent which the Secretaries determine to be comparable to the relationship which the money rates and investment yields for the calendar year immediately preceding the beginning of the taxable year bear to the money rates and investment yields for the calendar year 1970. The determination of the applicable rate for any such taxable year will be computed by multiplying 8 percent by the ratio which *(a)* the average yield on 5-year Treasury securities for the calendar year immediately preceding the beginning of such taxable year, bears to *(b)* the average yield on 5-year Treasury securities for the calendar year 1970. The applicable rate so determined shall be computed to the nearest one-hundredth of 1 percent. If such a determination and publication is made, the latest published percentage shall apply for any taxable year beginning in the calendar year with respect to which publication is made.

(3) No interest shall be payable in respect of taxes on amounts referred to in section 607(h)(2) (i) and (ii) of the Act (relating to withdrawals for research and development and payments against indebtedness in excess of basis) or in the case of any nonqualified withdrawal arising from the application of the recapture provision of section 606(5) of the Merchant Marine Act, 1936, as in effect on December 31, 1969.

(f) *Basis and holding period in the case of property purchased by the fund or considered purchased by the fund.* In the case of a nonqualified withdrawal of property other than money which was purchased by the fund (including deposited property considered under § 3.2(g)(1)(ii) as purchased by the fund), the adjusted basis of the property in the hands of the party is its adjusted basis to the fund on the day of the withdrawal. In determining the period for which the taxpayer has held the property withdrawn in a nonqualified withdrawal, there shall be included only the period beginning with the date on which the withdrawal occurred. For basis and holding period in the case of nonqualified withdrawals of property other than money deposited into the fund, see § 3.2(g)(4).

### § 3.8 Certain corporate reorganizations and changes in partnerships, and certain transfers on death. [Reserved]

### § 3.9 Consolidated returns. [Reserved]

### § 3.10 Transitional rules for existing funds.

(a) *In general.* Section 607(j) of the Act provides that any person who was maintaining a fund or funds under section 607 of the Merchant Marine Act, 1936, prior to its amendment by the Merchant Marine Act of 1970 (for purposes of this part referred to as ''old fund'') may continue to maintain such old fund in the same manner as under prior law subject to the limitations contained in section 607(j) of the Act. Thus, a party may not simultaneously maintain such old fund and a new fund established under the Act.

(b) *Extension of agreement to new fund.* If a person enters into an agreement under the Act to establish a new fund, he may agree to the extension of such agreement to some or all of the amounts in the old fund and transfer the amounts in the old fund to which the agreement is to apply from the old fund to the new fund. If an agreement to establish a new fund is extended to amounts from an old fund, each item in the old fund to which such agreement applies shall be considered to be transferred to the appropriate account in the manner provided for in § 3.8(d) in the new fund in a nontaxable transaction which is in accordance with the provisions of the agreement under which such old fund was maintained. For purposes of determining the amount of interest under section 607(h)(3)(C) of the Act and § 3.7(e), the

date of deposit of any item so transferred shall be deemed to be July 1, 1971, or the date of the deposit in the old fund, whichever is the later.

### § 3.11 Definitions.

(a) As used in the regulations in this part and as defined in section 607(k) of the Act—

(1) The term *eligible vessel* means any vessel—

(i) Constructed in the United States, and if reconstructed, reconstructed in the United States,

(ii) Documented under the laws of the United States, and

(iii) Operated in the foreign or domestic commerce of the United States or in the fisheries of the United States. Any vessel which was constructed outside of the United States but documented under the laws of the United States on April 15, 1970, or constructed outside the United States for use in the U.S. foreign trade pursuant to a contract entered into before April 15, 1970, shall be treated as satisfying the requirements of subdivision (i) of this subparagraph and the requirements of subparagraph (2)(i) of this section.

(2) The term *qualified vessel* means any vessel—

(i) Constructed in the United States and, if reconstructed, reconstructed in the United States,

(ii) Documented under the laws of the United States, and

(iii) Which the person maintaining the fund agrees with the Secretary of Commerce will be operated in the U.S. foreign, Great Lakes, or noncontiguous domestic trade or in the fisheries of the United States.

(3) The term *agreement vessel* means any eligible vessel or qualified vessel which is subject to an agreement entered into under section 607 of the Act.

(4) The term *vessel* includes cargo handling equipment which the Secretary of Commerce determines is intended for use primarily on the vessel. The term ''vessel'' also includes an ocean-going towing vessel or an ocean-going barge or comparable towing vessel or barge operated in the Great Lakes.

(b) Insofar as the computation and collection of taxes are concerned, other terms used in the regulations in this part, except as otherwise provided in the Act or this part, have the same meaning as in the Code and the regulations thereunder.

## PART 4—TEMPORARY INCOME TAX REGULATIONS UNDER SECTION 954 OF THE INTERNAL REVENUE CODE

Sec.
4.954–0 Introduction.
4.954–1 Foreign base company income; taxable years beginning after December 31, 1986.
4.954–2 Foreign personal holding company income; taxable years beginning after December 31, 1986.

AUTHORITY: 26 U.S.C. 7805.

Section 4.954–0 also issued under 26 U.S.C. 954 (b) and (c).

Section 4.954–1 also issued under 26 U.S.C. 954 (b) and (c).

Section 4.954–2 also issued under 26 U.S.C. 954 (b) and (c).

### § 4.954–0 Introduction.

(a) *Effective date.* (1) The provisions of §§ 4.954–1 and 4.954–2 apply to taxable years of a controlled foreign corporation beginning after December 31, 1986. Consequently, any gain or loss (including foreign currency gain or loss as defined in section 988(b)) recognized during such taxable years of a controlled foreign corporation is subject to these provisions. For further guidance, see § 1.954–0(a) of this chapter.

(2) The provisions of §§ 1.954A–1 and 1.954A–2 apply to taxable years of a controlled foreign corporation beginning before January 1, 1987. All references therein to sections of the Code are to the Internal Revenue Code of 1954 prior to the amendments made by the Tax Reform Act of 1986.

(b) *Outline of regulation provisions for sections 954(b)(3), 954(b)(4), 954(b)(5) and 954(c) for taxable years of a controlled foreign corporation beginning after December 31, 1986.*

(I) *§ 4.954–0 Introduction.*

(a) Effective dates.

(b) Outline.

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### § 4.954–1 Foreign base company income; taxable years beginning after December 31, 1986.

(a) *In general*—(1) *Purpose and scope.* Section 954 (b) through (g) and §§ 1.954–1T and 1.954–2T provide rules for computing the foreign base company income of a controlled foreign corporation. Foreign base company income is included in the subpart F income of a controlled foreign corporation under the rules of section 952 and the regulations thereunder. Subpart F income is included in the gross income of a United States shareholder of a controlled foreign corporation under the rules of section 951 and the regulations thereunder, and thus is subject to current taxation under section 1 or 11 of the Code. The determination of whether a foreign corporation is a controlled foreign corporation, the subpart F income of which is included currently in the gross income of its United States shareholders, is made under the rules of section 957 and the regulations thereunder.

(2) *Gross foreign base company income.* For taxable years of a controlled foreign corporation beginning after December 31, 1986, the gross foreign base company income of a controlled foreign corporation consists of the following categories of gross income:

(i) Its foreign personal holding company income, as defined in section 954(c) and § 1.954–2T,

(ii) Its foreign base company sales income, as defined in section 954(d) and the regulations thereunder,

(iii) Its foreign base company services income, as defined in section 954(e) and the regulations thereunder,

(iv) Its foreign base company shipping income, as defined in section 954(f) and the regulations thereunder, and

(v) Its foreign base company oil related income, as defined in section 954(g) and the regulations thereunder.

(3) *Adjusted gross foreign base company income.* The term ''adjusted gross foreign base company income'' means the gross foreign base company income of a controlled foreign corporation as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section.

(4) *Net foreign base company income.* The term ''net foreign base company income'' means the adjusted gross foreign base company income of a controlled foreign corporation reduced so as to take account of deductions properly allocable to such income under the rules of section 954(b)(5) and paragraph (c) of this section. In computing net foreign base company income, foreign personal holding company income is reduced (but not below zero) by related person interest expense before allocating and apportioning other expenses in accordance with the rules of paragraph (c) of this section and § 1.904(d)–5(c)(2).

(5) *Adjusted net foreign base company income.* The term ''adjusted net foreign base company income'' means the net foreign base company income of a controlled foreign corporation reduced by any items of net foreign base company income for which the high tax exception of paragraph (d) of this section is elected. The term ''foreign base company income'' as used in the Code and elsewhere in the regulations generally means adjusted net foreign base company income.

(6) *Insurance income definitions.* The term ''gross insurance income'' includes any item of gross income taken into account in determining insurance income under section 953 and the regulations thereunder. The term ''adjusted gross insurance income'' means gross insurance income as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section. The term ''net insurance income'' means adjusted gross insurance income reduced under section 953 and the regulations thereunder so as to take into account deductions properly allocable or apportionable to such income. The term ''adjusted net insurance income'' means net insurance income reduced by any items of net insurance income for which the high tax exception of paragraph (d) of this section is elected.

(7) *Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).* Earnings and profits of the controlled foreign corporation that are recharacterized as foreign base company income or insurance income under section 952(c) are items of adjusted net foreign base company income or adjusted net insurance income. Thus, they are not included in the gross foreign base company income or gross insurance income of the controlled foreign corporation in computing adjusted gross foreign base company income or adjusted gross insurance income (for purposes of applying the de minimis and full inclusion tests of paragraph (b) of this section).

(8) *Illustration.* The order of computation is illustrated by the following example. Computations in this paragraph (a)(8) and in paragraph (b)(5) of this section involving the operation of section 952(c) are included for purposes of illustration only and do not provide substantive rules concerning the operation of that section.

*Example.* (i) *Gross income. CFC,* a controlled foreign corporation, has gross income of $1000 for the current taxable year. Of that $1000 of income, $100 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and § 1.954–2T(b)(1)(ii), is not income from a trade or service receivable described in section 864(d)(1) or (6), and is not excluded from foreign personal holding company income under any provision of section 954(c) and § 1.954–2T. Another $50 is foreign base company sales income under section 954(d) and the regulations thereunder. The remaining $850 of gross income is not included in the definition of foreign base company income or insurance income under sections 954(c), (d), (e), (f), (g), or 953 and the regulations thereunder, and is foreign source general limitation income described in section 904(d)(1)(I) and the regulations thereunder.

(ii) *Expenses. CFC* has expenses for the current taxable year of $500. Of that $500, $8 is

from interest paid to a related person and is allocable to foreign personal holding company income along with $2 of other expense. Another $20 of expense is allocable to foreign base company sales. The remaining $470 of expense is allocable to income other than foreign base company income or insurance income.

(iii) *Earnings and deficits. CFC* has earnings and profits for the current taxable year of $500. In the prior taxable year, *CFC* had losses with respect to income other than gross foreign base company income or gross insurance income. By reason of the limitation provided under section 952(c)(1)(A) and the regulations thereunder, those losses reduced the subpart F income (consisting entirely of foreign source general limitation income) of *CFC* by $600 for the prior taxable year.

(iv) *Taxes.* Foreign tax of $30 is considered imposed on the interest income under the rules of section 954(b)(4) and paragraph (d) of this section. Foreign tax of $14 is considered imposed on the foreign base company sales income under the rules of section 954(b)(4) and paragraph (d) of this section. Foreign tax of $177 is considered imposed on the remaining foreign source general limitation income under the rules of section 954(b)(4) and paragraph (d) of this section. For the taxable year of the foreign corporation, the maximum U.S. rate of taxation under section 11 is 34 percent.

(v) *Conclusion.* Based on these facts, if *CFC* elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and paragraph (d), it will have $500 of subpart F income as defined in section 952(a) (consisting entirely of foreign source general limitation income) determined as follows. The following steps do not illustrate the computation of the subpart F income of a controlled foreign corporation that has income from a trade or service receivable treated as interest under section 864(d)(1) or interest described in section 864(d)(6).

*Step 1—Determine gross income:*

(1) Gross income .....$1000

*Step 2—Determine gross foreign base company income and gross insurance income:*

(2) Interest income included in foreign personal holding company income under section 954 (c) .....100
(3) Foreign base company sales income under section 954(d) .....50
(4) Total gross foreign base company income gross insurance income as defined in sections 954(c), (d), (e), (f) and (g) and 953 and the regulations thereunder (line (3) plus line (4)) .....150

*Step 3—Determine adjusted gross foreign base company income and adjusted gross insurance income:*

(5) Five percent of gross income (.05 × line (1)) .....50
(6) Seventy percent of gross income (.70 × line (1)) .....700
(7) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the de minimis test of paragraph (b) (line (4), or zero if line (4) is less than the lesser of line (5) or $1,000,000).....150
(8) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion test of paragraph (b) (line (4), or line (1) if line (4) is greater than line (6)) .....150

*Step 4—Compute net foreign base company income:*

(9) Related person interest expense and other expense allocable and apportionable to foreign personal holding company income.....10
(10) Deductions allocable and apportionable to foreign base company sales income.....20
(11) Foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (the lesser of line (2) or line (7), reduced (but not below zero) by line (9)).....90
(12) Foreign base company sales income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (the lesser of line (3) or line (7), reduced (but not below zero) by line (10)) .....30
(13) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) (line (11) plus line (12)) ..... 120

*Step 5—Compute net insurance income:*

(14) Net insurance income under section 953 and the regulations thereunder .....0

*Step 6—Compute adjusted net foreign base company income:*

(15) Foreign tax imposed on foreign personal holding company income (as determined under paragraph (d)) .....30
(16) Foreign tax imposed on foreign base company sales income (as determined under paragraph (d)).....14
(17) Ninety percent of the maximum U.S. corporate tax rate .....30.6
(18) Effective rate of foreign tax imposed on foreign personal holding

company income (interest) under section 954(b)(4) and paragraph (d) (line (15) divided by line (11)) .....33

(19) Effective rate of foreign tax imposed on $40 of foreign base company sales income under section 954(b)(4) and paragraph (d) (line (16) divided by line (12)) .....47

(20) Foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (11) if line (18) is greater than line (17)) .....90

(21) Foreign base company sales income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (12) if line (19) is greater than line (17)) .....30

(22) Adjusted net foreign base company income after applying section 954(b)(4) and paragraph (d) (line (13), reduced by the sum of line (20) and line (21)) .....0

*Step 7—Compute adjusted net insurance income:*

(23) Adjusted net insurance income.....0

*Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):*

(24) Earnings and profits for the current year .....500

(25) The excess in earnings and profits over subpart F income subject to being recharacterized as adjusted net foreign base company income under section 952(c)(2) (excess of line (24) over the sum of lines (22) and (23); if there is a deficit, then the limitation of section 952(c)(1) may apply for the current year) .....500

(26) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) and the regulations thereunder .....600

(27) Subpart F income as defined in section 952(a), assuming section 952(a) (3), (4), or (5) does not apply (the sum of line (22), line (23), and the lesser of line (25) or line (26)) .....500

(b) *Computation of adjusted gross foreign base company income and adjusted gross insurance income*—(1) *De minimis rule, etc.*—(i) *In general.* If the de minimis rule of paragraph (b)(1)(ii) of this section applies, then adjusted gross foreign base company income and adjusted gross insurance income are each equal to zero. If the full inclusion rule of paragraph (b)(1)(iii) of this section applies, then adjusted gross foreign base company income consists of all items of gross income of the controlled foreign corporation other than gross insurance income, and adjusted gross insurance income consists of all items of gross insurance income. Otherwise, the adjusted gross foreign base company income of a controlled foreign corporation consists of the gross foreign base company income of the controlled foreign corporation, and the adjusted gross insurance income of a controlled foreign corporation consists of the gross insurance income of the controlled foreign corporation.

(ii) *Five percent de minimis test*—(A) *In general.* The de minimis rule of this paragraph (b)(1)(ii) applies if the sum of the gross foreign base company income and the gross insurance income of a controlled foreign corporation is less than the lesser of—

(*1*) 5 percent of gross income, or

(*2*) $1,000,000.

Controlled foreign corporations having a functional currency other than the U.S. dollar shall translate the $1,000,000 threshold using the exchange rate provided under section 989(b)(3) and the regulations thereunder for amounts included in income under section 951(a).

(B) *Coordination with section 864(d).* Gross foreign base company income or gross insurance income of a controlled foreign corporation always includes items of income from trade or service receivables described in section 864(d)(1) or (6), even if the de minimis rule of this paragraph (b)(1)(ii) is otherwise applicable. In that case, adjusted gross foreign base company income consists only of the items of income from trade or service receivables described in section 864(d)(1) or (6) that are included in gross foreign base company income, and adjusted gross insurance income consists only of the items of income from trade or service receivables described in section 864(d)(1) or (6) that are included in gross insurance income.

(iii) *Seventy percent full inclusion test.* The full inclusion rule of this paragraph (b)(1)(iii) applies if the sum of the foreign base company income and the gross insurance income for the taxable year exceeds 70 percent of gross income.

(2) *Character of items of gross income included in adjusted gross foreign base company income.* The items of gross income included in the adjusted gross foreign base company income of a controlled foreign corporation retain their character as foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, or foreign base company oil related income. Items of gross income included in adjusted gross income because the full inclusion test of paragraph (b)(1)(iii) of this section is met are termed ''full inclusion foreign base company income,'' and constitute a separate category of adjusted gross foreign base company income for purposes of allocating and apportioning deductions under paragraph (c) of this section.

(3) *Coordination with section 952(c).* Items of gross foreign base company income or gross insurance income that are excluded from adjusted foreign base company income or adjusted gross insurance income because the de minimis test of paragraph (b)(1)(ii) of this section is met are potentially subject to recharacterization as adjusted net foreign base company income or adjusted net insurance income (or other categories of income included in the computation of subpart F income under section 952 and the regulations thereunder) for the taxable year under the rules of section 952(c). Items of full inclusion foreign base company income that are included in adjusted gross foreign base company income because the full inclusion test of paragraph (b)(1)(iii) of this section is met, and are included in subpart F income under section 952 and the regulations thereunder, do not reduce amounts that, under section 952(c), are subject to recharacterization in later years on account of deficits in prior years.

(4) *Anti-abuse rule*—(i) *In general.* For purposes of applying the de minimis and full inclusion tests of paragraph (b)(1) of this section, the income of two or more controlled foreign corporations shall be aggregated and treated as the income of a single corporation if one principal purpose for separately organizing, acquiring, or maintaining such multiple corporations is to avoid the application of the de minimis or full inclusion requirements of paragraph (b)(1) of this section. For purposes of this paragraph (b), a principal purpose need not be the purpose of first importance.

(ii) *Presumption.* Two or more controlled foreign corporations are presumed to have been organized, acquired or maintained to avoid the effect of the de minimis and full inclusion requirements of paragraph (b)(1) of this section if the corporations are related persons as defined in subdivision (iii) of this paragraph (b)(4) and the corporations are described in subdivision (A), (B), or (C). This presumption may be rebutted by proof to the contrary.

(A) The activities now carried on by the controlled foreign corporations, or the assets used in those activities, are substantially the same activities that were carried on, or assets that were previously held by a single controlled foreign corporation, and the United States shareholders of the controlled foreign corporations or related persons (as determined under subdivision (iii) of this paragraph (b)(4)) are substantially the same as the United States shareholders of the one controlled foreign corporation in that prior taxable year. A presumption made in connection with the requirements of this subdivision (A) of paragraph (b)(4)(ii) may be rebutted by proof that the activities carried on by each controlled foreign corporation would constitute a separate branch under the principles of § 1.367(a)–6T(g) if carried on directly by a United States person.

(B) The controlled foreign corporations carry on a business, financial operation, or venture as partners directly or indirectly in a partnership (as defined in section 7701(a)(2) and § 301.7701–3) that is a related person (as defined in subdivision (iii) of this paragraph (b)(4)) with respect to each such controlled foreign corporation.

(C) The activities carried on by the controlled foreign corporations would constitute a single branch operation under § 1.367(a)–6T(g)(2) if carried on directly by the United States person.

(iii) *Related persons.* For purposes of this paragraph (b), two or more persons are related persons if they are in a relationship described in section 267(b).

In determining for purposes of this paragraph (b) whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). In determining for purposes of this paragraph (b) whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(iv) *Illustration.* The following example illustrates the application of this paragraph (b)(4).

*Example.* USP is the sole United States shareholder of three controlled foreign corporations: *CFC1, CFC2* and *CFC3.* The three controlled foreign corporations all have the same taxable year. The three controlled foreign corporations are partners in *FP,* a foreign entity classified as a partnership under section 7701(a)(2) and § 301.7701–3 of the regulations. For their current taxable years, each of the controlled foreign corporations derives all of its income other than foreign base company income from activities conducted through *FP,* and its foreign base company income from activities conducted both jointly through *FP* and separately without *FP.* Based on the facts in the table below, for their current taxable years, the foreign base company income derived by each controlled foreign corporation, including income derived from *FP,* is less than five percent of the gross income of each controlled foreign corporation and is less than $1,000,000:

| | CFC1 | CFC2 | CFC3 |
|---|---|---|---|
| Gross income | $4,000,000 | $8,000,000 | $12,000,000 |
| Five percent of gross income | 200,000 | 400,000 | 600,000 |
| Foreign base company income | 199,000 | 398,000 | 597,000 |

Thus, without the application of the anti-abuse rule of this subparagraph (5), each controlled foreign corporation would be treated as having no foreign base company income after the application of the de minimis rule of section 954(b)(3)(A) and § 1.954–1T(b)(1).

However, under these facts the requirements of subdivision (i) of this paragraph (b)(4) are presumed to be met. The sum of the foreign base company income of the controlled foreign corporations is $1,194,000. Thus, the amount of adjusted gross foreign base company income will not be less than the amount of gross foreign base company income by reason of the de minimis rule of section 954(b)(3)(A) and this paragraph (b).

(5) *Illustration.* The following example illustrates computations required by sections 952 and 954 and this § 1.954–1T if the full inclusion test of paragraph (b)(1)(iii) is met (see paragraph (a)(8) for an example illustrating computations required if the de minimis test of paragraph (b)(1)(ii) is met):

*Example.* (i) *Gross Income. CFC,* a controlled foreign corporation, has gross income of $1,000 for the current taxable year. Of that $1,000 of income, $720 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and § 1.954–2T(b)(ii), is not income from trade or service receivables described in section 864(d) (1) or (6), and is not excluded from foreign personal holding company income under any provisions of section 954(c) and § 1.954–2T. The remaining $280 is services income that is not included in the definition of foreign base company income or insurance income under sections 954(c), (d), (e), (f), (g) or 953 and the regulations thereunder, and is foreign source general limitation income for purposes of section 904(d)(1)(I).

(ii) *Expenses. CFC* has expenses for the current taxable year of $650. Of that $650, $350 is from interest paid to related persons that is allocable to foreign personal holding company income along with $50 of other expense. The remaining $250 of expense is allocable to services income other than foreign base company income or insurance income.

(iii) *Earnings and deficits. CFC* has earnings and profits for the current taxable year of $350. In the prior taxable year, *CFC* had losses with respect to income other than foreign base company income or insurance income. By reason of the limitation provided under section 952(c)(1)(A) and the regulations thereunder, those losses reduced the subpart F income of *CFC* (consisting entirely of foreign source general limitation income) by $600 for the prior taxable year.

(iv) *Taxes.* A foreign tax of $120 is considered imposed on the $720 of interest income under the rules of section 954(b)(4) and paragraph (d) of this section, and a foreign tax of $2 is considered imposed on the services income under the rules of section 954(b)(4) and paragraph (d) of this section. For the taxable year of the foreign corporation, the maximum U.S. rate of taxation under section 11 is 34 percent.

(v) *Conclusion.* Based on these facts, if *CFC* elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and paragraph (d), it will have $350 of subpart F income as defined in section 952(a) determined as follows:

*Step 1—Determine gross income:*

(1) Gross income .....$1000

*Step 2—Compute gross foreign base company income and gross insurance income:*

(2) Gross foreign base company income and insurance income as defined in sections 954(c), (d), (e), (f), (g) and 953 and the regulations thereunder (interest income).....720

*Step 3—Compute adjusted gross foreign base company income:*

(3) Seventy percent of gross income (.70 × line (1)) .....700

(4) Adjusted gross foreign base company income or insurance income after the application of the full inclusion rule of this paragraph (b)(1) (line (2), or line (1) if line (2) is greater than line (3)) .....1000

(5) Full inclusion foreign base company income under paragraph (a)(2)(vi) (line (4) minus line (2)) ..... 280

*Step 4—Compute net foreign base company income:*

(6) Related person interest expense and other deductions allocable and apportionable to foreign personal holding company income under section 954(b)(5) and paragraph (c) ..... 400

(7) Deductions allocable and apportionable to full inclusion foreign base company income under section 954(b)(5) and paragraph (c) ..... 250

(8) Foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced (but not below zero) by line (6)) .....320

(9) Full inclusion foreign base company income after allocating deductions under section 954(b)(5) paragraph (c) of this section (line (5) reduced (but not below zero) by line (7)) .....30

(10) Total gross foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) (line (8) plus line (9)) .....350

*Step 5—Compute net insurance income:*

(11) Net insurance income under section 953 and the regulations thereunder .....0

*Step 6—Compute adjusted net foreign base company income:*

(12) Foreign tax imposed on foreign personal holding company income (interest) .....120

(13) Foreign tax imposed on full inclusion foreign base company income ..... 2

(14) Ninety percent of the maximum U.S. corporate tax rate .....30.6

(15) Effective rate of foreign tax imposed on $320 of foreign personal holding company income under section 954(b)(4) and paragraph (d) (line (12) divided by line (8)).....38

(16) Effective rate of foreign tax imposed of $30 of full inclusion foreign base company income under section 954(b)(4) and paragraph (d) (line (13) divided by line (9)) .....7

(17) Foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (8) if line (15) is greater than line (14)) ..... 320

(18) Full inclusion foreign base company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (9) if line (16) is greater than line (14)) ..... 0

(19) Adjusted net foreign base company income after applying section 954(b)(4) and paragraph (d) (line (10), reduced by the sum of line (17) and line (18)) .....30

*Step 7—Compute adjusted net insurance income:*

(20) Adjusted net insurance income.....0

*Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):*

(21) Earnings and profits for the current year .....350

(22) The excess in earnings and profits over subpart F income, which is subject to being recharacterized as adjusted net foreign base company income under section 952(c)(2) (excess of line (21) over the sum of line (19) and line (20)); if there is a deficit, then the limitation of 952(c)(1) may apply for the current year .....320

(23) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) and the regulations thereunder .....600

(24) Subpart F income as defined in section 952(a), assuming section 952(a) (3), (4), or (5) does not apply (the sum of line (19) and line (20) plus the lesser of line (22) or line (23)) .....350

(25) Amount of prior years' deficit remaining to be recharacterized as subpart F income in later years

under section 952(c) (excess of line (23) over line (22)) .....280

(c) *Computation of net foreign base company income.* The net foreign base company income of a controlled foreign corporation is computed by reducing (but not below zero) the amount of gross income in each of the categories of adjusted gross foreign base company income described in paragraph (b)(2) of this section, so as to take into account deductions allocable and apportionable to such income. For purposes of section 954 and this section, expenses must be allocated and apportioned consistent with the allocation and apportionment of expenses for purposes of section 904(d). For purposes of this § 1.954–1T, an item of net foreign base company income must be categorized according to the category of adjusted gross foreign base company income from which it is derived. Thus, an item of net foreign base company income must be categorized as a net item of—

(1) Foreign personal holding company income,

(2) Foreign base company sales income,

(3) Foreign base company services income,

(4) Foreign base company shipping income,

(5) Foreign base company oil related income, or

(6) Full inclusion foreign base company income.

(d) *Computation of adjusted net foreign base company income or adjusted net insurance income*—(1) *Application of high tax exception.* Adjusted net foreign base company income (or adjusted net insurance income) equals the net foreign base company income (or net insurance income) of a controlled foreign corporation, reduced by any item of such income (other than foreign base company oil related income as defined in section 954(g)) subject to the high tax exception provided by section 954(b)(4) and this paragraph (d). An item of income is subject to the high tax exception only if—

(i) It is established that the income was subject to creditable income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in section 11 or 15 for the taxable year of the controlled foreign corporation; and

(ii) An election is made under section 954(b)(4) and paragraph (d)(5) of this section to exclude the income from the computation of subpart F income.

See paragraph (d)(4) of this section for the definition of the term ''item of income.'' For rules concerning the treatment for foreign tax credit purposes of amounts excluded from subpart F under section 954(b)(4), see § 904–1.4(c)(1).

(2) *Effective rate at which taxes are imposed.* For purposes of this paragraph (d), the effective rate at which taxes are imposed on an item of income is—

(i) The amount of income taxes paid or accrued (or deemed paid or accrued) with respect to the item of income, determined under paragraph (d)(3) of this section, divided by

(ii) The item of net foreign base company income or net insurance income, determined under paragraph (d)(4) of this section (including the appropriate amount of income taxes referred to in subdivision (i) of this paragraph (d)(2), immediately above).

(3) *Taxes paid or accrued with respect to an item of income*—(i) *Income other than passive foreign personal holding company income.* The amount of income taxes paid or accrued with respect to an item of income (other than an item of foreign personal holding company income that is passive income) for purposes of section 954(b)(4) and this paragraph (d) is the amount of foreign income taxes that would be deemed paid under section 960 with respect to that item if that item were included in the gross income of a U.S. shareholder under section 951(a)(1)(A). For this purpose, the amounts that would be deemed paid under section 960 shall be determined separately with respect to each controlled foreign corporation and without regard to the limitation applicable under section 904(a).

(ii) *Passive foreign personal holding company income.* The amount of income taxes paid or accrued with respect to an item of foreign personal holding company income that is passive income for purposes of section 954(b)(4) and this paragraph (d) is the amount of foreign income taxes paid or accrued or deemed paid by the foreign corporation

that would be taken into account for purposes of applying the provisions of § 1.904–4(c) with respect to that item of income.

(4) *Item of income*—(i) *Income other than passive foreign personal holding company income.* The high tax exception applies (when elected) to all income that constitutes a single item under this paragraph (d)(4). A single item of net foreign base company income or net insurance income is an amount of net foreign base company income (other than foreign personal holding company income that is passive income) or net insurance income that:

(A) Falls within a single category of net foreign base company income, as defined in paragraph (c) of this section, or net insurance income, and

(B) Also falls within a single separate limitation category for purposes of sections 904(d) and 960 and the regulations thereunder.

(ii) *Passive foreign personal holding company income*—(A) *In general.* For purposes of this paragraph (d) a single item of net foreign personal holding company income that is passive income is an amount of such income that falls within a single group of passive income under the grouping rules of § 1.904–4(c) (3), (4), and (5).

(B) *Consistency rule.* An election to exclude income from subpart F must be consistently made with respect to all items of passive foreign personal holding company income eligible to be excluded. Thus, high-taxed passive foreign personal holding company income of a controlled foreign corporation must be excluded in its entirety, or remain subject to subpart F.

(5) *Procedure.* The election provided by this paragraph (d) must be made—

(i) By controlling United States shareholders, as defined in § 1.964–1(c)(5), by attaching a statement to such effect with their original or amended income tax returns, and including any additional information required by subsequent administrative pronouncements, or

(ii) In such other manner as may be prescribed in subsequent administrative pronouncements.

An election made under the procedure provided by this paragraph (d)(5) is binding on all United States shareholders of the controlled foreign corporation.

(6) *Illustrations.* The rules of this paragraph (d) are illustrated by the following examples.

*Example 1.* (i) *Items of income.* During its 1987 taxable year, controlled foreign corporation CFC receives from outside its country of operation portfolio dividend income of $100 and interest income of $100 (consisting of a gross payment of $150 reduced by a third-country withholding tax of $50). For purposes of illustration, assume that the CFC incurs no expenses. None of the income is taxed in CFC's country of operation. The dividend income was not subject to their-country withholding taxes. The interest income was subject to withholding taxes equal to $50, and is therefore high withholding tax interest for purposes of section 960 (pursuant to the operation of section 904). The dividend income is passive income for purposes of section 960. Accordingly, pursuant to paragraph (d)(4) of this section, CFC has two items of income: (1) $100 of FPHC/passive income (the dividends) and (2) $100 of FPHC/high withholding tax income (the interest). The election under paragraph (d)(5) of this section to exclude high-taxed income from the operation of subpart F is potentially applicable to each such item in its entirety.

(ii) *Effective rates of tax.* No foreign tax would be deemed paid under section 960 with respect to item (1). Therefore, the effective rate of foreign tax is 0, and the item may not be excluded from subpart F under the rules of this paragraph (d). Foreign tax of $50 would be deemed paid under section 960 with respect to item (2). Therefore, the effective rate of foreign tax is 33 percent ($50 of creditable taxes paid, divided by $150, consisting of the item of net foreign base company income ($100) plus creditable taxes paid thereon ($50). The highest rate of tax specified in section 11 for the 1987 taxable year is 34 percent. Accordingly, item (2) may be excluded from subpart F pursuant to an election under paragraph (d)(5) of this section, since it is subject to foreign tax at an effective rate that is greater than 30.6 percent (90 percent of 34 percent). However, it remains high withholding tax interest when included.

*Example 2.* The facts are the same as in Example 1, except that CFC's country of operation imposes a tax of $50 with respect to CFC's dividend income. The interest income is still high withholding tax interest. The dividend income is still passive income (without regard to the possible applicability of the high tax exception of section 904(d)(2)). Accordingly, CFC has two items of income for purposes of this paragraph (d): (1) $100 of FPHC/high withholding tax interest income, and (2) $50 of FPHC/passive income (net of the $50 foreign tax). Both items are taxed at

an effective rate greater than 31.6 percent. Item 1: Foreign tax ($50) divided by sum ($150) of income item ($100) plus creditable tax thereon ($50) equals 33 percent. Item 2: Foreign tax ($50) divided by sum ($100) of income item ($50) plus creditable tax thereon ($50) equals 50 percent. Accordingly, an election may be made under paragraph (d)(5) of this section to exclude either, both, or neither of items 1 and 2 from subpart F.

*Example 3.* The facts are the same as in Example 1, except that the $100 of portfolio dividend income is subject to a third-country withholding tax of $50, and the $150 of interest income is from sources within CFC's country of operation, is subject to a $10 income tax therein, and is not subject to a withholding tax. Although the interest income and the dividend income are both passive income, under paragraph (d)(4)(ii)(A) of this section they constitute separate items of income pursuant to the application of the grouping rules of §1.904–4(c). Accordingly, CFC has two items of income for purposes of this paragraph (d): (1) $50 (net of tax) of FPHC/non-country of operation/greater than 15 percent withholding tax income; and (2) $140 (net of $10 tax) of FPHC/country of operation income. Item 1 is taxed at an effective rate greater than 30.6 percent, but Item 2 is not. Item 1: Foreign tax ($50) divided by sum ($100) of income item ($50) plus creditable tax thereon ($50) equals 50 percent. Item 2: Foreign tax ($10) divided by sum ($150) of income item ($140) plus creditable tax thereon ($10) equals 6.67 percent. Therefore, an election may be made under paragraph (d)(5) of this section to exclude Item 1 but not Item 2 from subpart F.

*Example 4.* The facts are the same as in Example 3, except that the $150 of interest income is subject to an income tax of $50 in CFC's country of operation. Accordingly, CFC has two items of income, as in Example 4, but both items are taxed at an effective rate greater than 30.6 percent. Item 1: Foreign tax ($50) divided by sum ($100) of income item ($50) plus creditable tax thereon ($50) equals 50 percent. Item 2: Foreign tax ($50) divided by sum ($150) if income item ($100) plus creditable tax thereon ($50) equals 33 percent. Pursuant to the consistency rule of paragraph (d)(4)(ii)(B) of this section, CFC's shareholders must consistently elect or not elect to exclude from subpart F all items of FPHC income that are eligible to be excluded. Therefore, an election may be made to exclude both Item 1 and Item 2 from subpart F, or neither may be excluded.

(e) *Character of an item of income*—(1) *Substance of the transaction.* For purposes of section 954 and the regulations thereunder, items of income shall be characterized in accordance with the substance of the transaction, and not in accordance with the designation applied by the parties to the transaction. For example, an amount received as ''rent'' which actually constitutes income from the sale of property, royalties, or income from services shall not be characterized as ''rent'' but shall be characterized as income from the sale of property, royalties or income from services, respectively. Local law shall not be controlling in characterizing an item of income.

(2) *Separable character.* To the extent one of the definitional provisions of section 953 or 954 describes a portion of the income or gain derived from a transaction, that portion of income or gain is so characterized. Thus, a single transaction may give rise to income in more than one category of foreign base company income described in paragraph (a)(2) of this section. For example, if a controlled foreign corporation, in its business of purchasing and selling personal property, receives interest (including imputed interest and market discount) on an account receivable arising from a sale, a portion of the income derived from the transaction by the controlled foreign corporation will be interest, and another portion will be gain (or loss) from the sale of personal property. If the sale is denominated in a currency other than a functional currency as defined in section 985 and the regulations thereunder, the controlled foreign corporation may have additional income in the form of foreign currency gain as defined in section 988.

(3) *Predominant character.* The portion of income derived from a transaction that meets the definition of foreign personal holding company income is always separately determinable, and thus must always be segregated from other income and separately classified under paragraph (2) of this paragraph (e). However, the portion of income derived from a transaction that would meet a particular definitional provision under section 954 or 953 and the regulations thereunder (other than the definition of foreign personal holding company income) in unusual circumstances may be indeterminable. If such portion is indeterminable, it must be classified in accordance with the predominant character of the transaction. For example, if a controlled

foreign corporation engineers, fabricates, and installs a fixed offshore drilling platform as part of an integrated transaction, and the portion of income that relates to services is not accounted for separately from the portion that relates to sales, and is otherwise indeterminable, then the classification of income from the transaction shall be made in accordance with the predominant character of the particular integrated arrangement.

(4) *Coordination of categories of gross foreign base company income or gross insurance income.* The definitions of gross foreign base company income and gross insurance income are limited by the following rules (to be applied in numerical order):

(i) If an item of income is included in subpart F income under section 952(a)(1) and the regulations thereunder as insurance income, it is by definition excluded from any other category of subpart F income.

(ii) If an item of income is included in the foreign base company oil related income of a controlled foreign corporation, it is by definition excluded from any other category of foreign base company income, other than as provided in subdivision (i) of this paragraph (e)(4).

(iii) If an item of income is included in the foreign base company shipping income of a controlled foreign corporation, it is by definition excluded from any other category of foreign base company income, other than as provided in subdivisions (i) and (ii) of this paragraph (e)(4).

(iv) If an item of income is included in foreign personal holding company income of a controlled foreign corporation, it is by definition not included in any other category of foreign base company income, other than as provided in subdivisions (i), (ii), and (iii) of this paragraph (e)(4).

An item of income shall not be excluded from the definition of a category of gross foreign base company income or gross insurance income under this paragraph (e)(4) by reason of being included in the general definition of another category of gross foreign base company income or gross insurance income, if the item of income is excluded from that other category by a more specific provision of section 953 or 954 and the regulations thereunder. For example, income derived from a commodity transaction that is excluded from foreign personal holding company income under § 1.954–2T(f) as income from qualified active sales may be included in gross foreign base company income if it also meets the definition of foreign base company sales income. See § 1.954–2T(a)(2) for the coordination of overlapping categories within the definition of foreign personal holding company income.

[T.D. 8216, 53 FR 27492, July 21, 1988. Redesignated and amended by T.D. 8618, 60 FR 46530, Sept. 7, 1995]

### § 4.954–2 Foreign personal holding company income; taxable years beginning after December 31, 1986.

(a) *Computation of foreign personal holding company income*—(1) *In general.* Foreign personal holding company income consists of the following categories of income:

(i) Dividends, interest, rents, royalties, and annuities as defined in paragraph (b) of this section;

(ii) Gain from certain property transactions as defined in paragraph (e) of this section;

(iii) Gain from commodities transactions as defined in paragraph (f) of this section;

(iv) Foreign currency gain as defined in paragraph (g) of this section; and

(v) Income equivalent to interest as defined in paragraph (h) of this section.

Paragraph (a)(3) of this section provides rules for determining the use or purpose for which property is held, if a change in use or purpose would affect the computation of foreign personal holding company income under paragraphs (e), (f), and (g) of this section. Paragraphs (c) and (d) of this section provide rules for determining certain rents and royalties that are excluded from foreign personal holding company income under paragraph (b) of this section.

(2) *Coordination of overlapping definitions.* If a particular portion of income from a transaction in substance falls within more than one of the definitional rules of section 954(c) and this section, its character is determined under the rules of subdivision (i)

through (iii) of this paragraph (a)(2). The character of loss from a transaction must be similarly determined under the rules of this paragraph (a)(2).

(i) If a portion of the income from a transaction falls within the definition of income equivalent to interest under paragraph (h) of this section and the definition of gain from certain property transactions under paragraph (e) of this section, gain from a commodities transaction under paragraph (f) of this section (whether or not derived from a qualified hedging transaction or qualified active sales), or foreign currency gain under paragraph (g) of this section (whether or not derived from a qualified business transaction or a qualified hedging transaction), that portion of income is treated as income equivalent to interest for purposes of section 954(c) and this section.

(ii) If a portion of the income from a transaction falls within the definition of foreign currency gain under paragraph (g) of this section (whether or not derived from a qualified business transaction or a qualified hedging transaction) and the definition of gain from certain property transactions under paragraph (e) of this section, or gain from a commodities transaction under paragraph (f) of this section (whether or not derived from a qualified hedging transaction or qualified active sales), that portion of income is treated as foreign currency gain for purposes of section 954(c) and this section.

(iii) If a portion of the income from a transaction falls within the definition of gain from a commodities transaction under paragraph (f) of this section (whether or not derived from a qualified hedging transaction or qualified active sales) and the definition of gain from certain property transactions under paragraph (e) of this section, that portion of income is treated as gain from a commodities transaction for purposes of section 954(c) and this section.

(3) *Changes in the use or purpose with which property is held*—(i) *In general.* Under paragraphs (e), (f), and (g) of this section, transactions in certain property give rise to gain or loss included in the computation of foreign personal holding company income if the controlled foreign corporation holds that property for a particular use or purpose. For purposes of this section, in determining the purpose or use for which property is held, the period shortly before disposition is the most significant period. However, if a controlled foreign corporation held property with a purpose that would have caused its disposition to give rise to gain or loss included in the computation of foreign personal holding company income under this section, and prior to disposition the controlled foreign corporation changed the purpose or use for which it held the property to one that would cause its disposition to give rise to gain or loss excluded from the computation of foreign personal holding company income, then the later purpose or use shall be ignored unless it was continuously present for a predominant portion of the period during which the controlled foreign corporation held the property. Under paragraph (g)(4)(iii) of this section, a currency hedging transaction may be treated as two or more separate hedging transactions, such that each portion is separately considered in applying this paragraph (a)(3).

(ii) *Illustrations.* The following examples illustrate the application of this paragraph (a)(3).

*Example 1.* At the beginning of taxable year 1, *CFC,* a controlled foreign corporation, purchases a building for investment. During taxable years 1 and 2, *CFC* derives rents from this building that are included in the computation of foreign personal holding company income under paragraph (b)(1)(iii) of this section. At the beginning of taxable year 3, *CFC* changes the use of the building by terminating all leases, and using it in an active trade or business. At the beginning of taxable year 4, *CFC* sells the building at a gain. For purposes of paragraph (e) of this section (gains from the sale or exchange of certain property) the building is considered to be property that gives rise to rents, as described in paragraph (e)(2). Because there was a change of use at the beginning of year 3 that would cause the disposition of the building to give rise to gain or loss excluded from the computation of foreign personal holding company income, the characterization of the gain derived at the beginning of year 4 is determined according to the property's use during the predominant portion of the period from purchase to date of sale. Therefore, gain from the sale of that building is included in the computation of foreign

personal holding company income under paragraph (e) of this section.

*Example 2.* For taxable years 1, 2, and 3, *CFC,* a controlled foreign corporation, is engaged in the active conduct of a commodity business as a handler of gold, as defined in paragraph (f)(3)(iii), and substantially all of its business is as an active handler of gold, as defined in paragraph (f)(3)(iv). At the beginning of taxable year 1, *CFC* purchases 1000 ounces of gold for investment. At the beginning of taxable year 3, *CFC* begins holding that gold in physical form for sale to customers. During taxable year 3, *CFC* sells the entire 1000 ounces of gold in transactions described in paragraph (f)(3)(ii) at a gain. For purposes of paragraph (f), *CFC* is considered to hold the gold for investment, and not in its capacity as an active handler of gold. Thus, under paragraph (f)(3)(i), the gold is not considered to be sold in the active trade or business of the *CFC* as a handler of gold, and gain from the sale is included in the computation of foreign personal holding company income under paragraph (f) of this section.

*Example 3. CFC,* a controlled foreign corporation, is a regular dealer in unimproved land. The functional currency (as defined in section 985 and the regulations thereunder) of *CFC* is country X currency. On day 1 of its current taxable year, *CFC* enters into an agreement with A to pay $100 for certain real property to be held by *CFC* for investment. On day 10, under its method of accounting, *CFC* accrues the value of $100 in country X currency, but payment will not be made until the first day of the next taxable year (day 366). On day 190, *CFC* determines to hold the property for sale to customers in a transaction that would be a qualified business transaction under paragraph (g)(3) of this section. For purposes of this section, the land is considered to be held for investment, and the foreign currency gain attributable to that transaction is included in the computation of foreign personal holding company income under paragraph (g) of this section.

*Example 4. CFC,* a controlled foreign corporation, is a regular dealer in widgets. The functional currency (as defined in section 985 and the regulations thereunder) of *CFC* is country X currency. On day 1 of its current taxable year, *CFC* sells widgets held in inventory to A for delivery on day 60. The sales price is denominated in U.S. dollars, and payment is to be made by A on the same day the widgets are to be delivered to A. The remaining facts and circumstances are such that this sale would meet the definition of a qualified business transaction under paragraph (g)(4), the foreign currency gain from which would be excluded from the computation of foreign personal holding company income under paragraph (g). On day 1, *CFC* sells U.S. dollars forward for delivery in 60 days in a transaction that would be a qualified hedging transaction under paragraph (g)(5). On day 25 the sale of widgets to A is cancelled in a transaction that does not result in *CFC* realizing any foreign currency gain or loss with respect to the sale of widgets. However, *CFC* holds the dollar forward contract to maturity. Because the forward contract does not hedge a qualified business transaction during the period shortly before its maturity, it is not to be considered a qualified hedging transaction under paragraph (g), and any foreign currency gain or loss recognized therefrom is included in the computation of foreign personal holding company income under paragraph (g). However, if *CFC* identifies the portion of the foreign currency gain or loss derived from the forward contract that is attributable to days 1 through 25, and the portion that is attributable to days 25 through 60, the forward contract may be considered two separate transactions in accordance with the rules provided by paragraph (g)(4)(ii) of this section. Thus, the forward sale may be separately considered a qualified hedging transaction for day 1 through day 25, and the foreign currency gain or loss attributable to day 1 through day 25 may be excluded from the computation of foreign personal holding company income under paragraph (g) of this section.

*Example 5. CFC,* a controlled foreign corporation, has country X currency as its functional currency under section 985 and the regulations thereunder. On day 1 of the current taxable year, *CFC,* speculating on exchange rates, sells dollars forward for delivery in 120 days. On day 65, *CFC* sells widgets held in inventory at a price denominated in dollars to be paid on day 120 in a transaction that is a qualified business transaction. *CFC* had not made any other dollar sales between day 1 and day 65 and does not anticipate making any other dollar sales during the taxable year. On day 65, *CFC* accrues the value of $100 in country X currency. On day 120, *CFC* receives $100 payment for the widgets and recognizes foreign currency loss pursuant to that transaction. On day 120 *CFC* also delivers dollars in connection with the forward sale, and recognizes foreign currency gain pursuant to the delivery. Under this paragraph (a)(3) the currency transaction is considered to have been entered into for speculation, and any currency gain recognized by *CFC* on the forward sale of dollars must be included in the computation of foreign personal holding company income under paragraph (g). However, if *CFC* identifies the portion of the forward sale, and the foreign currency gain or therefrom, that is attributable to day 1 through day 64, and the portion that is attributable to day 65 through day 120, the forward sale may be considered two separate transactions in accordance with the rules provided by paragraph

(g)(4)(ii) of this section. Thus, the transaction for day 65 through day 120 may be considered a separate transaction that is a qualified hedging transaction, and the foreign currency gain attributable to day 65 through day 120 may be excluded from the computation of foreign personal holding company income under this paragraph (g) if all the other requirements for treatment as a qualified hedging transaction under paragraph (g) are met.

(4) *Definitions.* The following definitions apply for purposes of computing foreign personal holding company income under this section.

(i) *Interest.* The term ''interest'' includes amounts that are treated as ordinary income, original issue discount or interest income (including original issue discount and interest on a tax-exempt obligation) by reason of sections 482, 483, 864(d), 1273, 1274, 1276, 1281, 1286, 1288, 7872 and the regulations thereunder, or as interest or original issue discount income by reason of any other provision of law. For special rules concerning interest exempt from U.S. tax pursuant to section 103, see paragraph (b)(6) of this section.

(ii) *Inventory and similar property.* The term ''inventory and similar property'' (or ''inventory or similar property'') means property that is stock in trade of the controlled foreign corporation or other property of a kind which would properly be included in the inventory of the controlled corporation if on hand at the close of the taxable year (were the controlled foreign corporation a domestic corporation), or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of its trade or business. Rights to property held in bona fide hedging transactions that reduce the risk of price changes in the cost of ''inventory and similar property'' are included in the definition of that term if they are an integral part of the system by which a controlled foreign corporation purchases such property, and they are so identified by the close of the fifth day after the day on which the hedging transaction is entered into.

(iii) *Regular dealer.* The term ''regular dealer'' means a merchant with an established place of business that—

(A) Regularly and actively engages as a merchant in purchasing property and selling it to customers in the ordinary course of business with a view to the gains and profits that may be derived therefrom, or

(B) Makes a market in derivative financial products of property (such as forward contracts to buy or sell property, option contracts to buy or sell property, interest rate and currency swap contracts or other national principal contracts) by regularly and actively offering to enter into positions in such products to the public in the ordinary course of business.

Purchasing and selling property through a regulated exchange or established off-exchange market (for example, engaging in futures transactions) is not actively engaging as a merchant for purposes of this section.

(iv) *Dealer property.* Property held by a controlled foreign corporation is ''dealer property'' if—

(A) The controlled foreign corporation is a regular dealer in property of such kind, and

(B) The property is held by the controlled foreign corporation in its capacity as a dealer.

Property which is held by the controlled foreign corporation for investment or speculation is not such property.

(v) *Debt instrument.* The term ''debt instrument'' includes bonds, debentures, notes, certificates, accounts receivable, and other evidences of indebtedness.

(b) *Dividends, etc.*—(1) *In general.* Foreign personal holding company includes:

(i) Dividends, except certain dividends from related persons as described in paragraph (b)(3) of this section and distributions of previously taxed income under section 959(b) and the regulations thereunder;

(ii) Interest, except export financing interest as defined in paragraph (b)(2) of this section and certain interest received from related persons as described in paragraph (b)(3) of this section;

(iii) Rents and royalties, except certain rents and royalties received from related persons as described in (b)(4) of this section and rents and royalties derived in the active conduct of a trade or business as defined in paragraph (b)(5); and

(iv) Annuities.

(2) *Exclusion of certain export financing*—(i) *In general.* Pursuant to section 954(c)(2)(B), foreign personal holding company income computed under section 954(c)(1)(A) and this paragraph (b) does not include interest that is export financing interest. For purposes of section 954(c)(2)(B) and this section, the term ''export financing interest'' means interest that is derived in the conduct of a banking business and is export financing interest as defined in section 904(d)(2)(G) and the regulations thereunder. Pursuant to section 864(d)(5)(A)(iii), it does not include income from related party factoring that is treated as interest under section 864(d)(1) or interest described in section 864(d)(6).

(ii) *Conduct of a banking business.* For purposes of this section, export financing interest as defined in section 904(d)(2)(G) and the regulations thereunder is considered derived in the conduct of a banking business if, in connection with the financing from which the interest is derived, the corporation, through its own officers or staff of employees, engages in all the activities in which banks customarily engage in issuing and servicing a loan.

(iii) *Illustration.* The following example illustrates the application of this provision:

*Example. DS,* a domestic corporation, manufactures property in the United States. In addition to selling inventory (property described in section 1221(1)), *DS* occasionally sells depreciable equipment it manufactures for use in its trade or business, which is property described in section 1221(2). Less than 50 percent of the fair market value, determined in accordance with section 904(d)(2)(G) and the regulations thereunder, of each item of inventory or equipment sold by *DS* is attributable to products imported into the United States. *CFC,* a controlled foreign corporation related (as defined in section 954(d)) to *DS,* provides loans for the purchase of property from *DS,* if the property is purchased exclusively for use of consumption outside the United States.

If, in issuing and servicing loans made with respect to purchases from *DS* of depreciable equipment used in its trade or business, which is property described in section 1221(2) in the hands of *DS, CFC* engages in all the activities in which banks customarily engage in issuing and servicing loans, the interest accrued from these loans would be export financing interest meeting the requirements of paragraph (b)(2) of this section, which would not be included in foreign personal holding company income under section 954(c) and paragraph (b)(1)(ii) of this section. However, interest from the loans made with respect to purchases from *DS* of property which is inventory in the hands of *DS* cannot be export financing interest because it is treated as income from a trade or service receivable under section 864(d)(6) and the regulations thereunder, and thus is included in foreign personal holding company income under paragraph (b)(1)(ii) of this section. See § 1.864–8T(d) for rules concerning certain income from trade and service receivables qualifying under the same country exception of section 864(d)(7).

(3) *Exclusion of dividends and interest from related persons*—(i) *Excluded dividends and interest.* Foreign personal holding company income does not include dividends and interest if—

(A) The payor is a corporation that is a related person as defined in section 954(a)(3),

(B) The payor is created or organized (''incorporated'') under the laws of the same foreign country as the controlled foreign corporation, and

(C) A substantial part of the payor's assets are used in a trade or business in the payor's country of incorporation as determined under subdivision (iv) of this paragraph (b)(3).

Except as otherwise provided under this paragraph (b)(3), the principles of section 367(a) and regulations thereunder shall apply in determining whether the payor has a trade or business in its country of incorporation, and whether its assets are used in that trade or business.

(ii) *Interest paid out of adjusted foreign base company income or insurance income.* Interest may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(3) to the extent that the deduction for the interest is allocated under § 1.954–1T(c) to the payor's adjusted gross foreign base company income (as defined in § 1.954–1T(a)(3)), adjusted gross insurance income (as defined in § 1.954–1T(a)(6)), or other categories of income included in the computation of subpart F income under section 952(a), for purposes of computing the payor's net foreign base company income (as defined in § 1.954–

1T(a)(4), net insurance income (as defined in § 1.954–1T(a)(6)), or income described in sections 952(a) (3), (4), and (5).

(iii) *Dividends paid out of prior years' earnings.* Dividends are excluded from foreign personal holding company income under this paragraph (b)(3) only to the extent they are paid out of earnings and profits which were earned or accumulated during a period in which the requirements of subdivision (i) of this paragraph (b)(3) were satisfied or, to the extent earned or accumulated during a taxable year of the related foreign corporation ending on or before December 31, 1962, during a period in which the payor was a related corporation as to be controlled foreign corporation and the other requirements of subdivision (i) of this paragraph (b)(3) are substantially satisfied.

(iv) *Fifty percent substantial assets test.* A substantial part of the assets of the payor will be considered used in a trade or business located in its country of incorporation only if, for each quarter during such taxable year, the average value (as of the beginning and end of the quarter) of its assets which are used in the trade or business and are located in such country constitutes over 50 percent of the average value (as of the beginning and end of the quarter) of all the assets of the payor (including assets not used in a trade or business). For such purposes the value of assets shall be determined under subdivision (v) of this paragraph (b)(3), and the location of assets used in a trade or business of the payor shall be determined under subdivisions (vi) through (xi) of this paragraph (b)(3).

(v) *Value of assets.* For purposes of determining whether a substantial part of the assets of the payor are used in a trade or business in its country of incorporation, the value of assets shall be their actual value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be their adjusted basis.

(vi) *Location of tangible property used in a trade or business*—(A) *In general.* Tangible property (other than inventory and similar property) used in a trade or business is considered located in the country in which it is physically located.

(B) *Exception.* If tangible personal property used in a trade or business is intended for use in the payor's country of incorporation, but is temporarily located elsewhere, it will be considered located within payor's country of incorporation if the reason for its location elsewhere is for inspection or repair, and it is not currently in service in a country other than the payor's country of incorporation and is not to be placed in service in a country other than the payor's country of incorporation following the inspection or repair.

(vii) *Location of intangible property used in a trade or business*—(A) *In general.* The location of intangible property (other than inventory or similar property and debt instruments) used in a trade or business is determined based on the site of the activities conducted by the payor during the current year in connection with using or exploiting that property. An item of intangible property is located in the payor's country of incorporation during each quarter of the current taxable year if the activities connected with its use or exploitation are conducted during the entire current taxable year by the payor in its country of incorporation. For this purpose, the determination of the country in which services are performed shall be made under the principles of section 954(e) and § 1.954–4(c).

(B) *Property located in part in the payor's country of incorporation and in part in other countries.* If the activities connected with the use or exploitation of an item of intangible property are conducted during the current taxable year by the payor in the payor's country of incorporation and in other countries, then a percentage of the intangible (measured by the average value of the item as of the beginning and end of the quarter) is considered located in the payor's country of incorporation during each quarter. That percentage equals the ratio that the expenses of the payor incurred during the entire taxable year by reason of such activities that are conducted in the payor's country of incorporation bear to the expenses of the payor incurred during the entire taxable year by reason of all

such activities worldwide. Expenses incurred in connection with the use or exploitation of an item of intangible property are included in the computation provided by this paragraph (b)(3) if they are deductible under section 162 or includible in inventory costs or the costs of goods sold (were the payor a domestic corporation).

(viii) *Location of property held for sale to customers*—(A) *In general.* Inventory or similar property is considered located in the payor's country of incorporation during each quarter of the taxable year if the activities of the payor in connection with the production and sale, or purchase and release, of such property and conducted in the payor's country of incorporation during the entire taxable year. If the payor conducts such activities through an independent contractor, then the location of such activities shall be the place in which they are conducted by the independent contractor.

(B) *Inventory located in part in the payor's country of incorporation and in part in other countries.* If the activities connected with the production and sales, or purchase and resale, of inventory or similar property are conducted by the payor in the payor's country of incorporation and other countries, then a percentage of the inventory or similar property (measured by the average value of the item as of the beginning and end of the quarter) is considered located in the payor's country of incorporation each quarter. That percentage equals the ratio that the costs of the payor incurred during the entire taxable year by reason of such activities that are conducted in the payor's country of incorporation bear to all such costs incurred by reason of such activities worldwide. A cost incurred in connection with the production and sale or purchase and resale of inventory or similar property is included in this computation if it—

(*1*) Must be included in inventory costs or otherwise capitalized with respect to inventory or similar property under section 61, 263A, 471, or 472 and the regulations thereunder (whichever would be applicable were the payor a domestic corporation), or

(*2*) Would be deductible under section 162 (were the payor a domestic corporation) and is definitely related to gross income derived from such property (but not to all classes of gross income derived by the payor) under the principles of § 1.861–8.

(ix) *Location of debt instruments.* For purposes of this paragraph (b)(3), debt instruments are considered to be used in a trade or business only if they arise from the sale of inventory or similar property by the payor or from the rendition of services by the payor in the ordinary course of a trade or business of the payor, but only until such time as interest is required to be charged under section 482 and the regulations thereunder. Debt instruments that arise from the sale of inventory or similar property are treated as having the same location, proportionately, as inventory or similar property that is held during the same calendar quarter. Debt instruments arising from the rendition of services in the ordinary course of a trade or business are considered located on a proportionate basis in the countries in which the services to which they relate are performed.

(x) *Treatment of certain stock interests.* For the purpose of determining the value of assets used in a trade or business in the country of incorporation, stock directly or indirectly owned by the payor within the meaning of section 958(a) in a controlled foreign corporation (''lower-tier corporation''), which is incorporated in the same country as the payor, shall be considered located in the country of incorporation and used in a trade or business of the payor in proportion to the value of the assets of the lower-tier corporation that are used in a trade or business in the country of incorporation. The location of assets used in a trade or business of the lower-tier corporation shall be determined under the rules of this paragraph (b)(3).

(xi) *Determination of period during which property is used in a trade or business.* Property purchased or produced for use in a trade or business shall not be considered used in a trade or business until it is placed in service, and shall cease to be considered used in a trade or business when it is retired from service. The dates during which depreciable property is determined to

be in use must be consistent with the determination of depreciation under sections 167 and 168 and the regulations thereunder.

(xii) *Treatment of banks and insurance companies.* [Reserved.]

(4) *Exclusion of rents and royalties derived from related persons*—(i) *In general.* Foreign personal holding company income does not include rents or royalties if—

(A) The payor is a corporation that is a related person as defined in section 954(d)(3), and

(B) The rents or royalties are for the use of, or the privilege of using, property within the country under the laws of which the recipient of the payments is created or organized.

If the property is used both within and without the country under the laws of which the controlled foreign corporation is created or organized, the part of the rent or royalty attributable to the use of, or the privilege of using, the property outside such country of incorporation is, unless otherwise provided, foreign personal holding company income under this paragraph (b).

(ii) *Rents or royalties paid out of adjusted foreign base company income or insurance income.* Rents or royalties may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(4) to the extent that deductions for the payments are allocated under section 954(b)(5) and §1.954–1T(a)(4) to the payor's adjusted gross foreign base company income (as defined in §1.954–1T(a)(3)), adjusted gross insurance income (as defined in §1.954–1T(a)(6), or other categories of income included in the computation of subpart F income under section 952(a), for purposes of computing the payor's net foreign base company income (as defined in §1.954–1T(a)(4)), net insurance income (as defined in §1.954–1T(a)(6)), or income described in section 952(a) (3), (4), or (5).

(5) *Exclusion of rents and royalties derived in the active conduct of a trade or business.* Foreign personal holding company income shall not include rents or royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person within the meaning of section 954(d)(3). Whether or not rents or royalties are derived in the active conduct of a trade or business is to be determined from the facts and circumstances of each case; but see paragraph (c) or (d) of this section for specific cases in which rents or royalties will be considered for purposes of this paragraph to be derived in the active conduct of a trade or business. The frequency with which a foreign corporation enters into transactions from which rents or royalties are derived will not of itself establish the fact that such rents or royalties are derived in the active conduct of a trade or business.

(6) *Treatment of tax exempt interest.* Foreign personal holding company income includes all interest income, including interest that is exempt from U.S. tax pursuant to section 103 (''tax-exempt interest''). However, that net foreign base company income of a controlled foreign corporation that is attributable to such tax-exempt interest shall be treated as tax-exempt interest in the hands of the U.S. shareholders of the foreign corporation. Accordingly, any net foreign base company income that is included in the subpart F income of a U.S. shareholder and that is attributable to such tax-exempt interest shall remain exempt from the regular income tax, but potentially subject to the alternative minimum tax, in the hands of the U.S. shareholder.

(c) *Excluded rents*—(1) *Trade or business cases.* Rents will be considered for purposes of paragraph (b)(5) of this section to be derived in the active conduct of a trade or business if such rents are derived by the controlled foreign corporation (''lessor'') from leasing—

(i) Property which the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind,

(ii) Real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased,

(iii) Personal property ordinarily used by the lessor in the active conduct

of a trade or business, leased during a temporary period when the property would, but for such leasing, be idle, or

(iv) Property which is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and which is substantial in relation to the amount of rents derived from the leasing of such property.

(2) *Special rules*—(i) *Adding substantial value.* For purposes of paragraph (c)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* An organization in a foreign country will be considered substantial in relation to the amount of rents, for purposes of paragraph (c)(1)(iv) of this section, if active leasing expenses, as defined in paragraph (c)(2)(iii), equal or exceed 25 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section.

(iii) *Active leasing expenses* The term ''active leasing expenses'' means the deductions incurred by an organization of the lessor in a foreign country which are properly allocable to rental income and which would be allowable under section 162 to the lessor (were the lessor a domestic corporation) other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons with respect to, the lessor,

(B) Deductions for rents paid or accrued,

(C) Deductions which, although generally allowable under section 162, would be specifically allowable to the lessor (were the lessor a domestic corporation) under sections other than section 162 (such as sections 167 and 168), and

(D) Deductions for payments made to independent contractors with respect to the leased property.

(iv) *Adjusted leasing profit.* The term ''adjusted leasing profit'' means the gross income of the lessor from rents, reduced by the sum of—

(A) The rents paid or incurred by the controlled foreign corporation with respect to such gross rental income,

(B) The amounts which would be allowable to such lessor (were the lessor a domestic corporation) as deductions under section 167 or 168 with respect to such rental income, and

(C) The amounts paid to independent contractors with respect to such rental income.

(3) *Illustrations.* The application of this paragraph (c) is illustrated by the following examples.

*Example 1.* Controlled foreign corporation *A* is regularly engaged in the production of office machines which it sells or leases to others and services. Under paragraph (c)(1)(i) of this section, the rental income of *A* Corporation from the leases is derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 2.* Controlled foreign corporation *D* purchases motor vehicles which it leases to others. In the conduct of its short-term leasing of such vehicles in foreign country X, Corporation *D* owns a large number of motor vehicles in country X which it services and repairs, leases motor vehicles to customers on an hourly, daily, or weekly basis, maintains offices and service facilities in country X from which to lease and service such vehicles, and maintains therein a sizable staff of its own administrative, sales, and service personnel. Corporation *D* also leases in country X on a long-term basis, generally for a term of one year, motor vehicles which it owns. Under the terms of the long-term leases, Corporation *D* is required to repair and service, during the term of the lease, the leased motor vehicles without cost to the lessee. By the maintenance in country X of office, sales, and service facilities and its complete staff of administrative, sales, and service personnel, Corporation *D* maintains and operates an organization therein which is regularly engaged in the business of marketing and servicing the motor vehicles which are leased. The deductions incurred by such organization satisfy the 25-percent test of paragraph (c)(2)(ii) of this section; thus, such organization is substantial in relation to the rents Corporation *D* receives from leasing the motor vehicles. Therefore, under paragraph (c)(1)(iv) of this section, such rents are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 3.* [Reserved]

*Example 4.* Controlled foreign corporation *E* owns a complex of apartment buildings

which it has acquired by purchase. Corporation *E* engages a real estate management firm to lease the apartments, manage the buildings and pay over the net rents to the owner. The rental income of *E* Corporation from such leases is not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 5.* Controlled foreign corporation *F* acquired by purchase a twenty-story office building in a foreign country, three floors of which it occupies and the rest of which it leases. Corporation *F* acts as rental agent for the leasing of offices in the building and employs a substantial staff to perform other management and maintenance functions. Under paragraph (c)(1)(ii) of this section, the rents received by Corporation *F* from such leasing operations are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 6.* Controlled foreign corporation *G* owns equipment which it ordinarily uses to perform contracts in foreign countries to drill oil wells. For occasional brief and irregular periods it is unable to obtain contracts requiring immediate performance sufficient to employ all such equipment. During such a period it sometimes leases such idle equipment temporarily. After the expiration of such temporary leasing of the property, Corporation *G* continues the use of such equipment in the performance of its own drilling contracts. Under paragraph (c)(1)(iii) of this section, rents *G* receives from such leasing of idle equipment are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(d) *Excluded royalties*—(1) *Trade or business cases.* Royalties will be considered for purposes of paragarph (b)(5) of this section to be derived in the active conduct of a trade or business if such royalties are derived by the controlled foreign corporation (''licensor'') from licensing—

(i) Property which the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation, or production of, or in the acquisition of and addition of substantial value to, property of such kind, or

(ii) Property which is licensed as a result of the performance of marketing functions by such licensor and the licensor, through its own staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and which is substantial in relation to the amount of royalties derived from the licensing of such property.

(2) *Special rules*—(i) *Adding substantial value.* For purposes of paragraph (d)(1)(i), the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* An organization in a foreign country will be considered substantial in relation to the amount of royalties, for purposes of paragraph (d)(1)(ii) of this section, if the active licensing expenses, as defined in paragraph (d)(2)(iii) of this section, equal or exceed 25 percent of the adjusted licensing profit, as defined in paragraph (d)(2)(iv) of this section.

(iii) *Active licensing expenses.* The term ''active licensing expenses'' means the deductions incurred by an organization of the licensor which are properly allocable to royalty income and which would be allowable under section 162 to the licensor (were the licensor a domestic corporation) other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons with respect to, the licensor,

(B) Deductions for royalties paid or incurred,

(C) Deductions which, although generally allowable under section 162, would be specifically allowable to the licensor (were the controlled foreign corporation a domestic corporation) under sections other than section 162 (such as section 167), and

(D) Deductions for payments made to independent contractors with respect to the licensed property.

(iv) *Adjusted licensing profit.* The term ''adjusted licensing profit'' means the gross income of the licensor from royalties, reduced by the sum of—

(A) The royalties paid or incurred by the controlled foreign corporation with respect to such gross royalty income,

(B) The amounts which would be allowable to such licensor as deductions under section 167 (were the licensor a domestic corporation) with respect to such royalty income, and

(C) The amounts paid to independent contractors with respect to such royalty income.

(3) *Illustrations.* The application of this paragraph (d) is illustrated by the following examples.

*Example 1.* Controlled foreign corporation *A*, through its own staff of employees, owns and operates a research facility in foreign country X. At the research facility employees of Corporation A who are full time scientists, engineers, and technicians regularly perform experiments, tests, and other technical activities, which ultimately result in the issuance of patents that it sells or licenses. Under paragraph (d)(1)(i) of this section, royalties received by Corporation *A* for the privilege of using patented rights which it develops as a result of such research activity are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 2.* Assume that Corporation *A* in example 1, in addition to receiving royalties for the use of patents which it develops, receives royalties for the use of patents which it acquires by purchase and licenses to others without adding any value thereto. Corporation *A* generally consummates royalty agreements on such purchased patents as the result of inquiries received by it from prospective licensees when the fact becomes known in the business community, as a result of the filing of a patent, advertisements in trade journals, announcements, and contacts by employees of Corporation *A*, that Corporation *A* has acquired rights under a patent and is interested in licensing its rights. Corporation *A* does not, however, maintain and operate an organization in a foreign country which is regularly engaged in the business of marketing the purchased patents. The royalties received by Corporation *A* for the use of the purchased patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 3.* Controlled foreign corporation *B* receives royalties for the use of patents which it acquires by purchase. The primary business of Corporation *B*, operated on a regular basis, consists of licensing patents which it has purchased ''raw'' from inventors and, through the efforts of a substantial staff of employees consisting of scientists, engineers, and technicians, made susceptible to commercial application. For example, Corporation *B*, after purchasing patent rights covering a chemical process, designs specialized production equipment required for the commercial adaptation of the process and, by so doing, substantially increases the value of the patent. Under paragraph (d)(1)(i) of this section, royalties received by Corporation *B* from the use of such patent are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 4.* Controlled foreign corporation *D* finances independent persons in the development of patented items in return for an ownership interest in such items from which it derives a percentage of royalty income, if any, subsequently derived from the use by others of the protected right. Corporation *D* also attempts to increase its royalty income from such patents by contacting prospective licensees and rendering to licensees advice which is intended to promote the use of the patented property. Corporation *D* does not, however, maintain and operate an organization in a foreign country which is regularly engaged in the business of marketing the patents. Royalties received by Corporation *D* for the use of such patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(e) *Certain property transactions*—(1) *In general*—(i) *Inclusion in FPHC income.* Foreign personal holding company income includes the excess of gains over losses from the sale or exchange of—

(A) Property which gives rise to dividends, interest, rents, royalties or annuities as described in paragraph (e)(2) of this section, and

(B) Property which does not give rise to income, as described in paragraph (e)(3) of this section.

If losses from the sale or exchange of such property exceed gains, the net loss is not within the definition of foreign personal holding company income under this paragraph (e), and may not be allocated to, or otherwise reduce, other foreign personal holding company income under section 954(b)(5) and § 1.954–1T(c). Gain or loss from a transaction that is treated as capital gain or loss under section 988(a)(1)(B) is not foreign currency gain or loss as defined in paragraph (g), but is gain or loss from the sale or exchange of property which is included in the computation of foreign personal holding company income under this paragraph (e)(1). Paragraphs (e) (4) and (5) of this section provide specific rules for determining whether gain or loss from dispositions of debt instruments and dispositions of options or similar property must be included in the computation of foreign personal holding company income under this paragraph (e)(1). A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken

into account for purposes of determining foreign personal holding company income under any provision of this paragraph (e).

(ii) *Dual character property.* Property may only in part constitute property that gives rise to certain income as described in paragraph (e)(2) of this section or property that does not give rise to any income as described in paragraph (e)(3) of this section. In such cases, the property must be treated as two separate properties for purposes of this paragraph (e). Accordingly, the sale or exchange of such dual character property will give rise to gain or loss that in part must be included in the computation of foreign personal holding company income under this paragraph (e), and in part is excluded from such computation. Gain or loss from the disposition of dual character property must be bifurcated for purposes of this paragraph (e)(1)(i) pursuant to the method that most reasonably reflects the relative uses of the property. Reasonable methods may include comparisons in terms of gross income generated or the physical division of the property. In the case of real property, the physical division of the property will in most cases be the most reasonable method available. For example, if a controlled foreign corporation owns an office building, uses 60 percent of the building in its business, and rents out the other 40 percent, then 40 percent of the gain recognized on the disposition of the property would reasonably be treated as gain which is included in the computation of foreign personal holding company income under this paragraph (e)(1). This paragraph (e)(1)(ii) addresses the contemporaneous use of property for dual purposes; for rules concerning changes in the use of property affecting its classification for purposes of this paragraph (e), see paragraph (a)(3) of this section.

(2) *Property that gives rise to certain income*—(i) *In general.* Property the sale or exchange of which gives rise to foreign personal holding company income under this paragraph (e)(2) includes property that gives rise to dividends, interest, rents, royalties and annuities described in paragraph (b) of this section, except for rents and royalties derived from unrelated persons in the active conduct of a trade or business under paragraph (b)(5) of this section. The property described by this paragraph (e)(2) includes property which gives rise to export financing interest described in paragraph (b)(2) of this section and property which gives rise to income from related persons described in paragraphs (b)(3) and (b)(4) of this section.

(ii) *Exception.* Property described in this paragraph (e)(2) does not include—

(A) Dealer property (as defined in paragraph (a)(4)(iv) of this section), and

(B) Inventory and similar property (as defined in paragraph (a)(4)(ii) of this section) other than securities.

(3) *Property that does not give rise to income.* The term ''property that does not give rise to income'' for purposes of this section includes all rights and interests in property (whether or not a capital asset) except—

(i) Property that gives rise to dividends, interest, rents, royalties and annuities described in paragraph (e)(2) of this section and property that gives rise to rents and royalties derived in the active conduct of a trade or business under paragraph (b)(5) of this section;

(ii) Dealer property (as defined in paragraph (a)(4)(iv) of this section);

(iii) Inventory and similar property (as defined in paragraph (a)(4)(ii)) other than securities;

(iv) Property (other than real property) used in the controlled foreign corporation's trade or business that is of a character which would be subject to the allowance for depreciation under section 167 or 168 and the regulations thereunder (including tangible property described in § 1.167(a)–2 and intangibles described in § 1.167(a)–3);

(v) Real property that does not give rise to rental or similar income, to the extent used in the controlled foreign corporation's trade or business; and

(vi) Intangible property as defined in section 936(h)(3)(B) and goodwill that is not subject to the allowance for depreciation under section 167 and the regulations thereunder to the extent used in the controlled foreign corporation's trade or business and disposed of in connection with the sale of a trade or

business of the controlled foreign corporation.

(4) *Classification of gain or loss from the disposition of a debt instrument or on a deferred payment sale*—(i) *Gain.* Gain from the sale, exchange, or retirement of a debt instrument is included in the computation of foreign personal holding company income under this paragraph (e) unless—

(A) It is treated as interest income (as defined in paragraph (a)(4)(i) of this section); or

(B) It is treated as income equivalent to interest under paragraph (h) of this section.

(ii) *Loss.* Loss from the sale, exchange, or retirement of a debt instrument is included in the computation of foreign personal holding company income under this paragraph (e) unless—

(A) It is directly allocated to interest income (as defined in paragraph (a)(4)(i) of this section) or income equivalent to interest (as defined in paragraph (h) of this section) under any provision of the Code or regulations thereunder;

(B) It is required to be apportioned in the same manner as interest expense under section 864(e) or any other provision of the Code or regulations thereunder; or

(C) The debt instrument was taken in consideration for the sale or exchange of property (or the provision of services) by the controlled foreign corporation and gain or loss from that sale or exchange (or income from the provision of services) is not includible in foreign base company income under this section.

(5) *Classification of options and other rights to acquire or transfer property.* Subject to the exceptions provided in paragraphs (e)(3) (ii) and (iii) of this section (relating to certain dealer property and inventory property), rights to acquire or transfer property, including property that gives rise to income, are classified as property that does not give rise to income under paragraph (e)(3) of this section. These rights include options, warrants, futures contracts, options on a futures contract, forward contracts, and options on an index relating to stocks, securities or interest rates.

(6) *Classification of certain interests in pass through entities.* [Reserved]

(f) *Commodities transactions*—(1) *In general.* Except as otherwise provided in this paragraph (f), foreign personal holding company income includes the excess of gains over losses from commodities transactions. If losses from commodities transactions exceed gains, the net loss is not within the definition of foreign personal holding company income under this paragraph (f), and may not be allocated to, or otherwise reduce, foreign personal holding company income under section 954(b)(5) and § 1.954–1T(a)(4). The terms ''commodity'' and ''commodities transactions'' are defined in paragraph (f)(2) of this section. Gains and losses from qualified active sales and qualified hedging transactions are excluded from the computation of foreign personal holding company income under this paragraph (f). The term ''qualified active sales'' is defined in paragraph (f)(3). The term ''qualified hedging transaction'' is defined in paragraph (f)(4) of this section. An election is provided under paragraph (g)(5) of this section to include all gains and losses from section 1256 foreign currency transactions, which would otherwise be commodities transactions, in the computation of foreign personal holding company income under paragraph (g) instead of this paragraph (f). A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken into account for purposes of determining foreign personal holding company income under any provision of this paragraph (f).

(2) *Definitions*—(i) *Commodity.* For purposes of this section, the term ''commodity'' means:

(A) Tangible personal property of a kind which is actively traded or with respect to which contractual interests are actively traded, and

(B) Nonfunctional currency (as defined under section 988 and the regulations thereunder).

(ii) *Commodities transaction.* A commodities transaction means the purchase or sale of a commodity for immediate (spot) delivery, or deferred (forward) delivery, or the right to purchase, sell, receive, or transfer a commodity, or any other right or obligation with respect to a commodity, accomplished through a cash or off-exchange market, an interbank market, an organized exchange or board of trade, an over-the-counter market, or in a transaction effected between private parties outside of any market. Commodities transactions include, but are not limited to:

(A) A futures or forward contract in a commodity,

(B) A leverage contract in a commodity purchased from leverage transaction merchants,

(C) An exchange of futures for physical transaction,

(D) A transaction in which the income or loss to the parties is measured by reference to the price of a commodity, a pool of commodities, or an index of commodities,

(E) The purchase or sale of an option or other right to acquire or transfer a commodity, a futures contract in a commodity, or an index of commodities, and

(F) The delivery of one commodity in exchange for the delivery of another commodity, the same commodity at another time, cash, or nonfunctional currency.

(3) *Definition of the term ''qualified active sales''*—(i) *In general.* The term ''qualified active sales'' means the sale of commodities in the active conduct of a commodity business as a producer, processor, merchant, or handler of commodities if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities of like kind. The sale of commodities held by a controlled foreign corporation other than in its capacity as an active producer, processor, merchant or handler of commodities of like kind is not a qualified active sale.

(ii) *Sale of commodities.* The term ''sale of commodities'' means any transaction in which the controlled foreign corporation intends to deliver to a purchaser a commodity held by the controlled foreign corporation in physical form.

(iii) *Active conduct of a commodities business.* For purposes of this paragraph, a controlled foreign corporation is engaged in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities only if—

(A) It holds commodities as inventory or similar property (as defined in paragraph (a)(4)(ii)); and

(B) It incurs substantial expenses in the ordinary course of a commodities business from engaging in one of the following activities directly, and not through an independent contractor:

(*1*) Substantial activities in the production of commodities, including planting, tending or harvesting crops, raising or slaughtering livestock, or extracting minerals.

(*2*) Substantial processing activities prior to the sale of commodities including concentrating, refining, mixing, crushing, aerating, or milling; or

(*3*) Significant activities relating to the physical movement, handling and storage of commodities including preparation of contracts and invoices; arranging freight, insurance and credit; arranging for receipt, transfer or negotiation of shipping documents; arranging storage or warehousing, and dealing with quality claims; owning and operating facilities for storage or warehousing or owning or chartering vessels or vehicles for the transportation of commodities.

For purposes of this paragraph (f), a corporation is not engaged in a commodities business as a producer, processor, merchant, or handler of commodities if its business is primarily financial. In general, the business of a controlled foreign corporation is financial if it primarily engages in commodities transactions for investment or speculation, or if it primarily provides products or services to customers for investment or speculation.

(iv) *Substantially all.* Substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities if the activities described in paragraph (f)(3)(iii) give rise to 85 percent of the taxable income of the controlled foreign corporation (computed

as though the corporation were a domestic corporation). For this purpose, gains or losses from qualified hedging transactions, as defined in paragraph (f)(4), are considered derived from the qualified active sales to which they relate or are expected to relate.

(4) *Definition of the term ''qualified hedging transaction.''* The term ''qualified hedging transaction'' means a bona fide hedging transaction that:

(i) Is reasonably necessary to the conduct of business as a producer, processor, merchant or handler of a commodity in the manner in which such business is customarily and usually conducted by others;

(ii) Is entered into primarily to reduce the risk of price change (but not the risk of currency fluctuations) with respect to commodities sold or to be sold in qualified active sales described in paragraph (f)(3) of this paragraph; and

(iii) Is clearly identified on the controlled foreign corporation's records before the close of the fifth day after the day during which the hedging transaction is entered into and at a time when there is a reasonable risk of loss; however, if the controlled foreign corporation does not at such time specifically and properly identify the qualified active sales (or category of such sales) to which a hedging transaction relates, the district director in his sole discretion may determine which hedging transactions (if any) are related to qualified active sales.

(g) *Foreign currency gain*—(1) *In general.* Except as provided in paragraph (g)(2), foreign personal holding company income includes the excess of foreign currency gains over losses (as defined in section 988(b)) attributable to any section 988 transactions. If foreign currency losses exceed gains, the net loss is not within the definition of foreign personal holding company income under this paragraph (g), and may not be allocated to, or otherwise reduce, foreign personal holding company income under section 954(b)(5) and § 1.954–1T(a)(4). To the extent the gain or loss from a transaction is treated as interest income or expense under sections 988(a)(2) or 988(d) and the regulations thereunder, it is not included in the computation of foreign personal holding company income under this paragraph (g). (For other rules concerning income described in more than one category of foreign personal holding company income, see § 1.954–2(a)(2).) A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken into account for purposes of determining foreign personal holding company income under any provision of this paragraph (g).

(2) *Exceptions*—(i) *Qualified business units using the dollar approximate separate transactions method.* Any DASTM gain or loss computed under § 1.985–3(d) must be allocated under the rules of § 1.985–3 (e)(2)(iv) or (e)(3).

(ii) *Tracing to exclude foreign currency gain or loss from qualified business and hedging transactions.* A foreign currency gain or loss is excluded from the computation of foreign personal holding company income under this paragraph (g) if it is clearly identified on the records of the controlled foreign corporation as being derived from a qualified business transaction or a qualified hedging transaction. The term ''qualified business transaction'' is defined in paragraph (g)(3) of this section. The term ''qualified hedging transaction'' is defined paragraph (g)(4) of this section. However, currency gain or loss of a qualified business unit included in the computation of currency gain or loss under subdivision (i) of this paragraph (g)(2) may not be excluded from foreign personal holding company income under the tracing rule of this paragraph (g)(2)(ii). Furthermore, the tracing rule of this paragraph (g)(2)(ii) will not apply if a controlled foreign corporation makes the election provided by paragraph (g)(2)(iii) of this section.

(iii) *Election out of tracing.* A controlled foreign corporation may elect a method of accounting under which all foreign currency gains or losses attributable to section 988 transactions are included in foreign personal holding company income. The scope and requirements for this election are provided in paragraph (g)(5) of this section. This election does not apply to foreign currency gains or losses of a qualified business unit included in the

computation of gain or loss under paragraph (g)(2)(i) of this section.

(3) *Definition of the term ''qualified business transaction''*—(i) *In general.* The term ''qualified business transaction'' means a transaction (other than a ''qualified hedging transaction'' as described in paragraph (g)(4) of this section) that:

(A) Does not have investment or speculation as a significant purpose;

(B) Is not attributable to property or an activity of the kind that gives rise to subpart F income (other than foreign currency gain under this paragraph (g)), or could reasonably be expected to give rise to subpart F income (including upon disposition); for example, the transaction may not be attributable to stock or debt of another corporation (including related corporations organized and operating in the same country), or property likely to give rise to foreign base company sales or services income; and

(C) Is attributable to business transactions described in subdivision (ii) of this paragraph (g)(3).

A qualified business transaction includes the disposition of a debt instrument that constitutes inventory property under paragraph (a)(4)(ii) or dealer property under paragraph (a)(4)(iv) of this section. The provisions of this paragraph (g)(3) do not apply to the foreign currency gain or loss of a qualified business unit (as determined under § 1.985–3T(d)(2)) included in the computation of gain or loss under paragraph (g)(2)(i) of this section. The provisions of this paragraph (g)(3) do, however, apply to other currency transactions of a qualified business unit that elects (or is deemed to elect) the U.S. dollar as its functional currency under section 985(b)(3) and § 1.985–2T. Qualified business transactions and the amount of foreign currency gain or loss derived therefrom must be clearly identified on its records by the controlled foreign corporation. If the controlled foreign corporation is unable to specifically identify the qualified business transactions and the foreign currency gain or loss derived therefrom, the district director in his sole discretion may determine which transactions of the corporation giving rise to the foreign currency gains or losses are attributable to qualified business transactions.

(ii) *Specific business transactions.* A transaction of a controlled foreign corporation must meet the requirements of any of subdivisions (A) through (F) of this paragraph (g)(3)(ii) to be a qualified business transaction under this paragraph (g)(3).

(A) *Acquisition of debt instruments.* If the transaction is the acquisition of a debt instrument described in section 988(c)(1)(B)(i) and the regulations thereunder, the debt must be derived from—

(*1*) The sale of inventory and similar property to customers by the controlled foreign corporation in the ordinary course of regular business operations, or

(*2*) The rendition of services by the corporation in the ordinary course of regular business operations.

For purposes of this paragraph (g)(3)(ii)(A), a debt instrument will not be considered derived in the ordinary course of regular business operations unless the instrument matures, and is reasonably expected to be satisfied, within the period for which interest need not be charged under section 482 and the regulations thereunder.

(B) *Becoming the obligor under debt instruments.* If the transaction is becoming the obligor under a debt instrument described in section 988(c)(1)(B)(i) and the regulations thereunder, the debt must be incurred for:

(*1*) Payment of expenses that are includible by the controlled foreign corporation in the cost of goods sold under § 1.61–3 for property held primarily for sale to customers in the ordinary course of regular business operations, are inventoriable costs under section 471 and the regulations thereunder, or are allocable or apportionable under the rules of § 1.861–8 to gross income derived from inventory and similar property,

(*2*) Payment of expenses that are allocable or apportionable under the rules of § 1.861–8 to gross income derived from services provided by the controlled foreign corporation in the ordinary course of regular business operations,

(*3*) Acquisition of an asset that does not give rise to subpart F income during the current taxable year (other than by application of section 952(c)) and is not reasonably expected to give rise to subpart F income in subsequent taxable years, or

(*4*) Acquisition of dealer property as defined in paragraph (a)(4)(iv) of this section.

The identification requirements of subdivision (i) of this paragraph (g)(3) will not be met with respect to a borrowing if the controlled foreign corporation fails to clearly identify the debt and the expenses (or categories of expenses) to which it relates before the close of the fifth day after the day on which the expenses are incurred.

(C) *Accrual of any item of gross income.* If the transaction is the accrual (or otherwise taking into account) of any item of gross income or receipts as described in section 988(c)(1)(B)(ii) and the regulations thereunder, the item of gross income or receipts must be derived from:

(*1*) The sale of inventory and similar property in the ordinary course of regular business operations, or

(*2*) The provision of services by the controlled foreign corporation to customers in the ordinary course of regular business operations.

(D) *Accrual of any item of expense.* If the transaction is the accrual (or otherwise taking into account) of any item of expense as described in section 988(c)(1)(B)(ii) and the regulations thereunder, the item of expense must be:

(*1*) An expense that is includible by the controlled foreign corporation in the cost of goods sold under § 1.61–3 for property held primarily for sale to customers in the ordinary course of regular business operations, is an inventoriable cost under section 471 and the regulations thereunder, or is allocable or apportionable under the rules of § 1.861–8 to gross income derived from inventory and similar property, or

(*2*) An expense that is allocable or apportionable under the rules of § 1.861–8 to gross income derived from services provided by the controlled foreign corporation in the ordinary course of regular business operations.

(E) *Entering into forward contracts, futures contracts, options and similar instruments.* If the transaction is entering into any forward contract, futures contract, option or similar financial instrument and if such contract or instrument is not marked to market at the close of the taxable year under section 1256, as described in section 988(c)(1)(B)(iii) and the regulations thereunder, then the contract or instrument must be property held as dealer property as defined in paragraph (a)(4)(ii) of this section.

(F) *Disposition of nonfunctional currency.* If the transaction is the disposition of nonfunctional currency, as described in section 988(c)(1)(C) and the regulations thereunder, then the transaction must be for a purpose described in paragraph (g)(3)(ii)(B), for the payment of taxes not attributable to subpart F income, or must be the disposition of property held as dealer property as defined in paragraph (a)(4)(iv) of this section.

(G) *Transactions in business assets.* The acquisition or disposition of an asset that is used or held for use in the active conduct of a trade or business.

(4) *Definition of the term ''qualified hedging transaction''*—(i) *In general.* The term ''qualified hedging transaction'' means a bona fide hedging transaction meeting all the requirements of subdivisions (A) through (D) of this paragraph (g)(4)(i):

(A) The transaction must be reasonably necessary to the conduct of regular business operations in the manner in which such business operations are customarily and usually conducted by others.

(B) The transaction must be entered into primarily to reduce the risk of currency fluctuations with respect to property or services sold or to be sold or expenses incurred or to be incurred in transactions that are qualified business transactions under paragraph (g)(3) of this section.

(C) The hedging transaction and the property or expense (or category of property or expense) to which it relates must be clearly identified on the records of the controlled foreign corporation before the close of the fifth day after the day during which the hedging transaction is entered into and

at a time during which there is a reasonable risk of currency loss.

(D) The amount of foreign currency gain or loss that is attributable to a specific hedging transaction must be clearly identifiable on the records of the controlled foreign corporation or its controlling shareholder (as defined in § 1.964–1(c)(5)).

The provisions of this paragraph (g)(4) do not apply to transactions of a qualified business unit included in the computation of gain or loss under paragraph (g)(2)(i). The provisions of this paragraph (g)(4) do apply, however, to other currency transactions of a qualified business unit that elects (or is deemed to elect) the U.S. dollar as its functional currency under section 985(b)(3) and § 1.985–3T. If the controlled foreign corporation does not specifically identify the qualified business transactions (or category of qualified business transactions) to which a hedging transaction relates or is unable to specifically identify the amount of foreign currency gain or loss derived from the hedging transactions, the district director in his sole discretion may make the identifications required of the controlled foreign corporation and determine which hedging transactions (if any) are related to qualified business transactions, and the amount of foreign currency gain or loss attributable to the qualified hedging transactions.

(ii) *Change in purpose of hedging transaction.* If a hedging transaction is entered into for one purpose, and the purpose for that transaction subsequently changes, the transaction may be treated as two separate hedging transactions for purposes of this paragraph (g)(4). In such a case, the portion of the transaction that relates to a qualified business transaction is considered a qualified hedging transaction if it separately meets all the other requirements of this paragraph (g)(4) for treatment as a qualified hedging transaction. For purposes of paragraph (g)(4)(i)(C), the foreign corporation must identify on its records the portion of the transaction that relates to a qualified business transaction by the close of the fifth day after the day on which the hedge becomes so related (*i.e.*, either the day on which the hedge is first entered into or on the day on which it first relates to a qualified business transaction due to a change in its purpose). The foreign corporation must identify on its records the portion of the transaction that does not relate to a qualified business transaction by the close of the fifth day after the day on which the purpose for the hedging transaction changes.

(5) *Election out of tracing*—(i) *In general.* A controlled foreign corporation may elect to account for currency gains and losses under section 988 and gains and losses from section 1256 currency contracts by including in the computation of foreign personal holding company income under this paragraph (g) all foreign currency gains or losses attributable to section 988 transactions, and all gains or losses from section 1256 foreign currency contracts. Separate elections for section 1256 foreign currency contracts and section 988 transactions are not permitted. If a controlled foreign corporation makes the election described in this paragraph (g)(5)(i), the election is effective for all related persons as defined in section 954(d)(3) and the regulations thereunder.

(ii) *Exception.* The election provided by this paragraph (g)(5) does not apply to foreign currency gain or loss of a qualified business unit determined under § 1.985–3T(d)(2). It does, however, apply to other foreign currency gains or losses of a qualified business unit that elects (or is deemed to elect) the U.S. dollar as its functional currency.

(iii) *Procedure*—(A) *In general.* The election provided by this paragraph (g)(5) shall be made in the manner prescribed in this paragraph and in subsequent administrative pronouncements.

(B) *Time and manner.* The controlled foreign corporation may make the election by filing a statement with its original or amended information return for the taxable year for which the election is made. The controlling United States shareholders, as defined in § 1.964–1(c)(5), may make the election on behalf of the controlled foreign corporation and related corporations by filing a statement to such effect with their original or amended income tax returns for the taxable year during

which the taxable year of the controlled foreign corporation for which the election is made ends. The election is effective for the taxable year of the controlled foreign corporation for which the election is made, for the taxable years of all related controlled foreign corporations ending within such taxable year, and for all subsequent years of such corporations. The statement shall include the following information:

(*1*) The name, address, taxpayer identification number, and taxable year of each United States shareholder;

(*2*) The name, address, and taxable year of each controlled foreign corporation for which the election is effective; and

(*3*) Any additional information to be required by the Secretary by administrative pronouncement.

Each United States shareholder or controlled foreign corporation filing the election must provide copies of the election to all controlled foreign corporations for which the election is effective, and all United States shareholders of such corporations. However, failure to provide such copies will not void (or cause to be voidable) an election under this paragraph (g)(5).

(C) *Termination.* The election provided by this paragraph (g)(5) may be terminated only with the consent of the Commissioner: Attn.: CC:INTL.

(h) *Income equivalent to interest*—(1) *In general.* Foreign personal holding company income includes income that is equivalent to interest. Income equivalent to interest includes, but is not limited to, income derived from the following categories of transactions:

(i) An investment, or series of integrated transactions which include an investment, in which the payments, net payments, cash flows, or return predominantly reflect the time value of money, and

(ii) Transactions in which the payments or a predominant portion thereof are in substance for the use or forebearance of money, but are not generally treated as interest.

However, amounts treated as interest under section 954(c)(1)(A) and paragraph (b) of this section are not income equivalent to interest under this paragraph (h). Income from the sale of property will not be treated as income equivalent to interest for purposes of this paragraph (h), subject to the rule of paragraph (h)(4) of this section, unless the sale is part of an integrated transaction that gives rise to interest or income equivalent to interest. See sections 482, 483 and 1274 for the extent to which such income may be characterized as interest income subject to paragraph (b) of this section. Income equivalent to interest for purposes of this paragraph (h) includes all income attributable to a transfer of securities subject to section 1058. Income equivalent to interest also includes a portion of certain deferred payments received for the purpose of services, in accordance with the provisions of paragraph (h)(5) of this section. Income equivalent to interest does not include income attributable to notional principal contracts such as interest rate swaps, currency swaps, interest rate floor agreements, or similar contracts except to the extent that such contracts are part of an integrated transaction that gives rise to income equivalent to interest. Income derived from notional contracts by a person acting in its capacity as a regular dealer in such contracts will be presumed not to be integrated with an investment.

(2) *Illustrations.* The following examples illustrate the application of this paragraph (h):

*Example 1. CFC,* a controlled foreign corporation, promises that *A,* an unrelated person, may borrow up to $500 in principal for one year beginning at any time during the next three months at an interest rate of 10 percent. In exchange, *A* pays *CFC* a commitment fee of $2.00. Pursuant to this loan commitment, *CFC* lends $80 to *A*. As a result, the entire $2.00 fee is included in the computation of foreign personal holding company income under this paragraph (h)(1)(ii).

*Example 2.* (i) At the beginning of its current taxable year, *CFC,* a controlled foreign corporation, purchases at face value a one-year debt instrument issued by *A* having a $100 principal amount and bearing a floating rate of interest set at the London Interbank Offered Rate (''LIBOR'') plus one percentage point. Contemporaneously, *CFC* borrows $100 from *B* for one year at a fixed interest rate of 10 percent, using the debt instrument as security.

(ii) During its current taxable year, *CFC* accrues $11 of interest from *A* on the bond. That interest is foreign personal holding company income under section 954(c)(1) and

§ 1.954–2T(b), and thus is not income equivalent to interest. During its current taxable year, *CFC* incurs $10 of interest expense with respect to the borrowing from *B*. That expense is allocated and apportioned to, and reduces, foreign base company income or insurance income to the extent provided in sections 954(b)(5), 863(e), and 864(e) and the regulations thereunder.

*Example 3.* (i) At the beginning of its 1988 taxable year, *CFC*, a controlled foreign corporation, purchases at face value a one-year debt instrument issued by *A* having a $100 principal amount and bearing a floating rate of interest set at the London Interbank Offered Rate (''LIBOR'') plus one percentage point payable on the last day of *CFC*'s current taxable year. *CFC* subsequently determines that it would prefer receiving interest at a fixed rate, and, on January 1, 1989, enters into an agreement with *B*, an unrelated person, whereby *B* promises to pay *CFC* on the last day of *CFC*'s 1989 taxable year an amount equal to 10 percent on a notional principal amount of $100. In exchange, *CFC* promises to pay *B* on the last day of *CFC*'s 1989 taxable year an amount equal to LIBOR plus one percentage point on the notional principal amount.

(ii) *CFC* receives a total of $10 from *B*, and pays $9 to *B*. *CFC* also receives $9 from *A*. The $9 paid to *B* is directly allocated to, or is otherwise an adjustment to, the $10 received from *B*. The transactions are considered an intergrated transaction giving rise to $9 of interest income (paid by *A*) and, under paragraph (h)(1)(i), $1 of income equivalent to interest (paid by *B*).

*Example 4.* The facts are the same as in Example 3, except that *CFC* does not hold any debt obligations. Since the transaction with *B* is not integrated with an investment giving rise to interest or income equivalent to interest, the net $1 of income realized by *CFC* does not constitute income equivalent to interest.

*Example 5.* (i) *CFC*, a controlled foreign corporation, enters into an agreement with *A* whereby *CFC* purchases commodity X from *A* at a price of $100, and *A* contemporaneously repurchases commodity X from *CFC* for payment and delivery in 3 months at a price of $104 set by the forward market.

(ii) The transaction is in substance a loan from *CFC* to *A* secured by commodity X. Thus, *CFC* accrues $4 of gross income which is included in foreign personal holding company income as interest under section 954(c)(1)(A) and paragraph (b) of this section.

*Example 6.* (i) *CFC* purchases commodity Y on the spot market for $100 and contemporaneously, sells commodity Y forward for delivery and payment in 3 months at a price of $104 set by the forward market.

(ii) The $100 paid on the spot purchase of commodity Y offsets any market risk on the forward sale so that the $4 of income to be derived predominantly reflects time value of money. Thus, under paragraph (h)(1)(i), the spot purchase of commodity Y and the offsetting forward sale will be treated as an integrated transaction giving rise to $4 of income equivalent to interest.

(3) *Income equivalent to interest from factoring*—(i) *General rule.* Income equivalent to interest includes factoring income. Except as provided in paragraph (h)(3)(ii) of this section, the term ''factoring income'' includes any income (including any discount income or service fee, but excluding any stated interest) derived from the acquisition and collection or disposition of a factored receivable. The rules of this paragraph (h)(3) apply only with respect to the tax treatment of factoring income derived from the acquisition and collection or disposition of a factored receivable and shall not affect the characterization of an expense or loss of either the person whose goods or services gave rise to a factored receivable or the obligor under a receivable. The amount of income equivalent to interest realized with respect to a factored receivable is the difference (if a positive number) between the amount paid for the receivable by the foreign corporation and the amount that it collects on the receivable (or realizes upon its sale of the receivable).

(ii) *Exceptions.* Factoring income shall not include—

(A) Income treated as interest under section 864(d)(1) or (6) and the regulations thereunder (relating to income derived from trade or service receivables of related persons), even if such income is not treated as described in section 864(d)(1) by reason of the same-country exception of section 864(d)(7);

(B) Income derived from a factored receivable if payment for the acquisition of the receivable is made on or after the date on which stated interest begins to accrue, but only if the rate of stated interest equals or exceeds 120 percent of the Federal short term rate (as defined under section 1274) (or the equivalent rate for a currency other than the dollar) as of the date on which the receivable is acquired by the foreign corporation; or

(C) Income derived from a factored receivable if payment for the acquisition of the receivable by the foreign

corporation is made only on or after the anticipated date of payment of all principal by the obligor (or the anticipated weighted average date of payment of a pool of purchased receivables).

(iii) *Factored receivable.* For purposes of this paragraph (h)(3), the term ''factored receivable'' includes any account receivable or other evidence of indebtedness, whether or not issued at a discount and whether or not bearing stated interest, arising out of the disposition of property or the performance of services by any person, if such account receivable or evidence of indebtedness is acquired by a person other than the person who disposed of the property or provided the services that gave rise to the account receivable or evidence of indebtedness. For purposes of this paragraph (h)(3), it is immaterial whether the person providing the property or services agrees to transfer the receivable at the time of sale (as by accepting a third-party charge or credit card) or at a later time.

(iv) *Illustrations.* The following examples illustrate the application of this paragraph (h)(3).

*Example 1.* DP, a domestic corporation, owns all of the outstanding stock of FS, a controlled foreign corporation. FS acquires accounts receivable arising from the sale of property by unrelated corporation X. The receivables have a face amount of $100, and after 30 days bear stated interest equal to at least 120 percent of the applicable short term Federal rate (determined as of the date the receivable is acquired). FS purchases the receivables from X for $95 on Day 1 and collects $100 from the obligor under the receivable on Day 40. Income (other than stated interest) derived by FS from the factored receivables is factoring income within the meaning or paragraph (h)(3)(i) of this section and, therefore, is income equivalent to interest.

*Example 2.* The facts are the same as in example 1, except that FS does not pay X for the receivables until Day 30. Income derived by FS from the factored receivables is not factoring income by reason of paragraph (h)(3)(ii)(B) of this section.

*Example 3.* The facts are the same as in example 2, except that it is anticipated that all principal will be paid by the obligor of the receivables by Day 30. Income derived by FS from this ''maturity factoring'' of the receivables is not factoring income by reason of paragraph (h)(3)(ii)(C) of this section, and therefore does not give rise to income equivalent to interest.

*Example 4.* The facts are the same as in example 1, except that, rather than collecting $100 from the obligor under the factored receivable on Day 40, FS sells the receivable to controlled foreign corporation Y on Day 15 for $97. Both the income derived by FS on the factored receivable and the income derived by Y (other than stated interest) on the receivable are factoring income within the meaning of paragraph (h)(3)(i) of this section, and therefore, constitute income equivalent to interest.

*Example 5.* The facts are the same as in example 4, except that FS sells the factored receivable to Y for $99 on Day 45, at which time interest is accruing on the unpaid balance of $100. FS has $4 of net factoring income that is income equivalent to interest. Because interest was accruing at the time Y acquired the receivable at a rate equal to at least 120 percent of the applicable short term Federal rate, income derived by Y from the factored receivable is not factoring income by reason of pargraph (h)(3)(ii)(B).

*Example 6.* DP, a domestic corporation engaged in an integrated credit card business, owns all of the outstanding stock of FS, a controlled foreign corporation. On Day 1 individual A uses a credit card issued by DP to purchase shoes priced at $100 from X, a foreign corporation unrelated to DP, FS, or A. By prearrangement with DP, on Day 7, X transfers the receivable arising from A's purchase to FS in exchange for $95. FS collects $100 from A on Day 45. Income derived by FS on the factored receivable is factoring income within the meaning of paragraph (h)(3)(i) of this section and, therefore, is income equivalent to interest.

(4) *Determination of sales income.* Income equivalent to interest for purposes of this paragraph (h) does not include income from the sale of property unless the sale is part of an integrated transaction that gives rise to interest or income equivalent to interest. Income derived by a controlled foreign corporation will be treated as arising from the sale of property only if the corporation in substance carries out sales activities. Accordingly, an arrangement that is designed to lend the form of a sales transaction to a transaction that in substance constitutes and advance of funds will be disregarded. For example, if a controlled foreign corporation acquires property on 30-day payment terms from one person and sells that property to another person on 90 day payment terms and at prearranged prices and terms such that

the foreign corporation bears no substantial economic risk with respect to the purchase and sale other than the risk of non-payment, the foreign corporation has not in substance derived income from the sale of property.

(5) *Receivables arising from performance of services.* If payment for services performed by a controlled foreign corporation is not made until more than 120 days after the date on which such services are performed, then the income derived by the foreign corporation constitutes income equivalent to interest to the extent that interest income would be imputed under the principles of section 483 or the original issue discount provisions (section 1271 *et seq.*), if—

(A) Such provisions applied to contracts for the performance of services,

(B) The time period referred to in sections 483(c)(1) and 1274(c)(1)(B) were 120 days rather than six months, and

(C) The time period referred to in section 483(c)(1)(A) were 120 days rather than one year.

[T.D. 8216, 53 FR 27498, July 21, 1988; 53 FR 29801, Aug. 8, 1988, as amended by T.D. 8556, 59 FR 37672, July 25, 1994. Redesignated and amended by T.D. 8618, 60 FR 46530, Sept. 7, 1995]

## PART 5—TEMPORARY INCOME TAX REGULATIONS UNDER THE REVENUE ACT OF 1978

Sec.

5.856–1 Extensions of the grace period for foreclosure property by a real estate investment trust.
5.1502–45 Limitation on losses to amount at risk.
5.1561–1 Taxable years of component members of controlled group of corporations that include December 31, 1978.
5.6411–1 Tentative refund under claim of right adjustment.

AUTHORITY: 26 U.S.C. 7805.

### §5.856–1 Extensions of the grace period for foreclosure property by a real estate investment trust.

(a) *In general.* Under section 856(e), a real estate investment trust (''REIT'') may elect to treat as foreclosure property certain real property (including interests in real property), and any personal property incident to such real property, that the REIT acquires after December 31, 1973. In general, the REIT must acquire the property as the result of having bid in the property at foreclosure, or having otherwise reduced the property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of such property (where the REIT was the lessor) or on an indebtedness owed to the REIT which such property secured. Property that a REIT elects to treat as foreclosure property ceases to be foreclosure property with respect to such REIT at the end of a grace period. The grace period ends on the date which is 2 years after the date on which the REIT acquired the property, unless the REIT has been granted an extension or extensions of the grace period. If the grace period is extended, the property ceases to be foreclosure property on the day immediately following the last day of the grace period, as extended.

(b) *Rules for extensions of the grace period.* In general, §1.856–6(g) prescribes rules regarding extensions of the grace period. However, in order to reflect the amendment of section 856(e)(3) of the Code by section 363(c) of the Revenue Act of 1978, the following rules also apply:

(1) In the case of extensions granted after November 6, 1978, with respect to extension periods beginning after December 31, 1977, the district director may grant one or more extensions of the grace period for the property, subject to the limitation that no extension shall extend the grace period beyond the date which is 6 years after the date the REIT acquired the property. In any other case, an extension shall be for a period of not more than 1 year, and not more than two extensions can be granted with respect to the property.

(2) In the case of an extension period beginning after December 31, 1977, a request for an extension filed on or before March 28, 1980, will be considered to be timely if the limitation on the number and length of extensions in section 856(e)(3), as in effect before the amendment made by section 363(c) of the Revenue Act of 1978, would have barred the extension.

[T.D. 7767, 46 FR 11284, Feb. 6, 1981]

**§5.1502–45 Limitation on losses to amount at risk.**

(a) *In general*—(1) *Scope.* This section applies to a loss of any subsidiary if the common parent's stock meets the stock ownership requirement described in section 465(a)(1)(C).

(2) *Limitation on use of losses.* Except as provided in paragraph (a)(4) of this section, a loss from an activity of a subsidiary during a consolidated return year is includible in the computation of consolidated taxable income (or consolidated net operating loss) and consolidated capital gain net income (or consolidated net capital loss) only to the extent the loss does not exceed the amount that the parent is at risk in the activity at the close of that subsidiary's taxable year. In addition, the sum of a subsidiary's losses from all its activities is includible only to the extent that the parent is at risk in the subsidiary at the close of that year. Any excess may not be taken into account for the consolidated return year but will be treated as a deduction allocable to that activity of the subsidiary in the first succeeding taxable year.

(3) *Amount parent is at risk in subsidiary's activity.* The amount the parent is at risk in an activity of a subsidiary is the lesser of (i) the amount the parent is at risk in the subsidiary or (ii) the amount the subsidiary is at risk in the activity. These amounts are determined under paragraph (b) of this section and the principles of section 465. See section 465 and the regulations thereunder and the examples in paragraph (e) of this section.

(4) *Excluded activities.* The limitation on the use of losses in paragraph (a)(2) of this section does not apply to a loss attributable to an activity described in section 465(c)(3)(D).

(5) *Substance over form.* Any transaction or arrangement between members (or between a member and a person that is not a member) which does not cause the parent to be economically at risk in an activity of a subsidiary will be treated in accordance with the substance of the transaction or arrangement notwithstanding any other provision of this section.

(b) *Rules for determining amount at risk*—(1) *Excluded amounts.* The amount a parent is at risk in an activity of a subsidiary at the close of the subsidiary's taxable year does not include any amount which would not be taken into account under section 465 were the subsidiary not a separate corporation. Thus, for example, if the amount a parent is at risk in the activity of a subsidiary is attributable to nonrecourse financing, the amount at risk is not more than the fair market value of the property (other than the subsidiary's stock or debt or assets) pledged as security.

(2) *Guarantees.* If a parent guarantees a loan by a person other than a member to a subsidiary, the loan increases the amount the parent is at risk in the activity of the subsidiary.

(c) *Application of section 465.* This section applies in a manner consistent with the provisions of section 465. Thus, for example, the recapture of losses provided in section 465(e) applies if the amount the parent is at risk in the activity of a subsidiary is reduced below zero.

(d) *Other consolidated return provisions unaffected.* This section limits only the extent to which losses of a subsidiary may be used in a consolidated return year. This section does not apply for other purposes, such as §§1.1502–32 and 1.1502–19, relating to investment in stock of a subsidiary and excess loss accounts, repectively. Thus, a loss which reduces a subsidiary's earnings and profits in a consolidated return year, but is disallowed as a deduction for the year by reason of this section, may nonetheless result in a negative adjustment to the basis of an owning member's stock in the subsidiary or create (or increase) an excess loss account.

(e) *Examples.* The provisions of this section may be illustrated by the examples in this paragraph (e). In each example, the stock ownership requirement of section 465(a)(1)(C) is met for the stock of the parent (P), and each affiliated group files a consolidated return on a calendar year basis and comprises only the members described.

*Example (1).* In 1979, P forms S with a contribution of $200 in exchange for all of S's stock. During the year, S borrows $400 from a commercial lender and P guarantees $100 of the loan. S uses $500 of its funds to acquire a motion picture film. S incurs a loss of $120

for the year with respect to the film. At the close of 1979, the amount P is at risk in S's activity is $300. If S has no gain or loss in 1980, and there are no contributions from or distributions to P, at the close of 1980 P's amount at risk in S's activity will be $180.

*Example.* (2). P forms S–1 with a capital contribution of $1 on January 1, 1980. On February 1, 1980. S–1 borrows $100 with full recourse and contributes all $101 to its newly formed subsidiary S–2. S–2 uses the proceeds to explore for natural oil and gas resources. S–2 incurs neither gain nor loss from its explorations during the taxable year. As of December 31, 1980, P is at risk in the exploration activity of S–2 only to the extent of $1.

(f) *Effective date.* This section applies to consolidated return years ending on or after December 31, 1979.

[T.D. 7685, 45 FR 16484, Mar. 14, 1980]

### § 5.1561–1 Taxable years of component members of controlled group of corporations that include December 31, 1978.

(a) *In general.* This section prescribes a regulation for applying sections 301 (a) and (b) (19), and 106, of the Revenue Act of 1978 (the Act) in the case of certain taxable years of component members of a controlled group of corporations (as defined in section 1563 of the Internal Revenue Code). The section applies only to taxable years that include December 31, 1978, and only if the taxable year of at least one component member ends in 1979.

(b) *Background.* Section 301(a) of the Act amends section 11 of the Code (relating to tax imposed on corporations) to provide for taxable income brackets that are subject to tax at rates less than the maximum rate of 46 percent. Section 301(b)(19) of the Act amends section 1561(a) of the Code (relating to limitations on certain multiple tax benefits in the case of certain controlled corporations) to limit the component members of a controlled group to an aggregate amount in each bracket which does not exceed the maximum amount in such bracket to which a corporation which is not a component member of a controlled group is entitled. Section 106 of the Act amends section 21 of the Code (relating to effect of changes in rate of tax) to provide that the amendments made by section 301 of the Act shall be treated as a change in a rate of tax. Since the amendments made by section 301 of the Act are effective for taxable years beginning after December 31, 1978, under the amendment to section 21 the effective date of the change in rate of tax is January 1, 1979.

(c) *No apportionment plan in effect.* If no apportionment plan (see § 1.1561–3 of the Income Tax Regulations) is in effect with respect to December 31, 1978, the single $50,000 surtax exemption available before January 1, 1979, and the single bracket amounts available after December 31, 1978, shall be equally divided among the component members of the controlled group on December 31, 1978. In the case of a controlled group which includes component members that join in the filing of a consolidated return and other component members that do not join in the filing of such a return, each component member of the group (including each component member that joins in filing the consolidated return) shall be treated as a separate corporation for purposes of equally apportioning the $50,000 surtax exemption in effect before January 1, 1979, and the bracket amounts in effect after December 31, 1978. In such a case, the surtax exemption and bracket amounts of the corporations filing the consolidated return shall be the sum of the amount apportioned to each component member that joins in filing the consolidated return.

(d) *Apportionment plan.* (1) If one or more component members of the controlled group have a calendar taxable year and if an apportionment plan is adopted under § 1.1561–3 apportioning the entire $50,000 surtax exemption available for 1978 to such calendar-year members, then the amount in each taxable income bracket available for fiscal-year members is zero. If only a part of the $50,000 surtax exemption is apportioned to calendar-year members, then a proportionate part of the $25,000 amount in each taxable income bracket is available for the fiscal-year members. For example, if $30,000 (3/5 of $50,000) is apportioned to calendar-year members, 2/5 of the $25,000 amount in each bracket, or $10,000, as well as the remaining 2/5 of the 1978 surtax exemption, is available to the fiscal-year members.

(2) The amount in each taxable income bracket available to fiscal-year members may be apportioned among such members in any manner the controlled group may select. For example, the available amount in the first bracket (subject to a 17-percent rate) may be allocated to one member, the amount in the second bracket (subject to a 20-percent rate) may be allocated to another member, and so on. Moreover, the available amount in each bracket may be divided among the members in any manner the group may select.

(3) In computing 1978 tentative taxes under section 21, the total surtax exemption available to fiscal-year members for 1978 must be divided among such members in the same proportion as the sum of the available amount in each bracket is divided among them. Thus, if the sum of the available bracket amounts is $100,000 (*i.e.*, $25,000 in each bracket), and if corporation X is apportioned 30 percent, or $30,000, of this amount (regardless of which brackets corporation X may select), then 30 percent of the surtax exemption available to the fiscal-year members for 1978 (*i.e.*, 30 percent of $50,000, or $15,000) must be apportioned to corporation X.

(e) *Corporations affected.* The provisions of section 1561 may reduce the surtax exemption or bracket amounts of any corporation which is a component member of a controlled group of corporations and which is subject to the tax imposed by section 11, or by any other provision of subtitle A of the Code if the tax under such other provisions is computed by reference to the tax imposed by section 11. Such other provisions include, for example, sections 511(a)(1), 594, 802, 831, 852, 857, 882, 1201, and 1378.

(f) *Example.* This section may be illustrated by the following example:

*Example.* Corporations X, Y, and Z are component members of a controlled group of corporations on December 31, 1978. X has taxable income of $10,000 for the taxable year ending December 31, 1978. Y has taxable income of $60,000 for the taxable year ending June 30, 1979. Z has taxable income of $90,000 for the taxable year ending September 30, 1979. The group files an apportionment plan under § 1.1561–3 apportioning $10,000 (*i.e.*, ⅕ of $50,000) to X, the calendar-year member. Therefore, ⅘ of the amount in each bracket, or $20,000, is available to Y and Z, the fiscal-year members. Under the plan, Y is apportioned the entire amount in the first bracket and $10,000 of the amount in the second bracket. Z is apportioned $10,000 of the amount in the second bracket and the entire amount in the third and fourth brackets. Therefore, Y is apportioned $30,000, or ⅜ of the total available amount in the four brackets, and Z is apportioned $50,000, or ⅝ of the total available amount. The tax liabilities of Y and Z for their taxable years ending in 1979 are computed as follows: (Computation of X's tax liability for 1978, using a surtax exemption of $10,000, is not shown.)

1979 TENTATIVE TAX

| | Y |
|---|---|
| Taxable income | $60,000 |
| Tax on amount in first bracket: 17 percent of $20,000 | 3,400 |
| Tax on amount in second bracket: 20 percent of $10,000 | 2,000 |
| Tax on remaining income: 46 percent of $30,000 | 13,800 |
| 1979 tentative tax | 19,200 |

| | Z |
|---|---|
| Taxable income | 90,000 |
| Tax on amount in second bracket: 20 percent of $10,000 | 2,000 |
| Tax on amount in third bracket: 30 percent of $20,000 | 6,000 |
| Tax on amount in fourth bracket: 40 percent of $20,000 | 8,000 |
| Tax on remaining income: 46 percent of $40,000 | 18,400 |
| 1979 tentative tax | 34,400 |

1978 TENTATIVE TAX

| | Y |
|---|---|
| Taxable income | 60,000 |

1978 TENTATIVE TAX

| | | | |
|---|---|---|---|
| Normal tax: | | | |
| 20 percent of $7,500 (3/8 of $20,000) | | | 1,500 |
| 22 percent of $52,500 | | | 11,550 |
| | | | 13,050 |
| Surtax: | | | |
| Taxable income | $60,000 | | |
| Surtax exemption | 15,000 | (3/8 of $40,000) | |
| | $45,000 | ×26 percent | 11,700 |
| 1978 tentative tax | | | 24,750 |
| | | | Z |
| Taxable income | | | 90,000 |
| Normal tax: | | | |
| 20 percent of $12,500 (5/8 of $20,000) | | | 2,500 |
| 22 percent of $77,500 | | | 17,050 |
| | | | 19,500 |
| Surtax: | | | |
| Taxable income | $90,000 | | |
| Surtax exemption | 25,000 | (5/8 of $40,000) | |
| | $65,000 | × 26 percent | 16,900 |
| 1978 tentative tax | | | 36,450 |
| The 1978 and 1979 tentative taxes are apportioned as follows: | | | |
| Corporation Y: | | | |
| 1978—184/365 of $24,750 | | | 12,477 |
| 1979—181/365 of $19,200 | | | 9,521 |
| Total tax for taxable year | | | 21,998 |
| Corporation Z: | | | |
| 1978—92/365 of $36,450 | | | 9,187 |
| 1979—273/365 of $34,400 | | | 25,729 |
| Total tax for taxable year | | | 34,916 |

[T.D. 7583, 44 FR 872, Jan. 4, 1979]

## § 5.6411–1 Tentative refund under claim of right adjustment.

(a) *Effective date.* This section applies to applications for tentative refunds filed after November 5, 1978, under section 6411(d).

(b) *In general.* Section 6411(d) allows taxpayers to apply for a tentative refund of amounts treated under section 1341(b)(1) as an overpayment of tax under a claim of right adjustment. This section contains rules for filing an application for this tentative refund. The computation of amounts treated as an overpayment must be made in accordance with section 1341 and the regulations under that section.

(c) *Method of applying for tentative refund*—(1) *In general.* For a corporation, the application is made by filing Form 1139. For taxpayers other than corporations, the application is made by filing Form 1045. The application must be made by filing those forms even if the taxpayer is not applying for a tentative carryback adjustment under section 6411(a). If the taxpayer files the form to apply for the section 6411(d) tentative refund only, it may disregard those lines on the form used to compute the section 6411(a) carryback adjustment. If the taxpayer has a carryback of a net operating loss, credit, or capital loss for the taxable year (determined without the deduction described in section 1341(a)(2)) and applies for both the section 6411(a) tenative carryback adjustment and the section 6411(d) tentative refund, an ordering rule applies. The taxpayer must take into account any adjustments made in applying for the tentative carryback adjustment under section 6411(a) before determining the amount of the overpayment for which an application under section 6411(d) is being made. The taxpayer

must attach to the form a separate schedule containing the information required under paragraph (d) of this section.

(2) *Applications made before February 7, 1980.* Applications made before February 7, 1980 that are made under penalties of perjury will be considered meeting the requirements of this section if made by filing a separate statement whether or not it is attached to Form 1139 or 1045. This application, however, must contain the information required under paragraph (d) of this section (other than paragraph (d)(2)).

(d) *Information required*—(1) *In general.* The application must contain (i) the taxpayer's name, address, and identification number and (ii) the information set forth in paragraph (d) (2) and (3) of this section, determined in accordance with section 1341 and the regulations under that section. For example, the decrease in tax under paragraph (d)(3)(iii) of this section is determined under §1.1341–1(d)(4).

(2) *Computation under section 1341(a)(4).* The application must contain the following information related to the computation under section 1341(a)(4):

(i) The amount of income restored by the taxpayer to another during the taxable year and the amount of the corresponding deduction described in section 1341(a)(2);

(ii) The tax for the taxable year computed with the deduction described in section 1341(a)(2); and

(iii) The tax for each prior taxable year (determined before adjustment under section 1341) to which any net operating loss described in section 1341(b)(4)(A) may be carried and the decrease in tax for each of those years that results from the carryback of that loss.

(3) *Computation under section 1341(a)(5).* The application must contain the following information related to the computation under section 1341(a)(5):

(i) The tax for the taxable year without the deduction described in section 1341(a)(2);

(ii) The tax for each prior taxable year (determined before adjustment under section 1341) for which a decrease in tax is computed under section 1341(a)(5)(B);

(iii) The decrease in tax for each prior taxable year computed under section 1341(a)(5)(B), including any decrease resulting from a net operating loss or capital loss described in section 1341(b)(4)(B); and

(iv) The amount treated as an overpayment of tax under section 1341(b)(1).

(e) *Time and place for filing.* The application must be filed no earlier than the date of filing the return for the taxable year of restoration and no later than the date 12 months from the last day of that taxable year. The application must be filed with the Internal Revenue Service Center (or other office) where the taxpayer filed its return for the taxable year of restoration.

(f) *Not a claim for credit or refund.* An application for tentative refund under section 6411(d) is not a claim for credit or refund. The principles of paragraph (b)(2) of §1.6411–1 apply in determining the effect of an application for a tentative refund. For example, the filing of an application for tentative refund under section 6411(d) is not a claim for credit or refund in determining whether a claim for credit or refund was timely filed.

[T.D. 7672, 45 FR 8295, Feb. 7, 1980; 45 FR 17138, Mar. 18, 1980]

## PART 5c—TEMPORARY INCOME TAX REGULATIONS UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981

Sec.

5c.44F–1 Leases and qualified research expenses.
5c.103–1 Leases and capital expenditures.
5c.103–2 Leases and industrial development bonds.
5c.103–3 Leases and arbitrage.
5c.168(f)(8)–1 Special rules for leases.
5c.168(f)(8)–2 Election to characterize transaction as a section 168(f)(8) lease.
5c.168(f)(8)–3 Requirements for lessor.
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5c.168(f)(8)–5 Term of lease.
5c.168(f)(8)–6 Qualified leased property.
5c.168(f)(8)–7 Reporting of income, deductions and investment tax credit; at risk rules.
5c.168(f)(8)–8 Loss of section 168(f)(8) protection; recapture.
5c.168(f)(8)–9 Pass-through leases—transfer of only the investment tax credit to a

party other than the ultimate user of the property. [Reserved]
5c.168(f)(8)–10 Leases between related parties. [Reserved]
5c.168(f)(8)–11 Consolidated returns. [Reserved]
5c.442–1 Temporary regulations relating to change of annual accounting period.
5c.1305–1 Special income averaging rules for taxpayers otherwise required to compute tax in accordance with § 5c.1256–3.

AUTHORITY: 26 U.S.C. 168(f)(8)(G) and 7805.

SOURCE: T.D. 7791, 46 FR 51907, Oct. 23, 1981, unless otherwise noted.

### § 5c.44F–1 Leases and qualified research expenses.

For purposes of section 44F(b)(2)(A)(iii), the determination of whether any amount is paid or incurred to another person for the right to use personal property in the conduct of qualified research shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8). See § 5c.168(f)(8)–1(b).

### § 5c.103–1 Leases and capital expenditures.

For purposes of section 103(b)(6)(D) and § 1.103–10(b)(2)(iv)(*b*), the determination of whether property is leased and whether property is of a type that is ordinarily subject to a lease shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8).

### § 5c.103–2 Leases and industrial development bonds.

For purposes of section 103(b)(2), the determination of whether an obligation constitutes an industrial development bond shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8).

[T.D. 7800, 46 FR 63257, Dec. 31, 1981]

### § 5c.103–3 Leases and arbitrage.

In the case of a sale and leaseback transaction qualifying under section 168(f)(8), where the lessee's rental payments are substantially equal in timing and amount to the principal and interest payments on the lessor's note, the arbitrage provisions of section 103(c) and §§ 1.103–13, 1.103–14, and 1.103–15 shall apply to any obligations of the lessee (or party related to the lessee) without regard to the section 168(f)(8) lease transaction.

[T.D. 7800, 46 FR 63257, Dec. 31, 1981]

### § 5c.168(f)(8)–1 Special rules for leases.

(a) *In general.* Section 168(f)(8) of the Internal Revenue Code of 1954 provides special rules for characterizing certain agreements as leases and characterizing the parties to the agreement as lessors and lessees for Federal tax law purposes. These rules apply only with respect to qualified leased property. If all the requirements of section 168(f)(8) and §§ 5c.168(f)(8)–2 through 5c.168(f)(8)–11 are met, then the agreement shall be treated as a lease, and the party characterized as the lessor shall be treated as the owner of the property. In such case, the lessor shall be deemed to have entered into the lease in the course of carrying on a trade or business and shall be allowed accelerated cost recovery system (ACRS) deductions under section 168 and the investment tax credit under section 38 with respect to the leased property.

(b) *Exception for qualified research expenditures.* For purposes of section 44F(b)(2)(A)(iii), the determination of whether any amount is paid or incurred to another person for the right to use personal property in the conduct of qualified research shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8). Thus, if a lessee would be considered the owner of the property without regard to section 168(f)(8), any amounts paid by the lessee under the lease shall not be considered amounts paid or incurred for the right to use the property.

(c) *Other factors disregarded.* If an agreement meets the requirements of section 168(f)(8) and §§ 5c.168(f)(8)–2 through 5c.168(f)(8)–11, the following factors will not be taken into account in determining whether the transaction is a lease:

(1) Whether the lessor or lessee must take the tax benefits into account in order to determine that a profit is made from the transaction;

(2) The fact that the lessee is the nominal owner of the property for State or local law purposes (*e.g.*, has legal title to the property) and retains the burdens, benefits, and incidents of

ownership (such as payment of taxes and maintenance charges with respect to the property);

(3) Whether or not a person other than the lessee may be able to use the property after the lease term;

(4) The fact that the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price that is more or less than its fair market value at that time;

(5) The fact that the lessee or related party has provided financing or has guaranteed financing for the transaction (other than for the lessor's minimum 10 percent investment); and

(6) The fact that the obligation of any person is subject to any contingency or offset agreement. See, for example, the rent and debt service offset in Example (2) of paragraph (e).

An agreement that meets the requirements of section 168(f)(8) and §§ 5c.168(f)(8)–2 through 5c.168(f)(8)–11 may be treated by the parties as a lease for Federal Tax law purposes only. Similarly, a sale by the lessee of the leased property to the lessor in a transaction where the property is leased back under an agreement that meets the requirements of section 168(f)(8) may be treated by the parties as a sale for Federal tax law purposes only. The agreements need not comply with State law requirements concerning transfer of title, recording, etc.

(d) *Ownership in one of the parties.* Notwithstanding any other section, if neither the lessor nor the lessee would be the owner of the property without regard to section 168(f)(8), or, if any party with an economic interest in the property (other than the lessor or lessee or any subsequent transferee of their interests) claims ACRS deductions or any investment tax credit with respect to the leased property, an election under section 168(f)(8) with respect to such property shall be void as of the date of the execution of the lease agreement.

(e) *Examples.* The application of section 168(f)(8) and §§ 5c.168(f)(8)–2 through 5c.168(f)(8)–11 may be illustrated by the following examples:

*Example (1).* X Corp. wishes to acquire a $1 million piece of equipment which is ''qualified leased property'' as defined in section 168(f)(8)(D). The equipment has a 10-year economic life and falls within the 5-year ACRS class. Y Corp. is a person meeting the qualifications set forth in section 168(f)(8)(B)(i) and § 5c.168(f)(8)–3 and wishes to be the owner of the property for Federal tax law purposes. Y therefore purchases the equipment from the manufacturer for $1 million, paying $200,000 in cash and borrowing $800,000 from a bank (payable over 9 years and requiring nine equal annual payments of principal and interest of $168,000). Y then leases the equipment to X under an agreement providing for nine annual rental payments of $168,000, and the parties elect in accordance with the provisions of § 5c.168(f)(8)–2 to have the provisions of section 168(f)(8) apply. The timing and amount of the rental payments required to be made by X (the ''lessee-user'') under the lease will be exactly equal to the timing and amount of the principal and interest payments that Y (the ''lessor'') will be required to make to the bank under its purchase money note. Under these circumstances, Y is treated as the owner and lessor of the property for Federal tax law purposes; it therefore is entitled to the investment tax credit and the ACRS deductions with respect to the property. Y's basis in the property is $1 million. Y must report the rent as income and will be entitled to deduct the interest on the purchase money note. The aggregate payments required to be made by X under the lease are treated as rent in accordance with § 5c.168(f)(8)–7 and are deductible as such.

*Example (2).* The facts are the same as in example (1) except that X purchases the equipment for $1 million and wishes to transfer ownership of the property for Federal tax law purposes to Y under a sale and leaseback arrangement. Accordingly, X sells the property to Y for $200,000 in cash (which represents the agreed upon compensation for the tax benefits to be enjoyed by Y as lessor) plus a 9-year, $800,000 note calling for nine $168,000 annual payments of principal and interest. Y then leases the property back to X under an agreement providing for nine annual rental payments of $168,000. The parties elect in accordance with the provisions of § 5c.168(f)(8)–2 to have the provisions of section 168(f)(8) apply. The timing and amount of the rental payments required to be made by X (as the lessee-user) under the lease will be exactly equal to the timing and amount of the principal and interest payments that Y will be required to make to X under Y's purchase money note, so that the only cash transferred between X and Y is the $200,000 down payment. Y's obligation to make debt service payments on the note is contingent on X's obligation to make rental payments under the lease. Under these circumstances, Y is treated as the owner and lessor of the property for Federal tax law purposes; it therefore is entitled to the investment tax credit and ACRS deductions with respect to

the property. Y's basis in the property is $1 million. Y must report the rent as income and will be entitled to deduct the interest on the purchase money note. No gain or loss will be recognized by X on the sale of the property since the sale price equals X's basis in the property. X must report as income the interest paid by Y on the note and will be entitled to a deduction for the rental payments it makes under the lease in accordance with § 5c.168(f)(8)–7.

*Example (3).* Assume that in both examples (1) and (2) X has an option to purchase the equipment at the end of the lease term for $1.00. The fact that the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price that is more or less than its fair market value is not taken into account in determining the status of the transactions as leases under section 168(f)(8).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56148, Nov. 13, 1981]

### § 5c.168(f)(8)–2 Election to characterize transaction as a section 168(f)(8) lease.

(a) *Election*—(1) *In general.* The election to characterize a transaction as a lease qualifying under section 168(f)(8) shall be made within the time and manner as set forth in this section without regard to section 168(f)(4).

(2) *Lease agreement.* For an agreement to be treated as a lease under section 168(f)(8) and this section, the lease agreement must be executed not later than 3 months after the property was first placed in service, as defined in § 5c.168(f)(8)–6(b)(2)(i) (or prior to November 14, 1981, if the property was first placed in service by the lessee after December 31, 1980, and before August 14, 1981). The agreement must be in writing and must state that all of the parties to the agreement agree to characterize it as a lease for purposes of Federal tax law and elect to have the provisions of section 168(f)(8) apply to the transaction. The agreement must also name the party who will be treated as the lessor and the party who will be treated as the lessee.

(3) *Information return concerning the election.* (i) Except as provided in subdivision (ii), for each lease agreement, the lessor and lessee must jointly file Form 6793, Safe Harbor Lease Information Return, concerning their election under section 168(f)(8). The information return must be signed by both the lessor and the lessee and filed not later than the 30th day after the agreement is executed with the Commissioner of Internal Revenue, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attn: Form 6793). Unless the failure to file timely is shown to be due to reasonable cause, the failure to file the information return timely shall void the section 168(f)(8) election as of the date of the execution of the lease agreement. The information return shall include the following items:

(A) The name, address, and taxpayer identifying number of the lessor and the lessee (and the common parent company if a consolidated return is filed);

(B) The service center with which the income tax returns of the lessor and lessee are filed;

(C) A description of each property with respect to which the election is made;

(D) The date on which the lessee places the property in service (determined as defined in § 5c.168(f)(8)–6(b)(2)(i)), the date on which the lease begins, and the term of the lease;

(E) The recovery property class of the leased property under section 168(c)(2) (for example, 5 years) and the ADR midpoint life of the leased property;

(F) The terms of the payments between the parties to the lease transaction;

(G) Whether the ACRS deductions and the investment tax credit are allowable to the same taxpayer;

(H) The aggregate amount paid to outside parties to arrange or carry out the transaction, such as, for example, legal and investment banking fees;

(I) For the lessor only: The unadjusted basis of the property as defined in section 168(d)(1);

(J) For the lessor only: If the lessor is a partnership or a grantor trust, the name, address, and taxpayer identifying number of the partners or the beneficiaries, and the Service Center with which the income tax return of each partner or beneficiary is filed; and

(K) Such other information as may be required by the return or its instructions.

The aggregate amount paid to outside parties which is described in paragraph

(a)(3)(i)(H) of this section need not be disclosed unless it is reasonable to estimate that either the lessor or the lessee will lease property under section 168(f)(8) for the calendar year which has an aggregate adjusted basis to such person of more than $1,000,000. If either the lessor or the lessee reasonably expects to lease property with an aggregate basis of more than $1,000,000, then both parties must disclose their transaction costs.

(ii) In the case of an agreement executed before January 1, 1982, only the lessor is required to file the information return described in paragraph (a)(3)(i) of this section and the return must be postmarked not later than January 31, 1982. Unless the failure to file timely is shown to be due to reasonable cause, or unless the lessee files the information return postmarked by January 31, 1982, the lessor's failure to file the information return timely shall be a disqualifying event as of February 1, 1982, which shall cause an agreement to cease to be treated as a lease under section 168(f)(8). For the Federal income tax consequences of a disqualifying event, see § 5c.168(f)(8)–8.

(iii) A copy of the information return described in paragraph (a)(3) (i) and (ii) shall be filed by each party with its timely filed Federal income tax return for its taxable year during which the lease term begins. However, for taxable years ending in 1981 with respect to lease agreements executed during calendar year 1981, such statement shall be filed by the later of (A) the due date (taking extensions into account) of the party's 1981 Federal income tax return, or (B) where the filing of an amended return is required, with the amended return within 3 months following the execution of the lease agreement. For the requirement to file an amended return within 3 months and the consequences of the failure to so file, see § 5c.168(f)(8)–6(b)(2)(ii). A taxpayer that is required to file the information return with its Federal income tax return before an information return form is available shall file, in lieu of the required information return, a statement which contains the information set forth in subparagraphs (A) through (J) of pargraph (a)(3)(i). The failure by the lessor to file the information return (or, if applicable, the statement referred to in the preceding sentence) with its timely filed Federal income tax return shall be a disqualifying event which shall cause an agreement to cease to be treated as a lease under section 168(f)(8). For the Federal income tax consequences of a disqualifying event, see § 5c.168(f)(8)–8.

(4) *Election is irrevocable.* An agreement made pursuant to paragraph (a)(2) of this section shall be irrevocable as of the later of the date such agreement was executed or November 23, 1981.

(5) *Disposition by lessee.* Except in the case of transactions described in subparagraph (6), of this paragraph, if the lessee (or any transferee of the lessee's interest) sells or assigns its interest in the lease or in the property, the agreement will cease to be characterized as a lease under section 168(f)(8) as of the time of the sale or assignment unless the transferee furnishes to the lessor within 60 days following the transfer the transferee's written consent to take the property subject to the lease, and the transferee and lessor file a statement with their timely filed Federal income tax returns for the taxable year in which the transfer occurs containing the following information:

(i) The name, address, and taxpayer identifying number of the lessor and the transferee;

(ii) The district director's office with which the income tax returns of the lessor and transferee are filed;

(iii) A description of the property; and

(iv) Confirmation of the transferee's consent.

See § 5c.168(f)(8)–8 for the Federal income tax consequence where an agreement ceases to be characterized as a lease under section 168(f)(8).

(6) *Disposition of lessee's interest in bankruptcy, etc., or similar proceeding.* In the case of an agreement executed after May 31, 1982, where the lessee's interest in the lease or in the property is sold or assigned in a bankruptcy, liquidation, receivership, a court-supervised foreclosure, or in any similar proceeding for the relief or protection of insolvent debtors in Federal or State court, the agreement will continue to

be characterized as a lease under section 168(f)(8) and the purchaser or assignee shall take the property subject to the lease if—

(i) Prior to the consummation of the sale or assignment, the lessor gives written notice of its Federal income tax ownership to the judicial or administrative body having jurisdiction over the proceeding and to the debtor in possession of the interest or, if at such time a trustee, receiver or similar person has been appointed by the court, to the person appointed. The notice must contain a request that the court and the debtor or the person appointed provide a copy of the notice to the purchaser or assignee prior to the consummation of the sale or assignment. Within 60 days following the sale or assignment, the lessor must provide notice of its Federal income tax ownership and copies of the lease agreement, and, in the case of a sale and leaseback transaction, the lessor's purchase money obligation, to the purchaser or assignee;

(ii) The lessor files a statement with its timely filed Federal income tax return for the taxable year in which the sale or assignment occurs containing the following information:

(A) The name, address, and taxpayer identifying number of the lessor and the purchaser or assignee;

(B) The district director's office with which the Federal income tax returns of the lessor and purchaser or assignee are filed;

(C) A description of the property; and

(iii) Prior to the consummation of the sale or assignment, all secured lenders of the lessee with interests in the property, which interests arose not later than the time the lessee first used the property under the lease (and which were perfected in accordance with applicable local law), specifically either exclude or release in writing the Federal income tax ownership of the property from their interests.

The purchaser or assignee of the interest with respect to which this paragraph applies shall file a statement with its timely filed Federal income tax return for the taxable year in which the sale or assignment occurs containing the information described in subdivision (ii) of this subparagraph. If the interest is subsequently transferred (other than in a bankruptcy, liquidation, receivership, court-supervised foreclosure, or similar proceeding) during the term of the lease, the agreement will continue to be characterized as a lease under section 168(f)(8) and the transferee will take the property subject to the lease if either (A) the lessor gives the transferee, prior to the transfer, a copy of the lease, written notice of its Federal income tax ownership, and, in the case of a sale and leaseback transaction, a copy of the lessor's purchase money obligation, and the lessor files a statement with its timely filed Federal income tax return as described in subdivision (ii) of this subparagraph, or (B) within 60 days following the transfer, the transferee agrees in writing to take the property subject to the lease and the lessor and transferee file a statement with their timely filed Federal income tax returns within the time and in the manner described in paragraph (a)(5) of this section. However, an agreement will not continue to be characterized as a lease under this subparagraph if, under another applicable provision, it would cease to be characterized as a lease. See § 5c.168(f)(8)–8 for the Federal income tax consequences where an agreement ceased to be characterized as a lease under section 168(f)(8).

(7) *Consequences of taking the property subject to the lease agreement.* For purposes of §§ 5c.168(f)(8)–1 through 5c168(f)(8)–11, in a situation where a transferee of a lessee's interest acquires the property subject to the lease, the transferee shall be deemed to have acquired a leasehold interest in the property equal to the remaining lease term, any unpaid obligation of the lessor arising in connection with the sale of the property by the original lessee in a sale and leaseback transaction, and any option of the lessee to purchase the property. Any consideration paid by the transferee for the property shall be allocated to the lessor's obligation to the extent of the unpaid balance of the obligation. Any excess over the unpaid balance shall be

allocated between the leasehold interest and the purchase option in proportion to their relative fair market values. As the new lessee, the transferee shall not be entitled to claim any ACRS deduction with respect to the property while the lease remains in effect and shall not be entitled to any investment tax credit with respect to the property. The transferee shall report interest income on the lessor's obligation, and shall be entitled to deduct the rent paid under the lease, in accordance with § 5c.168(f)(8)–7. In addition, the transferee shall be entitled to amortize the portion of its cost allocable to the leasehold interest. Coversely, as long as the lease remains in effect, the lessor will continue to be recognized as the owner of the property for Federal income tax purposes, shall be required to report rents due under the lease, and shall be entitled to deduct interest on its obligation.

(8) *Election to treat certain leases under subparagraph (6) rules.* The lessor under a section 168(f)(8) lease executed on or before May 31, 1982, may elect to have the provisions of paragraph (a)(6) of this section apply in the case of a sale or assignment of the lessee's interest in the lease or in the property in a bankruptcy, receivership, liquidation, court-supervised foreclosure, or similar proceeding. The election of the lessor with respect to any leased property may be made at any time prior to the consummation of any sale or assignment of such property in a bankruptcy, etc., or similar proceeding, by complying with the provisions of subparagraph (6) of this paragraph.

(b) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

*Example (1).* X Corp. maintains its books and records for Federal tax law purposes on a calendar year basis. On February 1, 1981, X acquires certain equipment for use in its business, and the equipment is deemed to be placed in service on that date within the meaning of § 5c.163(f)(8)–6(b)(2)(i). On November 1, 1981, X sells the equipment to Y and leases it back under a lease in which the parties elect to have the provisions of section 168(f)(8) apply. The election is considered timely for purposes of making Y the owner of the property under section 168(f)(8) since the lease agreement was executed before November 14, 1981.

*Example (2).* The facts are the same as in example (1) except that X Corp.'s taxable year ends on February 28, 1981. X claimed the investment tax credit and depreciation deductions with respect to the property in its return filed April 1, 1981. The lease will qualify for safe harbor treatment under section 168(f)(8) provided X, within 3 months after the lease agreement was executed, files an amended return pursuant to § 5c.168(f)(8)–6(b)(2)(ii) for its taxable year ending February 28, 1981, in which X foregoes its right to claim any investment tax credit or ACRS deductions with respect to the property subject to the lease.

*Example (3).* X Corp. (as lessee) sells certain new equipment to Y Corp. (as lessor) and leases it back under a section 168(f)(8) lease. During the term of the lease X sells its interest in the property to T Corp. (other than in a bankruptcy or similar proceeding), and T does not give Y a written consent to take the property subject to the leased. The agreement ceases to be treated as a lease under section 168(f)(8) as of the date of the sale.

*Example (4).* The facts are the same as in example (3) except that the sale of the property takes place while X is under the jurisdiction of a court in a bankruptcy proceeding. All lenders of X having perfected interests in the property that arose by the time the property was first used under the lease have specifically either excluded or released the ownership of the property for Federal income tax purposes from their interests. Within the required time periods, Y gives appropriate notification to the court, the bankruptcy trustee, and T that the property is subject to the lease and files the required statement with its Federal income tax return for the taxable year in which the sale occurs. The agreement continues to be treated as a lease under section 168(f)(8). T will take the property subject to the lease. T must allocate the purchase price among the lessor's note, the leasehold interest, and the option (if any) to purchase the property.

*Example (5).* The facts are the same as in example (4), except that one lender of X having a perfected and timely interest in the property does not specifically exclude or release the Federal income tax ownership of the property from its interest. The agreement will cease to be treated as a lease under section 168(f)(8) as of the date of the transfer to T. The result would be the same if Y failed to furnish any of the notices required by subdivision (i) of paragraph (a) and (6) or failed to file a statement as required by subdivision (ii) of paragraph (a)(6).

*Example (6).* The facts are the same as in example (4). In addition, during the term of the lease T transfers the property to U Corp. and Y fails to furnish U with written notice that the property is subject to the lease prior to the sale and U refuses to agree to

consent to the lease agreement. The agreement will cease to be treated as a lease under section 168(f)(8) as of the date of the transfer to U. The result would be the same if Y furnished U with timely written notice of its tax ownership but failed to file the required statement with its tax return for its taxable year in which the sale occurred.

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56148, Nov. 13, 1981; T.D. 7800, 46 FR 63257, Dec. 31, 1981]

### § 5c.168(f)(8)–3 Requirements for lessor.

(a) *Qualified lessor.* In order for an agreement to be treated as a lease under section 168(f)(8), the party characterized in the agreement as the lessor must be a qualified lessor. The term ''qualified lessor'' means—

(1) A corporation which is neither an electing small business corporation under section 1371(b) nor a personal holding company under section 542(a), or

(2) A partnership all of whose partners are corporations described in subparagraph (1), or

(3) A grantor trust whose grantor and beneficiaries are all corporations described in paragraph (a)(1) or partnerships described in paragraph (a)(2).

(b) *Effect of disqualification of lessor.* If at any time during the term of the agreement the lessor ceases to be a qualified lessor, the agreement will lose its characterization as a lease under section 168(f)(8) as of the date of the event causing such disqualification. If any partner of a partnership described in paragraph (a)(2) ceases to be a corporation described in paragraph (a)(1), the partnership entity shall cease to be a qualified lessor. Similarly, if any beneficiary of a trust described in paragraph (a)(3) ceases to be a corporation described in paragraph (a)(1), the trust shall cease to be a qualified lessor. See § 5c.168(f)(8)–8 for the Federal income tax consequences of such a disqualification.

(c) *One tax owner per property.* Only one person may be a qualified lessor under section 168(f)(8) with respect to leased property. Thus, property that is subject to a lease under section 168(f)(8) may not be subleased under a lease for which a section 168(f)(8) election is made. In addition, if a lessor sells or assigns in a taxable transaction its interest in a section 168(f)(8) lease or in the underlying property, the lease shall cease to qualify under section 168(f)(8) and no other lease may be executed under section 168(f)(8) with respect to the property. The preceding sentence applies to a sale or assignment of its interest by a partner of a lessor that is a partnership described in paragraph (a)(2) of this section or by a beneficiary of a lessor that is a trust described in paragraph (a)(3) of this section. See § 5c.168(f)(8)–8 for the Federal income tax consequences where a lease ceases to qualify under section 168(f)(8). However, lease brokers, agents, etc., may, for example, prepare executory contracts with the lessee whereby the broker's assignee may execute a lease as lessor, and, if the requirements of section 168(f)(8) and §§ 5c.168(f)(8)–1 through 5c.168(f)(8)–11 are met, the lease will qualify under section 168(f)(8).

(d) *Examples.* The application of paragraph (c) may be illustrated by the following examples:

*Example (1).* X Corp. (as lessee) sells certain new equipment to Y Corp. (as lessor) and leases it back under a section 168(f)(8) lease. Within 3 months after the property was placed in service, Y assigns its interest in the lease to Z. Upon the transfer to Z, the lease will no longer qualify for treatment under section 168(f)(8). The property may not thereafter be the subject of a section 168(f)(8) lease.

*Example (2).* X Corp., which wishes to acquire certain equipment for use in its business and to transfer ownership of the property for Federal income tax law purposes, purchases the equipment and enters into an executory contract with LB, a lease broker, under which X agrees to execute a section 168(f)(8) lease as lessee with a third party lessor. At a later date (but within the prescribed 3-month period), LB arranges for X and T Corp. (which wishes to secure Federal income tax law ownership) to execute a lease agreement in accordance with § 5c.168(f)(8)–2. The lease will qualify for treatment under section 168(f)(8).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56149, Nov. 13, 1981]

### § 5c.168(f)(8)–4 Minimum investment of lessor.

(a) *Minimum investment.* Under section 168(f)(8)(B)(ii), an agreement will

not be characterized as a lease for purposes of section 168(f)(8) unless the qualified lessor has a minimum at risk investment which, at the time the property is placed in service under the lease and at all times during the term of the lease, is not less than 10 percent of the adjusted basis of the leased property. As the adjusted basis of the leased property is reduced by capital cost recovery deductions, the minimum investment required will also be reduced to 10 percent of the revised adjusted basis, until the adjusted basis has been completely recovered, at which time no minimum investment will be required. Financing provided by the lessee or a party related to the lessee, such as a recourse note given by the lessor to the lessee, will not be taken into account in determining the lessor's minimum investment.

(b) *At risk amount.* The minimum investment which the lessor has at risk with respect to the leased property for purposes of paragraph (a) of this section includes only consideration paid and recourse indebtedness incurred by the lessor to purchase the property. The lessor must have sufficient net worth (without regard to the value of any leases which qualify under section 168(f)(8)) to satisfy any personal liability incurred. Any tax benefits which the lessor derives from the leased property shall not be taken into account to reduce the amount the lessor has at risk. An agreement between the lessor and the lessee requiring either or both parties to purchase or sell the qualified leased property at some price (whether or not fixed in the agreement) at the end of the lease term shall not affect the amount the lessor has at risk with respect to the property. However, an option held by the lessor to sell the property that is exercisable before the end of the period prescribed under section 168(c)(2) for the recovery property class of the leased property (taking into account any election by the lessor or lessee under section 168(b)(3)) shall reduce the amount the lessor is considered to have at risk by the amount of the option price at the time the option becomes exercisable.

**§ 5c.168(f)(8)–5 Term of lease.**

(a) *Term of lease—Basic rules.* To qualify as a lease under section 168(f)(8) and § 5c.168 (f)(8)–1 (a), the lease agreement must provide for a term that does not exceed the maximum term described in paragraph (b) of this section; such term must also at least equal the minimum term described in paragraph (c).

(b) *Maximum term.* For purposes of section 168(f)(8)(B)(iii) and this section, the term of the lease may not exceed the greater of—

(1) 90 percent of the useful life of the property under section 167, or

(2) 150 percent of the asset depreciation range (ADR) present class life (''midpoint'') of such property, applicable as of January 1, 1981 (without regard to section 167(m)(4)), published in Rev. Proc. 77–10, 1977–1 C. B. 548, and revisions thereto.

Solely for purposes of this paragraph (b), ''useful life'' means the period when the leased asset can reasonably be expected to be eonomically useful in anyone's trade or business; such term does not mean the period during which the lessor expects to lease the property. Any option to extend the term of the lease, whether or not at fair market value rent, must be included in the term of the lease for purposes of this paragraph. If several different pieces of property are the subject of a single lease, the maximum allowable term for such lease will be measured with respect to the property with the shortest life. In no case, however, will the lease term qualify under this section if such term with respect to any piece of property is less than the minimum term described in paragraph (c).

(c) *Minimum term.* For purposes of this section, the term of the lease must at least equal the period prescribed under section 168(c)(2) for the recovery property class of the leased property. For example, if a piece of leased equipment is in the 5-year recovery property class, the lease agreement must have a minimum term of 5 years. In general, the determination of whether property is 3-year recovery property, 5-year recovery property, etc., in the hands of the lessor will be based on the characterization of the property in the hands of the owner as determined without regard to the section 168(f)(8) lease. Thus,

for example, property which is public utility property or RRB replacement property absent the section 168(f)(8) lease will be characterized as such in the hands of the lessor for purposes of section 168(f)(8). However, with respect to RRB replacement property, the transitional rule of section 168(f)(3) shall be inapplicable to the lessor. In addition, any election under section 168(b)(3) by the lessor with respect to the class of recovery property to which the qualified leased property is assigned shall apply to the leased property in determining the term of the lease. A lease term that does not exceed the term required to satisfy the minimum lease term of this paragraph will be deemed to comply with the maximum lease term described in paragraph (b) if such minimum lease term exceeds such maximum lease term.

(d) *Examples.* The application of this section may be illustrated by the following examples:

*Example (1).* X Corp. (as lessee) and Y Corp. (as lessor) enter into a lease which they elect to be treated under section 168(f)(8) with respect to a chemical manufacturing facility that will also generate steam for use in the production of electricity. The assets comprising the chemical plant are described in ADR guideline class 28.0 (midpoint life of 9.5 years), and the assets comprising the steam plant are described in ADR class 00.4 (midpoint life of 22 years). To satisfy the maximum lease term requirement of section 168(f)(8)(B)(iii)(II) and § 5c.168 (f)(8)–5(b), the lease term may not exceed 14.25 years (150 percent of the 9.5 year midpoint life of the chemical plant).

*Example (2).* The facts are the same as in example (1) except that the chemical plant and the steam plant are the subject of separate leases. For purposes of section 168(f)(8)(B)(iii)(II) and § 5c.168(f)(8)–5 (b), the maximum term of the lease with respect to the chemical plant is 14.25 years (150 percent of 9.5 years) and the maximum term of the lease with respect to the steam plant is 33 years (150 percent of 22 years).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981; 50 FR 13020, Apr. 2, 1985]

### § 5c.168(f)(8)–6 Qualified leased property.

(a) *Basic rules*—(1) *In general.* An agreement shall be treated as a section 168(f)(8) lease only if the property which is leased is qualified leased property. Qualified leased property is recovery property as defined in section 168(c) and is either—

(i) Except as provided in subparagraph (2), new section 38 property of the lessor which is leased no later than 3 months after the date the property was placed in service (or prior to November 14, 1981, if the property was placed in service after December 31, 1980, and before August 14, 1981) and which, if acquired by the lessee, would have been new section 38 property of the lessee, or

(ii) Property which is a qualified mass commuting vehicle (as defined in section 103(b)(9)) and which is financed in whole or in part by proceeds from an issue of obligations the interest on which is excludable from income under section 103(a).

(2) *Sale and leaseback arrangement.* (i) Where the leased property is purchased, directly or indirectly, by the lessor from the lessee (or a party related to the lessee), the property will not be qualified leased property unless the property was (or would have been) new section 38 property of the lessee and was purchased and leased no later than 3 months after the date the property was placed in service by the lessee (or prior to November 14, 1981, if the property was placed in service by the lessee after December 31, 1980 and before August 14, 1981) and with respect to which the lessor's adjusted basis does not exceed the adjusted basis of the lessee (or a party related to the lessee) at the time of the lease. If the lessor's adjusted basis in the property exceeds the seller's adjusted basis with respect to the property at the beginning of the lease, the property will not be qualified leased property.

(ii) For purposes of this paragraph (a)(2) and paragraph (b)(3)(ii) of this section, transactional costs with respect to a sale and leaseback arrangement that are not currently deductible shall be allocated to the lease agreement (and not included in the lessor's adjusted basis with respect to the property) and amortized over the term of the lease. These costs include legal and investment banking fees and printing costs.

(iii) The application of this paragraph (a)(2) may be illustrated by the following examples:

*Example (1).* X, an airline, contracts to have an airplane constructed for a fixed price of $10 million. Prior to completion of construction of the airplane, the value of the airplane increases to $11 million. X buys the airplane at the contract price of $10 million and, before it is placed in service, sells the airplane at its fair market value of $11 million to Y and then leases it back. The lease will not qualify for safe harbor protection under section 168(f)(8) because the lessor's adjusted basis in the airplane exceeds the lessee's adjusted basis. This result obtains even though the airplane qualifies as new section 38 property of X airline.

*Example (2).* Assume the same facts as in example (1) except that, prior to completion of the construction of the airplane, X assigns its contract to Y for $1 million, and Y thereafter buys the airplane at the contract price of $10 million. The acquisition by Y is treated as an indirect purchase from the lessee. Because Y's adjusted basis in the airplane would exceed the lessee's adjusted basis, the lease will not qualify under section 168(f)(8).

(b) *Special rules*—(1) *New section 38 property*. (i) New section 38 property is section 38 property described in subsection (b) of section 48 and the regulations thereunder other than a qualified rehabilitated building (within the meaning of section 48(g)(1)). Qualified leased property must be new section 38 property at the beginning of the lease and must continue to be section 38 property in the hands of the lessor and the lessee throughout the lease term. The fact that the lessee used the property within the 3-month period prior to the lease will not disqualify the property as new section 38 property of the lessee.

(ii) The application of this paragraph (b)(1) may be illustrated by the following examples:

*Example (1).* N is a hospital exempt from Federal income tax and wishes to purchase certain equipment for use in furtherance of its exempt functions (*i.e.*, other than for use in an unrelated trade or business). O, a qualified lessor as defined in § 5c.168(f)(8)–3(a), acquires the property and leases it to N. Since the equipment would not be new section 38 property of N if N had acquired it by virtue of section 48(a)(4) (relating to exception from definition of section 38 property for certain property used by certain tax-exempt organizations), the equipment is not qualified leased property and the lease does not qualify under section 168(f)(8). Whether O is considered the owner of the property for Federal tax law purposes will be determined without regard to the provisions of section 168(f)(8).

*Example (2).* P Corp. is constructing progress expenditure property as defined in section 46(d)(2) for R Corp. Progress expenditure property is property which it is reasonable to believe will be section 38 property in the hands of the taxpayer when it is placed in service. Before the date that the property is placed in service (as defined in § 5c.168(f)(8)–6(b)(2)(i)), the property is not new section 38 property. Accordingly, progress expenditure property cannot be qualified leased property.

*Example (3).* R Corp., a foreign railroad, acquires new rolling stock and enters into a sale and leaseback transaction with B Corp., a domestic corporation. R uses the rolling stock within and without the United States, but predominantly outside the United States within the meaning of section 48(a)(2)(A). Section 48(a)(2)(B)(ii) is inapplicable to R because R is neither a domestic railroad corporation nor a United States person; therefore, the rolling stock cannot be section 38 property to R. The property is not qualified leased property.

(2) *Placed in service.* (i) Property shall be considered as placed in service at the time the property is placed in a condition or state of readiness and availability for a specifically assigned function. If an entire facility is leased under one lease, property which is part of the facility will not be considered placed in service under this rule until the entire facility is placed in service. If the lessee claims any investment tax credit or ACRS deductions with respect to any component which is part of an entire facility that is subsequently leased, the lessee must file an amended return within the time prescribed in paragraph (b)(2)(ii) of this section in which it foregoes its claim to the investment tax credit and ACRS deductions. If such amended return may not be filed because the time for filing a claim for refund with respect to any component under section 6511 has expired, each component of the facility will be considered as placed in service at the time the individual component is placed in a condition or state of readiness and availability for a specifically assigned function and not when the entire facility is placed in service.

(ii) For purposes other than determining whether property is qualified leased property, property subject to a lease under section 168(f)(8) will be deemed to have been placed in service not earlier than the date such property is used under the lease. If the lessee

claims any investment tax credit or ACRS deductions with respect to property placed in service under a lease, the lessee must file an amended return within 3 months following the execution of the lease agreement in which the lessee foregoes its claim to the investment tax credit and ACRS deductions with respect to the leased property or the election under section 168(f)(8) will be void.

(iii) The application of this paragraph (b)(2) may be illustrated by the following examples:

*Example (1).* X Corp. acquires equipment on December 31, 1982, and places the equipment in service. X's taxable year ends December 31. On March 20, 1983, X sells the equipment to Y Corp. and leases it back in a transaction that qualifies under section 168(f)(8). The property is considered to be new section 38 property to X under paragraph (b)(1). X is not allowed any investment tax credit or ACRS deductions with respect to the property in 1982 because the property is not considered to have been placed in service for purposes other than determining whether it is qualified leased property until it is used under the lease under subdivision (ii) of this subparagraph (2). If X has claimed credits or deductions on its 1982 return, it must file an amended return for 1982 within 3 months following the execution of the lease agreement or the election will be void.

*Example (2).* In March 1985, K Corp. completes reconditioning of a machine, which it constructed and placed in service in 1982 and which has an adjusted basis in 1985 of $10,000. The cost of reconditioning amounts to an additional $20,000. K would be entitled to a basis of $20,000 in computing its qualified investment in new section 38 property for 1985. In May 1985, K enters into a sale and leaseback transaction with L Corp. with respect to the reconditioned parts of the machine that are new section 38 property to K. K and L elect to have section 168(f)(8) apply. Assuming that the adjusted basis of the leased property is the same to L as it is to K, the property qualifies as qualified leased property under section 168(f)(8)(D)(ii) and L is considered the tax owner of the property. Since, for purposes other than determining whether property is qualified leased property, the property is deemed originally placed in service not earlier than the date the property is used under the lease, the property is new section 38 property to L and L may claim the investment tax credit (and ACRS deductions) with respect to the leased property.

(3) *Qualified mass commuting vehicle.* (i) A qualified mass commuting vehicle as defined in section 103(b)(9) will constitute qualified leased property for purposes of section 168(f)(8)(D)(iii) and this section provided all of the following requirements are met:

(A) At least part (as, for example, 5 percent) of the financing for the purchase of such vehicle must be derived from proceeds of obligations the interest on which is excludable from income under section 103(a)(1) (whether or not such obligations are described in section 103(b)(4)(I));

(B) The vehicle must be recovery property (*i.e.*, it must have been first placed in service by the lessee after December 31, 1980); and

(C) The vehicle must not have been previously leased under a section 168(f)(8) lease by the lessee.

A qualified mass commuting vehicle that is qualified leased property may be leased under section 168(f)(8) at any time after December 31, 1980. The requirement of paragraph (b)(3)(i)(A) of this section may be satisfied where the vehicles leased under a section 168(f)(8) lease are refinanced with proceeds of an obligation the interest on which is excludable from income under section 103(a)(1).

(ii) Where the leased property is purchased, directly or indirectly, by the lessor from the lessee (or a party related to the lessee), the property will not qualify under this subsection unless the lessor's adjusted basis in the property does not exceed the adjusted basis of the lessee (or related party) at the time of the execution of the lease. The adjusted basis of property to a lessee (or related party) shall be determined under Part II of Subchapter O of Chapter I of the Code for purposes of determining gain, except that the adjustment described in section 1016(a)(3) and §1.1016–4 need not be made for property acquired during calendar year 1981 and leased no later than March 1, 1982.

(iii) In a transaction characterized as a lease under section 168(f)(8), the lessor's adjusted basis may not include that portion, if any, of the cost of the vehicle to the lessee (or related party) that is financed, directly or indirectly, with an Urban Mass Transportation

Administration (UMTA) grant (excluding a grant under the interstate transfer provision of the Federal-Aid Highway Act (FAHA)), a FAHA grant, or any other Federal grant. Where a vehicle is included as part of an UMTA-funded project, 80 percent of the vehicle's cost will be deemed to be financed with an UMTA grant and 20 percent will be deemed to be financed from non-Federal sources without regard to whether the UMTA funds or the non-Federal funds are traceable to any particular vehicle included within the project. For purposes of this subparagraph and paragraph (b)(3)(ii) of this section, amounts originating from non-Federal sources which are paid or incurred with respect to leased property by a State or political subdivision of the State (or political subdivision created by the joint authorization of two or more States) shall be taken into account in computing the lessee's adjusted basis in the leased property as if the lessee had paid or incurred such amounts.

(iv) If a vehicle is purchased pending approval of an UMTA grant, the lessor's unadjusted basis in the vehicle may equal the lessee's unadjusted basis unreduced by any subsequently approved UMTA grant; however, if an UMTA grant is later approved and the vehicle is included as part of an UMTA-funded project, except as provided hereinafter in this subparagraph, the lease shall terminate with respect to an undivided 80 percent interest in the vehicle. For the Federal income tax consequences of the termination of a lease, see §5c.168(f)(8)–8. If such a subsequently approved UMTA grant is used to purchase additional qualified mass commuting vehicles, the portion of each vehicle deemed to be allocable to non-UMTA financing (*i.e.*, 20 percent) may be leased under section 168(f)(8). If a vehicle is purchased pending approval of an UMTA grant and leased under section 168(f)(8), the lease will not be deemed to have terminated with respect to 80 percent of the vehicle when the UMTA grant is later approved if the total interest leased before the grant is approved did not exceed 20 percent of the lessee's adjusted basis in the vehicle (unadjusted basis prior to March 1, 1982) unreduced by any subsequently approved UMTA grant. For purposes of this subparagraph and paragraph (b)(3)(iii) of this section, the allocation principles applicable to UMTA grants shall apply in the case of FAHA grants except that 85 percent and 15 percent shall be substituted for 80 percent and 20 percent, respectively. Similar allocation rules shall also apply to other Federal grants used to finance the acquisition of qualified mass commuting vehicles.

(v)(A) Notwithstanding the provisions of §5c.168(f)(8)–2(a)(3)(iii), the lessee in a transaction to which this paragraph (b)(3) applies is not required to file an information return or a statement concerning its election under section 168(f)(8).

(B) Notwithstanding the provisions of §5c.168(f)(8)–2(a)(5), if the transfer of a qualified mass commuting vehicle is not otherwise a disqualifying event, the transferee is not required to file the statement mentioned therein.

(C) The fact that a qualified mass commuting vehicle is not section 38 property because it is used by an exempt entity will not disqualify the lease under §5c.168(f)(8)–8(b)(4); however, a disqualifying event will occur, and the agreement will cease to be characterized as a lease under section 168(f)(8), with respect to a vehicle which (*1*) ceases to be a qualified mass commuting vehicle or (*2*) would cease to be section 38 property if used by a taxable entity as, for example, a vehicle used predominantly outside the United States. For the Federal income tax consequences of a disqualifying event, see §5c.168(f)(8)–8.

(vi) The lessor of a qualified vehicle will not be allowed an investment tax credit with respect to it under section 38.

(vii) The application of this paragraph (b)(3) may be illustrated by the following examples:

*Example (1).* On July 1, 1981, a unit of city X, X Transit Authority (XTA), purchases 100 buses after receiving an UMTA grant for 80 percent of their purchase price. Fifteen percent of the purchase price is financed with a combination of State and local governmental grants and 5 percent is financed with proceeds from an issue of tax-exempt obligations described in section 103(b)(4)(I). Because UMTA financed an 80 percent interest

in the 100 buses, XTA may lease under section 168(f)(8) only a 20 percent interest in each bus. If XTA were to lease 100 percent of 20 buses, only 20 percent of such buses would be deemed to be leased under a safe harbor lease.

*Example (2).* The facts are the same as in example (1) except that UMTA has not yet approved XTA's application in 1981. Pending the UMTA approval, XTA purchases and places in service 20 buses in July 1981. The 20 buses are financed with tax-exempt obligations described in section 103(b)(4)(I). On December 15, 1981, XTA sells a 100 percent interest in these 20 buses to Corporation M and leases them back under a lease in which the parties elect to have the provisions of section 168(f)(8) apply. M is a calendar-year taxpayer and claims an ACRS deduction with respect to the buses on its return for taxable year 1981. On July 1, 1982, UMTA approves XTA's grant application, thus enabling XTA to purchase an additional 80 buses. Because 80 percent of the original 20 buses are deemed to have been financed by UMTA beginning on July 1, 1982, the safe harbor lease terminates with respect to an undivided 80 percent interest in the 20 buses. If XTA would be considered the owner of the buses without regard to section 168(f)(8), the termination will result in a deemed sale of an undivided 80 percent interest in the 20 buses by M to XTA. The amount realized by M on the sale will include a proportionate part of the outstanding amount of M's debt plus the sum of any other consideration received by M. M will realize gain or loss, depending upon its basis, with applicable section 1245 recapture. However, XTA may lease the 20 percent interest in the 80 new buses it purchased in 1982 which is deemed to have been financed with non-Federal funds.

*Example (3).* The facts are the same as in example (2) except that the grant approved by UMTA is used to purchase and renovate a bus garage facility. Eighty percent of the original 20 buses are deemed to have been financed by UMTA beginning on July 1, 1982. The lease would still terminate with respect to an undivided 80 percent interest in the vehicles. XTA cannot lease the garage facility under 168(f)(8) because it does not constitute a qualified mass commuting vehicle.

*Example (4).* The facts are the same as in example (2) except that on December 15, 1981, XTA sells and leases back only a 20 percent interest in the 20 buses acquired in July 1981. When the UMTA grant is later approved, the lease will not terminate with respect to any portion of the 20 buses. In addition, XTA may lease the 20 percent interest in the 80 new buses purchased in 1982 and deemed to have been financed with non-Federal funds.

*Example (5).* On August 1, 1982, UMTA approves a grant for a major 5-year capital expenditure program to improve city Y's rapid rail transit system. None of the funds relating to this UMTA-funded project, provided either by UMTA or by city Y, will be used to purchase qualified mass commuting vehicles. Instead, a number of rapid rail cars and buses will be purchased entirely with funds provided with a combination of grants by the State and city governments and of proceeds from an issue of tax-exempt obligations described in section 103(a). Because none of the rapid rail cars and buses are included as part of the UMTA-funded project, no part of them is deemed to be financed by UMTA. If at least 5 percent of the cost of the qualified mass commuting vehicles is provided by tax exempt obligations under section 103(a), the vehicles will be qualified leased property in their entirety.

*Example (6).* City Z has a mass transit agency (ZTA) which purchases on July 1, 1982, 10 buses for which it pays $1,000,000, 95 percent of which is derived from grants from city Z and 5 percent from tax exempt obligations described in section 103(a). The buses have a useful life within the meaning of § 1.167(a)–1(b) of 10 years and their salvage value is zero. On July 1, 1983, ZTA sells these buses to corporation P and leases them back in a transaction which the parties elect to have treated as a lease under section 168(f)(8). At the time of the sale and leaseback, ZTA's adjusted basis in the 10 buses under section 1016(a)(3) and § 1.1016–4 is $900,000 ($1,000,000 cost less $100,000 of depreciation sustained, computed on a stright-line basis). Before the transaction will qualify under section 168(f)(8) and § 5c.168(f)(8)–6(b)(3)(ii), P's adjusted basis in the vehicles may not exceed ZTA's basis, or $900,000. Assuming that the transaction qualifies under section 168(f)(8) and that corporation P is a calendar year taxpayer, P may claim ACRS deductions for 1982 of $135,000 (15 percent of $900,000).

*Example (7).* The facts are the same as in example (6) except that the sale and leaseback transaction is closed on December 31, 1982. P's adjusted basis in the vehicles may not exceed ZTA's basis, or $950,000 ($1,000,000 cost less $50,000 of depreciation sustained, computed on a straight-line basis).

*Example (8).* The facts are the same as in example (6) except that ZTA purchases the buses on June 1, 1981, and enters into the sale and leaseback transaction with corporation P on December 31, 1981. Under § 5c.168(f)(8)–6(b)(3)(ii), no adjustment is made to ZTA's basis in the buses for depreciation sustained. Therefore, P's basis in the buses may equal ZTA's cost of $1,000,000.

*Example (9).* On July 1, 1981, a unit of city W, W Transit Authority (WTA), purchases 100 buses with local grants derived entirely from a city W sales tax. The buses do not constitute qualified leased property under § 5c.168(f)(8)–6(b)(3) because no part of the financing for their purchase was derived from the proceeds of tax exempt obligations.

*Example (10).* The facts are the same as in example (9) except that on November 1, 1981, WTA borrows 5 percent of the cost of the buses and pledges them as security. The interest on WTA's obligation is excludable from income under section 103(a)(1). On December 31, 1981, WTA sells to T Corp. all 100 buses and leases them back. Under §5c.168(f)(8)–6(b)(3)(i), each bus is deemed to be financed with the proceeds of tax exempt obligations. Therefore, if the vehicles otherwise meet the definition of qualified leased property, all the vehicles will be qualified leased property under this section.

(4) *Foreign lessees.* In addition to the other provisions of this section, property which is leased under a section 168(f)(8) lease to a foreign person shall not be qualified leased property unless the gross income attributable to the property from all sources (determined without regard to section 872(a) or 882(b)) is effectively connected with a trade or business within the United States, and the taxable income, if any, attributable to the property is subject to tax under section 871(b)(1) or 882(a)(1). For this purpose, if income attributable to the property is not included in gross income of a foreign lessee, and is exempt from taxation, under sections 872 or 833, or if the income is otherwise exempt from taxation under any income tax convention to which the United States is a party, then the property shall not be qualified leased property.

(5) *Other rules.* (i) Qualified leased property may include undivided interests in property or property regardless of whether or not it is considered separate property under State or local law. If property subject to a section 168(f)(8) lease is later determined not to be qualified leased property, disqualification of the lease under section 168(f)(8) will apply only as to that property.

(ii) The application of this paragraph (b)(5) may be illustrated by the following examples:

*Example (1).* On July 1, 1981, X Corp. contracts to have a manufacturing facility constructed for use in its business. Construction of the facility is completed on July 1, 1982, and the facility is deemed to be placed in service as of that date under §5c.168(f)(8)–6(b)(2)(i). The facility is comprised of a mixture of new section 38 property and buildings that do not qualify as section 38 property. On August 1, 1982, X sells the new section 38 property in the facility to Y and leases it back under an agreement in which the parties elect to be treated as a lease described in section 168(f)(8). Assuming that the other requirements of this paragraph are met, the new section 38 property contained in the facility will be qualified leased property. If it is later determined that property subject to the section 168(f)(8) lease is not new section 38 property (and thus not qualified leased property), the safe harbor protection will be lost only as to that property.

*Example (2).* X Corp. acquires a certain piece of equipment (which is new section 38 property) for use in its business. Within 3 months, X sells a 70 percent undivided interest in the property to lessor A and a 10 percent undivided interest in the property to lessor B and leases both portions back under separate section 168(f)(8) leases. The investment tax credit and ACRS deductions associated with the property will be divided among X, lessor A, and lessor B, on a basis of 20 percent, 70 percent, and 10 percent, respectively.

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56150, Nov. 13, 1981; T.D. 7800, 46 FR 63258, Dec. 31, 1981]

### §5c.168(f)(8)–7 Reporting of income, deductions and investment tax credit; at risk rules.

(a) *In general.* The fact that the lessor's payments of interest and principal and the lessee's rental payments under the lease are not equal in amount will not prevent the lease from qualifying under section 168(f)(8). However, see paragraph (b) for special requirements in sale and leaseback transactions. In determining the parties' income, deductions, and investment tax credit under the lease, the rules in paragraphs (c) through (g) of this section shall apply regardless of the overall method of accounting otherwise used by the parties.

(b) *Requirements for sale and leaseback transaction.* If the property leased is financed by the lessee (or a related party of the leasee) in a sale and leaseback transaction, the lease will not qualify under section 168(f)(8) unless—

(1) The term of the lessor's purchase money obligation is coterminous with the term of the lease, and

(2) The lessor's obligation bears a reasonable rate of interest. For this purpose, a rate of interest shall be presumed to be reasonable if, on the date the agreement is executed, it is within 3 percentage points of (i) the rate in effect under section 6621, the prime rate in effect at any local commercial bank,

or the most recent applicable rate determined by the Secretary under § 1.385–6 (e)(2)(i), or (ii) an arm's-length rate as defined in § 1.482–2, or (iii) any rate between any two of the rates described by subdivisions (i) and (ii) of this paragraph(b)(2).

(c) *Interest deductions and income*—(1) *Deductibility from income.* In determining the amount of interest that a lessor may deduct in a taxable year with respect to its purchase money obligation given to the lessee or to a third party creditor, the lessor may not claim a deduction that would be—

(i) Greater than a deduction that would be allowed to an accrual basis taxpayer under a level-payment mortgage, amortized over a period equal to the term of the lessor's obligation, or

(ii) Less than a deduction that would be allowed to an accrual basis taxpayer under a straight line amortization of the principal over the term of the lessor's obligation.

In cases in which the property is not financed by the lessee or a party related to the lessee, the computation of the interest deduction may take into account fluctuations in the interest rate which are dependent on adjustments in the prime rate or events outside the control of the lessor and the third party creditor.

(2) *Includibility in income.* The lessee shall include interest on the lessor's purchase money obligation in income at the same time and in the same amount as the lessor's interest deductions, as determined under paragraph (c)(1).

(d) *Rental income and deductions*—(1) *Deductibility from income.* The amount of the lessee's rent deduction under a section 168(f)(8) lease with respect to any taxable year shall be a pro rata portion of the aggregate amount required to be paid by the lessee to the lessor under the terms of the lease agreement. If the lessee is required to purchase the leased property at the end of the lease term, of if the lessor has an option to sell the property to the lessee, rent shall not include the lesser of—

(i) The amount of the lessee's purchase obligation, whether fixed by the terms of the lease agreement or conditioned on the exercise of the lessor's option to sell the property to the lessee, or

(ii) The fair market value of the property at the end of the lease term determined at the beginning of the lease term.

For this purpose, fair market value shall be determined without taking into account any increase or decrease for inflation or deflation during the lease term. Rent deductions may be adjusted pursuant to the terms of the lease agreement to account for fluctuations which are dependent on events outside the control of the lessor and lessee, such as a change in the interest rate charged by a third party creditor of the lessor on the debt incurred to finance the purchase of the leased property.

(2) *Includibility in income.* The lessor shall include rent in income as follows:

(i) In the case of prepayments of rent, the earlier of when such rent is paid by the lessee or accrued under the lease, and

(ii) In the case of other rent, at the same time and in the same amount as the lessee's rent deductions, as determined under paragraph (d)(1).

(e) *ACRS deductions.* The deductions that the lessor is allowed under section 168(a) with respect to property subject to a section 168(f)(8) lease shall be determined without regard to the limitation in section 168(f)(10)(B)(iii). The recovery class of qualified leased property in the hands of the lessor shall be determined by the character of the property in the hands of the owner of the property without regard to section 168(f)(8). Any elections under section 168(b)(3) by the lessor with respect to the class of recovery property to which the qualified leased property is assigned shall apply to the leased property. However, with respect to RRB replacement property, the transitional rule of section 168(f)(3) shall be inapplicable to the lessor.

(f) *At risk requirements.* The amount of the investment credit and ACRS deductions that a lessor shall be allowed with respect to the leased property shall be limited to the extent the at risk rules under the investment tax credit provisions and section 465 apply to the lessee or to the lessor. In determining the amount the lessee would be

at risk, the at risk rules will be applied as if the lessee had not elected to have section 168(f)(8) apply. Thus, for example, if, without regard to section 168(f)(8), an individual lessee would be treated as the owner of the leased property for Federal tax law purposes, the lessor under a section 168(f)(8) lease would be allowed ACRS deductions or investment tax credits with respect to the property only to the extent that the lessee may have claimed them had the parties not elected treatment under section 168(f)(8). In addition, the ACRS deductions and investment tax credits that a lessor is allowed with respect to the property are further limited to the extent that the at risk rules apply to the lessor as owner of the property under the section 168(f)(8) lease. If the lessor and the lessee are subject to the at risk rules, the lessor is allowed only the lesser of the ACRS deductions and investment tax credits allowable to the lessor and the lessee.

(g) *Limitation on section 48(d) amount.* If in a sale and leaseback transaction the lessor elects pursuant to section 48(d) to treat the lessee (which is the user of the property) as having acquired the property for purposes of claiming the investment tax credit, the lessee shall be treated as acquiring the property for an amount equal to the basis of the property to the lessor (and not for an amount equal to its fair market value). The investment tax credit allowable to the lessee is further limited to the extent the at risk rules apply to either the lessor or to the lessee. See paragraph (f) of this section.

(h) *Examples.* The application of the provisions of this section may be illustrated by the following examples.

*Example (1).* Y, a qualified lessor, acquires a piece of equipment which is qualified leased property for $1 million and leases it to X under a lease which the parties properly elect to have characterized as a lease described in section 168(f)(8). The equipment has a 10-year economic life and falls within the 5-year ACRS class. Under the terms of the lease, X, the lessee-user, is obligated to pay Y nine annual payments of $10,000 and, at the end of the lease term, Y has the option to sell the property to X for $2,160,000. Under §5c.168(f)(8)–7(d), the aggregate payments required to be made by X under the lease are $2,250,000 ($90,000 rent plus $2,160,000 option price) and are treated as rent to Y (less a reasonable estimate for the residual value of the property) and taxable as such. Assuming a reasonable estimate of the residual value is zero, the full $2,250,000 will be treated as rent, and under §5c.168(f)(8)–7(d), such amount is deductible by X and includible in Y's income ratably over the term of the lease, *i.e.*, at a rate of $250,000 per year ($2,250,000 divided by 9).

*Example (2).* The facts are the same as in example (1) except that under the terms of the lease X is obligated to make rental payments of $100,000 for each of the first 5 years of the lease and $300,000 for each of the 4 remaining years under the lease. Further, X has an option to purchase the equipment for $1.00 at the end of the lease term. Pursuant to §5c.168(f)(8)–7(d), X's aggregate rental payments are deductible by X and are includible in Y's income ratably over the term of the lease. Thus, the annual rental payments are deemed to be $188,000 per year ($1,700,000 divided by 9).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56150, Nov. 13, 1981]

### §5c.168(f)(8)–8 Loss of section 168(f)(8) protection; recapture.

(a) *In general.* Upon the occurrence of an event that causes an agreement to cease to be characterized as a lease under section 168(f)(8), the characterization of the lessor and lessee shall be determined without regard to section 168(f)(8).

(b) *Events which cause an agreement to cease to be characterized as a lease.* A disqualifying event shall cause an agreement to cease to be treated as a lease under section 168(f)(8) as of the date of the disqualifying event. A disqualifying event shall include the following:

(1) The lessor sells or assigns its interest in the lease or in the qualified leased property in a taxable transaction.

(2) The failure by the lessor to file a copy of the information return (or applicable statement) with its income tax return as required in §5c.168(f) (8)–2 (a)(3)(iii).

(3) The lessee (or any transferee of the lessee's interest) sells or assigns its interest in the lease or in the qualified leased property in a transaction not described in §5c.168(f)(8)–2(a)(6) and the transferee fails to execute, within the prescribed time, the consent described in §5c.168(f)(8)–2(a)(5), or either the lessor or the transferee fail to file statements with their income tax returns as required by that paragraph.

(4) The property ceases to be section 38 property as defined in § 1.48–1 in the hands of the lessor or lessee, for example, due to its conversion to personal use or to use predominantly outside the United States, or to use by a lessee exempt from Federal income taxation.

(5) The lessor ceases to be a qualified lessor by becoming an electing small business corporation or a personal holding company (within the meaning of section 542(a)).

(6) The minimum investment of the lessor becomes less than 10 percent of the adjusted basis of the qualified leased property as described in section 168(f)(8)(B)(ii) and § 5c.168(f)(8)–4.

(7) The lease terminates.

(8) The property becomes subject to more than one lease for which an election is made under section 168(f)(8).

(9) Retirements and casualties. [Reserved]

(10) The property is transferred in a bankruptcy or similar proceeding and the lessor fails either to furnish the appropriate notification or to file a statement with its income tax return as required by § 5c.168(f)(8)–2(a)(6).

(11) The property is transferred in a bankruptcy or similar proceeding and not all lenders with perfected and timely interests in the property specifically exclude or release the Federal income tax ownership of the property as required under § 5c.168(f)(8)–2(a)(6)(iii.)

(12) The property is transferred subsequent to a bankruptcy or similar proceeding and the lessor fails to furnish notice to the transferee prior to the transfer or fails to file a statement with its income tax return, and either the lessor fails to secure the transferee's consent or the lessor or the transferee fail to file statements with their returns.

(13) The property is leased under the provisions of section 168(f)(8)(D)(iii) and § 5c.168(f)(8)–6(b)(3) and ceases to be a qualified mass commuting vehicle.

(14) The failure by the lessor to file the required information return described in § 5c.168(f)(8)–2 (a)(3)(ii) by January 31, 1982, unless the lessee files such return by January 31, 1982.

(c) *Recapture.* The required amount of recapture of the investment tax credit and of accelerated cost recovery deductions after a disqualifying event shall be determined under sections 47 and 1245, respectively.

(d) *Consequences of loss of safe harbor protection.* The tax consequences of a disqualifying event depend upon the characterization of the parties without regard to section 168(f)(8). If the lessee would be the owner of the property without regard to section 168(f)(8), the disqualifying event will be deemed to be a sale of the qualified leased property by the lessor to the lessee. The amount realized by the lessor on the sale will include the outstanding amount (if any) of the lessor's debt on the property plus the sum of any other consideration received by the lessor. A disposition that results from a disqualifying event shall not be treated as an installment sale under section 453.

(e) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

*Example (1).* M Corp. and N Corp. enter into a sale and leaseback transaction in which the leaseback agreement is characterized as a lease under section 168(f)(8) and M is treated as the lessor. In the second year of the lease, M becomes an electing small business corporation under subchapter S. The agreement ceases to be treated as a lease under section 168(f)(8) as of the date of the subchapter S election. Without respect to section 168(f)(8), N would be considered the owner of the property. The disqualification of M will be treated as a sale of the qualified leased property from M to N for the amount of the purchase money debt on the property then outstanding. M will realize gain or loss, depending upon its basis, with applicable investment tax credit and section 1245 recapture. N will acquire the property with a basis equal to the amount of the outstanding obligation. The property will not be used section 38 property to N under § 1.48–3(a)(2).

*Example (2).* Q Corp. (as lessor) and P Corp. (as lessee) enter into a lease that is characterized as a lease under section 168(f)(8). The lease has a 6-year term. P has no option to renew the lease or to purchase the property. At the end of 6 years, if P would be considered the owner of the property without regard to section 168(f)(8), upon the termination of the lease the property will be deemed to be sold by Q to P for the amount of the purchase money debt outstanding with respect to the property.

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56150, Nov. 13, 1981; T.D. 7800, 46 FR 63259, Dec. 31, 1981]

**§ 5c.168(f)(8)–9 Pass-through leases—transfer of only the investment tax credit to a party other than the ultimate user of the property. [Reserved]**

**§ 5c.168(f)(8)–10 Leases between related parties. [Reserved]**

**§ 5c.168(f)(8)–11 Consolidated returns. [Reserved]**

**§ 5c.442–1 Temporary regulations relating to change of annual accounting period.**

(a) *Applicability*. The rules of paragraph (b) of this section apply to a request for a change of annual accounting period if—

(1) The taxpayer requesting the change of annual accounting period is an individual;

(2) The purpose for the change of annual accounting period is to benefit as of the first day of a calendar year from changes in the individual income tax rates that do not apply until the first day of the taxpayer's taxable year because of section 21(d) (relating to inapplicability of section 21 to changes made by the Economic Recovery Tax Act of 1981);

(3) The requested change of annual accounting period is from a fiscal year to a calendar year;

(4) In the case of a principal partner in a partnership formed after April 1, 1954, whose principal partners all change to a calendar year, the partnership changes to a calendar year;

(5) In the case of a shareholder in an electing small business corporation whose shareholders all change to a calendar year, the small business corporation changes to a calendar year; and

(6) The short period involved in the change ends on December 31, 1981 or December 31, 1982.

(b) *Special rules*. In the case of a request for a change of annual accounting period described in paragraph (a) of this section, the following special rules apply:

(1) The substantial business purpose requirement contained in § 1.442–1(b) (relating to change of annual accounting period) does not apply.

(2) If the short period involved in the change ends on December 31, 1981, the application for change of annual accounting period may be filed at any time on or before June 15, 1982.

(3) The taxpayer may obtain approval of a change of annual accounting period in the manner set forth in Rev. Proc. 82–25, 1982–15 I.R.B.

(4) The taxpayer shall disclose on the application for change of accounting period any partnership formed after April 1, 1954 in which the taxpayer is a principal partner and any electing small business corporation in which the taxpayer is a shareholder.

(5) Approval of the change of annual accounting period will be granted without regard to the number of years that have elapsed since the taxpayer's previous change of annual accounting period.

(6) No subsequent change of annual accounting period will be approved if the short period involved in the subsequent change would end fewer than 5 calendar years after the last day of the short period involved in the change of accounting period described in paragraph (a) of this section. If the short period involved in the subsequent change would end more than 5 calendar years after the last day of the short period involved in the change of accounting period described in paragraph (a) of this section, the Commissioner will determine whether to approve such change—

(i) Without regard to the change of annual accounting period described in paragraph (a) of this section; and

(ii) In the case of a change to the fiscal year used by the taxpayer before the change of annual accounting period described in paragraph (a) of this section, without regard to the number of years that have elapsed since the taxpayer previously adopted such fiscal year.

(Sec. 7805, Internal Revenue Code of 1954 (68A Stat. 917 (26 U.S.C. 7805)))

[T.D. 7816, 47 FR 15331, Apr. 9, 1982]

**§ 5c.1305–1 Special income averaging rules for taxpayers otherwise required to compute tax in accordance with § 5c.1256–3.**

(a) *In general*. If an eligible individual (as defined in section 1303 and the regulations thereunder) is described in the first sentence of § 5c.1256–3(a), chooses the benefits of income averaging and

otherwise complies with the special rules under section 1304 and the regulations thereunder, and has averagable income (as defined in section 1302 and the regulations thereunder) in excess of $3,000, then the individual shall compute the tax under section 1301 as provided in this section. The computation under this section shall be in lieu of the computation under § 5c.1256–3.

(b) *Computation of tax.* The individual shall compute the tax under section 1301 as follows:

*Step (1).* Compute tax under section 1301 and the regulations thereunder on all taxable income, including gains or losses on regulated futures contracts subject to section 1256(a) and the regulations thereunder, using rates applicable to the taxpayer for the taxable year which includes June 23, 1981.

*Step (2).* Compute tax under section 1301 and the regulations thereunder on all taxable income, including gains or losses on regulated futures contracts subject to section 1256(a) and the regulations thereunder, using rates applicable to the taxpayer for taxable years beginning in 1982.

*Step (3).* Compute the percentage of adjusted gross income attributable to all sources except regulated futures contracts subject to section 1256(a) and the regulations thereunder.

*Step (4).* Compute the percentage of adjusted gross income attributable to regulated futures contracts subject to section 1256(a) and the regulations thereunder. Both the percentage in Step (3) and the percentage in Step (4) are to be rounded to the nearest percent. The sum of both percentages must equal 100 percent.

*Step (5).* Multiply the result of Step (1) with the result of Step (3).

*Step (6).* Multiply the result of Step (2) with the result of Step (4).

*Step (7).* Add the result of Step (5) and the result of Step (6). This is the tax for the individual under section 1301 for the taxable year which includes June 23, 1981.

(c) *Option to defer tax.* If an individual computes the tax under section 1301 as provided in paragraph (a) of this section, the individual may also opt to pay part or all of the deferrable tax under income averaging (as defined in paragraph (d) of this section) for the taxable year which includes June 23, 1981, in 2 or more, but not more than 5, equal installments in accordance with this section. Such individual may not opt to pay part or all of the deferrable tax in installments under § 5c.1256–3. An individual opting to defer payment must attach a statement to Form 6781 indicating the computation of deferrable tax under income averaging, the number of installments in which the individual opts to pay the deferrable tax under income averaging, and the amount of each such payment.

(d) *Deferrable tax under income averaging.* The deferrable tax under income averaging is the excess of—

(1) The tax for the taxable year which includes June 23, 1981, computed pursuant to paragraph (b) of this section, over

(2) The tax for the taxable year which includes June 23, 1981, computed pursuant to paragraph (b) of this section, except that pre-transitional year gain or loss (as described in § 5c.1256–2(g)) is omitted for purposes of recomputing the percentage in Step (4). As computed under this subparagraph (2), the sum of the percentage in Step (3) and Step (4) will not equal 100 percent.

(e) *Rules of application.* The provisions of § 5c.1256–3 (c), (f), (g), (h), (i), and (j) shall apply in computing the tax and in determining the deferrable tax under income averaging under this section.

(f) *Examples.* The application of this section may be illustrated by the following examples:

*Example (1).* Individual A is a single, calendar year taxpayer with no dependents. A reported the following amounts for the following years on line 34 of Form 1040:

1977—$80,000
1978—$90,000
1979—$100,000
1980—$110,000

A reports the following amounts for the following lines on Form 1040 for 1981:

line 7—$120,000
line 12—$600,000
line 32b—$19,000
line 33—$1,000

The amount on line 12 is computed as follows: $937,500 of gain is attributable to regulated futures contracts subject to section 1256(a). Of that total, 40 percent is short term capital gain ($375,000) and 60 percent is long term capital gain ($562,500). Of the long term capital gain, 40 percent is taxable ($225,000). Therefore, A reports $600,000 on line 12 ($375,000+$225,000).

The result of Step (1) is $464,013.41. The result of Step (2) is $337,051.52. The result of Step (3) is 17 percent. The result of Step (4) is 83 percent. The result of Step (5) is

$78,882.28. The result of Step (6) is $279,752.76. The result of Step (7) is $358,635.04. This is A's tax for 1981 under section 1301.

*Example (2).* The facts are the same as in Example (1), except that $703,125 of the $937,500 gain attributable to regulated futures contracts is pre-transitional year gain or loss (as described in § 5c.1256–2(g)). A's tax for 1981 under section 1301 is $358,635.04. A may opt to pay in installments a maximum of $221,004.68 of the tax due in 1981. If A opts to defer the maximum amount and pay in 5 equal installments, A must pay for 1981 a tax of $181,831.30. Each of the 4 succeeding installments is $44,200.94 plus interest computed in accordance with § 5c.1256–3(g)(3).

(Secs. 1305 and 7805 of the Internal Revenue Code of 1954 (78 Stat. 110, 26 U.S.C. 1305; 68A Stat. 917, 26 U.S.C. 7805); secs. 508(c) and 509 of the Economic Recovery Tax Act of 1981 (95 Stat. 333–335))

[T.D. 7826, 47 FR 38692, Sept. 2, 1982]

## PART 5e—TEMPORARY INCOME TAX REGULATIONS, TRAVEL EXPENSES OF MEMBERS OF CONGRESS

AUTHORITY: Secs. 280A(f)(4)(B) and 7805 of the Internal Revenue Code of 1954 (95 Stat. 1641, 26 U.S.C. 7805; 68A Stat. 917, 26 U.S.C. 7805).

### § 5e.274–8 Travel expenses of Members of Congress.

(a) *In general.* Members of Congress (including any Delegate and Resident Commissioner) who are away from home within the meaning of section 162 (a), in the Washington, DC area, may elect in accordance with paragraph (f) of this section to deduct an amount described in paragraph (c) of this section as living expenses, without substantiation. A Member who elects under this section may not deduct any amount for the living expenses described in paragraph (b). A Member who does not make an election under this section must substantiate his expenses for living in Washington, DC in accordance with section 274 and § 1.274–5.

(b) *Living expenses covered.* The amount allowed to be deducted without substantiation, pursuant to this section, for costs incurred for living in the Washington, DC area represents amounts expended for meals, lodging, and other incidental expenses. Meals include the actual cost of the food and expenses incident to the preparation and serving thereof. Lodging includes amounts paid for rent, care of premises, utilities, insurance and depreciation of household furnishings owned by the Member. In the case of a Member who lives in a residence owned by him in the Washington, DC area, the cost of lodging also includes depreciation on such residence. Other incidental expenses include laundry, cleaning, and local transportation. Local transportation includes travel within a 50 mile radius of Washington, DC, whether by private automobile, taxicab or other transportation for hire. Interest and taxes on personal property will not be considered expenses to be included within this paragraph.

(c)(1) *Amounts allowed without substantiation.* The amount that may be deducted pursuant to section 162 and these regulations is an amount equal to the product of the number of Congressional days in the taxable year, multiplied by the designated amount. The designated amount is—

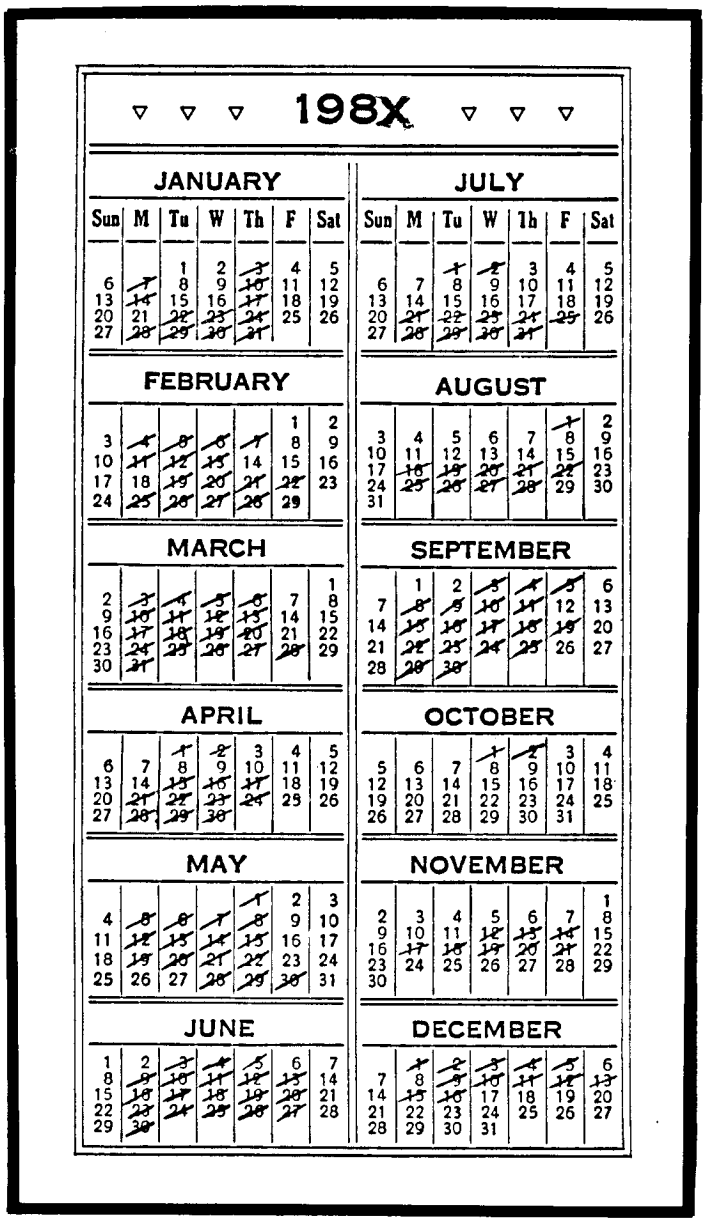
(i) In the case of a Member who deducts interest and taxes attributable to the ownership of a personal residence in the Washington, DC area, two-thirds of the maximum amount of actual subsistence for Washington, DC payable pursuant to 5 U.S.C. 5702(c), or

(ii) In the case of a Member not described in paragraph (c)(1)(i), the maximum amount of actual subsistence for Washington, DC payable pursuant to 5 U.S.C. 5702(c).

A Member who incurs interest and taxes on his residence in the Washington, DC area may forego the deduction of such amounts and use the designated amount prescribed by paragraph (c)(1)(ii).

(2) If a Member, who lives in a residence owned by him in the Washington, DC area, chooses to deduct amounts prescribed in paragraph (c)(1) of this section, the Member must treat as an adjustment to the basis of such residence an amount equal to 20 percent of the maximum amount of actual subsistence multiplied by the number of Congressional days. Such adjustments will be considered a proper adjustment for exhaustion, wear, and tear under this subtitle.

(d) *Congressional days.* The number of Congressional days with respect to a Member is the number of days in the taxable year less the number of days in periods in which the Member's Congressional chamber was not in session for 5 consecutive days or more (including Saturday and Sunday). The number of days with respect to a Member is determined without regard to whether or not the Member was in the Washington, DC area on such days.



198X

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| 27 | 28 | 29 | 30 | 31 | | |

| FEBRUARY | | | | | | |
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| MARCH | | | | | | |
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| APRIL | | | | | | |
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| MAY | | | | | | |
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| JUNE | | | | | | |
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| 29 | 30 | | | | | |

| JULY | | | | | | |
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| Sun | M | Tu | W | Th | F | Sat |
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| 20 | 21 | 22 | 23 | 24 | 25 | 26 |
| 27 | 28 | 29 | 30 | 31 | | |

| AUGUST | | | | | | |
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| 31 | | | | | | |

| SEPTEMBER | | | | | | |
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| 7 | 8 | 9 | 10 | 11 | 12 | 13 |
| 14 | 15 | 16 | 17 | 18 | 19 | 20 |
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| 28 | 29 | 30 | | | | |

| OCTOBER | | | | | | |
|---|---|---|---|---|---|---|
| | | | 1 | 2 | 3 | 4 |
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| NOVEMBER | | | | | | |
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| 30 | | | | | | |

| DECEMBER | | | | | | |
|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 |
| 7 | 8 | 9 | 10 | 11 | 12 | 13 |
| 14 | 15 | 16 | 17 | 18 | 19 | 20 |
| 21 | 22 | 23 | 24 | 25 | 26 | 27 |
| 28 | 29 | 30 | 31 | | | |

(e) *Other deductible amounts.* This section does not preclude the deduction of otherwise allowable expenses for travel fares (other than local travel in the Washington, DC), long distance telephone and telegraph, and travel expenses incurred other than in the Washington, DC area. However, such

expenses are subject to the substantiation requirements of section 274.

(f) *Election.* To elect to deduct the amounts prescribed by this section, a Member must attach to his return for the taxable year a statement indicating, (1) that the deduction for travel expenses while living in the Washington, DC area are computed pursuant to § 5e.274–8, and (2) whether a separate deduction is being taken for interest and taxes paid or incurred with respect to the personal residence of the Member if in the Washington, DC area.

(g) *Effective date.* This section is effective for taxable year beginning after December 31, 1980.

(h) *Examples.* The following examples are based on a calendar from a Final Edition of the Calendar of the United States, House of Representatives and History of Legislation. The marked days indicate days the House of Representatives was in session.

*Example 1* In determining the number of Congressional days for 198X for which the designated amount may be computed, the number of days in such year is reduced by 125 days determined as follows:

| | Days |
|---|---|
| Feb. 14–18 | 5 |
| Apr. 3–14 | 12 |
| May 23–27 | 5 |
| July 3–20 | 18 |
| Aug. 2–17 | 16 |
| Aug. 29–Sept. 2 | 5 |
| Oct. 3–Nov. 11 | 40 |
| Nov. 22–Nov. 30 | 9 |
| Dec. 17–Dec. 31 | 15 |
| Total | 125 |

Thus for 198X (a leap year) a typical Member of the House of Representatives will have 241 (366 − 125) Congressional days.

*Example 2* On August 1, Z a calendar year taxpayer is elected to the Congress to fill the unexpired term of Member Y. In determining the number of Congressional days, Z may only consider the number of days during the year for which he was a Member of Congress. For Z the number of Congressional days is 68.

*Example 3* Member X, a calendar year taxpayer, owns his own home in Washington, DC, where he lives with his family. While in Washington, DC, Member X is away from home within the meaning of section 162(a). X maintains no records attributable to his expenses in Washington, DC X has been a Member of Congress for the entire year. The maximum amount of subsistence for Washington, DC for 198X is $75. X may deduct for 198X $18,075 (241 days×$75) attributable to expenses while away from home in Washington, DC. Even if X maintained records as to living expenses in Washington, DC, X may choose to deduct $18,075 as the total amount attributable to living expenses in Washington, DC. If X deducts $18,075 X may not deduct any interest and taxes under section 163 or 164 attributable to the residence in Washington, DC.

*Example 4* Member C, a calendar year taxpayer owns his own home in Washington, DC, where he lives with his family. While in Washington, DC. Member C is away from home within the meaning of section 162(a). C can establish that he paid $12,000 as interest on a mortgage and $3,000 in local real estate taxes. C has been a Member of Congress for the entire year. C may choose to deduct $12,050 (241 days×[⅔×$75]) attributable to expenses in Washington, DC. Further, C may deduct under sections 163 and 164 $12,000 of interest and $3,000 of taxes respectively.

*Example 5* Assume the same facts as in Example (4). In addition, on March 15, 16, and 17, Member C travels to New York City to deliver a speech for which he receives an honorarium which he includes in income. C receives no additional amounts for travel reimbursement. While in New York City C incurs $350 for 3 nights lodging at a hotel and $150 for meals. In addition to the amounts deductible pursuant to this section, C may deduct the $500 as a travel expenses. Such deduction is subject to the substantiation rules of section 274.

*Example 6* Assume the same facts as example (5). Member C receives, in addition to the honorarium, $600 reimbursement for travel expenses. C must include the $600 in income and may deduct the travel expenses he incurred.

[T.D. 7802, 47 FR 2987, Jan. 21, 1982; 47 FR 4680, Feb. 2, 1982]

## PART 5f—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

Sec.

5f.103–1 Obligations issued after December 31, 1982, required to be in registered form.
5f.103–2 Public approval of industrial development bonds.
5f.103–3 Information reporting requirements for certain bonds.
5f.163–1 Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form.
5f.168(f)(8)–1 Questions and answers concerning transitional rules and related matters regarding certain safe harbor leases.

5f.442–1 Temporary regulations relating to change of annual accounting period.
5f.6045–1 Returns of information of brokers and barter exchanges.

AUTHORITY: 26 U.S.C. 7805. Secs. 5f.103–1 and 5f.163–1 also issued under 26 U.S.C. 103(j), 26 U.S.C. 163(f), and 96 Stat. 595. Sec. 5f.6045–1 also issued under 26 U.S.C. 6045.

### § 5f.103–1 Obligations issued after December 31, 1982, required to be in registered form.

(a) *Registration; general rule.* Interest on a registration-required obligation (as defined in paragraph (b) of this section) shall not be exempt from tax notwithstanding section 103 (a) or any other provision of law, exclusive of any treaty obligation of the United States, unless the obligation is issued in registered form (as defined in paragraph (c) of this section).

(b) *Registration-required obligation.* For purposes of this section, the term ''registration-required obligation'' means any obligation except any one of the following:

(1) An obligation not of a type offered to the public. The determination as to whether an obligation is not of a type offered to the public shall be based on whether similar obligations are in fact publicly offered or traded.

(2) An obligation that has a maturity at the date of issue of not more than 1 year.

(3) An obligation issued before January 1, 1983. An obligation first issued before January 1, 1983, shall not be considered to have been issued on or after that date merely as a result of the existence of a right on the part of the holder of such obligation to convert the obligation from registered form into bearer form, or as a result of the exercise of such a right.

(4) An obligation described in § 5f.163–1 (c) (relating to certain obligations issued to foreign persons).

(c) *Registered form*—(1) *General rule.* An obligation issued after January 20, 1987, pursuant to a binding contract entered into after January 20, 1987, is in registered form if—

(i) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder,

(ii) The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent) (as described in paragraph (c)(2) of this section), or

(iii) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred through both of the methods described in subdivisions (i) and (ii).

(2) *Special rule for registration of a book entry obligation.* An obligation shall be considered transferable through a book entry system if the ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an interest in the obligation.

(d) *Effective date.* The provisions of this section shall apply to obligations issued after December 31, 1982, unless issued on an exercise of a warrant for the conversion of a convertible obligation if such warrant or obligation was offered or sold outside the United States without registration under the Securities Act of 1933 and was issued before August 10, 1982.

(e) *Special rules.* The following special rules apply to obligations issued after January 20, 1987, pursuant to a binding contract entered into after January 20, 1987.

(1) An obligation that is not in registered form under paragraph (c) of this section is considered to be in bearer form.

(2) An obligation is not considered to be in registered form as of a particular time if it can be transferred at that time or at any time until its maturity by any means not described in paragraph (c) of this section.

(3) An obligation that as of a particular time is not considered to be in registered form by virtue of subparagraph (2) of this paragraph (e) and that, during a period beginning with a later time and ending with the maturity of the obligation, can be transferred only by a means described in paragraph (c) of this section, is considered to be in

registered form at all times during such period.

(f) *Examples.* The application of this section may be illustrated by the following examples:

*Example (1).* Municipality X publicly offers its general debt obligations to United States persons. The obligations have a maturity at issue exceeding 1 year. The obligations are registration-required obligations under § 5f.103–1(b). When individual A buys an obligation, X issues an obligation in A's name evidencing A's ownership of the principal and interest under the obligation. A can transfer the obligation only by surrendering the obligation to X and by X issuing a new instrument to the new holder. The obligation is issued in registered form.

*Example (2).* Municipality Y issues a single obligation on January 4, 1983 to Bank M provided that (i) Bank M will not at any time transfer any interest in the obligation to any person unless the transfer is recorded on Municipality Y's records (except by means of a transfer permitted in (ii) of this example) and (ii) interests in the obligation that are sold by Bank M (and any persons who acquire interests from M) will be reflected in book entries. C, an individual, buys an interest in Y's obligation from Bank M. Bank M receives the interest or principal payments with respect to C's interest in the obligation as agent for C. Bank M records interests in the Municipality Y obligation as agent of Municipality Y. Any transfer of C's interest must be reflected in a book entry in accordance with Bank M's agreement with Municipality Y. Since C's interest can only be transferred through a book entry system maintained by the issuer (or its agent), the obligation is considered issued in registered form. Interest received by C is excludable from gross income under section 103(a).

*Example (3).* Municipality Z wishes to sell its debt obligations having a maturity in excess of 1 year. The obligations are sold to Banks N, O, and P, all of which are located in Municipality Z. By their terms the obligations are freely transferable, although each of the banks has stated that it acquired the obligations for purposes of investment and not for resale. Obligations similar to the obligations sold by Municipality Z are traded in the market for municipal securities. The obligations issued by Municipality Z are of a type offered to the public and are therefore registration-required under § 5f.103–1 (b).

*Example (4).* Corporation A issues an obligation that is registered with the corporation as to both principal and any stated interest. Transfer may be effected by the surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder. The obligation can be converted into a form in which the right to the principal of, or stated interest on, the obligation may be effected by physical transfer of the obligation. Under § 5f.103–1 (c) and (e), the obligation is not considered to be in registered form and is considered to be in bearer form.

*Example (5).* Corporation B issues its obligations in a public offering in bearer definitive form. Beginning at X months after the issuance of the obligations, a purchaser (either the original purchaser or a purchaser in the secondary market) may deliver the definitive bond in bearer form to the issuer in exchange for a registration receipt evidencing a book entry record of the ownership of the obligation. The issuer maintains the book entry system. The purchaser identified in the book entry as the owner of record has the right to receive a definitive bearer obligation at any time. Under § 5f.103–1 (c) and (e), the obligation is not considered to be issued in registered form and is considered to be issued in bearer form. All purchasers of the obligation are considered to hold an obligation in bearer form.

*Example (6).* Corporation C issues obligations in bearer form. A foreign person purchases a definitive bearer obligation and then sells it to a United States person. At the time of the sale, the United States person delivers the bearer obligation to Corporation C and receives an obligation that is identical except that the obligation is registered as to both principal and any stated interest with the issuer or its agent and may be transferred at all times until its maturity only through a means described in § 5f.103–1(c). Under § 5f.103–1(e), the obligation is considered to be in registered form from the time it is delivered to Corporation C until its maturity.

(g) *Cross-references.* See section 103A(j)(1) for the registration requirement of certain mortgage subsidy bonds issued after December 31, 1981, and § 6a.103A–1(a)(5) for the definition of registered form for such obligations issued after December 31, 1981, and on or before December 31, 1982. See also section 103(h) (requiring registration of certain energy bonds issued on or after October 18, 1979).

[T.D. 7852, 47 FR 51361, Nov. 15, 1982, as amended by T.D. 8111, 51 FR 15463, Dec. 19, 1986]

### § 5f.103–2 Public approval of industrial development bonds.

(a) *General rule.* An industrial development bond (within the meaning of § 1.103–7(b)(1) issued after December 31, 1982, shall be treated as an obligation not described in section 103(a) unless it

is issued as part of an issue which satisfies the public approval requirement of section 103(k) and paragraph (c) of this section or is described in the exceptions set forth in paragraph (b) of this section.

(b) *Exceptions*—(1) *No extension of maturity.* Paragraph (a) of this section does not apply to a refunding obligation if—

(i) It refunds an obligation which was approved under section 103(k) and this section (or which is treated as approved pursuant to paragraph (f) of this section), and

(ii) It has a maturity date which is not later than the maturity date of the obligation to be refunded.

(2) *Refunding of pre-July 1, 1982, obligation.* Paragraph (a) of this section does not apply to an obligation issued solely to refund an obligation which—

(i) Was issued before July 1, 1982, and

(ii) Has a term which does not exceed 3 years.

The term of an obligation is determined without regard to whether it is a refunding obligation. With respect to the refunding of an issue also containing obligations with terms which exceed 3 years, paragraph (b)(2) applies only if the refunding issue proceeds are used solely to refund obligations with terms not exceeding 3 years and to pay reasonable incidental costs of the refunding (*e.g.,* legal and accounting fees, printing costs, and rating fees) attributable thereto. Paragraph (b)(2) applies only to issues issued after December 31, 1982, the proceeds of which are used to refund issues issued prior to July 1, 1982. Thus, subsequent refundings of such refunding issues must satisfy the public approval requirement of section 103(k) and paragraph (c) of this section.

(c) *Public approval requirement*—(1) *In general.* An issue is publicly approved if prior to the date of issue the governmental unit(s) described in subparagraphs (2) and (3) this paragraph (c) approve the issue, in the manner described in paragraph (d) of this section. See paragraph (f) for rules pertaining to determining the scope of an approval and paragraph (g)(1) for the definition of ''governmental unit''.

(2) *Issuer approval.* The governmental unit (i) which will issue the obligations or (ii) on behalf of which the issue is to be issued must approve the issue (''issuer approval''). If the issuer is not a governmental unit, the governmental unit on behalf of which the issuer acts shall be determined in a manner consistent with determinations under § 1.103–1, and such unit must approve the issue. However, in the case of an issuer which issues obligations on behalf of more than one governmental unit (*e.g.,* an authority which acts for two counties), any one of such units may give the issuer approval required by this paragraph (c)(2).

(3) *Host approval.* Each governmental unit the geographic jurisdiction (as defined in paragraph (g)(4)) of which contains the site of a facility to be financed by the issue must approve the issue (''host approval''). However, if the entire site of a facility to be financed by the issue is within the geographic jurisdiction of more than one governmental unit within a State (counting the State as a governmental unit within such State), then any one of such units may provide host approval for the issue with respect to that facility. For purposes of this paragraph (c)(3), if property to be financed by the issue is located within two or more governmental units but not entirely within either of such units, each portion of the property which is located entirely within the smallest respective governmental units may be treated as a separate facility. The issuer approval (as described in paragraph (c)(2)) may be treated as a host approval if the governmental unit giving the issuer approval is also a governmental unit described in this paragraph (c)(3). See paragraph (e)(2) with respect to host approval by a governmental unit with no applicable elected representative.

(d) *Method of public approval.* For purposes of this section, an issue is approved by a governmental unit only if—

(1) An applicable elected representative (as defined in paragraph (e)) of such unit approves the issue following a public hearing (as defined in paragraph (g)(2)) held in a location which, under the facts and circumstances, is convenient for residents of the unit, and for which there was reasonable public notice (as defined in paragraph (g)(3)), or

(2) A referendum of the voters of the unit (as defined in paragraph (g)(5)) approves the issue.

An approval may satisfy the requirements of this section without regard to the authority under State or local law for the acts constituting such approval. The location of hearing will be presumed convenient for residents of the unit if it is located in the approving governmental unit's capital or seat of government. If more than one governmental unit is required to provide a public hearing, such hearings may be combined as long as the combined hearing is a joint undertaking that provides all of the residents of the participating governmental units (*i.e.*, those relying on such hearing as an element of public approval) a reasonable opportunity to be heard. The location of any combined hearing is presumed to provide a reasonable opportunity to be heard provided it is no farther than 100 miles from the seat of government of each participating governmental unit beyond whose geographic jurisdiction the hearing is conducted.

(e) *Applicable elected representative*—(1) *In general.* The applicable elected representative of a governmental unit means—

(i) Its elected legislative body,

(ii) Its chief elected executive officer,

(iii) In the case of a State, the chief elected legal officer of the State's executive branch of government, or

(iv) Any official elected by the voters of the unit and designated for purposes of this section by the unit's chief elected executive officer or by State or local law to approve issues for the unit.

For purposes of subdivisions (ii), (iii), and (iv) of this paragraph (e)(1), an official shall be considered elected by the voters of the unit only if he is popularly elected at-large by the voters of the governmental unit. If an official popularly elected at-large by the voters of a governmental unit is appointed or selected pursuant to State or local law to be the chief executive officer of the unit, such official is deemed to be an elected chief executive officer for purposes of this section but for no longer than his tenure as an official elected at-large. In the case of a bicameral legislature which is popularly elected, both chambers together constitute an applicable elected representative, but neither chamber does independently, unless so designated under paragraph (e)(1)(iv). If multiple elected legislative bodies of a governmental unit have independent legislative authority, however, the body with the more specific authority relating to the issue is the only legislative body described in paragraph (e)(1)(i) of this section. See paragraph (h), Example (7) of this section.

(2) *Governmental unit with no applicable elected representative.* (i) The applicable elected representatives of a governmental unit with no representative (but for this paragraph (e)(2) and section 103(k)(2)(E)(ii)) are deemed to be those of the next higher governmental unit (with an applicable elected representative) from which the governmental unit derives its authority. For purposes of this subparagraph (2), a governmental unit derives its authority from another unit which—

(A) Enacts a specific law (*e.g.*, a provision in a State constitution, charter or statute) by or under which the governmental unit is created,

(B) Otherwise empowers or approves the creation of the governmental unit, or

(C) Appoints members to the governing body of the governmental unit.

In the case of a governmental unit with no applicable elected representative (but for this paragraph (e)(2)), any unit described in subdivision (A), (B), or (C) or this paragraph (e)(2)(i) may be treated as the next higher unit, without regard to the relative status of all of such units under State law.

(ii) In the case of a host approval (as required under paragraph (c)(3) of this section), a unit may be treated as the next higher unit, only if—

(A) The facility is located within its geographic jurisdiction, and

(B) Eligible individuals, if any, residing at the site of the facility are entitled to vote for the applicable elected representative of that unit (as determined under this paragraph (e)).

(3) *On behalf of issuers.* In the case of an issuer which is not a governmental unit but which issues bonds on behalf of a governmental unit, the applicable elected representative is any applicable elected representative of the unit on behalf of which the bonds are issued. If

the unit on behalf of which the bonds are issued has no applicable elected representative (but for paragraph (e)(2) of this section), the applicable elected representative of the governmental unit is determined in the manner described in paragraph (e)(2).

(f) *Scope of approval*—(1) *In general.* Public approval is required by section 103(k) and this section for issues of industrial development bonds, except as otherwise provided in paragraphs (a) and (b) of this section. An issue is treated as approved if the governmental units (described in paragraph (c) of this section in relation to the issue) have approved either—

(i) The issue (by approving each facility to be financed), not more than one year before the date of issue, or

(ii) A plan of financing for each facility financed by the issue pursuant to which the issue in question is timely issued (as required in paragraph (f)(3) of this section).

In either case, the scope of the approval is determined by the information, as specified in paragraph (f)(2), contained in the notice of hearing (when required) and the approval.

(2) *Information required.* A facility is within the scope of an approval if the notice of hearing (when required) and the approval contain—

(i) A general, functional description of the type and use of the facility to be financed (*e.g.*, ''a 10,000 square foot machine shop and hardware manufacturing plant'', ''400-room airport hotel building'', ''dock facility for supertankers'', ''convention center auditorium and sports arena with 25,000 seating capacity'', ''air and water pollution control facilities for oil refinery''),

(ii) The maximum aggregate face amount of obligations to be issued with respect to the facility,

(iii) The initial owner, operator, or manager of the facility,

(iv) The prospective location of the facility by its street address or, if none, by a general description designed to inform readers of its specific location.

An approval is valid for purposes of this section with respect to any issue used to provide publicly approved facilities, notwithstanding insubstantial deviations with respect to the maximum aggregate face amount of the bonds issued under the approval for the facility, the name of its initial owner, manager, or operator, or the type or location of the facility from that described in the approval. An approval or notice of public hearing will not be considered to be adequate if any of the items in subdivisions (i) through (iv) of this subparagraph (2), with respect to the facility to be financed, are unknown on the date of the approval or the date of the public notice.

(3) *Timely issuance pursuant to a plan of financing.* An issue is timely issued pursuant to a plan of financing for a facility if—

(i) The issue is issued no later than 3 years after the first issue pursuant to the plan, and

(ii) The first such issue in whole or in part issued pursuant to the plan was issued no later than 1 year after the date of approval.

(4) *Facility—definition.* For purposes of this paragraph (f), the term ''facility'' includes a tract or adjoining tracts of land, the improvements thereon and any personal property used in connection with such real property. Separate tracts of land (including improvements and connected personal property) may be treated as one facility only if they are used in an integrated operation.

(g) *Definitions.* For purposes of this section—

(1) *Governmental unit.* Governmental unit has the same meaning as in § 1.103–1. Thus, a governmental unit is a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof. The term ''political subdivision'' denotes any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit.

(2) *Public hearing.* Public hearing means a forum providing a reasonable opportunity for interested individuals to express their views, both orally and in writing, on the proposed issue of bonds and the location and nature of a proposed facility to be financed. In general, a governmental unit may select its own procedure for the hearing, provided that interested individuals

have a reasonable opportunity to express their views. Thus, it may impose reasonable requirements on persons who wish to participate in the hearing, such as a requirement that persons desiring to speak at the hearing so request in writing at least 24 hours before the hearing or that they limit their oral remarks to 10 minutes. For purposes of this public hearing requirement, it is not necessary, for example, that the applicable elected representative who will approve the bonds be present at the hearing, that a report on the hearing be submitted to that official, or that State administrative procedural requirements for public hearings in general be observed. However, compliance with such State procedural requirements (except those at variance with a specific requirement set forth in this section) will generally assure that the hearing satisfies the requirements of this section. The hearing may be conducted by any individual appointed or employed to perform such function by the governmental unit or its agencies, or by the issuer (if on behalf of issuer). Thus, for example, for bonds to be issued by an authority that acts on behalf of a county, the hearing may be conducted by the authority, the county, or an appointee or employee of either.

(3) *Reasonable public notice*. Reasonable public notice means published notice which is reasonably designed to inform residents of the affected governmental units, including residents of the issuing unit and the governmental unit where a facility is to be located, of the proposed issue. The notice must state the time and place for the hearing and contain the information contained in paragraph (f)(2) of this section. Notice is presumed reasonable if published no fewer than 14 days before the hearing. Except in the locality of the facility, publication is presumed to be reasonably designed to inform residents of the approving governmental unit if given in the same manner and same locations as required of the approving governmental unit for any other purposes for which applicable State or local law specifies a notice of public hearing requirement (including laws relating to notice of public meetings of the governmental unit). Notice is presumed reasonably designed to inform affected residents in the locality of the facility only if published in one or more newspapers of general circulation available to residents of that locality or if announced by radio or television broadcast to those residents.

(4) *Geographic jurisdiction*. Geographic jurisdiction is the area encompassed by the boundaries prescribed by State or local law for a governmental unit or, if there are no such boundaries, the area in which a unit may exercise such sovereign powers that make that unit a governmental unit for purposes of § 1.103–1 and this section.

(5) *Voter referendum*. A voter referendum is a vote by the voters of the affected governmental unit conducted in the manner and at such a time as voter referenda on matters relating to governmental spending or bond issuances by the governmental unit under applicable State and local law.

(h) *Examples*. The provisions of this section may be illustrated by the following examples:

*Example (1)*. State X proposes to issue an industrial development bond, the proceeds of which are to finance a facility located entirely within the geographic jurisdiction of City Y (which is located in State X). Under the provisions of paragraph (c), only State X must approve the issue because State X is the issuer and the facility is to be located entirely within the State's geographic jurisdiction. Its applicable elected representative must approve the issue after the public notice and public hearing requirements are satisfied.

*Example (2)*. (i) Industrial Development Authority X proposes to issue an industrial development bond, the proceeds of which are to finance a facility located entirely within the geographic jurisdiction of City Y (which is located in State Z). Authority X acts on behalf of State Z. Under the provisions of paragraph (c), only State Z must approve the issue because State Z is the governmental unit on behalf of which Authority X, the issuer, is acting and the facility is to be located entirely within its geographic jurisdiction.

(ii) State Z has a governor, an elected bicameral legislature and an appointed attorney general who is the chief legal officer of State Z. Under the laws of State Z, the attorney general must approve any issue of industrial development bonds. The approval by the attorney general is not a sufficient approval under this section, since the attorney

general is not an applicable elected representative within the meaning of this section. Under the provisions of paragraphs (d) and (e), either the governor, both chambers of the legislature or any popularly elected official of the State who is designated for this purpose by the governor or by State law must approve the issue after the public notice and public hearing requirements are satisfied.

*Example (3).* (i) County Y, a county in State X, proposes to issue an industrial development bond, the proceeds of which are to finance a facility located entirely within its jurisdiction. Under the provisions of paragraph (c), only County Y must approve the issue because County Y is the issuer and the facility is to be located entirely within the geographic jurisdiction of County Y.

(ii) County Y has no elected officials or legislature. County Y derives its authority from State X which is the next higher governmental unit with an applicable elected representative. The laws of State X designate the attorney general, who is an official of State X elected at-large, as the official who must approve any issue of industrial development bonds for the State. Under this section, State X's attorney general is an applicable elected representative who may approve the issue after the public notice and public hearing requirements are satisfied.

*Example (4).* (i) City X, a city located in County Y and State Z, proposes to issue an industrial development bond, the proceeds of which are to finance a facility located entirely within the geographic jurisdiction of City X. Under the provisions of paragraph (c), only City X must approve the issue because it is the issuer and the facility is to be located entirely within the geographic jurisdiction of City X.

(ii) Mayor A, the chief elected executive officer of City X, has designated, for purposes of this section, Deputy Mayor B, an official of City X elected at-large, to approve industrial development bond issues for the city. Under the provisions of paragraph (e), Deputy Mayor B may approve the issue, since he is an applicable elected representative, after the public notice and public hearing requirements are satisfied.

*Example (5).* (i) County M proposes to issue an industrial development bond to finance a project located partly within the geographic jurisdiction of County M and partly within the geographic jurisdiction of County N. Both counties are located in State X. The part of the project in County N is also located partly within the geographic jurisdiction of City O and partly within the geographic jurisdiction of City P. Under the provisions of paragraph (c)(2), County M must give issuer approval. Additionally, under the provisions of paragraph (c)(3), either State X, County N, or both Cities O and P, must give host approval.

(ii) Counties M and N will approve the issue, but neither has any officials who are elected at-large by the voters of the respective governmental units. Both governmental units derive their authority from State X which is the next higher governmental unit with an applicable elected representative. Under the provisions of paragraph (e), an applicable elected representative of State X must approve the issue for Counties M and N after the public notice and public hearing requirements are satisfied.

*Example (6).* (i) County M proposes to issue an industrial development bond to finance two facilities. One facility is located entirely within the geographic jurisdiction of County M and the second facility is located partly within the geographic jurisdiction of County M and partly within the geographic jurisdiction of County N. The second facility is also located within the geographic jurisdictions of Cities O and P, which cities are located within the geographic jurisdiction of County N. Under the provisions of paragraph (c)(2), County M must give issuer approval. Additionally, under the provisions of paragraph (c)(3), either State X, County N, or both Cities O and P, must give host approval.

(ii) Counties M and N will approve the issue. Each has a chief elected executive officer. Under the provisions of paragraphs (d) and (e), the chief elected executive officer of each county may approve the issue, after the public notice and public hearing requirements are satisfied.

*Example (7).* (i) State X proposes to issue an industrial development bond to finance a facility located partly within the geographic jurisdiction of State X and partly within the geographic jurisdiction of State Y. That portion of the facility located in State Y is located entirely within the geographic jurisdiction of City Z. State X must give issuer approval. Additionally, either State Y or City Z must give host approval as that part of the facility to be located outside State X will be entirely within the geographic jurisdiction of each unit.

(ii) Under the provisions of paragraphs (d) and (e), the governor of State X may approve the issue, after the public notice and public hearing requirements are satisfied. City Z (assuming that it give host approval for the bond) has a city council and a school board, both of which are elected legislative bodies with independent jurisdiction. The authority of the school board is limited under State law to matters directly concerning the provision of public education. Under paragraph (e), the school board is not an applicable elected representative of City Z but the city council is an applicable elected representative of City Z. The city council may approve the issue after the public hearing and public notice requirements are satisfied.

*Example (8).* (i) Public Housing Authority M, a governmental unit, proposes to issue an

industrial development bond to finance several housing projects with known sites located entirely within its geographic jurisdiction. M's geographic jurisdiction is coextensive with the combined geographic jurisdictions of Counties N and O. The projects are separately owned and managed. They are not adjacent to each other. The projects also are located in County N. Under the provisions of paragraph (c), M must give issuer approval.

(ii) M, which has no elected officials or legislature, was created by both Counties N and O pursuant to a special statute of State Q permitting such a joint undertaking. Both Counties N and O have an applicable elected representative. Under the provisions of paragraph (e)(2), either County N, County O, or State Q is deemed to be the next higher governmental unit with an applicable elected representative, and an applicable elected representative from any of these units may give the issuer approval for Authority M. Therefore, either the applicable representative of County N, County O, or State Q can give the issuer approval for Authority M.

(iii) For purposes of the host approval, the issuer approval by M will satisfy the host approval requirement only if the applicable elected representative of County N or State Q gives issuer approval for M. Under the provisions of paragraph (e)(2), the host approval requirement is satisfied only if qualified persons residing at the site of the facility are entitled to vote for the applicable elected representative who gave the approval (*i.e.*, the representative of State Q or County N). However, if the applicable elected representative of O gave issuer approval for Authority M, a separate host approval would be required because the residents of the sites where the projects are located (*i.e.*, County N) could not note for the applicable elected representative of County O.

(iv) Public Housing Authority M conducts a public hearing concerning prospective housing projects following notice thereof published in a newspaper of general circulation in County N. Additionally, M provides notice to the residents of O (which are also within M's jurisdiction) in the manner required for notice of public hearing for other purposes under State Q law. Following the public hearing, the chief elected executive officer of County N approves for Authority M prospective issues for the project. M issues two $7 million issues, one for each project. One issue is issued six months after the date of approval; the second issue is issued thirteen months thereafter. On these facts, only the first issue satisfied the public approval requirement of this section.

[T.D. 7892, 48 FR 21117, May 11, 1983]

## § 5f.103–3 Information reporting requirements for certain bonds.

(a) *General rule.* Under section 103(l), any private purpose bond issued after December 31, 1982 (including any obligation issued thereafter to refund private purpose bonds issued before December 31, 1982) shall be treated as an obligation not described in section 103(a) unless the information reporting requirement (as described in paragraph (c) of this section) is substantially satisfied with respect to the issue of which the bond is a part. For rules concerning bonds issued after December 31, 1986, see § 1.149(e)–1 of this chapter.

(b) *Private purpose bonds.* For purposes of this section, the term ''private purpose bond'' means—

(1) Any industrial development bond (as defined in section 103(b)(2) and § 1.103–7(b)(1)), or

(2) Any obligation which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly—

(i) To finance loans to individuals for educational or related expenses (hereinafter referred to as a ''student loan bond''), or

(ii) By an organization described in section 501(c)(3) which is exempt from taxation by reason of section 501(a) (hereinafter referred to as ''private exempt entity bond'').

The meaning of the terms ''major portion'' and ''directly or indirectly'' shall be the same as under § 1.103–7. Student loan bonds include, but are not limited to, qualified scholarship funding bonds (as defined in section 103(e)).

(c) *Information required.* An obligation satisfies the requirements of section 103(l) and this section only if it is issued as part of an issue with respect to which the issuer, based on information and reasonable expectations determined as of the date of issue, submits on Form 8038 the information required therein, including—

(1) The name, address, and employer identification number of the issuer,

(2) The date of issue (as defined in paragraph (g)(1)),

(3) The face amount of the issue,

(4) The total purchase price of the issue,

(5) The amount allocated to a reasonably required reserve or replacement fund,

(6) The amount of lendable proceeds (as defined in paragraph (g)(4) of this section),

(7) The stated interest rate of each maturity (as defined in paragraph (g)(2) of this section) or, if the interest rate is variable, a description of the method under which the interest rate is computed,

(8) The term (as defined in paragraph (g)(3)) of each maturity,

(9) A general description of the property to be financed by the issue (including property financed by an obligation that will be refunded with the issue proceeds) which includes—

(i) The type of bond issued, that is, a student loan bond, a private exempt entity bond, or an industrial development bond and in the case of an industrial development bond described in section 103(b)(4), the subparagraph of section 103(b)(4) that describes the property, *e.g.*, for a football stadium, that the property is described in section 103(b)(4)(B),

(ii) The recovery classes (as defined in section 168(c)(2)), if applicable, of the various items of financed property and the approximate amount of lendable proceeds attributable thereto,

(iii) The approximate amount of lendable proceeds attributable to land or other property not described in subdivision (ii),

(iv) In the case of obligations described in section 103(b)(6) or private exempt entity bonds, the four-digit Standard Industrial Classification Code of the facilities financed,

(10) If section 103(k) (relating to public approval requirement for industrial development bonds) applies to such issue, the name(s) of the approving governmental unit(s) and of the applicable elected representative(s) (as defined in section 103(k)(2)(E) and § 5f.103–2(e)) or a description of the voter referendum that approved the issue for such unit(s), and

(11) The name, address, and employer identification number of—

(i) Each initial principal user (as defined in paragraph (g)(5) of this section) of any facilities provided with the proceeds of the issue,

(ii) The common parent, if any, of any affiliated group of corporations (as defined in section 1504(a) but determined without regard to the exceptions of section 1504(b)) of which such initial principal user is a member, and

(iii) Any person (not included under paragraph (c)(11)(i)) that is treated as a principal user under section 103(b)(6)(L), but only if the issue is treated as a separate issue under section 103(b)(6)(K).

The information to be supplied must be determined based on information and reasonable expectations as of the date of issue. Therefore, such statement need not be amended to report information learned subsequent to the date of issue. However, if the statement is filed after the date of issue it may reflect such information and the reasonable expectations of the issuer as of that date.

(d) *Additional information.* An issuer may supply the following information—

(1) The average maturity of the issue (as defined in section 103(b)(14)), and

(2) The average reasonably expected economic life (as defined in section 103(b)(14)) of the facility which is financed with the issue.

(e) *Time for filing.* The statement required by section 103(l) and this section shall be filed not later than the 15th day of the 2nd calendar month after the close of the calendar quarter in which the obligation is issued. It may be filed at any time before such date but must be complete based on facts and reasonable expectations as of the date of issue. The Secretary may grant an extension of time for filing the statement required under section 103(l) and this section if there is reasonable cause for the failure to file such statement in a timely fashion.

(f) *Place for filing.* Form 8038 is to be mailed to the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255.

(g) *Definitions.* For purposes of this section—

(1) The term *date of issue* means the date on which the issuer physically exchanges the first of the obligations which are part of the issue for the underwriter's (or other purchaser's) funds. In the event that amounts are

periodically advanced with respect to an issue, the date of issue is when the first of such obligations under the issue is created and the funds are advanced.

(2) The term *maturity* means those obligations of the issue having both the same maturity date and the same stated interest rate.

(3) The term *term of an issue* means the duration of the period beginning on the date of issue and ending on the latest maturity date of any obligation of the issue without regard to optional redemption dates.

(4) The term *lendable proceeds* means the amount of the original proceeds, net of amounts allocated to a reasonably required reserve or replacement fund. See generally § 1.103–13(b) and § 1.103–14(d) for further definitions.

(5) The term *initial principal user* means each person who as of the date of issue is obligated to use the facility to such an extent that under section 103(b)(6) such person would be treated as a principal user. With respect to organizations described in section 501(c)(3), however, such determination is made without regard to whether such organization is treated as an exempt organization under section 103(b)(3) and § 1.103–7(b)(2).

[T.D. 7892, 48 FR 21120, May 11, 1983, as amended by T.D. 8129, 52 FR 7411, Mar. 11, 1987; T.D. 8425, 57 FR 36003, Aug. 12, 1992]

### § 5f.163–1 Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form.

(a) *Denial of deduction generally.* Interest paid or accrued on a registration-required obligation (as defined in paragraph (b) of this section) shall not be allowed as a deduction under section 163 or any other provision of law unless such obligation is issued in registered form (as defined in § 5f.103–1(c)).

(b) *Registration-required obligation.* For purposes of this section, the term ''registration-required obligation'' means any obligation except any one of the following:

(1) An obligation issued by a natural person.

(2) An obligation not of a type offered to the public. The determination as to whether an obligation is not of a type offered to the public shall be based on whether similar obligations are in fact publicly offered or traded.

(3) An obligation that has a maturity at the date of issue of not more than 1 year.

(4) An obligation issued before January 1, 1983. An obligation first issued before January 1, 1983, shall not be considered to have been issued on or after such date merely as a result of the existence of a right on the part of the holder of such obligation to convert such obligation from registered form into bearer form, or as a result of the exercise of such a right.

(5) An obligation described in subparagraph (1) of paragraph (c) (relating to certain obligations issued to foreign persons).

(c) [Reserved]

(d) *Effective date.* The provisions of this section shall apply to obligations issued after December 31, 1982, unless issued on an exercise of a warrant for the conversion of a convertible obligation if such warrant or obligation was offered or sold outside the United States without registration under the Securities Act of 1933 and was issued before August 10, 1982.

(e) *Obligations first issued after December 31, 1982, where the right exists for the holder to convert such obligation from registered form into bearer form.* [Reserved]

(f) *Examples.* The application of this section may be illustrated by the following examples:

*Example (1).* All of the shares of Corporation X are owned by two individuals, A and B. X desires to sell all of its assets to Corporation Y, all of the shares of which are owned by individual C. Following the sale, Corporation X will be completely liquidated. As partial consideration for the Corporation X assets, Corporation Y delivers a promissory note to X, secured by a security interest and mortgage on the acquired assets. The note given by Y to X is not of a type offered to the public.

*Example (2).* Corporation Z has a credit agreement with Bank M pursuant to which Corporation Z may borrow amounts not exceeding $10X upon delivery of Z's note to Bank M. The note Z delivers to M is not of a type offered to the public.

*Example (3).* Individuals D and E operate a retail business through partnership DE. D wishes to loan partnership DE $5X. DE's note evidencing the loan from D is not of a type offered to the public.

*Example (4).* Individual F owns one-third of the shares of Corporation W. F makes a cash advance to W. W's note evidencing F's cash advance is not of a type offered to the public.

*Example (5).* Closely-held Corporation R places its convertible debentures with 30 individuals who are United States persons. The offering is not required to be registered under the Securities Act of 1933. Similar debentures are publicly offfered and traded. The obligations are not considered of a type not offered to the public.

*Example (6).* In 1980, Corporation V issued its bonds due in 1986 through an offering registered with the Securities and Exchange Commission. Although the bonds were initially issued in registered form, the terms of the bonds permit a holder, at his option, to convert a bond into bearer form at any time prior to maturity. Similarly, a person who holds a bond in bearer form may, at any time, have the bond converted into registered form.

(i) Assume G bought one of Corporation V's bonds upon the original issuance in 1980. In 1983, G requests that V convert the bond into bearer form. Except for the change from registered to bearer form, the terms of the bond are unchanged. The bond held by G is not considered issued after December 31, 1982, under § 5f.163–1(b)(4).

(ii) Assume H buys one of Corporation V's bonds in the secondary market in 1983. The bond H receives is in registered form, but H requests that V convert the obligation into bearer form. There is no other change in the terms of the instrument. The bond held by H is not considered issued after December 31, 1982, under § 5f.163–1(b)(4).

(iii) Assume the same facts as in (ii) except that in 1984 I purchases H's V Corporation bond, which is in bearer form. I requests V to convert the bond into registered form. There is no other change in the terms of the instrument. In 1985, I requests V to convert the bond back into bearer form. Again, there is no other change in the terms of the instrument. The bond purchased by I is not considered issued after December 31, 1982, under § 5f.163–1(b)(4).

*Example (7).* Corporation U wishes to make a public offering of its debentures to United States persons. U issues a master note to Bank N. The terms of the note require that any person who acquires an interest in the note must have such interest reflected in a book entry. Bank N offers for sale interests in the Corporation U note. Ownership interests in the note are reflected on the books of Bank N. Corporation U's debenture is considered issued in registered form.

*Example (8).* Issuer S wishes to make a public offering of its debt obligations to United States persons. The obligations will have a maturity in excess of one year. On November 1, 1982, the closing on the debt offering occurs. At the closing, the net cash proceeds of the offering are delivered to S, and S delivers a master note to the underwriter of the offering. On January 2, 1983, S delivers the debt obligations to the purchasers in definitive form and the master note is cancelled. The obligations are not registration-required because they are considered issued before January 1, 1983.

*Example (9).* In July 1983, Corporation T sells an issue of debt obligations maturing in 1985 to the public in the United States. Three of the obligations of the issue are issued to J in bearer form. The balance of the obligations of the issue are issued in registered form. The terms of the registered and bearer obligations are identical. The obligations issued to J are of a type offered to the public and are registration-required obligations. Since the three obligations are issued in bearer form, T is subject to the tax imposed under section 4701 with respect to the three bearer obligations. In addition, interest paid or accrued on the three bearer obligations is not deductible by T. Moreover, since the issuance of the three bearer obligations is subject to tax under section 4701, J is not prohibited from deducting losses on the obligations under section 165(j) or from treating gain on the obligations as capital gain under section 1232(d). The balance of the obligations in the issue do not give rise to liability for the tax under section 4701, and the deductibility of interest on such obligations is not affected by section 163(f).

*Example (10).* Broker K acquires a bond issued in 1980 by the United States Treasury through the Bureau of Public Debt. Broker K sells interests in the bond to the public after December 31, 1982. A purchaser may acquire an interest in any interest payment falling due under the bond or an interest in the principal of the bond. The bond is held by Custodian L for the benefit of the persons acquiring these interests. On receipt of interest and principal payments under the bond, Custodian L transfers the amount received to the person whose ownership interest corresponds to the bond component giving rise to the payment. Under section 1232B, each bond component is treated as an obligation issued with original issue discount equal to the excess of the stated redemption price at maturity over the purchase price of the bond component. The interests sold by K are obligations of a type offered to the public. Further, the interests are, in accordance with section 1232B, considered issued after December 31, 1982. Accordingly, the interests are registration-required obligations under § 5f.163–1(b).

[T.D. 7852, 47 FR 51362, Nov. 15, 1982, as amended by T.D. 7965, 49 FR 33235, Aug. 22, 1984]

### § 5f.168(f)(8)–1 Questions and answers concerning transitional rules and related matters regarding certain safe harbor leases.

The following questions and answers concern the transitional rules and related matters regarding certain safe harbor leases under section 208(d) of the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97–248) (''TEFRA''):

*Q–1: If a lessee, prior to the period beginning after December 31, 1980, and ending before July 2, 1982 (the ''window period''), enters into a binding contract to acquire property and the property is delivered to the lessee during the window period, is the property eligible for the transitional rule provided in section 208(d)(3) of TEFRA which applies the safe harbor leasing rules of section 168(f)(8) of the Internal Revenue Code of 1954 as in effect before the enactment of TEFRA?*

A–1: Yes, assuming all other requirements of the TEFRA transitional rules are met. Section 208(d)(3)(A) (i) and (ii) of TEFRA provide alternative tests under which an item of property may constitute ''transitional safe harbor lease property'' for purposes of the transitional rules under the modifications to the safe harbor lease provisions of section 168(f)(8). The tests are:

(i) The lease entered into a binding contract to acquire the property;

(ii) The lessee entered into a binding contract to construct the property;

(iii) The property was acquired by the lessee; or

(iv) Construction of the property was commenced by or for the lessee.

These tests are stated in the alternative, and, accordingly, property may be eligible for pre-TEFRA safe harbor leasing if any one of the tests is satisfied. Thus, if a lessee acquired property during the window period, the property may be eligible for pre-TEFRA safe harbor leasing even though a binding contract to acquire the property was executed before the window period. Similarly, if construction of property commences during the window period, the property may be eligible for pre-TEFRA safe harbor leasing even though a binding contract to construct the property was executed before the window period.

*Q–2: How do the transitional rules apply to components of an integrated manufacturing, production, or extraction process, none of which would be considered ''placed in service'' until all of the components are placed in service?*

A–2: (i) The transitional rules regarding acquisition, binding contracts, and commencement of construction are applied to each separate item of property which is part of a manufacturing, production, or extraction process. What constitutes a separate item will be determined on a case-by-case basis, taking into account all relevant factors. In general, a discrete component capable of performing a function which is separate from or in addition to the function of other components to which it may be related is a separate item of property; but an item that is integrated into a component which performs a function separate from other components to which it is related is not itself a separate item of property. For example, a bolt or a nut that is used to construct a machine does not constitute a separate item of property. On the other hand, the transitional rules will not be applied to an entire facility as a whole, as was the case under the investment tax credit transition rule of section 50 in *Hawaiian Independent Refinery, Inc. v. United States*, 49 AFTR 2d 675 (Ct. Cl. Tr. Judge 1982), where the taxpayer was held to have constructed a property which consisted of an entire refinery complex. Thus, for example, for purposes of these transitional rules, an oil or gas well, storage tanks, and pipeline located on a lease would not be considered a single item of property. Although each item is related to the production of oil or gas, each is discrete and each is capable of performing a separate function from the other. In addition, in the case of an integrated manufacturing, production, or extraction process, commencement of construction of one item of property within the process would not be considered construction of any other item of property that is part of the process.

(ii) If property qualifies as transitional safe harbor lease property, all direct and indirect costs allocable to the property (except for those described in § 5c.168(f)(8)–6(a)(2)(ii)) and required to be capitalized for Federal income tax purposes will also qualify as transitional safe harbor lease property to the extent such costs are incurred on or before the date on which the property is leased under section 168(f)(8).

(iii) The adjusted basis to the lessor of property leased on or prior to December 1, 1982, under a transitional safe harbor lease shall be deemed to include all direct and indirect costs (including installation costs) described in subdivision (ii) allocable to such property that were incurred before it was leased despite the fact that such costs were not included in the lessor's adjusted basis of such property under the terms of the lease agreement, provided that the parties to such agreement reasonably believed that they had leased the whole of such property. Such costs will be treated as having been included in the lessor's adjusted basis of such safe harbor lease property on the date the lease agreement was executed without regard to any provisions in the lease agreement that limits the dollar amount of the permissible adjustment of the lessor's adjusted basis to such property. To qualify for inclusion of

such direct and indirect costs within the basis of such property, the parties to such agreement must file an amended Form 6793, the Safe Harbor Lease Information Return, no later than April 21, 1983, which reflects the parties' intent to include installation and other such costs within the basis of such property. For purposes of this subdivision, a transitional safe harbor lease is a lease either which was executed after July 1, 1982, and on or prior to December 1, 1982, or which includes some transitional safe harbor lease property, as defined in TEFRA section 208(d)(3), that was placed in service after July 1, 1982, and on or prior to December 1, 1982.

*Q–3: What test will be applied in determining whether an item of property is constructed or acquired by the lessee?*

A–3: Except as expressly provided in section 208(d)(3) (D) or (E) of TEFRA, the determination of whether and when any such events occurred with respect to an item of property will generally be made in accordance with the principles and precedents prior to TEFRA under the investment tax credit and depreciation allowance transitional provisions. See §§ 1.48–2(b)(6) and 1.167(c)–1(a)(2), which provide definitions of the term ''acquired'', and §§ 1.48–2(b)(1) and 1.167(c)–1(a)(1), which provide definitions of the term ''constructed by''. Also see Rev. Rul. 80–312, 1980–2 C.B. 21, which discusses the factors to be considered in determining when a taxpayer has control over a project being constructed.

In general, for purposes of TEFRA section 208(d)(3), construction of an item of property is considered to have commenced when physical work of a significant nature has begun with respect to the property. Thus, construction does not begin when parts or components which enter into construction are acquired. If property is assembled from purchased parts or components, the commencement of construction occurs when actual assembly of the property begins. If a taxpayer manufactures a major part or component of an item of property for itself, construction will be considered to have begun when the manufacturing of that part or component commences. However, construction of an item of property will not be considered as begun if physical work by the taxpayer relates to minor parts or components. Clearing and grading of land will be considered in determining when construction begins on an item of property only if they are directly associated with the construction of the property.

*Q–4: Under section 168(f)(8)(J), the at-risk rules are liberalized for closely held lessors that engage in safe harbor leasing. These rules apply ''in the case of property placed in service after the date of enactment of this subparagraph,'' namely, after September 3, 1982.*

*Do the liberalized at-risk rules apply in the case where otherwise qualified property is placed in service by a lessee in August of 1982 but is leased by a corporate lessor subject to the at-risk rules after September 3, 1982?*

A–4: The liberalized at-risk rule in section 168 (f)(8)(J) is applicable in this case because, in determining whether property is placed in service before or after the date of enactment of section 168(f)(8)(J), the relevant date is the date the property is placed in service by the lessor. Additionally, a closely held corporate lessor, which is not a personal service corporation, may lease transitional safe harbor lease property placed in service after September 3, 1982, under the liberalized at-risk rule.

*Q–5: Is it necessary for property placed in service by a lessee in December of 1982 to be leased before January 1, 1983, in order to qualify under the general transitional rule of section 208(d)(3)(A) of TEFRA, which requires that the property be placed in service before January 1, 1983?*

A–5: The legislative intent of this transitional rule was to provide a 3-month period after property is placed in service by a lessee in which a safe harbor lease could be entered into. *Cf.* section 209(c) of TEFRA (3-month window applies to true leases entered into after 1983). The legislative intent further was to permit property to qualify as transitional safe harbor lease property if it was placed in service by the end of 1982 by a lessee. Accordingly, transitional safe harbor lease property placed in service in 1982 by a lessee may be leased in a safe harbor lease transaction within 3 months after it is placed in service by the lessee without losing its status as transitional safe harbor lease property.

However, for all other purposes of the Code other than section 168(f)(8)(D)(i), section 168(f)(8)(D)(viii)(II) will apply and the property will be treated as originally placed in service not earlier than the date that the property is used under the lease. Thus, for example, if transitional safe harbor lease property is placed in service in December of 1982 and leased under section 168(f)(8) in January of 1983, the property will not lose its status as transitional safe harbor lease property, but the basis adjustment rules of section 48(g) will apply with respect to the property.

*Q–6: Will a contract to acquire property be considered ''binding'' for purposes of section 208(d)(3)(A)(i) of TEFRA if the contract contains no liquidated damages clause?*

A–6: Generally, an irrevocable contract which contains no provision for liquidated damages in the event of breach or cancellation would be considered binding. Morover, in determining the amount of the lessee's potential liability, the fair market value of the property will not be taken into account. For example, if a lessee entered into an irrevocable contract to purchase an asset for $100

and the contract contained no provision for liquidated damages, the contract would be considered binding notwithstanding the fact that the property at all times after July 1, 1982, had a value of $99 and under local law the seller could only recover the difference in the event the lessee failed to perform. On the other hand, if the contract by its terms provided for liquidated damages of less than 5 percent of the purchase price which is in lieu of any damages allowable by law, in the event of breach or cancellation, the contract would not be considered binding.

*Q–7: How does the 50-percent limitation on lessors in section 168(i)(1) and the 45-percent limitation on lessees in section 168(f)(8)(D)(ii) apply to corporations which are part of an affiliated group filing consolidated returns?*

A–7: Both the 50-percent limitation on lessors and the 45-percent limitation on lessees will be applied on a consolidated basis for corporations filing consolidated returns.

*Q–8: Section 168(f)(8)(J) liberalized the at-risk rules for safe harbor leasing and provides that in cases where the safe harbor lessee would be considered the owner of the property without regard to the safe harbor lease, the lessor is considered to be at risk with respect to the property in an amount equal to the amount the lessee is considered at risk with respect to such property as determined under section 465.*

*Will a corporate lessor that would ordinarily be subject to the at-risk rules under section 465 be exempt from such rules under section 168(f)(8)(J) in a situation where acquisition of the leased property is financed with nonrecourse debt by a lessee that is not subject to the at-risk rules?*

A–8: Yes. The liberalized at-risk rules of section 168(f)(8)(J) will apply in cases where the lessee's ACRS deductions and investment tax credit with respect to the property would not have been limited under the at-risk rules had the parties not elected treatment under section 168(f)(8).

*Q–9: Section 168(f)(8)(J)(ii) excepts certain service corporations from the liberalized at-risk rules of section 168(f)(8)(J)(i). Does the exception in subdivision (ii) also extend to subsidiaries of such service corporations that file consolidated returns?*

A–9: Yes. The liberalized at-risk rules of section 168(f)(8)(J)(i) will not apply to any subsidiary filing a consolidated return with a service organization described in section 168(f)(8)(J)(ii).

*Q–10: Will property lose its status as transitional safe harbor lease property under section 208(d)(3) of TEFRA solely by reason of the fact that the person who is a party to a binding contract to acquire the property assigns his rights in the contract to another person?*

A–10: When a person who is a party to a binding contract transfers his rights in the contract (or the property covered by the contract) to another person and the transferor (or a corporation which is a member of the same affiliated group as the transferor) will use the property under a lease for a period not less than 50 percent of the appropriate recovery period for the leased property under section 168(c), then to the extent of the transferred rights, this other person will succeed to the position of the transferor with respect to the binding contract and the property. Accordingly, under these circumstances, property will not lose its status as transitional safe harbor lease property.

In addition, property will not be disqualified as transitional safe harbor lease property solely by reason of a transfer by a person of his rights in a contract (or the property covered by the contract) in a transaction in which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor (*e.g.*, transfers governed by sections 332, 351, 361, 721, and 731). Thus, for example, if a corporation entered into a binding contract for the construction or acquisition of property prior to July 1, 1982, and after such date assigned the contract to a corporation within the same affiliated group which files consolidated returns, the assignee will be entitled to treat the property acquired pursuant to the contract as transitional safe harbor lease property, assuming the property would have so qualified in the hands of the transferor. Similarly, if a joint venture or partnership between two corporations entered into a binding contract or commenced construction of property before July 2, 1982, but dissolved and distributed its assets to the partners or joint venturers after July 2, 1982, the joint venturers or partners may treat the assets as transitional safe harbor lease property, assuming the property would have so qualified had the joint venture or partnership remained in existence.

*Q–11: During 1982, Corporation Y placed in service section 38 property with a total cost of $100X. On August 15, 1982, Corporation Y placed in service the last component of an entire facility within the meaning of § 5c.168(f)(8)–6(b)(2). The facility had a total cost basis of $40X, of which $30X was transitional safe harbor lease property within the meaning of section 208(d)(3) of TEFRA and $10X was not transitional safe harbor lease property. On November 1, 1982, Corporation Y sold and leased back under a section 168(f)(8) lease the $30X of transitional safe harbor lease property in the facility.*

*Will the entire facility rule in § 5c.168(f)(8)–6(b)(2) apply in this situation where the taxpayer has not leased all of the section 38 property in the facility?*

A–11: No. The placed in service date, for purposes of the rule requiring that property be leased within 3 months after such property was placed in service by the lessee, would be determined under the entire facility rule in § 5c.168(f)(8)–6(b)(2) only if Corporation Y had leased all the qualified leased

property in the facility. Since Corporation Y leased only the $30X of transitional section 38 property, of the facility and did not lease the $10X of nontransitional property, Corporation Y may not rely on the entire facility rule of § 5c.168(f)(8)–6(b)(2) for purposes of determining the placed in service date for the property under the section 168(f)(8) lease.

*Q–12: Assume the same facts as in Q–11, except that Corporation Y had also placed in service by August 15, 1982, $30X of miscellaneous machinery and equipment all of which was transitional safe harbor lease property within the meaning of section 208(d)(3) of TEFRA. On November 1, 1982, in addition to the $30X of transitional property in the facility, Corporation Y also sold and leased back under a separate section 168(f)(8) lease the $30X of miscellaneous machinery and equipment.*

*Will the entire facility rule in § 5c.168(f)(8)–6(b)(2) apply in this situation to the $30X of transitional property in the facility?*

A–12: Yes. Since Corporation Y leased $30X of transitional machinery and equipment and the $30X of the facility which consisted of transitional property, Corporation Y can lease none of the nontransitional property in the facility because, by reason of the 45-percent cap on lessees contained in section 168(f)(8)(D) (ii) and (iii) and (I), it is not qualified leased property for purposes of section 168(f)(8). Thus, on the facts, Corporation Y has leased all the qualified leased property in the facility.

*Q–13: Corporation X constructed a manufacturing complex consisting of three integrated operational components, each with a different ADR present class life midpoint, which together constitute an ''entire facility'' within the meaning of § 5c.168(f)(8)–6(b)(2). The last components of the facility were placed in service on August 15, 1982. On October 1, 1982, Corporation X sold to Corporation Z and leased back under section 168(f)(8) all the qualified leased property of the facility.*

*For purposes of the rule requiring that property be leased within 3 months after such property was placed in service by the lessee, will the leased components of the entire facility be considered placed in service by the lessee on August 15, 1982, the date the last components were placed in service, if the components are leased at one time pursuant to documents consisting of three section 168(f)(8) leases with different terms to reflect the different ADR midpoint lives of the qualified leased property in the facility?*

A–13: Yes. If the entire facility rule in § 5c.168(f)(8)–6(b)(2) applies, the facility components which were placed in service prior to August 15, 1982, will be treated as placed in service by the lessee on August 15, 1982, for purposes of the 3-month rule. This rule will apply if all the qualified leased property of the facility is leased at one time. The documentation may be in the form of multiple, simultaneously executed agreements or maybe in the form of an agreement comprised of one or more parts or schedules. Each of the multiple agreements, or each of the parts or schedules of an agreement, may have different lease terms for property with different ADR midpoint lives, so long as each such agreement or part of schedule individually would be treated as a lease under section 168(f)(8), taking into account the entire facility rule, with lease terms commencing on the same date. A single transaction effected by multiple agreements or by an agreement with one or more parts or schedules will meet the maximum lease term requirement of § 5c.168(f)(8)–5(b) so long as each agreement or each part or schedule of an agreement meets the maximum lease term requirement.

*Q–14: Under § 5c.168(f)(8)–6(b)(2), the special rule for facilities applies only if the entire facility is leased under a section 168(f)(8) lease.*

*Will a transaction not qualify under section 168(f)(8) if the parties, acting in good faith, omit an insubstantial portion of the qualified lease property from the lease?*

A–14: No. The facility rule of § 5c.168(f)(8)–6(b)(2) will apply if the parties, acting in good faith, substantially comply with its terms.

*Q–15: When will construction of an aircraft be considered to have been begun after June 25, 1981, and before February 20, 1982, for purposes of TEFRA section 208(d)(3)(D)?*

A–15: Construction of an aircraft will be considered to have been begun after June 25, 1981, and before February 20, 1982, if during such period any of the following events occurred:

(i) Construction or reconstruction of a subassembly designated for the aircraft was commenced;

(ii) Construction of a lot increment of subassemblies (one or more of which was designated for the aircraft) was commenced; or

(iii) The stub wing join occurred.

*Q–16: Does the definition of assets used in the manufacture or production of steel for purposes of TEFRA section 208(d)(2)(F) include all assets used in this function (such as electrical and steam generators and distribution equipment, coke oven by-product equipment) although not necessarily includible in the former ADR guideline class for primary steel mill products?*

A–16: Yes, all assets that are used, in their primary function, as an integral part of the steel manufacturing or production process are included. *Cf.* § 1.48–1(d)(4). However, the steel manufacturing or production process does not include processing beyond the production of primary ferrous metals (as defined by the ADR Class for Manufacture of Primary Ferrous Metals).

*Q–17: Where a qualified mass commuting vehicle meets the requirements for both the TEFRA section 208(d)(2) transitional rule and the TEFRA section 208(d)(5) special rule for mass commuting vehicles, which provision will control?*

A–17: The general transitional rule of TEFRA section 208(d)(2) will apply. Thus, pursuant to TEFRA section 208(d)(2)(B), the provisions of section 168(f)(8)(J), but not the provisions of section 168(i)(1), will apply only to such property. If the general transitional rule does not apply to a specific mass commuting vehicle, the provision of section 168(i)(1) applies to the lessor who leases such vehicle.

*Q–18: Does the definition of a qualified mass commuting vehicle include component parts of a qualified mass commuting vehicle—such as an undercarriage of a subway car or the costs of rehabilitation or reconstruction of a mass commuting vehicle (or component part thereof)?*

A–18: Yes.

[T.D. 7850, 47 FR 50853, Nov. 10, 1982, as amended by T.D. 7879, 48 FR 11942, Mar. 22, 1983]

### § 5f.442–1 Temporary regulations relating to change of annual accounting period.

(a) *In general.* Notwithstanding paragraph (c) (1) and (2) of § 1.442–1 of the Income Tax Regulations, a corporation which—

(1) Is described in section 934(b) and is an inhabitant of the Virgin Islands (within the meaning of section 28(a) of the Revised Organic Act of the Virgin Islands (48 U.S.C. 1642)), or

(2) Has in effect an election under section 936 may change its taxable year only if it secures the prior approval of the Commissioner in accordance with paragraph (b)(1) of § 1.442–1.

(b) *Effective date.* This section shall apply only if the statement described in paragraph (c)(1) of § 1.442–1 is filed after September 3, 1982.

[T.D. 7864, 47 FR 57921, Dec. 29, 1982; 48 FR 3367, Jan. 25, 1983]

### § 5f.6045–1 Returns of information of brokers and barter exchanges.

(a)–(b) [Reserved]

(c) *Reporting by brokers.*

(1)–(2) [Reserved]

(3) *Exceptions*—(i) *Sales effected for exempt recipients*—(A) *In general.* No return of information is required with respect to a sale effected for a customer that is an exempt recipient as defined in paragraph (c)(3)(i)(B) of this section.

(B) *Exempt recipient defined.* The term ''exempt recipient'' means—

(*1*) A corporation as defined in section 7701(a)(3), whether domestic or foreign;

(*2*) An organization exempt from taxation under section 501(a) or an individual retirement plan;

(*3*) The United States or a State, the District of Columbia, a possession of the United States, a political subdivision of any of the foregoing, a wholly-owned agency or instrumentality of any one or more of the foregoing or a pool or partnership composed exclusively of any of the foregoing;

(*4*) A foreign government, a political subdivision thereof, an international organization or any wholly-owned agency or instrumentality of the foregoing;

(*5*) A foreign central bank of issue (as defined in § 1.895–1(b)(1) as a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency);

(*6*) A dealer in securities or commodities registered as such under the laws of the United States or a State;

(*7*) A futures commission merchant registered as such with the Commodity Futures Trading Commission;

(*8*) A real estate investment trust (as defined in section 856);

(*9*) An entity registered at all times during the taxable year under the Investment Company Act of 1940;

(*10*) A common trust fund (as defined in section 584(a));

(*11*) A financial institution such as a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or other similar organization; or

(*12*) A person registered under the Investment Advisers Act of 1940 who regularly acts as a broker within the meaning of paragraph (a)(1) of § 1.6045–1.

The terms used in this paragraph (c)(3)(i)(B) shall have the same meaning as those contained in 26 CFR 31.3452(c)–1 (revised as of April 1, 1983). A broker may treat any person described in paragraph (c)(3)(i)(B) (*1*) through (*11*) of this section as an exempt recipient without requiring such person to file an exemption certificate if the conditions of 26 CFR 31.3452(c)–1

(revised as of April 1, 1983) are satisfied. A broker may treat any person described in paragraph (c)(3)(i)(B)(*12*) of this section as an exempt recipient without requiring such person to file an exemption certificate if the person's status as a registered investment adviser who regularly acts as a broker within the meaning of paragraph (a)(1) of § 1.6045–1 is known generally in the investment community. Alternatively, a broker can require any exempt recipient to file an exemption certificate and may treat an exempt recipient who fails to file such certificate as a recipient which is not exempt.

(ii) *Multiple brokers.* In the case of a sale in which a broker is instructed to initiate the sale by a person that is an exempt recipient described in paragraph (c)(3)(i)(B) (*6*), (*7*), (*11*), or (*12*), of this section, no return of information is required with respect to the sale by the broker so instructed. In the case of a redemption of stock or retirement of securities, only the broker responsible for paying the holder redeemed or retired, or crediting the gross proceeds on the sale to such holder's account, is required to report the sale.

(iii) *Cash on delivery transactions.* In the case of a sale of securities through a ''cash on delivery'' account, a ''delivery versus payment'' account, or other similar account or transaction, only the broker which receives the gross proceeds from the sale against delivery of the securities sold is required to report the sale. If, however, such broker's customer is another broker (''second-party broker'') which is an exempt recipient, then only the second-party broker is required to report the sale.

(iv) *Custodians, trustees and partnerships.* No return of information is required with respect to a sale effected by a custodian or trustee in its capacity as such or a redemption of a partnership interest by a partnership provided the sale is otherwise reported by the custodian or trustee on a properly filed From 1041 or the redemption is otherwise reported by the partnership on a properly filed Form 1065, and all Schedule K–1 reporting requirements are satisfied.

(v) *Sales at issue price.* No return of information is required with respect to a sale of an interest in a regulated investment company (within the meaning of section 851) that computes its current price per share for purposes of distributions, redemptions, and purchases so as to stabilize the price per share at a constant amount that approximates its issue price or the price at which it was originally sold to the public.

(vi) *Obligor payments on certain obligations.* No return of information is required with respect to payments representing obligor payments on—

(A) Nontransferable obligations (including savings bonds, savings accounts, checking accounts, and NOW accounts);

(B) Obligations as to which the entire gross proceeds are reported by the broker on Form 1099 under provisions of the Internal Revenue Code other than section 6045 (including stripped coupons issued prior to July 1, 1982); or

(C) Retirement of short-term obligations (*i.e.*, obligations with a fixed maturity date not exceeding one year from the date of issue) that have original issue discount, as defined in section 1232(b)(1).

(vii) *Callable obligations.* No return of information is required with respect to payments representing obligor payments on demand obligations that also are callable by the obligor and that have no premium or discount.

(viii) *Foreign currency.* No return of information is required with respect to a sale of foreign currency other than a sale pursuant to a forward contract or regulated futures contract that requires delivery of foreign currency.

(ix) *Fractional share.* No return of information is required with respect to a sale of a fractional share of stock if the gross proceeds on the sale of the fractional share are less than $20.

(x) *Certain retirements.* No return of information is required from an issuer or its agent with respect to the retirement of book entry or registered form obligations as to which the relevant books and records indicate that no interim transfers have occurred.

(4) *Examples.* The following examples illustrate the application of the reporting requirements:

*Example (1).* A, an individual who is not an exempt recipient, places an order with B, a person generally known in the investment

community to be a federally registered broker/dealer, to sell A's stock in a publicly traded corporation. B, in turn, places an order to sell the stock with C, a second broker, which will execute the sale. B discloses to C the identity of the customer placing the order. C is not required to make a return of information with respect to the sale because C was instructed by B, an exempt recipient as defined in paragraph (c)(3)(i)(B)(6) of this section, to initiate the sale. B is required to make a return of information with respect to the sale.

*Example (2).* The facts are the same as in Example (1) except that B has an omnibus account with C so that B does not disclose to C whether the transaction is for a customer of B or for B's own account. C is not required to make a return of information with respect to the sale because C was instructed by B, an exempt recipient as defined in paragraph (c)(3)(i)(B)(6) of this section, to initiate the sale. B is required to make a return of information with respect to the sale.

*Example (3).* D, an individual who is not an exempt recipient, enters into a ''cash on delivery'' (''COD'') stock transaction by instructing K, a federally registered broker/dealer, to sell stock owned by D, and to deliver the proceeds to L, a custodian bank. In addition, concurrently with the above instructions, D instructs L to deliver D's stock to K (or K's designee) against delivery of such proceeds from K. The records of both K and L with respect to this transaction show an account in the name of D. Pursuant to paragraph (h)(1) of §1.6045–1, D is considered the customer of K and L. Under paragraph (c)(3)(iii) of this section, K is not required to make a return of information with respect to the sale because K will pay the gross proceeds to L against delivery of the securities sold. L is required to make a return of information with respect to the sale.

*Example (4).* The facts are the same as in Example (3) except that E, a federally registered investment adviser who regularly acts as a broker within the meaning of paragraph (a)(1) of §1.6045–1, instructs K to sell stock owned by D and to deliver the proceeds to L. In addition, concurrently with the above instructions, E instructs L to delivery D's stock to K (or K's designee) against delivery of such proceeds from K. The records of both K and L with respect to this transaction show an account in the name of E. Pursuant to paragraph (h)(1) of §1.6045–1, E is considered the customer of K and L. Under paragraph (c)(3)(iii) of this section, K is not required to make a return of information with respect to the sale because K will pay the gross proceeds to L against delivery of the securities sold. In addition, L is not required to make a return of information with respect to the sale because L's customer, E, is another broker which is an exempt recipient. E is required to make a return of information with respect to the sale. The result would be the same even if the records of K and L with respect to this transaction show an account in the name of D.

*Example (5).* F, an individual who is not an exempt recipient, owns bonds that are held by G, a federally registered broker/dealer, in an account for F with G designated as nomineee for F. Upon the retirement of the bonds, the gross proceeds are automatically credited to the account of F. G is required to make a return of information with respect to the retirement because G is the broker responsible for making payment of the gross proceeds to F.

[T.D. 7960, 49 FR 22282, May 29, 1984]

## PART 6a—TEMPORARY REGULATIONS UNDER TITLE II OF THE OMNIBUS RECONCILIATION ACT OF 1980

Sec.

6a.103A–1 Interest on mortgage subsidy bonds.
6a.103A–2 Qualified mortgage bond.
6a.103A–3 Qualified veterans' mortgage bonds.
6a.6652(g)–1 Failure to make return or furnish statement required under section 6039C.

AUTHORITY: 26 U.S.C. 7805.

Sections 6a.103A–2(k), (l), and (m) also issued under 26 U.S.C. 103A(j) (3), (4), and (5).

### §6a.103A–1 Interest on mortgage subsidy bonds.

(a) *In general*—(1) *Mortgage subsidy bond.* A mortgage subsidy bond shall be treated as an obligation not described in section 103 (a)(1) or (a)(2). Thus, the interest on a mortgage subsidy bond is includable in gross income and subject to Federal income taxation.

(2) *Exceptions.* Any qualified mortgage bond and any qualified veterans' mortgage bond shall not be treated as a mortgage subsidy bond. See §6a.103A–2 with respect to requirements of qualified mortgage bonds and §6a.103A–3 with respect to requirements of qualified veterans' mortgage bonds.

(3) *Additional requirement.* In addition to the requirements of §6a.103A–2, §6a.103A–3, and this section, qualified mortgage bonds and qualified veterans' mortgage bonds shall be subject to the requirements of section 103(c) and the regulations thereunder.

(4) *Advance refunding.* On or after December 5, 1980, no tax-exempt obligation may be issued for the advance refunding of a mortgage subsidy bond (determined without regard to section 103A(b)(2) or §6a.103A–1(a)(2)). An obligation issued for the refunding of a mortgage subsidy bond will be considered to be an advance refunding obligation if it is issued more than 180 days before the prior issue is discharged.

(5) *Registration.* Any obligation that is part of a qualified mortgage bond issue or qualified veterans' mortgage bond issue and which is issued after December 31, 1981, must be in registered form. The term ''in registered form'' has the same meaning as in §1.6049–2(d). Thus, in general, an obligation is issued in registered form if it is registered as to both principal and interest and if its transfer must be effected by the surrender of the old instrument to the issuer and by either the reissuance of the old instrument to a new holder or the issuance of a new instrument to a new holder.

(b) *Definitions.* For purposes of §§6a.103A–2, 6a.103A–3, and this section the following definitions apply:

(1) *Mortgage subsidy bond.* (i) The term ''mortgage subsidy bond'' means any obligation which is issued as part of an issue a significant portion of the proceeds of which is to be used directly or indirectly to provide mortgages on owner-occupied residences.

(ii) For purposes of subdivision (i), a significant portion of the proceeds of an issue is used to provide mortgages if 5 percent or more of the proceeds are so used.

(2) *Mortgage.* The term ''mortgage'' includes deeds of trust, conditional sales contracts, pledges, agreements to hold title in escrow, and any other form of owner financing.

(3) *Bond.* The term ''bond'' means any obligation. The term ''obligation'' means any evidence of indebtedness.

(4) *State.* (i) The term ''State'' includes a possession of the United States and the District of Columbia.

(ii) For purposes of subdivision (i), obligations issued by or on behalf of any State or local governmental unit by constituted authorities impowered to issue such obligations are the obligations of such governmental unit. See §1.103–1(b).

(5) *Proceeds.* The term ''proceeds'' includes original proceeds and investment proceeds. The terms ''original proceeds'' and ''investment proceeds'' shall have the same meaning as in §1.103–13(b)(2). Unless otherwise provided in §6a.103A–2 or this section, however, amounts earned from the investment of proceeds which are derived from qualified mortgage bonds in non-mortgage investments may not be commingled for the purposes of accounting for expenditures with other non-bond amounts, and such proceeds are investment proceeds even though not treated as investment proceeds for purposes of section 103(c). Repayments of principal on mortgages shall be treated as proceeds of an issue. Amounts (such as State appropriations or surplus funds) which are provided by the issuer or a private lender in conjunction with a qualified mortgage bond or a qualified veterans' mortgage bond shall not be treated as proceeds of a mortgage subsidy bond under this section. However, fees which are paid by a participating financial institution pursuant to an agreement with the issuer whereby such institution receives the right to originate or service mortgages and which are retained by an issuer are treated as original proceeds of the issue. Amounts provided by the issuer or a private lender may be treated as proceeds of an issue for purposes of section 103(c).

(6) *Single-family and owner-occupied residences.* Except for purposes of §6a.103A–2 (g) and (h)(2)(ii), the terms ''single-family'' and ''owner-occupied,'' when used with respect to residences, include two-, three-, and four-family residences—

(i) One unit of which is occupied by the owner of the units, and

(ii) Which were first occupied as a residence at least 5 years before the mortgage is executed.

[T.D. 7780, 46 FR 34314, July 1, 1981; 46 FR 37890, July 23, 1981, as amended by T.D. 7794, 46 FR 55514, Nov. 10, 1981]

### §6a.103A–2 Qualified mortgage bond.

(a) *In general*—(1) *Qualified mortgage bond.* A qualified mortgage bond shall not be treated as a mortgage subsidy

bond, and the interest on a qualified mortgage bond will be exempt from Federal income taxation.

(2) *Termination date.* No obligation issued after December 31, 1987, shall be treated as part of a qualified mortgage bond issue.

(b) *Definitions and special rules.* For purposes of this section and § 6a.103A–1, the following definitions apply:

(1) *Qualified mortgage bond.* The term ''qualified mortgage bond'' means one or more obligations issued by a State or any political subdivision thereof (hereinafter referred to as ''governmental unit'') as part of an issue—

(i) All of the original proceeds of which, net of the costs of issuing the obligations and proceeds invested in a reasonably required reserve fund (such net amount hereinafter in this section referred to as ''lendable proceeds''), are to be used to finance owner-occupied residences, and

(ii) Which meets each of the requirements of § 6a.103A–1 and this section.

A qualified mortgage bond does not include any bond that is an industrial development bond under section 103(b).

(2) *Constitutional home rule city.* The term ''constitutional home rule city'' means, with respect to any calendar year, any political subdivision of a State which, under a State constitution which was adopted in 1970 and effective on July 1, 1971, had home rule powers on the 1st day of the calendar year.

(3) *Targeted area residence.* The term ''targeted area residence'' means a residence in an area which is either—

(i) A qualified census tract, or

(ii) An area of chronic economic distress.

(4) *Qualified census tract.* (i) The term ''qualified census tract'' means a census tract in which 70 percent or more of the families have an income which is 80 percent or less of the State-wide median family income.

(ii) The determination under subdivision (i) shall be made on the basis of the most recent decennial census for which data are available. With respect to any particular bond issue, such determination may be based upon the decennial census data available 3 months prior to the date of issuance and shall not be affected by official changes to such data during or after such 3-month period.

(iii) The term ''census tract'' means a census tract as defined by the Secretary of Commerce.

(5) *Areas of chronic economic distress.* (i) The term ''area of chronic economic distress'' means an area designated by a State as meeting the standards established by that State for purposes of this subparagraph and approved by the Secretary and by the Secretary of Housing and Urban Development in accordance with the criteria set forth in (iii) of this subparagraph. A State may withdraw such designation at any time, with reasonable cause. Such withdrawal shall be effective upon notification by the State to the Assistant Secretary for Housing/Federal Housing Commissioner of the Department of Housing and Urban Development. Such withdrawal shall not affect the tax-exempt status of any outstanding issue of obligations.

(ii) For purposes of making a designation under this subparagraph, withdrawing a designation, or making any other submission, ''State'' means the governor of a State, or a State official commissioned by the governor or by State statute for such purposes.

(iii) The following criteria will be used in evaluating a proposed designation of an area of chronic economic distress:

(A) The condition of the housing stock, including the age of the housing and the number of abandoned and substandard residential units. Data pertinent to this criterion include the number and percentage of housing units that were constructed prior to 1940, the average age of the housing stock, the number and percentage of abandoned housing units, and the number and percentage of substandard residential units.

(B) The need of area residents for owner financing under a qualified mortgage bond issue as indicated by low per capita income, a high percentage of families in poverty, a high number of welfare recipients, and high unemployment rates. Data pertinent to this criterion include the per capita income of the population in the area, the number and percentage of families eligible to receive food stamps from a

program pursuant to 7 U.S.C. 2011, the number and percentage of families eligible to receive payments under the Aid to Families with Dependent Children program, and the unemployment rate.

(C) The potential for use of owner financing under a qualified mortgage bond issue to improve housing conditions in the area. Data pertinent to this criterion include the number and percentage of owner-occupied homes that are substandard, the number and percentage of families that are low- or moderate-income renters, and the number and percentage of substandard units in the area that will be improved through the use of owner financing provided by the proceeds of a qualified mortgage bond issue.

(D) The existence of a housing assistance plan which provides a displacement program and a public improvements and services program (similar to the Housing Assistance Plan (HAP) required by the Department of Housing and Urban Development under the Community Development Block Grant program (42 U.S.C. 5301 *et seq.*)).

This determination shall be based upon the most recent data availabe. The certification described in subdivision (iv)(C) shall satisfy the criteria set forth in subdivisions (C) and (D). A certification described in (iv)(D) shall satisfy the criteria set forth in subdivisions (A) and (B): *Provided,* That the majority of the households in the proposed area have incomes less than 80 percent of the median income for the standard metropolitan statistical area (SMSA) in which the proposed area is located or, if the proposed area is not within a SMSA, less than 80 percent of the median income for the State.

(iv) A proposal by the State that an area be approved as an area of chronic economic distress shall contain the following information:

(A) A description of the proposed area by its geographical limits.

(B) Maps of the State and of areas within the State that are qualified census tracts and existing or proposed areas of chronic economic distress.

(C) Where applicable, a certification of the local Area Manager of the Department of Housing and Urban Development in which the proposed area is located that the proposed area is a Neighborhood Strategy Area (NSA) under 24 CFR 570.301(c) promulgated pursuant to the Community Development Block Grant program or an area comparable to a NSA which has been reviewed and approved by the Area Manager as meeting the standards for an NSA.

(D) Where applicable, a certification from the HUD Area Manager with jurisdiction over the proposed area that the proposed area is within a geographic area which has been declared eligible for grants under the Urban Development Action Grant Program, Pursuant to 24 CFR 570.452, by the Secretary of Housing and Urban Development.

(E) Statistical and descriptive information pertinent to the criteria enumerated in subdivision (iii) of this subparagraph, and a succinct statement of how the information furnished satisfies those criteria. Such statistical information shall be based upon the most recent data available.

(F) If the State so desires, a written request for a conference prior to any adverse decision on the proposed designation.

(G) A certification by the Governor or designated official that the proposed designation conforms to these regulations.

(v) The proposed designation and the information furnished with it as required by subdivision (iv) of this subparagraph shall be submitted in triplicate to the Assistant Secretary for Housing/Federal Housing Commissioner of the Department of Housing and Urban Development (Attention: Office of State Agency and Bond Financed Programs, Rm. 6138, 451 7th Street, SW., Washington, D.C. 20410).

(vi) Only those areas of chronic economic distress that have been previously designated by the State and approved in accordance with this subparagraph at least 3 months prior to the date of issuance need to be taken into account for any particular bond issue. Residences located in areas designated as areas of chronic economic distress approved in accordance with this subparagraph within such 3-month period or after the date of issue, however, may be treated as targeted area

residences. However, for purposes of paragraph (h)(2), relating to the specified portion of proceeds to be placed in targeted areas, and paragraph (i)(3)(ii)(A), relating to the 1½ year temporary period, only areas approved as areas of chronic economic distress in accordance with this subparagraph at the time of issue may be taken into consideration.

(6) *Standard metropolitan statistical area.* A standard metropolitan statistical area (''SMSA'') is an area in and around a city of 50,000 inhabitants or more (or equivalent area) and defined by the Secretary of Commerce as an SMSA.

(7) *Statistical area.* The term ''statistical area'' means—

(i) An SMSA,

(ii) Any county (or portion thereof) which is not within an SMSA, or

(iii) If there is insufficient recent statistical information with respect to a county (or portion thereof) described in subdivision (ii) of this subparagraph, such other area as may be designated by the Commissioner, upon proper application, as a substitute for such county (or portion thereof).

For purposes of subdivisions (ii) and (iii) of this subparagraph, in Alaska, the entire State, and in Louisiana, a parish, shall be treated in a manner similar to a county.

(8) *Acquisition cost.* (i) The term ''acquisition cost'' means the cost of acquiring a residence from the seller as a completed residential unit. Acquisition cost includes the following:

(A) All amounts paid, either in cash or in kind, by the purchaser (or a related party or for the benefit of the purchaser) to the seller (or a related party or for the benefit of the seller) as consideration for the residence.

(B) If a residence is incomplete, the reasonable cost of completing the residence whether or not the cost of completing construction is to be financed with bond proceeds. For example, where a mortgagor purchases a building which is so incomplete that occupancy of the building is not permitted under local law, the acquisition cost includes the cost of completing the building so that occupancy of the building is permitted.

(C) Where a residence is purchased subject to a ground rent, the capitalized value of the ground rent. Such value shall be calculated using a discount rate equal to the yield on the issue (as defined in § 6a.103A–2(i)(2)(vi)).

(ii) The term ''acquisition cost'' does not include the following:

(A) The usual and reasonable settlement or financing costs. Settlement costs include titling and transfer costs, title insurance, survey fees, or other similar costs. Financing costs include credit reference fees, legal fees, appraisal expenses, ''points'' which are paid by the buyer (but not the seller, even though borne by the mortgagor through a higher purchase price) or other costs of financing the residence. However, such amounts will be excluded in determining acquisition cost only to the extent that the amounts do not exceed the usual and reasonable costs which would be paid by the buyer where financing is not provided through a qualified mortgage bond issue. For example, if the purchaser agrees to pay to the seller more than a pro rata share of property taxes, such excess shall be treated as part of the acquisition cost of a residence.

(B) The value of services performed by the mortgagor or members of the mortgagor's family in completing the residence. For purposes of the preceding sentence, the family of an individual shall include only the individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. For example, where the mortgagor builds a home alone or with the help of family members, the acquisition cost includes the cost of materials provided and work performed by subcontractors (whether or not related to the mortgagor) but does not include the imputed cost of any labor actually performed by the mortgagor or a member of the mortgagor's family in constructing the residence. Similarly, where the mortgagor purchases an incomplete residence the acquisition cost includes the cost of material and labor paid by the mortgagor to complete the residence but does not include the imputed value of the mortgagor's labor or the labor of the mortgagor's family in completing the residence.

(C) The cost of land which has been owned by the mortgagor for at least 2 years prior to the date on which construction of the residence begins.

(iii) The following examples illustrate the provisions of subparagraph (8):

*Example (1).* A contracts with B, a builder of single-family residences, for the purchase of a residence. Under the terms of the contract, B will deliver a residential unit to A that contains an uncompleted recreation room and an unfinished third floor and which lacks a garage. Normally, a completed recreation room, a finished third floor and a garage are provided as part of the residence built by B. The contract price for the residence is $58,000. At the same time, A contracts with C, an affiliate of B, to complete the recreation room and third floor and to construct the garage for a contract price of $10,000. C will perform this work after A receives title to the unit from B. Under § 6a.103A–2(b)(8)(i)(A), the acquisition cost of A's completed residential unit is $68,000, which represents the contract price of the residence plus the cost of completion of the recreation room and third floor and construction of the garage.

*Example (2).* E owns a single-family residence which E has listed for sale. D contracts to purchase E's residence, and the contract provides for a selling price of $30,000. D also agrees to pay an unsecured debt in the amount of $5,000, which E owes to X, a local bank. D further agrees to purchase from E the refrigerator, stove, washer, and dryer located in E's residence for $500. Such amount is equal to the fair market value of such personalty. D also agrees to purchase the light fixtures, curtain rods, and wall-to-wall carpeting for a fair market value price of $700. Under § 6a.103A–2(b)(8)(i)(A), the acquisition cost of D's completed residential unit is $35,700. Such amount includes the $5,000 unsecured debt paid off by D. The $500 paid for the refrigerator, stove, washer, and dryer are not included because such items are not included within the definition of a residence under § 6a.103A–2(d)(4). Such definition does include, however, the light fixtures, curtain rods, and wall-to-wall carpeting purchased by D.

*Example (3).* F contracts with G to purchase G's home for $40,000. After purchasing the residence, F pays a party unrelated to G $3,000 for painting, minor repairs, and refinishing the floors. Under § 6a.103A–2(b)(8)(i)(A), the acquisition cost of the residence is $40,000. Such fix-up expenses are not treated as part of the acquisition costs. If G had incurred such fix-up expenses, however, F may not reduce his acquisition cost of the residence by such amounts.

(9) *Qualified home improvement loan.* (i) The term ''qualified home improvement loan'' means the financing (whether or not secured by a mortgage), in an amount which does not exceed $15,000 with respect to any residence, of alterations, repairs, and improvements on, or in connection with, an existing single-family, owner-occupied residence by the owner thereof, but only if such items substantially protect or improve the basic livability or energy efficiency of the residence.

(ii) Alterations, repairs, or improvements that satisfy the requirement of subdivision (i) of this subparagraph include the renovation of plumbing or electric systems, the installation of improved heating or air conditioning systems, the addition of living space, or the renovation of a kitchen area. Items that will not be considered to substantially protect or improve the basic livability of the residence include swimming pools, tennis courts, saunas, or other recreational or entertainment facilities.

(iii) If—

(A) Two or more qualified home improvement loans are provided for the same residence, whether or not by the same lender, and

(B) Any person who had a present ownership interest in such residence at the time the previous qualified home improvement loan or loans were made has a present ownership interest in the residence at the time the subsequent qualified home improvement loan is made,

Then the allowable amount of the subsequent qualified home improvement loan shall be reduced by the amount, at origination, of any previous qualified home improvement loan, so that the sum of such loans does not exceed $15,000.

(iv) The following example illustrates the provisions of subparagraph (9):

*Example.* A and B jointly own a residence located in Town M. They obtain a qualified home improvement loan for $10,000 from Town M. A acquires B's interest in the residence. A applies to State X for a qualified home improvement loan. The maximum amount of a qualified home improvement loan which may be made by State X is $5,000, the amount that when added to the $10,000 previous loan from Town M does not exceed $15,000.

(10) *Qualified rehabilitation loans.* (i) The term ''qualified rehabilitation loan'' means any owner financing provided in connection with—

(A) A qualified rehabilitation, or

(B) The acquisition of a residence with respect to which there has been a qualified rehabilitation,

But only if the mortgagor to whom such financing is provided is the first resident of the residence after completion of the rehabilitation. Where there are two or more mortgagors of a rehabilitation loan, the first residency requirement is met if any of the mortgagors meets the first residency requirement.

(ii) The term ''qualified rehabilitation'' means any rehabilitation of a residence if—

(A) There is a period of at least 20 years between the date on which the building was first used and the date on which physical work on such rehabilitation begins,

(B) 75 percent or more of the existing external walls of such building are retained in place as external walls in the rehabilitation process, and

(C) The expenditures for such rehabilitation are 25 percent or more of the mortgagor's adjusted basis in the residence (including the land on which the residence is located).

(iii) For purposes of (A) and (B), the rules applicable to the investment tax credit for qualified rehabilitated buildings under section 48(g)(1) (A)(iii) and (B) shall apply. However, unlike section 48(g)(1)(B), once a building meets the 20-year test, more than one rehabilitation of that building within a 20-year period may qualify as a qualified rehabilitation.

(iv) The adjusted basis to the mortgagor is the mortgagor's adjusted basis for purposes of determining gain or loss on the sale or exchange of a capital asset (as defined in section 1221). The mortgagor's adjusted basis shall be determined as of the date of completion of the rehabilitation, or, if later, the date the mortgagor acquires the residence, *i.e.*, the date on which the mortgagor includes in basis any amounts expended for rehabilitation that are expended for capital assets.

(v) The amounts expended by the mortgagor for rehabilitation include all amounts expended for rehabilitation regardless of whether the amounts expended were financed from the proceeds of the loan or from other sources, and regardless of whether the expenditure is a capital expenditure, so long as the expenditure is made during the rehabilitation of the residence and is reasonably related to the rehabilitation of the residence. The value of services performed by the mortgagor or members of the mortgagor's family (as used in § 6a.103A–2(b)(8)(ii)(B)) in rehabilitating the residence will not be included in determining the rehabilitation expenditures for purposes of the 25-percent test.

(vi) Where a mortgagor purchases a residence that has been substantially rehabilitated, the 25-percent test is determined by comparing the total expenditures made by the seller for the rehabilitation of the residence with the acquisition cost of the residence to the mortgagor. The total expenditures made by the seller for rehabilitation do not include the cost of acquiring the building or land but do include all amounts directly expended by the seller in rehabilitating the building (excluding overhead and other indirect charges).

(c) *Good faith compliance efforts*—(1) *Mortgage eligibility requirements.* An issue of qualified mortgage bonds which fails to meet one or more of the requirements of paragraphs (d), (e), (f), and (j) of this section shall be treated as meeting such requirements if each of the following provisions is met.

(i) The issuer in good faith attempted to meet all such requirements before the mortgages were executed. Good faith requires that the trust indenture, participation agreements with loan originators, and other relevant instruments contain restrictions that permit the financing of mortgages only in accordance with such requirements. In addition, the issuer must establish reasonable procedures to ensure compliance with such requirements. Such procedures include reasonable investigations by the issuer or its agent to determine that the mortgages satisfy such requirements.

(ii) Ninety-five percent or more of the lendable proceeds (as defined in § 6a.103A–2(b)(1)) that were devoted to

owner financing were devoted to residences with respect to which, at the time the mortgages were executed or assumed, all such requirements were met. In determining whether the proceeds are devoted to owner financing which meets such requirements, the issuer may rely on an affidavit of the mortgagor that the property is located within the issuer's jurisdiction and an affidavit of the mortgagor and the seller that the requirements of § 6a.103A–2(f) are met. The issuer may also rely on his own or his agent's examination of copies of income tax returns which were filed with the Internal Revenue Service and which are provided by the mortgagor or obtained by the issuer or loan originator in accordance with the procedures set forth in § 301.6103(c)–1 which indicate that, during the preceding 3 years, the mortgagor did not claim deductions for taxes or interest on indebtness with respect to real property constituting his principal residence, in addition to an affidavit of the mortgagor that the requirements of § 6a.103A–2(e) are met. The mortgagor may also provide the issuer or his agent with an affidavit that the mortgagor was not required to file such return in accordance with section 6012 during one or all of the preceding 3 years. Where a particular mortgage fails to meet more than one of these requirements, the amount of the mortgage will be taken into account only once in determining whether the 95-percent requirement is met. However, all of the defects in the mortgage must be corrected pursuant to paragraph (c)(1)(iii) of this section.

(iii) Any failure to meet such requirements is corrected within a reasonable period after such failure is discovered. For example, where a mortgage fails to meet one or more of such requirements those failures can be corrected by calling the nonqualifying mortgage or by replacing the nonqualifying mortgage with a qualifying mortgage.

(iv) *Examples.* The following examples illustrate the application of paragraph (c)(1) of this section:

*Example (1).* State X issues obligations to be used to provide mortgages for owner-occupied residences. X contracts with bank M to originate and service the mortgages. The trust indenture and participation agreement require that the mortgages meet the mortgage eligibility requirements referred to in paragraph (c)(1). In addition, pursuant to procedures established by X, M obtains a signed affidavit from each applicant that the applicant intends to occupy the property as his or her principal residence within 60 days after the final closing and thereafter to maintain the property as his or her principal residence. Further, M obtains from each applicant copies certified by the Internal Revenue Service of the applicant's Federal tax returns for the preceding 3 years and examines each statement to determine whether the applicant has claimed a deduction for taxes on real property which was the applicant's principal residence pursuant to section 164(a)(1) or a deduction pursuant to section 163 for interest paid on a mortgage secured by real property which was the applicant's principal residence. Also in accordance with X's procedures, M obtains from each applicant a signed affidavit as to facts that are sufficient for M to determine whether the residence is located within X's jurisdiction and affidavits from the seller and the buyer that the purchase price and the new mortgage requirements have been met, and neither M nor X knows or has reason to believe that such affidavits are false. The mortgage instrument provides that the mortgage may not be assumed by another person unless X determines that the principal residence, 3-year, and purchase price requirements are met at the time of the assumption. These facts are sufficient evidence of the good faith of the issuer and meet the requirements of paragraph (c)(1)(i). Further, if 95 percent of the lendable proceeds are devoted to owner financing which according to these procedures meet the requirements of paragraphs (d), (e), (f), and (i), then the issue meets the requirements of paragraph (c)(1)(ii).

*Example (2).* State Y issues obligations to be used to provide mortgages for owner-occupied residences. Y contracts with bank N to originate and service the mortgages. The trust indenture and participation agreement require that the mortgagor certify compliance with the requirements referred to in paragraph (c)(1). By itself, this certification is not sufficient evidence of the good faith of the issuer to meet the requirements referred to in paragraph (c)(1).

*Example (3).* The facts are the same as in Example 1, except that M discovers through a verification procedure required by X that, at the time of closing, A fraudulently executed the residencey affidavit. Instead of occupying the property as a principal residence, A leased the property to B for one year. A did not use the property as his residence during the lease term. Thus, at the time that A's mortgage was executed the residence failed to meet the requirements of paragraph (d) of this section.

More than 95 percent of the lendable proceeds of the issue were devoted to residences which met all the requirements referred to in paragraph (c)(1) at the time the mortgages were executed. Furthermore, pursuant to a provision in the mortgage instrument M called the loan. Any failures with respect to other mortgages are corrected by M. Based on these facts, the issue meets the requirements of subparagraph (c)(1).

*Example (4).* The facts are the same as in Example (1), except that the issuer requires copies of the applicant's signed tax returns that were filed with the Internal Revenue Service for the preceding 3 years but does not require that such returns be certified. If 95 percent of the lendable proceeds are devoted to owner financing which according to these procedures meet the requirements of paragraphs (d), (e), (f), and (i), then the issue meets the requirements of paragraph (c)(1)(ii).

(2) *Nonmortgage eligibility requirements.* An issue of qualified mortgage bonds which fails to meet one or more of the requirements of paragraphs (g), (h), and (i) of this section and § 6a.103A–1(a)(5) shall be treated as meeting such requirements if each of the following provisions is met.

(i) The issuer in good faith attempted to meet all such requirements. This good faith requirement will be met if all reasonable steps are taken by the issuer to ensure that the issue complies with these requirements.

(ii) Any failure to meet such requirements is due to inadvertent error, *e.g.*, mathematical error, after taking reasonable steps to comply with such requirements.

(iii) The following examples illustrate the application of this subparagraph (2):

*Example (1).* City X issues obligations to finance owner-occupied residences. However, despite taking all reasonable steps to determine accurately the size of the market share limitation, as provided in paragraph (g)(3), the limit is exceeded because the amount of the mortgages originated in the area during the past 3 years is incorrectly computed as a result of mathematical error. Such facts are sufficient evidence of the good faith of the issuer to meet the requirements of paragraph (c)(2).

*Example (2).* City Y issues $25 million of bonds to finance single-family, owner-occupied homes. Attorney A gives an opinion that the bonds satisfy the arbitrage requirements of § 6a.103A–2(i) and § 6a.103A–1(a)(3). In fact, however, the legal conclusion reached by A is erroneous, and the bonds do not meet the requirements of § 6a.103A–2(i). The issue does not meet the requirements of subparagraph (c)(2) because the erroneous opinion does not constitute inadvertent error.

(d) *Residence requirements*—(1) *In general.* An issue meets the requirements of this paragraph only if all of the residences for which owner financing is provided under the issue meet the requirements of this paragraph. A residence meets the requirements of this paragraph only if—

(i) It is a single-family residence (as defined in § 6a.103A–1(b)(6)) which, at the time the mortgage is executed or assumed, can reasonably be expected by the issuer to become the principal residence of the mortgagor within a reasonable time after the financing is provided; and

(ii) It is located within the jurisdiction of the authority issuing the obligation.

(2) *Affidavit.* The requirements of subparagraph (1)(i) of this paragraph may normally be met if the mortgagor executes an affidavit of his intent to use the residence as his principal residence within a reasonable time (*e.g.*, 60 days) after the financing is provided.

(3) *Principal residence.* Whether a residence is used as a principal residence depends upon all the facts and circumstances of each case, including the good faith of the mortgagor. A residence which is primarily intended to be used in a trade or business shall not satisfy the requirements of this paragraph. For purposes of the preceding sentence, any use of a residence which does not qualify for a deduction allowable for certain expenses incurred in connection with the business use of a home under section 280A shall not be considered as a use in a trade or business. Except for certain owner-occupied residences described in paragraph (b)(6) of § 6a.103A–1, a residence more than 15 percent of the total area of which is reasonably expected to be used primarily in a trade or business does not satisfy the requirements of this subparagraph. Further, a residence used as an investment property or a recreational home does not satisfy the requirements of this subparagraph.

(4) *Residence.* (i) The term ''residence'' includes stock held by a tenant-stockholder in a cooperative housing

corporation (as those terms are defined in section 216(b) (1) and (2)). It does not include property such as an appliance, a piece of furniture, a radio, *etc.*, which, under applicable local law, is not a fixture. The term also includes factory-made housing which is permanently fixed to real property. The determination of whether factory-made housing is permanently fixed to real property shall be made on the basis of the facts and circumstances of each particular case.

(ii) *Land.* Land appurtenant to a residence shall be considered as part of the residence only if such land reasonably maintains the basic livability of the residence and does not provide, other than incidentally, a source of income to the mortgagor.

(5) *Examples.* The following examples illustrate the application of this paragraph (d):

*Example (1).* A contracts to purchase a new residence from B. Since B is unable to move from the residence until 1 month after the scheduled closing date, A agrees to lease the residence to B for 1 month at a rent equal to the fair rental value. A applies for a mortgage to be provided from the proceeds of a qualified mortgage bond. In light of all the facts and circumstances in the case, the fact that A temporarily leases the residence to B does not prevent the residence from being considered as property that can reasonably be expected to be used as A's principal residence within a reasonable period of time after financing is provided.

*Example (2).* C contracts to purchase a new residence located on 2 acres of land in city X. City X has a zoning regulation which prevents the subdividing of any lot in that part of the city for use as a private residence into parcels of less than 2 acres. In light of all the facts and circumstances in the case, the fact that the residence is located on 2 acres of land appurtenant to the residence does not prevent the entire property from being considered as property to be used by C as a residence.

*Example (3).* D contracts to purchase a new residence located on 40 acres of land that D intends to farm. Any financing provided for the purchase of that portion of the property intended to be farmed will not be considered as financing provided for an owner-occupied residence.

(e) *3-year requirement*—(1) *In general.* An issue meets the requirements of this paragraph only if each of the mortgagors to whom owner financing is provided under the issue meets the requirements of this paragraph. A mortgagor meets the requirements of this paragraph only if the mortgagor had no present ownership interest in a principal residence at any time during the 3-year period prior to the date on which the mortgage is executed. For purposes of the preceding sentence, the mortgagor's interest in the residence with respect to which the financing is being provided shall not be taken into account.

(2) *Exceptions.* Subparagraph (1) shall not apply with respect to—

(i) Any financing provided with respect to a targeted area residence (as defined in § 6a.103A–2(b)(3)),

(ii) Any qualified home improvement loan (as defined in § 6a103A–2(b)(9)), and

(iii) Any qualified rehabilitation loan (as defined in § 6a.103A–2(b)(10)).

(3) *Multiple mortgagors.* In the event that there is more than one mortgagor with respect to a particular residence, each of such mortgagors must meet the 3-year requirement. A person who is liable under a note secured by the mortgage but who does not have a present ownership interest in a residence subject to the mortgage need not meet the 3-year requirement. For example, where a parent of a home purchaser cosigns the note for a child but the parent takes no interest in the residence, it is not necessary that the parent meet the 3-year requirement since the parent is not a mortgagor of the residence.

(4) *Included interests.* Examples of interests which constitute present ownership interests are the following:

(i) A fee simple interest;

(ii) A joint tenancy, a tenancy in common, or tenancy by the entirety;

(iii) The interest of a tenant-shareholder in a cooperative;

(iv) A life estate;

(v) A land contract (*i.e.*, a contract pursuant to which possession and the benefits and burdens of ownership are transferred although legal title is not transferred until some later time); and

(vi) An interest held in trust for the mortgagor (whether or not created by the mortgagor) that would constitute a present ownership interest if held directly by the mortgagor.

(5) *Excluded interests.* Examples of interests which do not constitute present ownership interests are the following:

(i) A remainder interest;

(ii) A lease with or without an option to purchase;

(iii) A mere expectancy to inherit an interest in a principal residence;

(iv) The interest that a purchaser of a residence acquires on the execution of a purchase contract; and

(v) An interest in other than a principal residence during the previous 3 years.

(f) *Purchase price requirements*—(1) *In general.* An issue meets the requirements of this paragraph only if the acquisition cost (as defined in § 6a.103A–2(b)(8)) of each residence, other than a targeted area residence, for which owner financing is provided does not exceed 90 percent of the average area purchase price applicable to such residence. In the case of a targeted area residence (as defined in § 6a.103A–2(b)(3)), the acquistion cost may not exceed 110 percent of the average area purchase price applicable to such residence.

(2) *Exception.* Paragraph (1) shall not apply with respect to any qualified home improvement loan (as defined in § 6a.103A–2(b)(9)).

(3) *Average area purchase price.* The term ''average area purchase price'' means, with respect to any residence, the average purchase price of all single-family residences in the statistical area (as defined in § 6a.103A–2(b)(7)) in which the residence being financed is located for the most recent 12-month period for which sufficient statistical information is available. The determination whether a particular residence meets the purchase price requirement shall be made as of the date on which the commitment to provide the financing is made or, if earlier, the date of purchase of the residence.

(4) *Special rules.* (i) In the case of a qualified rehabilitation loan, the requirements of this paragraph are met if the mortgagor's adjusted basis in the property as of the completion of the rehabilitation (including the cost of the rehabilitation) meets the requirements of paragraph (f)(1). For this purpose, a rehabilitated residence is to be treated as a residence which has been previously occupied.

(ii) The determination of average area purchase price shall be made separately with respect to—

(A) Residences which have not been previously occupied;

(B) Residences which have been previously occupied; and

(C) One-family, two-family, three-family, and four-family residences.

(5) *Safe harbor limitation.* (i) For purposes of meeting the requirements of this paragraph, an issuer may rely upon average area purchase price limitations published by the Treasury Department for the statistical area in which a residence is located. These safe harbor limitations will be effective for the period stated at the time of publication. An issuer may use a limitation different from such safe harbor limitation for any statistical area (as defined in § 6a.103A–2(b)(7)) for which the issuer has more accurate and comprehensive data.

(ii) The following example illustrates the application of subparagraph (5)(i):

*Example.* The average area purchase price safe harbor limitation for new single-family residences published by the Treasury Department for the second half of 1981 for the jurisdiction of governmental unit X is $41,500. However, on July 1, 1981, X determines that its average area purchase price for new single-family residences is actually $43,000. Such determination is based on a comprehensive survey of residential housing sales in the jurisdiction over the previous calendar year. The data accumulated are based on records maintained by the county clerk's office in X's jurisdiction, which enables X to compute average area purchase prices separately for new and used residences and for one-, two-, three-, and four-family residences. X cannot reasonably update such data more often than once a year. X may use average area purchase prices computed from these data for mortgages made from July 1, 1981, through June 30, 1982, rather than the safe harbor published by the Treasury Department.

(g) *Limitation on aggregate amount of qualified mortgage bonds issued during any calendar year*—(1) *In general.* An issue meets the requirements of this section only if the aggregate amount of bonds issued pursuant thereto, when added to the sum of (i) the aggregate amount of qualified mortgage bonds

previously issued by the issuing authority during the calendar year and (ii) the amount of qualified mortgage bonds which the issuing authority previously elected not to issue under section 25(c)(2)(A)(ii) and the regulations thereunder during the calendar year, does not exceed the applicable limit (''market limitation'') for such authority for such calendar year.

(2) *State housing finance agency.* Except as provided in paragraph (g)(4) of this section, the market limitation for any State housing finance agency for any calendar year shall be 50 percent of the State ceiling for such year. For purposes of the preceding sentence, if any State has more than one housing finance agency all such agencies shall be treated as a single agency.

(3) *Other issuers.* Except as provided in paragraph (g)(4), the market limitation for any issuing authority (other than a State housing finance agency) for any calendar year is an amount equal to that authority's proportionate share of 50 percent of the State ceiling amount for such calendar year. The proportionate share is an amount which bears the same ratio to 50 percent of the State ceiling for such year as—

(i) The average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences located within the jurisdiction of such issuing authority, bears to

(ii) An average determined in the same way for the entire State.

(4) *Constitutional home rule city.* (i) In determining the market limitation for any constitutional home rule city (as defined in paragraph (b)(2) of this section), subparagraph (3) shall be applied by substituting ''100 percent'' for ''50 percent.''

(ii) In a State with one or more constitutional home rule cities, in computing the market limitation for issuers other than constitutional home rule cities, the State ceiling amount for any calendar year shall be reduced by the aggregate market limitation for such year for all constitutional home rule cities in the State.

(5) *Overlapping jurisdictions.* (i) For purposes of subparagraph (3) of this paragraph, if an area is within the jurisdiction of two or more governmental units, such area shall be treated as only within the jurisdiction of the unit having jurisdiction over the smallest geographical area. However, the governmental unit with jurisdiction over the smallest geographical area may enter into a written agreement to allocate all or a designated portion of such overlapping area to the governmental unit having jurisdiction over the next smallest geographical area.

(ii) Where two governmental units have authority to issue mortgage subsidy bonds and both governmental units have jurisdiction over the identical geographical area, the aggregate principal amount of mortgages on residences located within that area shall be allocated to the governmental unit having broader sovereign powers.

(6) *State ceiling.* (i) Except as provided in paragraph (g)(6)(v), the State ceiling applicable to any State for any calendar year shall be the greater of—

(A) 9 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences located within the jurisdiction of such State, or

(B) $200,000,000.

Only single-family owner-occupied residences (without regard to the definition of such term under § 6a.103A–1(b)(6)) may be used in determining the market limitation regardless of whether or not residences with up to four family units are to be financed by the program. First and second mortgages or mortgages used to refinance an existing mortgage shall be used in making such determination. Liens, special assessments, and similar encumbrances may not be taken into consideration.

(ii) For mortgages on residences with more than one family unit, the full amount of the mortgage shall be applied toward the market limitation and not merely that portion allocable to the owner-occupied unit.

(iii) For purposes of determining the State ceiling amount applicable to any State for any calendar year an issuer may rely upon the State ceiling amount published by the Treasury Department for such calendar year. An

issuer may rely on a different State ceiling amount than such safe-harbor limitation where the issuer has made a more accurate and comprehensive determination of such amount.

(iv) The following example illustrates the application of subparagraphs (3) and (6) of this paragraph (g):

*Example.* Pursuant to the allocation rule provided in subparagraph (3), City Y determines that its maximum market limitation in 1981 is $15,000,000. This determination is based on records maintained by the county clerk's office from which data for the preceding 3 years have been accumulated by City Y as to the number of sales of single-family homes in City Y's jurisdiction, the purchase price in each such sales transaction, the number of such sales that were financed by mortgages and the volume of second mortgages and refinancing on previously purchased owner-occupied single-family residences. This information, combined with estimates made by City Y of the average mortgage-loan-to-purchase-price ratio and the ratio of sales of single-family, owner-occupied residences to all sales of single-family residences from a representative sample of sales transactions, enables Y to estimate the preceding 3 years' annual aggregate mortgage volume by using the following formula:

$$v = 1/3 \sum_{i=t-3}^{t-1} \left(u_i . w_i . x_i . y_i . z_i\right) + a_i,$$

where

$v$=The preceding 3 years' average annual aggregate volume of mortgages on single-family, owner-occupied residences in City Y,

$u_i$=Number of sales of single-family residences,

$w_i$=Average purchase price of all sales,

$x_i$=Percent of all sales transactions that were financed with mortgages,

$y_i$=Estimated average mortgage-loan-to-purchase-price ratio,

$z_i$=Estimated percent of sales that were owner-occupied residences,

$a_i$=Total volume of second mortgages and refinancing on previously purchased owner-occupied, single-family residences,

$i$=The annual period of calculation, and

$t$=The current year.

City Y determines its applicable limit for 1981 based on the following formula:

$L=0.5\ (v/s)\ r$, where

$L$=Market limitation for City Y for the current year,

$s$=The preceding 3 years' average annual aggregate volume of mortgages on single-family, owner-occupied residences in State X, and

$r$=Ceiling for State X (*i.e.*, $r$=the greater of .09s or $200,000,000).

City Y may use the Treasury estimate of s which will be published with the mortgage volume safe harbor limitation. City Y may rely on its determination of its market limitation for obligations issued during 1981.

(v) *Reduction in State ceiling.* If for any calendar year an issuer of mortgage credit certificates, as defined in section 25 and the regulations thereunder, fails to meet the requirements of section 25 (d)(2) and the regulations thereunder, relating to the limit on the aggregate amount of mortgage credit certificates that may be issued, the applicable State ceiling under paragraph (g)(6)(i) of this section for the State in which the program operates will be reduced by 1.25 times the correction amount (as defined in section 25 (f)(2) and the regulations thereunder) with respect to that failure for the calendar year following the calendar year in which the Commissioner determines the correction amount with respect to that failure.

(7) *Excess obligations.* Where an issue of obligations when added to the aggregate amount of bonds issued by the same issuing authority in the same calendar year exceeds the market limitation determined in accordance with this paragraph (g), no portion of the issue will be treated as a qualified mortgage bond issue, and interest on such obligations shall be subject to Federal income taxation. However, previously issued qualified mortgage bond issues which met the market limitation at the time of their issuance will not cease to be qualified mortgage bond issues even though a subsequent issue causes the aggregate amount of obligations to exceed such limitation for a calendar year.

(8) *Transitional rule obligations.* In applying this paragraph (g) to any calendar year, there shall not be taken into account any bond which, by reason of section 1104 of the Mortgage Subsidy Bond Tax Act of 1980 (94 Stat. 2670) (relating to transitional rules), receives the same tax treatment as bonds issued on or before April 24, 1979.

(9) *Procedure for providing a different allocation.* (i) A State may, by law enacted after December 5, 1980, provide a different formula for allocating the

State ceiling amount among the governmental units in such State (other than constitutional home rule jurisdictions) having authority to issue qualified mortgage bonds.

(ii) The governor of any State may proclaim a different formula than provided in subparagraphs (g)(2) and (g)(3) for allocating the State ceiling amount among the governmental units in such State having authority to issue qualified mortgage bonds. The authority of the governor to proclaim a different formula shall not apply after the earlier of—

(A) The 1st day of the 1st calendar year beginning after the 1st calendar year after 1980 during which the legislature of the State met in regular session, or

(B) The effective date of any State legislation dealing with such ceiling enacted after December 5, 1980.

If, on or before either date, the governor of any State exercises the authority to provide a different allocation, such allocation shall be effective until the date specified in (B).

(iii) Unless otherwise provided in a State constitutional amendment or by law changing the home rule provisions adopted in the manner provided by the State constitution, the allocation of that portion of the State ceiling which is allocated to any constitutional home rule city may not be changed by the governor or State legislature unless such city agrees to such different allocation.

(iv) Where a State elects to make a different allocation in accordance with subdivision (i) or (ii) of this subparagraph, the determination as to whether a particular bond issue meets the requirements of paragraph (g) of this section will be based upon the allocation in effect at the time such bonds were issued. Moreover, the authority to provide for a different allocation may not be used directly or indirectly to increase the State ceiling amount.

(v) An issuing authority located in a State with one or more constitutional home rule cities may use an alternative method to those provided in subparagraphs (2), (3), and (4) for determining such issuing authority's market limitation if, prior to issuing any obligations for the calendar year, it demonstrates to the satisfaction of the Commissioner that—

(A) The use of the methods provided in subparagraph (2), (3), or (4) would impose an unreasonable hardship on the issuing authority, and

(B) Such alternative method is reasonable.

(h) *Portion of loans required to be placed in targeted areas*—(1) *In general.* An issue meets the requirements of this paragraph only if—

(i) The portion of the lendable proceeds (as defined in § 6a.103A–2(b)(1)) of the issue specified in subparagraph (2) is made available for owner financing of targeted area residences (as defined in § 6a.103A–2(b)(3)) for at least 1 year after the date on which owner financing is first made available with respect to targeted area residences, and

(ii) The issuer attempts with reasonable diligence to place such proceeds in qualified mortgages.

Proceeds are considered first made available with respect to targeted area residences on the date on which any financing of mortgages with the lendable proceeds of an issue first becomes available. Reasonable diligence requires that the issuer and the loan originators use reasonable efforts in trying to place mortgages in targeted areas, such as by advertising that mortgage funds are available for targeted areas. Reasonable diligence is not shown by merely providing in the governing instruments that the required amount be set aside for targeted areas.

(2) *Specified portion.* The specified portion of lendable proceeds of an issue required to be made available in targeted areas is the lesser of—

(i) 20 percent of the lendable proceeds, or

(ii) 40 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences in targeted areas within the jurisdiction of the issuing authority.

(3) *Safe harbor.* For purposes of computing the required portion of proceeds specified in subparagraph (2)(ii) of this paragraph, where such provision is applicable, an issuer may rely upon the

amount produced by the following formula:

$$P = .2(X/Y \times Z),$$

where

P=Required portion to be made available in targeted areas,

X=Average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences within the State in which the issuing jurisdiction is located,

Y=The total population within the State, based on the most recent decennial census for which data are available, and

Z=The total population in the targeted areas located within the issuer's jurisdiction, based on the most recent decennial census for which data are available.

The issuing jurisdiction may use the Treasury Department estimate of X which will be published with the mortgage volume safe harbor limitation.

(4) *Minimum amount.* (i) The specified portion required to be made available in targeted areas is a minimum amount. More than the minimum amount may be (but need not be) made available in targeted areas.

(ii) With respect to any proceeds not required to be made available in targeted areas, the requirements of this paragraph do not abrogate the requirement of the arbitrage rules that due diligence be used in placing lendable proceeds into mortgages.

(i) *Arbitrage and investment gain*—(1) *In general.* An issue meets the requirements of this paragraph only if such issue meets the requirements of subparagraphs (2), (3), and (4) of this paragraph. For purposes of these requirements, all determinations of yield, effective interest rates, and amounts required to be paid or credited to mortgagors under paragraph (i)(4)(i) of this section shall be made on an actuarial basis taking into account the present value of money. The requirements of section 103A(i) and this paragraph are applicable in addition to the requirements of section 103(c) and §§ 1.103–13, 1.103–14, and 1.103–15.

(2) *Effective rate of mortgage interest not to exceed bond yield by more than 1 percentage point*—(i) *Maximum yield.* An issue of qualified mortgage bonds shall be treated as meeting the requirements of this subparagraph only if the excess of—

(A) The effective rate of interest on the mortgages financed by the issue, over

(B) The yield on the issue,

is not greater over the term of the issue than 1 percentage point.

(ii) *Effective rate of interest.* (A) In determining the effective rate of interest on any mortgage for purposes of this subparagraph, there shall be taken into account all fees, charges, and other amounts borne by the mortgagor which are attributable to the mortgage or to the bond issue. Such amounts include points, commitment fees, origination fees, servicing fees, and prepayment penalties paid by the mortgagor.

(B) Items that shall be treated as borne by the mortgagor and shall be taken into account in calculating the effective rate of interest also include—

(*1*) All points, commitment fees, origination fees, or similar charges borne by the seller of the property;

(*2*) The excess of any amounts received from any person other than the mortgagor by any person in connection with the acquisition of the mortgagor's interest in the property over the usual and reasonable costs incurred by a person acquiring like property where owner financing is not provided through the use of qualified mortgage bonds.

(C) The following items shall not be treated as borne by the mortgagor and shall not be taken into account in calculating the effective rate of interest:

(*1*) Any expected rebate of arbitrage profit (as required by § 6a.103A–2(i)(4)).

(*2*) Any application fee, survey fee, credit report fee, insurance fee or similar settlement or financing cost to the extent such amount does not exceed amounts charged in such area in cases where owner financing is not provided through the use of qualified mortgage bonds. For example, amounts paid for FHA, VA, or similar private mortgage insurance on an individual's mortgage need not be taken into account so long as such amounts do not exceed the amounts charged in the area with respect to a similar mortgage that is not financial with qualified mortgage bonds. Premiums charged for pool mortgage insurance will be considered

amounts in excess of the usual and reasonable amounts charged for insurance in cases where owner financing is not provided through the use of qualified mortgage bonds.

(D)(*1*) Where amounts other than those derived from the proceeds of a mortgage subsidy bond are used to finance single-family residences such amounts will not be treated as the proceeds of a qualified mortgage bond issue and will not be subject to the limitations set forth in subparagraphs (2), (3), and (4) of this paragraph (i). Such amounts may, however, be treated as proceeds for purposes of the requirements of section 103(c) and the regulations thereunder. Thus, the portion of the mortgage pool financed by the proceeds of a qualified mortgage bond issue will be subject to the limitations of subparagraphs (2), (3), and (4) of this paragraph (i), while the portion not provided with bond proceeds will not be subject to such limitations. The interest rate, points, origination fees, servicing fees, and other amounts charged with respect to that portion of a mortgage loan financed with non-bond amounts may not exceed the reasonable and customary amount which would be charged where financing is not provided through a qualified mortgage bond issue. Where the charge does exceed such reasonable and customary amount, any excess will be taken into account in computing the effective interest rate on the portion of the loan provided with the proceeds of the qualified mortgage bond issue. Furthermore, where such fees and other charges are less than the reasonable and customary charges, the issuer may not allocate that portion of the charges on the loan amounts made with bond proceeds which is equal to such differential to loan amounts made with non-bond proceeds.

(*2*) If any mortgage is allocated to two or more sources of funds, the receipt of amounts which are described in paragraph (i)(2)(ii) (A) and (B) of this section, repayments of principal, or payments of interest on such mortgage must be allocated to each source of funds.

(E) The effective rate of interest on any mortgage shall be determined in a manner consistent with actuarial methods and shall take into account the discounted value of all amounts from the time received to an amount equal to the ''purchase price'' of the mortgage. Such discount rate is the effective rate of interest on the mortgages. The ''purchase price'' of a mortgage means the net amount loaned to the mortgagor. For example, if a mortgage loan is in the amount of $30,000 and the mortgagor is charged one point ($300) as an origination fee which amount is deducted from loan proceeds available to the mortgagor, the purchase price is $29,700. If interest on an issue is paid semiannually, all regular monthly mortgage payments and prepayments of principal may be treated as being received at the end of each semiannual debt service period.

(*1*) If interest on an issue is paid semiannually, all regular monthly mortgage payments may be treated as being received at the end of each semiannual debt service period.

(*2*) Prepayments of principal shall be treated as being received on the last day of the month in which the issuer reasonably expects to receive such prepayments.

(F) The rate shall be determined on a composite basis for all mortgages financed by the issue.

(iii) *Example.* The following example illustrate the provisions of subparagraph (2)(ii) of this paragraph:

*Example.* Purchaser A contracts with seller B, who is represented by real estate agent C, for the purchase of B's residence for $65,000. A applies to County X for a mortgage provided by the proceeds of a qualified mortgage bond. County X requires that agent C provide it with a principal residence affidavit as well as verify the purchase price of the residence and the location of the purchasers previous residences. Due to the increased administrative burden imposed on agent C by County X, C charges B a real estate commission of 8 percent ($5,200), rather than 6 percent ($3,900). The normal real estate commission is 6 percent. Since the 8 percent commission charged by C and paid by B is in excess of the usual and reasonable real estate commission where owner financing is not provided through the use of qualified mortgage bonds, 2 percent ($1,300) shall be treated as borne by A and taken into account in calculating the effective rate of interest on the mortgage.

(iv) *Prepayment assumption* In determining the affective rate of interest on

mortgages, it shall be assumed that the mortagage prepayment rate for mortgages made out of both original proceeds and mortgages that the issuer expects with reasonable certainty to be made out of prepayments of principal will be equal to 100 percent of the rate set forth in the most recent mortgage maturity experience table for mortgages having the same term insured under section 203 of the National Housing Act and published by the Federal Housing Administration in ''Survivorship and Decrement Tables for HUD/FHA Home MORTGAGE Insurance Program'' for the region, or, if available, the State in which the residence is located. For purposes of applying these tables, either the original balance method or the declining balance method of calculating mortgage loan prepayments may be used. For proceeds used to finance qualified home improvement loans or shorter term qualified rehabilitation loans for which there are no comparable FHA mortgage maturity experience tables, the assumption used by the issuer as to the rate of prepayment shall be based upon the reasonable expectations of the issuer, as reflected, where applicable, by the issuer's prior experience with such loans.

(v) *Net losses.* The projected net losses on the mortgage pool (after foreclosure and payment of insurance proceeds), based on the most recent default experience for the area in which the residences are located, shall be taken into consideration in calculating the effective rate of interest on the mortgages. However, where mortgages provided under an issue are insured with FHA, VA, or private mortgage insurance, in conjunction with pool mortgage insurance, the expected net losses will be presumed to be zero. In the event that the actual losses on the mortgage pool exceed the projected net losses which were taken into consideration in calculating the effective rate of interest on the mortgages, investment proceeds earned from nonmortgage assets may be used to recover the excess losses and need not be paid or credited to the mortgagors under § 6a.103A–2(i)(4).

(vi) *Yield on the issue.* (A) The yield on an issue of qualified mortgage bonds shall be calculated on the basis of—

(*1*) The issue price, and

(*2*) An expected maturity for the bonds which is consistent with the prepayment assumption required under subparagraph (2)(iv) of this paragraph.

The expected maturity will be considered consistent with such prepayment assumption if all prepayments are assumed to be used to call bonds proportionately (*i.e.*, a ''strip'' call). The preceding sentence shall not apply to prepayments of mortgages provided from original proceeds to the extent such prepayments are used to provide mortgages.

(B) For purposes of (*1*) of this subdivision (vi), the term ''issue price'' shall have the same meaning as in section 1232(b)(2). Thus, in general, such term means the initial offering price to the public, not including bond houses and brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers, at which price a substantial amount of such obligations were sold or, if privately placed, the price paid by the first buyer of such obligations or the acquisition cost of the first buyer.

(3) *Nonmortgage investments*—(i) *Maximum investment.* Except as provided in subdivision (ii) of this subparagraph, an issue meets the requirements of this subparagraph only if—

(A) At no time during any bond year does the aggregate amount invested in nonmortgage investments, *e.g.*, reasonably required reserve funds, with a yield materially higher than the yield on the issue exceed 150 percent of the debt service on the issue for the current bond year, and

(B) Such aggregate amount invested in nonmortgage assets with a yield materially higher than the yield on the issue is promptly and appropriately reduced as mortgages are repaid.

The amount subject to the maximum investment rule in subdivision (i)(A) of this subparagraph includes the original bond proceeds, investment proceeds and repayments of principal on the mortgages. For purposes of subdivision (B), the amount described in subdivision (A) shall be considered promptly and appropriately reduced if beginning in the first bond year after the expiration of the temporary period for original proceeds described in subdivision

(ii)(A) of this subparagraph, such amount is reduced within 30 days of the beginning of each bond year by an amount equal to the difference between the average scheduled monthly mortgage receipts for the bond year (excluding any receipts that were scheduled with respect to mortgages that were discharged in the preceding bond year) and the average scheduled monthly mortgage receipts for the preceding bond year.

(ii) *Temporary periods.* Subparagraph (3)(i) of this paragraph shall not apply to—

(A) Proceeds (including prepayments of principal designated to be used to acquire additional mortgages) of the issue invested for an initial temporary period not to exceed 1 year (1½ years for proceeds required to be set aside for placing mortgages in targeted areas) until such proceeds are needed for mortgages, and

(B) Repayments of principal and interest on mortgages that are contributed to a bona fide debt service fund (as defined in §1.103–13(b)(12)) and invested for a 13-month temporary period as provided in §1.103–14(b)(10).

(iii) *Debt service defined.* For purposes of subparagraph (3)(i)(A) of this paragraph, the debt service on the issue for any bond year is the scheduled amount of interest and amortization of principal payable for such year with respect to such issue. There shall not be taken into account amounts scheduled with respect to any bond which has been retired before the beginning of the bond year.

(iv) *Nonmortgage investments.* A nonmortgage investment is any investment other than an investment in a qualified mortgage. For example, a mortgage-secured certificate or obligation is a nonmortgage investment. Investment earnings from participation fees (described in §6a.103A–1(b)(5)) are treated as investment proceeds on nonmortgage investments unless such fees are used to pay debt service or to finance owner occupied residences.

(v) *Bonds issued after June 30, 1993.* Section 1.148–2(f)(2)(iv) applies to bonds issued after June 30, 1993, in lieu of this paragraph (i)(3).

(4) *Arbitrage and investment gains to be used to reduce costs of owner financing—*

(i) *Rebate requirement.* An issue shall be treated as meeting the requirements of this subparagraph only if an amount equal to the sum of:

(A) The excess of—

(*1*) The net amount earned on all nonmortgage investments pursuant to subparagraph (3)(i) and (ii) of this paragraph (other than investments attributable to an excess described in this subdivision (A)) over

(*2*) The amount which would have been earned if the investments were invested at a rate equal to the yield on the issue, plus

(B) Any income attributable to the excess described in subdivision (A),—

shall be paid or credited to the mortgagors as rapidly as practicable. Such amount may be disproportionately distributed to the mortgagors if the larger portion of such amount is distributed to lower income mortgagors. The determination of the excess described in subdivision (A) shall take into account any reinvestment of nonmortgage investment receipts and any gain or loss realized on the disposition of nonmortgage investments. In addition, where nonmortgage investments are retained by the issuer after retirement of an issue, any unrealized gains or losses as of the date of retirement of such issue must be taken into account, in calculating the amount to be rebated to the mortgagors. The amount described in subdivision (A)(*2*) is the amount that would have been earned if the investments in nonmortgage obligations were invested at a rate equal to the yield on the issue calculated in the same manner as provided in §6a.103A–2(i)(2)(vi) and by using the same compounding method. For purposes of subdivision (B), any income attributable to the excess described in subdivision (A) shall be taken into account whether or not such income exceeds the yield on the bonds.

(ii) *Computation period.* Whether earnings are amounts described in subdivision (i) (A) or (B) of this subparagraph shall be determined by making computations on an annual basis. For example, if at the end of the first year the earnings on nonmortgage investments exceed the amount that could have been earned if such investments were invested at the bond yield, the

amount of earnings equal to such difference constitutes an excess described in subdivision (i)(A) of this subparagraph. In the following year, investment proceeds earned on such excess must be taken into account, whether or not such earnings exceed the yield on the bonds, and may not be treated as ''negative arbitrage''.

(iii) *Paid or credited.* For purposes of subdivision (i) of this subparagraph, amounts are paid or credited to mortgagors as rapidly as practicable if such amounts are paid or credited to such mortgagors at the time the mortgagor discharges the mortgage, for example, through prepayment of the entire principal amount or through making the last regular payment on the mortgage. The amount paid or credited to the mortgagors must have a present value at least equal to the present value of the amount described in subdivision (i) of this subparagraph, using the yield on the bonds as the discount rate. In the case of prepayments, the cumulative amount required to be rebated under subparagraph (4)(i) of this paragraph may be determined as of a date before the actual prepayment but not more than 1 year earlier than the date of prepayment. Except as provided in subparagraph (2)(v) or subparagraph (4)(iv) of this paragraph, such amount may not be subject to the claim of any party, *e.g.*, a bondholder, and may not be paid over to any party other than the mortgagor or the United States.

(iv) *Reduction where issuer does not use full 1 percentage point.* (A) The amount required to be paid or credited to mortgagors under subparagraph (4)(i) of this paragraph shall be reduced by the amount which (if it were treated as an interest payment made by mortgagors) would result in the excess referred to in subparagraph (2)(i) of this paragraph being equal to 1 percentage point. Such amount shall be fixed and determined as of the yield determination date. This fixed dollar amount may be received by the issuer at any time but may not be adjusted for the time of payment. Such fixed dollar amount shall be equal to the difference between the purchase price of mortgages financed by the proceeds of the issue and the present value of expected payments of principal and interest on such mortgages, using a discount rate equal to the bond yield plus 1 percentage point.

(B) The following example illustrates the provisions of subparagraph (4)(iv)(A) of this paragraph:

*Example.* In 1981, County X issues obligations to provide mortgages for owner-occupied residences. The yield paid on the obligations is 10 percent, and the effective rate of interest on the mortgages provided by the proceeds of such obligations is 9.75 percent. X maintains a reasonably required reserve fund which is invested at 15 percent and intends to recover that additional amount computed in the manner described in subparagraph (4)(iv) which could have been earned from investment of the proceeds in mortgages with an effective interest rate of 11 percent from the arbitrage earned from the reserve fund nonmortgage assets. X plans to recover such amount from the arbitrage over a period of 3 years; thus, X will not recover such amount until 1984. X may not adjust the amount to be received to account for the time when such amount will be received.

(v) *Election to pay United States.* Subparagraph (4)(i) of this paragraph shall be satisfied with respect to any issue if the issuer elects in writing before issuing the obligations to pay over to the United States—

(A) Not less frequently than once each 5 years after the date of issue, an amount equal to 90 percent of the aggregate amount described in subdivision (i) earned during such period (and not theretofore paid to the United States), and

(B) Not later than 30 days after the redemption of the last obligation, 100 percent of such aggregate amount not theretofore paid to the United States.

(j) *New mortgages*—(1) *In general.* An issue meets the requirements of this paragraph only if no part of the proceeds of such issue is to be used to acquire or replace an existing mortgage. All of the lendable proceeds must be used to provide mortgage loans to persons who did not have a mortgage (whether or not paid off) on the residence securing the mortgage note at any time prior to the execution of the mortgage.

(2) *Exceptions.* For purposes of this paragraph, the replacement of—

(i) Construction period loans,

(ii) Bridge loans or similar temporary initial financing, and

(iii) In the case of a qualified rehabilitation, an existing mortgage,

shall not be treated as the acquisition or replacement of an existing mortgage. Generally, temporary initial financing is any financing which has a term of 24 months or less.

(3) *Assumptions.* An issue meets the requirement of this paragraph only if a mortgage with respect to which owner financing has been provided under such issue may be assumed only if the requirements of paragraphs (d), (e), and (f) of this section are met with respect to such assumption. The determination of whether these requirements are met is based upon the facts as they exist at the time of the assumption as if the loan were being made for the first time. For example, the purchase price requirement is to be determined by reference to the average area purchase price at the time of the assumption and not when the mortgage was originally placed. If the bond documents and relevant mortgage instruments provide that a mortgage may be assumed only if the issuer has determined that the conditions stated in this subparagraph are satisfied, the good faith and 95-percent requirements of paragraph (c)(1)(i) and (ii) of this section will be considered satisfied with respect to the requirements of this subparagraph at the time the mortgages were executed. However, any failure to meet the requirements of this subparagraph at the time a mortgage is assumed is subject to the remedy requirement in paragraph (c)(1)(iii) of this section.

(4) *Examples.* The following examples illustrate the application of this paragraph (j):

*Example (1).* In June 1981 mortgagor A obtained a mortgage from a private lending institution in order to construct a house on land which A purchased without a mortgage in May 1981. In January 1982 A applies to obtain permanent financing on the residence from a program sponsored by State housing finance agency Y. Such program is funded with the proceeds of qualified mortgage bonds. If A meets the other requirements of this section, A qualifies for such permanent financing since the replacing of construction financing is not treated as the acquisition or replacement of an existing mortgage.

*Example (2).* In June 1981 mortgagor B purchased a new residence in a targeted area but was unable to sell his former residence. Therefore, B obtained temporary financing for his new residence until his former residence was sold. In October 1981 B applies to County Z to obtain financing from a program funded with proceeds of qualified mortgage bonds. Such financing is needed by B to replace the temporary financing for his new residence. If B meets the other requirements of this section, the mortgage qualifies for such permanent financing since the permanent financing replaces temporary initial financing.

*Example (3).* In 1979 mortgagor C purchased a residence but was unable to obtain financing from a program sponsored by County W because such program prohibited loans from the program which were in excess of 80 percent of the fair market value of the property. Therefore, in 1979 C obtained financing from a private lending institution with the intention of refinancing when he accumulated sufficient equity in the property. In 1981 C has accumulated sufficient equity in the property so as to comply with the requirements of the program. C applies to County W to refinance under the program, which is funded with the proceeds of qualified mortgage bonds. Even if C met the other requirements of this section, the mortgage would fail to meet the requirement of paragraph (j) since such a mortgage would replace an existing mortgage.

*Example (4).* In 1969 mortgagor D purchased a residence and obtained financing from a private lending institution. In 1981 D applies to County U for a loan for the rehabilitation of the property and for the refinancing of the existing mortgage. The program is funded with qualified mortgage bonds. If D meets the other requirements of this section the mortgage qualifies for such permanent financing since the replacement of the mortgage is not treated as the replacement or acquisition of an existing mortgage.

*Example (5).* In 1950 mortgagor E purchased a residence, obtaining a mortgage from a private lending institution to finance the purchase price. In 1980 E completed repaying the mortgage. In 1981 E applies for a loan from a program sponsored by State housing finance agency X and funded with the proceeds of qualified mortgage bonds. The mortgage does not meet the requirements of paragraph (j) since E had a previous mortgage on his residence, even though such mortgage was previously released.

(k) *Information reporting requirement.* See § 1.103A–2(k) for rules relating to section 103A(j)(3).

(l) *Policy statement.* See § 1.103A–2(l) for rules relating to section 103A(j)(5).

(m) *State certification.* See § 1.103A–2(m) for rules relating to section 103A(j)(4).

(98 Stat. 901 (26 U.S.C. 103A(j) (3) and (4)); 68A Stat. 917 (26 U.S.C. 7805))

[T.D. 7780, 46 FR 34314, July 1, 1981, as amended by T.D. 7794, 46 FR 55514, Nov. 10, 1981; T.D. 7817, 47 FR 22361, May 24, 1982; T.D. 7819, 47 FR 24701, June 8, 1982; T.D. 7821, 47 FR 28094, June 29, 1982; T.D. 7995, 49 FR 48293, Dec. 12, 1984; T.D. 8023, 50 FR 19355, May 8, 1985; T.D. 8049, 50 FR 35547, Sept. 3, 1985; T.D. 8476, 58 FR 33553, June 18, 1993]

**§ 6a.103A–3 Qualified veterans' mortgage bonds.**

(a) *In general.* A qualified veterans' mortgage bond shall not be treated as a mortgage subsidy bond, and the interest shall be exempt from Federal income taxation.

(b) *Qualified veterans' mortgage bond.* (1) With respect to obligations issued prior to July 19, 1984, the term ''qualified veterans' mortgage bond'' means any issue of obligations—

(i) Which meets the requirements of § 6a.103A–1, § 6a.103A–2(j) (1) and (2), and this section;

(ii) Substantially all of the proceeds of which are to be used to provide financing for single-family, owner-occupied residences (which meet the requirements of § 6a.103A–1(b)(6) and § 6a.103A–2(d)) for veterans; and

(iii) Payment of the principal and interest on which is secured by a pledge of the full faith and credit of the issuing State.

A qualified veterans' mortgage bond does not include any bond that is an industrial development bond under section 103(b).

(2) With respect to obligations issued after July 18, 1984, the term ''qualified veterans' mortgage bond'' means any issue of obligations—

(i) Which meets the requirements of § 6.103A–1, § 6a.103A–2(d) (relating to residence requirements), (j) (1) and (2) (relating to new mortgage requirement), and (k) (relating to information reporting requirement), and this section;

(ii) Substantially all of the proceeds of which are to be used to provide financing for qualified veterans; and

(iii) Payment of the principal and interest on which is secured by a pledge of the full faith and credit of the issuing State.

A qualified veterans' mortgage bond does not include any bond that is an industrial development bond under section 103(b).

(c) *Qualified veteran.* (1) An issue meets the requirements of this paragraph only if each of the mortgagors to whom owner financing is provided is a qualified veteran.

(2) With respect to obligations issued prior to July 19, 1984, the term ''qualified veteran'' means any veteran.

(3) With respect to obligations issued after July 18, 1984, the term ''qualified veteran'' means any veteran who—

(i) Served on active duty at some time before January 1, 1977, and

(ii) Applied for financing before the later of—

(A) The date 30 years after the date on which such veteran left active service, or

(B) January 1, 1985.

(4) The term ''veteran'' shall have the same meaning as in 38 U.S.C. 101(2), that is, a person who served in the active military, naval, or air service, and who was discharged or released therefrom under conditions other than dishonorable.

(d) *Husband and wife.* For purposes of this section, if a residence is to be owned by a husband and wife as joint tenants, as tenants by the entirety, or as community property, and if one spouse is a veteran, then both spouses shall be treated as satisfying the requirements of paragraph (c) of this section.

(e) *Substantially all.* For purposes of this section, the term ''substantially all'' shall have the same meaning as in § 1.103–8.

(f) *Qualified home improvement loan.* The term ''qualified home improvement loan'' means the financing (whether or not secured by a mortgage) of alterations, repairs, and improvements on, or in connection with, an existing single-family, owner-occupied residence by a veteran who is the owner thereof. The alterations, repairs, and improvements, however, must substantially protect or improve the basic livability or energy efficiency of the property, such as the renovation of

plumbing or electric systems, the installation of improved heating or air conditioning systems, the addition of living space, or the renovation of a kitchen area. Items that will not be considered to substantially protect or improve the basic livability of the property include swimming pools, tennis courts, saunas, or other recreational or entertainment facilities.

(g) *Volume limitation*—(1) *In general.* In the case of obligations issued after June 22, 1984, an issue meets the requirements of this paragraph only if the aggregate amount of obligations issued pursuant thereto, when added to the aggregate amount of qualified veterans' mortgage bonds previously issued by the State during the calendar year, does not exceed the State veterans limit for such calendar year. In determining the aggregate amount of qualified veterans' mortgage bonds issued in calendar year 1984, obligations issued prior to June 23, 1984, shall not be taken into account.

(2) *State veterans limit.* (i) The State veterans limit for any State is the amount equal to—

(A) The aggregate amount of qualified veterans' mortgage bonds issued by the State during the period beginning on January 1, 1979, and ending on June 22, 1984 (not including the amount of any qualified veterans' mortgage bonds actually issued during the calendar year, or the applicable portion of 1984, in such period for which the amount of such bonds was the lowest), divided by

(B) The number (not to exceed 5) of calendar years after 1978 and before 1985 during which the State issued qualified veterans' mortgage bonds.

In determining the number of calendar years after 1978 and before 1985 during which the State issued qualified veterans' mortgage bonds, any qualified veterans' mortgage bonds issued after June 22, 1984, shall not be taken into account. A State that did not issue qualified veterans' mortgage bonds during the period beginning on January 1, 1979, and ending on June 22, 1984, may not issue qualified veterans' mortgage bonds after June 22, 1984.

(ii) In the case of any obligation which has a term of 1 year or less and which was issued to provide financing for property taxes, the amount taken into account under this paragraph with respect to such obligation shall be 1/15 of its principal amount.

(3) *Examples.* The following examples illustrate the provisions of this paragraph:

*Example (1).* State R issued the following issues of qualified veterans' mortgage bonds: a $200 million issue on March 31, 1979, a $150 million issue on May 1, 1980, a $75 million issue on September 1, 1981, a $200 million issue on June 5, 1982, a $125 million issue on March 1, 1983, a $60 million issue on April 1, 1984, and a $100 million issue on September 1, 1984. R issued no other issues of qualified veterans' mortgage bonds during the period beginning January 1, 1979, and ending on December 31, 1984. The aggregate amount of qualified veterans' mortgage bonds issued during the period January 1, 1984, through June 22, 1984 ($60 million), is not taken into account in determining R's State veterans limit because that is the lowest aggregate amount of qualified veterans' mortgage bonds issued during the calendar year or the applicable portion of 1984, in the period beginning on January 1, 1979, and ending on June 22, 1984. Thus, R's State veterans limit is $150 million ($750 million (which is the sum of $200 million, $150 million, $75 million, $200 million, and $125 million) divided by 5). The September 1, 1984, issue is not included in determinig the State veterans limit because that issue was issued after June 22, 1984. The September 1, 1984, issue of qualified veterans' mortgage bonds meets the requirements of § 6a. 103A–3 (g) since the aggregate amount of qualified veterans' mortgage bonds issued in calendar year 1984 (not including obligations issued prior to June 23, 1984), does not exceed the State veterans limit.

*Example (2).* State S issued a $100 million issue of qualified veterans' mortgage bonds on March 31, 1984. S issued no other issues of qualified veterans' mortgage bonds during the period beginning on January 1, 1979, and ending on June 22, 1984. The aggregate amount of qualified veterans' mortgage bonds issued in the calendar year, or the applicable portion of 1984, in the period January 1, 1979, through June 22, 1984, for which the amount of bonds was the lowest is zero. Thus, the State veterans limit for S is $100 million (($100 million minus $0) divided by 1).

(h) *Good faith compliance efforts*—(1) *Mortgage eligibility requirements.* An issue of qualified veterans' mortgage bonds issued after July 18, 1984, which fails to meet the requirements of section 103A(o)(1), § 6a.103A–2(d) relating to residence requirements), and § 6a.103A–2(j) (1) and (2) (relating to new

mortgage requirements) shall be treated as meeting such requirements if each of the following provisions is complied with:

(i) The issuer in good faith attempted to meet all such requirements before the mortgages were executed. Good faith requires that the trust indenture, participation agreements with loan originators, and other relevant instruments contain restrictions that permit the financing of residences only in accordance with such requirements. In addition, the issuer must establish reasonable procedures to ensure compliance with such requirements. Such procedures include reasonable investigations by the issuer to satisfy such requirements.

(ii) Ninety-five percent or more of the lendable proceeds (as defined in § 6a.103A–2(b)(1)) that were devoted to owner-financing were devoted to residences with respect to which, at the time the mortgages were executed, all such requirements were met. In determining whether a person is a qualified veteran the issuer may rely on copies of the mortgagor's certificate of discharge indicating that the mortgagor served on active duty at some time before January 1, 1977, and stating the date on which the mortgagor left active service provided that neither the issuer nor its agent knows or has reason to believe that such affidavit is false. Where a particular mortgage fails to meet more than one of these requirements, the amount of the mortgage will be taken into account only once in determining whether the 95-percent requirement is met. However, all of the defects in the mortgage must be corrected pursuant to subdivision (iii).

(iii) Any failure to meet such requirements is corrected within a reasonable period after such failure is discovered. For example, failures can be corrected by calling the nonqualifying mortgage or by replacing the nonqualifying mortgage with a qualifying mortgage.

(2) *Nonmortgage eligibility requirements.* An issue of qualified veterans' mortgage bonds issued after July 18, 1984, which fails to meet the requirements of paragraph (g) of this section shall be treated as meeting such requirements if each of the requirements of § 6a.103A–2(c)(2) (i) and (ii) is met.

(98 Stat. 901(26 U.S.C. 103A(j) (3) and (4)); 68A Stat. 917 ( 26 U.S.C. 7805))

[T.D. 7780, 46 FR 34314, July 1, 1981; 46 FR 37890, July 23, 1981, as amended by T.D. 7995, 49 FR 48297, Dec. 12, 1984]

### § 6a.6652(g)–1 Failure to make return or furnish statement required under section 6039C.

(a) *Amount imposed.* In the case of each failure to meet the requirements of—

(1) Section 6039C, relating to information returns with respect to United States real property interests, or

(2) Section 6039C(b)(3), relating to statements to be provided to substantial investors in United States real property interests,

on or before the date prescribed therefor (determined with regard to any extension of time for filing), the person failing to meet such requirement shall pay $25 for each day during which such failure continues.

(b) *Limitation*—(1) *Domestic corporations and nominees.* The maximum penalty which may be imposed under paragraph (a) of this section on a domestic corporation or nominee for failure to meet the requirements of section 6039C(a) for any calendar year is $25,000.

(2) *Partnerships, trusts, estates and foreign corporations.* The maximum penalty which may be imposed on a partnership, trust, estate or foreign corporation for failure to meet the requirements of section 6039C(b) for any calendar year is $25,000.

(3) *Foreign persons holding U.S. real property interests and nominees.* The maximum penalty which may be imposed on a foreign person holding a U.S. real property interest or on a nominee holding a U.S. real property interest for a foreign person for failure to meet the requirements of section 6039C(c) for any calendar year is the lesser of $25,000 or 5 percent of the aggregate of the fair market value of the U.S. real property interests owned by such person at any time during such calendar year.

(c) *Definitions*—(1) *Fair market value.* The term ''fair market value'' as used in this section is defined in § 6a.897–1

(in the FEDERAL REGISTER 47 FR 41541, Sept. 21, 1982).

(2) *Failure.* The term ''failure to meet the requirements of section 6039C'' includes the failure to file a return for any calendar year on the date prescribed therefor (determined with regard to any extension of time for such filing), or the omission on a return of one or more items of information required by section 6039C and the regulations thereunder to be provided on the return. It also includes the failure to furnish a statement required by section 6039C(b)(3). The failure to furnish a return required under section 6039C(b)(1) and the failure to furnish a statement to a substantial investor as required by section 6039C(b)(3), are separate failures for purposes of paragraph (a) of this section. Also, each failure to provide a statement to each substantial investor is a separate failure for purposes of paragraph (a). Thus, if an entity has 100 substantial investors as defined in section 6039C and fails to furnish any of the required statements to substantial investors, there are 100 separate failures to furnish the required statement.

(3) *Aggregate of the fair market value of the United States real property interests.* The ''aggregate of the fair market value of the U.S. real property interests'' is the total of the fair market values of each U.S. real property interest owned at any time during the calendar year. Fair market value is determined as of December 31 of such year for property held at the end of the year and on the date of disposition for property disposed of during the year.

(d) *Attribution of ownership.* For purposes of calculating the penalty limitation under § 6a.6652(g)–1(b)(3) with respect to failure to meet the requirements of section 6039C(c), U.S. real property interests held by a partnership, trust, or estate shall be treated as owned proportionately by its partners or beneficiaries.

(e) *Exceptions*—(1) *Provision of security.* If a person otherwise required by section 6039C to file a return for a calendar year or furnish a statement to a substantial investor complies with the requirements of § 6a.6039C–5 relating to furnishing security in lieu of filing such return, or is exempt, by virtue of § 6a.6039C–5(f), from filing a return for such year with respect to its U.S. real property interests held, no penalty will be imposed under paragraph (a) of this section for failure to file such return or furnish such statement.

(2) *Showing of reasonable cause.* No amount shall be imposed under paragraph (a) of this section for a failure described in such paragraph if it is established to the satisfaction of the Director of the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, Pennsylvania 19155 or in the case of returns concerning the Virgin Islands, the Commissioner of the Bureau of Internal Revenue, Tax Division, Charlotte Amalie, St. Thomas, V.I. 00801, that such failure is due to reasonable cause and not to willful neglect. An affirmative showing of reasonable cause must be made in the form of a written statement, made under the penalties of perjury, containing a declaration by the person failing to make a return or furnish a statement under section 6039C setting forth all the facts alleged as reasonable cause. Whether reasonable cause is shown may depend upon the subsection of section 6039C under which the failure occurs. However, the fact that stock of a foreign corporation, or any other interest in any entity to which this section applies, is registered in bearer form does not constitute reasonable cause under this paragraph (e)(2) of this section for failure to comply with the requirements of section 6039C(b). Also, the fact that disclosure of ownership would contravene a secrecy law of any country does not constitute reasonable cause for failure to comply with the requirements of section 6039C(b). Where a return has been filed and there is an omission of one or more items of information required by section 6039C and the regulations thereunder, one of the facts to be considered in determining whether such failure is due to reasonable cause is the materiality of the item omitted.

(3) *Spouse or parent already filed with respect to same property.* If an individual files a return with respect to all U.S. real property interests held by such individual in accordance with § 6a.6039C–4(b), no penalty shall be imposed under this section on such individual's spouse

or minor child for failure to file a return under § 6a.6039C–4 with respect to the same property.

(f) *Manner of payment.* The amount imposed under paragraph (a) of this section on any person shall be paid in the same manner as tax upon the issuance of a notice and demand therefor.

(g) *Examples.* The provisions of this section may be illustrated by the following examples:

*Example (1).* Domestic corporation X is required under section 6039C (a) to make a return for calendar year 1982. X does not file such return on or before May 15, 1983 as required under § 6a.6039C–1(c). The failure to file the return for calendar year 1982 continues throughout calendar years 1983, 1984, 1985, and 1986. The failure to file is not due to reasonable cause and no security has been furnished in lieu of filing. The maximum penalty which can be imposed on X for failure to file the 1982 return is $25,000, determined as follows:

| | Penalty incurred in given year | Cumulative penalty for failure to file 1982 return |
|---|---|---|
| Total penalty incurred in 1983 ($25 per day × 230 days) | $5,750 | $5,750 |
| Total penalty incurred in 1984 (a leap year): ($25 per day × 366 days) | 9,150 | 14,900 |
| Total penalty incurred in 1985 ($25 per day × 365 days) | 9,125 | 24,025 |
| Total penalty incurred in 1986 (lesser of $25 per day × 365 days or $975 (remaining penalty which may be imposed)) | 975 | 25,000 |

*Example (2).* The facts are the same as in example (1) except that X also fails to file a return under section 6039C (a) for calendar year 1983. The failure to file its return for calendar year 1983 continues throughout calendar years 1984, 1985, 1986 and 1987. The total penalty which may be imposed on X for failure to file its return for calendar year 1983 is $25,000. The amount of penalty which can be imposed on X in calendar years 1984, 1985, 1986 and 1987 is determined as follows:

| | Penalty for 1982 failure | Penalty for 1983 failure | Total penalty for given year |
|---|---|---|---|
| Penalty incurred in 1984 (a leap year): | | | |
| For failure to file 1982 return ($25 per day × 366 days) | $9,150 | ..... | ..... |
| For failure to file 1983 return ($25 per day × 230 days) | ..... | $5,750 | ..... |
| Total | ..... | ..... | $14,900 |
| Penalty incurred in 1985: | | | |
| For failure to file 1982 return ($25 per day × 365 days) | 9,125 | ..... | ..... |
| For failure to file 1983 return ($25 per day × 365 days) | ..... | 9,125 | ..... |
| Total | ..... | ..... | 18,250 |
| Penalty incurred in 1986: | | | |
| For failure to file 1982 return (lesser of $25 per day × 365 days or $975 (remaining penalty which may be imposed)) | 975 | ..... | ..... |
| For failure to file 1983 return ($25 per day × 365 days) | ..... | 9,125 | ..... |
| Total | ..... | ..... | 10,100 |
| Penalty incurred in 1987: | | | |
| For failure to file 1983 return (lesser of $25 per day × 365 days or $1,000 (remaining penalty which may be imposed)) | | 1,000 | ..... |
| Total | ..... | ..... | 1,000 |

*Example (3).* Foreign corporation Y is required under section 6039C(b)(1) to make a return for calendar year 1982. In addition, Y is required under section 6039C(b)(3) to furnish statements to each substantial investor in U.S. real property interests. Y has 10 such substantial investors. Y does not file such return on or before May 15, 1983 as required under § 6a.6039C–1(c), nor does it furnish the required statements on or before January 31, 1983 as required under § 6a.6039C–3(h). The failure to file the return for calendar year 1982 and to furnish the required statements for 1982 continues throughout calendar years 1984 and 1985. The failure to meet the requirements of section 6039C(b) are not due to reasonable cause and no security has been furnished in lieu of filing. The total penalty which can be imposed on Y for failure to file the return and statements required under section 6039C(b) for calendar year 1982 is $25,000. The amount of penalty incurred by Y in calendar year 1983 for failure to file the return and statements for calendar year 1982 is $25,000, determined as follows:

| | |
|---|---|
| Penalty incurred in 1982: | |
| For failure to file return ($25 per day × 230 days) | $5,750 |
| For each failure to furnish a statement required by section 6039C(b)(3) ($25 per day × 10 statements × the 334 days from February 1, 1983 to December 31, 1983 ($83,500) but not more than $19,250 (which when added to $5,750 would total $25,000)) | 19,250 |

| | |
|---|---|
| Total | 25,000 |

Since Y has incurred the maximum penalty for failure to file its return and statements required for 1982 by the end of calendar year 1983, no further penalty for these failures is imposed.

*Example (4).* Under section 6039C(c) foreign person Y is required to make a return for calendar year 1982. Y does not file such return on May 15, 1983 and the failure is not due to reasonable cause. No security has been furnished in lieu of filing. All properties owned by Y in 1982 are U.S. real property interests. Y purchased property M in January 1982 when its fair market value was $10,000. In March, Y purchased property N when its fair market value was $15,000. In November, Y sold property M for $20,000. The fair market value of property N on December 31, 1982, was $20,000. The total of the fair market values of M and N (M as of the date of its sale and N as of December 31, 1982) is $40,000. The maximum penalty which may be imposed on Y for failure to meet the requirements of section 6093C(c) for any calendar year is the lesser of $25,000 or 5 percent of the aggregate of the fair market values of the U.S. real property interests owned by Y at any time during such calendar year. Since $2,000 (5 percent of $40,000) is less than $5,750 ($25 times 230 days, the number of days in calendar year 1983 for which the failure continues), the maximum penalty which may be imposed on Y in 1983 is $2,000. Since the maximum penalty for the failure to file the 1982 return is incurred in 1983, no amount may be imposed for Y's continuing failure to file the return for calendar year 1982 during calendar years after 1983.

(h) *Effective date.* This section shall apply to 1980 and subsequent calendar years. The calendar year 1980 shall be treated as beginning on June 19, 1980 and ending on December 31, 1980.

[T.D. 7866, 48 FR 648, Jan. 6, 1983]

## PART 7—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976

Sec.

7.48–1 Election to have investment credit for movie and television films determined in accordance with previous litigation.
7.48–2 Election of forty-percent method of determining investment credit for movie and television films placed in service in a taxable year beginning before January 1, 1975.
7.48–3 Election to apply the amendments made by sections 804 (a) and (b) of the Tax Reform Act of 1976 to property described in section 50(a) of the Code.
7.57(d)–1 Election with respect to straight line recovery of intangibles.
7.105–1 Questions and answers relating to exclusions of certain disability income payments.
7.105–2 Substantial gainful activity.
7.367(b)–1 Other transfers.
7.367(b)–2 Definitions.
7.367(b)–3 Special rules.
7.367(b)–4 Certain exchanges described in more than one Code provision.
7.367(b)–5 Complete liquidation of foreign subsidiary.
7.367(b)–6 Exchange of stock in a foreign investment company.
7.367(b)–7 Exchange of stock described in section 354.
7.367(b)–8 Transfer of assets by a foreign corporation in an exchange described in section 351.
7.367(b)–9 Attribution of earnings and profits on an exchange described in section 351, 354, or 356.
7.367(b)–10 Distribution of stock described in section 355.
7.367(b)–11 Deficit in earnings and profits.
7.367(b)–12 Subsequent treatment of amounts attributed or included in income.
7.367(b)–13 Examples.
7.367(c)–1 Section 355 distribution treated as an exchange.
7.367(c)–2 Contribution of capital to controlled corporations.
7.465–1 Amounts at risk with respect to activities begun prior to effective date; in general.
7.465–2 Determination of amount at risk.
7.465–3 Allocation of loss for different taxable years.
7.465–4 Insufficient records.
7.465–5 Examples.
7.704–1 Partner's distributive share.
7.936–1 Qualified possession source investment income.
7.999–1 Computation of the international boycott factor.
7.6039A–1 Information regarding carryover basis property acquired from a decedent.
7.6041–1 Return of information as to payments of winnings from bingo, keno, and slot machines.

AUTHORITY: 26 U.S.C. 7805, unless otherwise stated.

Section 7.367 (b)–1 also issued under 26 U.S.C. 367 (b).

Section 7.367 (b)–2 also issued under 26 U.S.C. 367 (b).

Section 7.367 (b)–3 also issued under 26 U.S.C. 367 (b).

Section 7.367 (b)–4 also issued under 26 U.S.C. 367 (b).

Section 7.367 (b)–5 also issued under 26 U.S.C. 367 (b).

Section 7.367 (b)–6 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–7 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–8 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–9 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–10 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–11 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–12 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–13 also issued under 26 U.S.C. 367 (b).

### § 7.48–1 Election to have investment credit for movie and television films determined in accordance with previous litigation.

(a) *Generally.* Under section 804(c)(3) of the Tax Reform Act of 1976 (Pub. L. 94–455, 90 Stat. 1595), any taxpayer who filed an action in any court of competent jurisdiction before January 1, 1976, for a determination of such taxpayer's rights to investment credit under section 38 of the Internal Revenue Code of 1954 with respect to any film placed in service in any taxable year beginning before January 1, 1975, may elect to have investment credit on all films placed in service in taxable years beginning before January 1, 1975, (except those subject to an election under section 804(e)(2) of the Act), determined as though section 804 of the Act (except section 804(c)(3) of the Act) had not been enacted.

(b) *Manner of making the election.* The election allowed by section 804(c)(3) of the Act may be made by a notification in the form of a letter signed by the taxpayer or an authorized representative of the taxpayer stating:

(1) The taxpayer's name, address, and identification number;

(2) The taxable years in which the films were placed in service with respect to which the election shall apply; and

(3) The court in which the litigation was commenced and information adequate to identify the particular litigation, for example, the names of the litigants, the date the suit was commenced, and the court case or docket number of the litigation.

The letter should be sent to the Deputy Commissioner of Internal Revenue, Attention: CC:RL:Br2, Room 4617, 1111 Constitution Avenue, N.W., Washington, DC 20224.

(c) *Time for making the election.* The election under section 804(c)(3) of the Act must be made not later than January 3, 1977. If mailed, the cover containing the notification of such election must be postmarked not later than January 3, 1977.

(d) *Revocation of election.* An election under section 804(c)(3) of the Act, once made, shall be irrevocable.

[T.D. 7449, 41 FR 56629, Dec. 29, 1976]

### § 7.48–2 Election of forty-percent method of determining investment credit for movie and television films placed in service in a taxable year beginning before January 1, 1975.

(a) *General rule.* Under section 804(c)(2) of the Tax Reform Act of 1976 (90 Stat. 1595), taxpayers who placed movie or television films (here- inafter referred to as films and tapes) in service during taxable years beginning before January 1, 1975, may elect to have their investment credit on all such films and tapes determined under section 46(c) of the Code using an amount equal to 40 percent of aggregate production costs in lieu of the basis of such property. If the election is made, 100 percent is the applicable percentage used in determining qualified investment under section 46(c) of the Code regardless of actual useful life. The election can be made only with respect to qualified films and tapes that are new section 38 property and the investment credit is allowed only to the extent that a taxpayer has an ownership interest in the film or tape. No investment credit is allowed under section 804(c)(2) of the Act on any film or tape that is not section 38 property or that was produced and shown exclusively outside of the United States. Thus, no election may be made under this section with respect to a film or tape which is suspension period property to which section 48(h) applies or to a film or tape which is termination period property to which section 49(a) applies. Any investment credit taken on any film or tape subject to the election is not subject to recapture because of an early disposition or because a film or tape

otherwise ceases to be section 38 property under section 47(a) of the Code. Thus, there will be no recapture because a film or tape is used outside the United States under section 48(a)(2) of the Code or section 804(c)(1)(C) of the Act, or because of any disposition under section 47(a)(7)(B) of the Code.

(b) *Time and manner of making an election*—(1) *Time for making the election*. The election under section 804(c)(2) of the Act must be made not later than April 25, 1977.

(2) *Manner of making the election*. An election under this section must be made by filing amended income tax returns for each taxable year beginning before January 1, 1975, in which films and tapes subject to the election were placed in service, together with a statement signed by the taxpayer containing the information described below. The amended returns and the statement must be filed with the district director having audit jurisdiction over the last return filed to which the election relates. Each amended return shall contain a schedule listing by name all films and tapes placed in service during the year to which the amended return relates and setting forth all computations necessary to determine the aggregate production costs of each such film or tape listed and the ownership interest of the taxpayer in each film or tape listed. In the case of a taxpayer which is a partner, shareholder of an electing small business corporation, or beneficiary of a trust or estate, such computations must be adequate to determine the ownership interest of the partnership, electing small business corporation, or trust or estate in each such film or tape, (a taxpayer which is a partner, shareholder, or beneficiary may satisfy the requirements of the preceding sentence by attaching to his amended return a copy of an amended return, if one is filed, of the partnership, electing small business corporation, or trust or estate which sets forth computations necessary to determine the ownership interest of the entity in each such film or tape.) No amended return need be filed for a taxable year if application of the election to films and tapes placed in service during that year would not affect tax liability for any taxable year.

The statement shall contain the following information:

(i) The taxpayer's name and taxpayer identification number (under section 6109 of the Code).

(ii) A statement that the taxpayer is making the election under section 804(c)(2) of the Act.

(iii) A statement that the taxpayer agrees that the period for assessment and collection under section 6501 of the Code will remain open until December 31, 1978, solely with respect to adjustments of tax liability attributable to investment credit allowed on films and tapes placed in service in each year covered by the election. Unless the district director notifies the taxpayer within 7 days of receipt of the statement that such extension is denied, it will be presumed that the district director consents to such extension. Of course, the period covered by this statement may be extended beyond December 31, 1978 by mutual agreement. This statement does not shorten the regular statutory period for any year or take precedence over a previous or subsequent agreement with the Internal Revenue Service extending the statutory period for any year.

(iv) A list of the addresses used by the taxpayer on each return filed during each taxable year subject to the election.

(v) A statement that the taxpayer consents to join in judicial proceedings to determine the investment credit allowable and entitlement to investment credit on any film or tape subject to the election, which meets all of the requirements set forth in paragraph (b)(3) of this section.

(vi) A statement as to whether an election has been made by the taxpayer under section 804(e)(2) of the Act for films and tapes which are property described in section 50(a) of the Code which were placed in service in taxable years beginning before January 1, 1975.

(vii) A list by name of all films or tapes placed in service during the years to which the election relates.

(viii) With respect to each film or tape listed in paragraph (b)(2)(vii) of this section, a list of all producers, distributors, and persons with a participation interest (with addresses where available).

(ix) In the case of an election made by a partner, shareholder of an electing small business corporation (as defined in section 1371(b) of the Code), or beneficiary, a statement indicating the name, taxpayer identification number, and address for tax return purposes of the respective partnership, electing small business corporation, or trust or estate.

(3) *Consent to join in judicial proceedings.* No election may be made by any taxpayer unless the statement made under paragraph (b)(2)(v) of this section provides that the taxpayer shall:

(i) Treat the determination of the investment credit allowable on each film or tape subject to an election as a separate cause of action;

(ii) Make all reasonable efforts necessary to join in or intervene in any judicial proceeding in any court for determining the person entitled to, and the amount of, the investment credit allowable with respect to any film or tape covered by the election after receiving notice from the Commissioner of Internal Revenue or his delegate indicating that a conflicting claim to the investment credit for such film or tape is being asserted in such court by another person; and

(iii) Consent to revocation of the election by the Commissioner of Internal Revenue or his delegate with respect to all films and tapes placed in service in taxable years for which the election applies, if the taxpayer fails to make all reasonable efforts necessary to join in or intervene in any judicial proceeding under paragraph (b)(3)(ii) of this section.

(4) *Who makes the election.* The election must be made separately by each person who has an ownership interest. However, where a film or tape is owned by a partnership, electing small business corporation (as defined in section 1371(b) of the Code), or trust or estate, the election must be made separately by each partner, shareholder or beneficiary. The election is not to be made by a partnership or electing small business corporation, and is to be made by a trust or estate only if the trust or estate in determining its tax liability would be allowed investment credit on a film or tape subject to the election. The election of any partner, shareholder, beneficiary or trust or estate shall be effective regardless of whether any related partner, shareholder, beneficiary, or trust or estate makes the election.

(5) *Additional time to perfect election.* A taxpayer that by April 25, 1977, files a statement containing the information described in paragraph (b)(2) (i) through (v) of this section shall be deemed to have made a timely election under paragraph (b)(2) of this section if by July 5, 1977, the taxpayer has complied with all of the requirements of paragraph (b)(2) of this section. If a taxpayer demonstrates to the satisfaction of the district director that it is unable to meet the July 5, 1977, date even though it has made a good faith effort to do so, the district director may at his discretion extend that date to no later than October 4, 1977, for that taxpayer. Requests for extensions of the July 5, 1977, date should be addressed to the district director with whom the statement was filed.

(c) *Revocation of election*—(1) *Revocation by taxpayer.* (i) Except as provided in paragraph (c)(1)(ii) of this section, an election made under section 804(c)(2) of the Act may not be revoked by a taxpayer unless consent to revoke the election is obtained from the Commissioner of Internal Revenue or his delegate. Application for consent to revoke the election will be accepted only if permanent regulations are issued which contain rules which may not reasonably have been anticipated by taxpayers at the time the election was made. Any permanent regulations will provide a reasonable period of time within which taxpayers will be permitted to apply for consent to revoke the election and will allow revocation (where revocation is not barred by the limitations on credit or refund inspection 6511 of the Code) in the event of a determination by the Commissioner of Internal Revenue or his delegate that such permanent regulations contain provisions that may not reasonably have been anticipated by taxpayers at the time of making such election.

(ii) An election properly made under section 804(e)(2) of the Act, to have sections 48(k) and 47 (a)(7) of the Code apply to films and tapes which are

property described in section 50(a) of the Code and which were placed in service in taxable years beginning before January 1, 1975, shall automatically revoke any election under section 804(c)(2) of the Act with respect to such films and tapes. Such revocation does not require the consent of the Commissioner of Internal Revenue or his delegate.

(2) *Revocation by Commissioner.* The Commissioner of Internal Revenue or his delegate shall revoke an election made under section 804(c)(2) of the Act if a taxpayer fails to make all reasonable efforts necessary to join in or intervene, in a judicial proceeding for determination of the person entitled to, and the amount of, the investment credit allowable with respect to any film or tape covered by the election after receiving notice from the Commissioner or his delegate which indicates that a conflicting claim to the investment credit for such film or tape is being asserted in court by another person.

(d) *Furnishing of supplementary information required.* If these regulations are revised to require the furnishing of information in addition to that which was furnished with the amended returns and statement of election filed pursuant to paragraph (b) (2) and (3) of this section, the taxpayer must furnish such additional information in a statement addressed to the district director with whom the amended return and statement of election were filed.

((68A Stat. 917; 26 U.S.C. 7804); sec. 804(c)(2)(C) and (D) of the Tax Reform Act of 1976 (90 Stat. 1595))

[T.D. 7474, 42 FR 17123, Mar. 31, 1977; T.D. 7480, 42 FR 19479, Apr. 14, 1977]

### §7.48–3 Election to apply the amendments made by sections 804 (a) and (b) of the Tax Reform Act of 1976 to property described in section 50(a) of the Code.

(a) *General rule.* Under section 804(e)(2) of the Tax Reform Act of 1976 (90 Stat. 1596), taxpayers may elect to apply the amendments made by section 804 (a) and (b) of the Act to movie and television films that are property described in section 50(a) of the Code and that were placed in service in taxable years beginning before January 1, 1975.

(b) *Time for and manner of making election*—(1) *Time for making election.* The election under section 804(e)(2) the Act must be made not later than October 4, 1977.

(2) *Manner of making election.* The election under section 804(e)(2) shall be made by applying the same rules applicable under section 804(c)(2) as described in §7.48–2(b) (2), (3), and (4) except that §7.48–2(b)(2)(ii) shall be read to require a statement that the taxpayer is making an election under section 804(e)(2) of the Act, and §7.48–2(b)(2)(vi) shall not apply. An election properly made under section 804(e)(2) of the Act may not be revoked after October 4, 1977.

(Sec. 804(e)(2), Tax Reform Act of 1976 (90 Stat. 1596))

[T.D. 7509, 42 FR 47828, Sept. 22, 1977]

### §7.57(d)–1 Election with respect to straight line recovery of intangibles.

(a) *Purpose.* This section prescribes rules for making the election permitted under section 57(d)(2), as added by the Tax Reform Act of 1976. Under this election taxpayers may use cost depletion to compute straight line recovery of intangibles.

(b) *Election.* The election under section 57(d) is subject to the following rules:

(1) The election is made within the time prescribed by law (including extensions thereof) for filing the return for the taxable year in which the intangible drilling costs are paid or incurred or, if later, by July 25, 1978.

(2) The election is made separately for each well. Thus, a taxpayer may make the election for only some of his or her wells.

(3) The election is made by using, for the well or wells to which the election applies, cost depletion to compute straight line recovery of intangibles for purposes of determining the amount of the preference under section 57(a)(11).

(4) The election may be made whether or not the taxpayer uses cost depletion in computing taxable income.

(5) The election is made by a partnership rather than by each partner.

(c) *Computation of cost depletion.* For purposes of computing straight line recovery of intangibles through cost depletion, both depletable and depreciable intangible drilling and development costs for the taxable year are taken into account. They are treated as if capitalized, added to basis, and recovered under § 1.611–2(a). Costs paid or incurred in other taxable years are not taken into account.

(Secs. 57(d) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1551; 68A Stat. 917; 26 U.S.C. 57(d), 7805))

[T.D. 7541, 43 FR 17816, Apr. 26, 1978; 43 FR 18993, May 3, 1978]

## § 7.105–1 Questions and answers relating to exclusions of certain disability income payments.

The following questions and answers relate to the exclusion of certain disability income payments under section 105(d) of the Internal Revenue Code of 1954, as amended by sections 505 (a) and (c) of the Tax Reform Act of 1976 (90 Stat. 1566):

Q–1: *What effect on the sick pay exclusion does the new law have?*

A–1: The ''sick pay'' provisions of prior law (which allowed a limited exclusion from gross income of sick pay received before mandatory retirement age by active employees temporarily absent from work because of sickness or injury, as well as by disability retirees) have been replaced by provisions of the new law (which provide for a limited exclusion of disability payments but restrict its application to individuals retired on disability who meet certain requirements as to permanent and total disability, age, etc.) (Q–4). As a result of the more restrictive provisions of the new law, many taxpayers who qualified for the exclusion in previous taxable years will not be eligible to claim the disability payments exclusion beginning with the effective date of the new law.

Q–2: *What is the effective date of the new law relating to disability exclusion?*

A–2: The disability income exclusion and related annuity provisions of the Tax Reform Act of 1976 are effective for taxable years beginning on or after January 1, 1977. In addition, the Tax Reduction and Simplification Act of 1977 allows certain taxpayers to begin excluding pension or annuity costs in taxable years beginning in 1976. In the case of a retiree who uses the cash receipts and disbursements method of accounting, the new law applies to payments received on or after the effective date even if the payment is for a period before the effective date. Thus, a payment for December 1976 that is received in January 1977 by a calendar-year, cash-basis taxpayer is controlled by the new law.

Q–3: *What are disability payments?*

A–3: In general, disability payments are amounts constituting wages or payments in lieu of wages made under provisions of a plan providing for the payment of such amounts to an employee for a period during which the employee is absent from work on account of permanent and total disability. Amounts paid to such an employee after mandatory retirement age is attained are not wages or payments in lieu of wages for purposes of the disability income exclusion.

Q–4: *Who is eligible to exclude disability payments?*

A–4: A taxpayer who receives disability payments in lieu of wages under a plan providing for the payment of such amounts may qualify for the exclusion provided all of the following requirements are met:

(1) The taxpayer has not reached age 65 (see Q–9) before the end of the taxable year;

(2) The taxpayer has not reached mandatory retirement age (see Q–8) before the beginning of the taxable year;

(3) The taxpayer retired on disability (see Q–10) (or if retired prior to January 1, 1977 and did not retire on disability, would have been eligible to retire on disability at the time of such retirement);

(4) The taxpayer was permanently and totally disabled (see Q–11) when the taxpayer retired (or if the taxpayer retired before January 1, 1977, was permanently and totally disabled on January 1, 1976, or January 1, 1977); and

(5) The taxpayer has not made an irrevocable election not to claim the disability income exclusion (see Q–17 through Q–19).

Q–5: *What limitations are placed on the amounts excludable?*

A–5: The amount of disability income that is excludable:

(a) Cannot exceed the amount of the disability income payments received for any pay period;

(b) Cannot exceed a maximum weekly rate of $100 per taxpayer. Thus, the maximum disability income exclusion allowable on a joint return (see Q–7) in the usual case where one spouse receives disability payments, generally, would be $5,200, and if both spouses received disability payments the maximum exclusion, generally, would be $10,400 ($5,200 for each spouse);

(c) Cannot exceed, in the case of a disability income payment for a period of less than a week, a prorated portion of the amount otherwise excludable for that week (see Q–6); and

(d) Cannot exceed, for the entire taxable year, the total amount otherwise excludable for such taxable year reduced, dollar for dollar, by the amount by which the taxpayer's adjusted gross income (determined without

regard to the disability income exclusion) exceeds $15,000. Where a disability income exclusion is claimed by either or both spouses on a joint return, the taxpayer's adjusted gross income means the total adjusted gross income of both spouses combined (determined without regard to the disability income exclusion) (see also Q–7).

Q–6: *On what occasion is a taxpayer likely to receive part-week disability payments? How do you prorate such payments?*

A–6: Such part-week payments may be received when one of the following events occurs after the first day of the taxpayer's normal workweek: (a) the disability retirement commences: (b) the taxpayer reaches mandatory retirement age in a taxable year prior to the taxable year in which such taxpayer attains age 65; or (c) the taxpayer dies. To prorate a part-week disability income payment for purposes of the exclusion, the taxpayer must:

(1) Determine the ''daily exclusion,'' which is the lesser of—

(a) The taxpayer's daily rate of disability pay, or

(b) $100 divided by the number of days in the taxpayer's normal workweek.

(2) Multiply the daily exclusion by the number of days for which the part-week payment was made.

Thus, for a taxpayer whose normal workweek was Monday through Friday and whose retirement on permanent and total disability began on Wednesday, the first disability income payment would include a payment for a part-week consisting of three days. Assuming that the daily exclusion determined in (1), above, is $20, the taxpayer's exclusion for the first week would be $60 ($20×3).

Q–7: *What filing restrictions apply to a married taxpayer who claims a disability income exclusion?*

A–7: A taxpayer married at the close of the taxable year who lived with his or her spouse at any time during such taxable year must file a joint return in order to claim the disability income exclusion. However, a taxpayer married at the close of the taxable year who lived apart from his or her spouse for the entire taxable year may claim the exclusion on either a joint or separate return.

Q–8: *What is ''mandatory retirement age''?*

A–8: Generally, mandatory retirement age is the age at which the taxpayer would have been required to retire under the employer's retirement program, had the taxpayer not become disabled.

Q–9: *Does a taxpayer reach age 65 on the day before his or her 65th birthday for purposes of the disability income exclusion, as is the case for purposes of the exemption for age and the credit for the elderly?*

A–9: No. For purposes of the disability income exclusion, a taxpayer reaches age 65 on the day of his or her 65th birthday anniversary. Thus, a taxpayer whose 65th birthday occurs on January 1, 1978, is not considered to reach age 65 during 1977, for purposes of the disability income exclusion.

Q–10: *What does ''retired on disability'' mean?*

A–10: Generally, it means that an employee has ceased active employment in all respects because of a disability and has retired under a disability provision of a plan for employees. However, an employee who has actually ceased active employment in all respects because of a disability may be treated as ''retired on disability'' even though the employee has not yet gone through formal ''retirement'' procedures, as for example, where an employer carries the disabled employee in a non-retired status under the disability provisions of the plan solely for the purpose of continuing such employee's eligibility for certain employer-provided fringe benefits. In addition, such an employee may be treated as ''retired on disability'' even though the initial period immediately following his or her ceasing of employment on account of a disability must first be used against accumulated ''sick leave'' or ''annual leave'' prior to the employee being formally placed in disability retirement status.

Q–11: *What is permanent and total disability?*

A–11: It is the inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that:

(a) Can be expected to result in death;

(b) Has lasted for a continuous period of not less than 12 months; or

(c) Can be expected to last for a continuous period of not less than 12 months. The substantial gainful activity referred to is not limited to the activity, or a comparable activity, in which the individual customarily engaged prior to such individual's retirement on disability.

See § 7.105–2 for additional information relating to substantial gainful activity.

Q–12: *If a taxpayer retired on disability but it is not clear until the following taxable year that the disability as of the date of such retirement was permanent and total (so that the employee did not exclude any amount as disability income in the earlier taxable year), may the taxpayer* file an amended return to claim the disability income exclusion for the taxable year in which such taxpayer retired on disability which was permanent and total?

A–12: Yes.

Q–13: *What proof must a taxpayer furnish to establish the existence of permanent and total disability?*

A–13: If retired on disability before January 1, 1977: A certificate from a qualified physician attesting that—

(a) The taxpayer was permanently and totally disabled on January 1, 1976 or January 1, 1977; or

(b) The records of the Veterans Administration show that the taxpayer was permanently and totally disabled as defined in 38

CFR 3.340 or 3.342 on January 1, 1976 or January 1, 1977.

If retired on disability during 1977 or thereafter: A certificate from a qualified physician attesting that—

(a) The taxpayer was permanently and totally disabled on the date he or she retired; or

(b) The records of the Veterans Administration show that the taxpayer was permanently and totally disabled as defined in 38 CFR 3.340 or 3.342 on the date he or she retired.

In either case, the taxpayer must attach the certificate or a copy of the certificate to his or her income tax return. The certificate shall give the physician's name and address. No certificate from any employer is required with regard to the determination of permanent and total disability.

Q–14: *For what period does a taxpayer eligible (see Q–4) for the disability income exclusion (without regard to the $15,000 income phaseout explained in Q–5) continue to be eligible for such exclusion?*

A–14: Unless the taxpayer earlier makes the irrevocable election not to claim the disability income exclusion described in Q–17 through Q–19, such taxpayer continues to be eligible until the earlier of:

(a) The beginning of the taxable year in which the taxpayer reaches age 65; and

(b) The day on which the taxpayer reaches mandatory retirement age.

Q–15: *May a taxpayer while eligible (see Q–4) for the disability income exclusion under the new law, exclude any applicable pension or annuity costs?*

A–15: No. This is true even though while eligible for the disability income exclusion, such taxpayer is unable to exclude any amount of the disability income payments because of the $15,000 income phaseout (see Q–5).

Q–16: *When will a taxpayer who is eligible (see Q–4) to exclude disability income payments (without regard to the $15,000 phaseout explained in Q–5) under the new law be able to exclude any applicable pension or annuity costs?*

A–16: In general, such a taxpayer will begin to exclude any of his or her pension or annuity costs under applicable rules of the Code beginning on the first day of the taxable year in which he or she attains age 65 or, if mandatory retirement age is attained in an earlier taxable year, beginning on the day the taxpayer attains mandatory retirement age.

Q–17: *May a taxpayer who is eligible (see Q–4) to exclude disability income payments (without regard to the $15,000 phaseout explained in Q–5) under the new law begin to exclude applicable pension or annuity costs in an earlier taxable year?*

A–17: Yes, but such a taxpayer must make the election described in Q–18 and Q–19 in which case the taxpayer would no longer be eligible for the disability income exclusion.

Q–18: *What is an election not to claim the disability income exclusion?*

A–18: It is an irrevocable election for the taxable year for which the election is made, and each taxable year thereafter. If such an election is made the taxpayer will begin to recover tax-free, out of the payments, his or her annuity costs as provided under the applicable provision of the Code.

Q–19: *How does a taxpayer who is eligible to exclude disability income payments (without regard to the $15,000 phaseout explained in Q–5) under the new law make this election?*

A–19: The election is made by means of a statement attached to the taxpayer's income tax return (or amended return) for the taxable year in which the taxpayer wishes to have the applicable annuity rule apply. The statement shall set forth the taxpayers qualifications to make the election (i.e., that the taxpayer is eligible (see Q–4) to exclude disability income payments (without regard to the $15,000 income phaseout explained in Q–5)) and that such taxpayer irrevocably elects not to claim the benefit of excluding disability income payments under section 105(d), as amended, for such taxable year and each taxable year thereafter. The election cannot be made for any taxable year beginning before January 1, 1976.

Q–20: *Did the changes made by the Tax Reduction and Simplification Act provide any relief to taxpayers eligible for the sick pay exclusion in taxable years beginning in 1976?*

A–20: Yes. As originally enacted, the more restrictive provisions of the disability income exclusion applied to taxable years beginning in 1976. The Tax Reduction and Simplification Act postponed the effective date of these provisions for 1 year. Thus, taxpayers may claim the sick pay exclusion in taxable years beginning in 1976.

(Secs. 105(d) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1566; 68A Stat. 917; 26 U.S.C. 105(d); 7805))

[T.D. 7450, 41 FR 56630, Dec. 29, 1976, as amended at 42 FR 2954, Jan. 14, 1977; T.D. 7544, 43 FR 19655, May 8, 1978]

## § 7.105–2 Substantial gainful activity.

(a) *Purpose.* This section defines substantial gainful activity for purposes of section 105(d) and § 7.105–1, prescribes rules for determining whether a taxpayer has the ability to engage in substantial gainful activity, and provides examples of the application of the definition and rules in specific factual situations.

(b) *Definition.* Substantial gainful activity is the performance of significant duties over a reasonable period of time

in work for remuneration or profit (or in work of a type generally performed for remuneration or profit).

(c) *General rules.* (1) Full-time work under competitive circumstances generally indicates ability to engage in substantial gainful activity.

(2) Work performed in self-care or the taxpayer's own household tasks, and nonremunerative work performed in connection with hobbies, institutional therapy or training, school attendance, clubs, social programs, and similar activities is not substantial gainful activity. However, the nature of the work performed may be evidence of ability to engage in substantial gainful activity.

(3) The fact that a taxpayer is unemployed for any length of time is not, of itself, conclusive evidence of inability to engage in substantial gainful activity.

(4) Regular performance of duties by a taxpayer in a full-time, competitive work situation at a rate of pay at or above the minimum wage will conclusively establish the taxpayer's ability to engage in substantial gainful activity. For purposes of paragraphs (c)(4) and (c)(5) of this section, the minimum wage is the minimum wage prescribed by section 6(a)(1) of the Fair Labor Standards Act of 1938, as amended, 29 U.S.C. 206(a)(1).

(5) Regular performance of duties by a taxpayer in a part-time, competitive work situation at a rate of pay at or above the minimum wage will conclusively establish the taxpayer's ability to engage in substantial gainful activity, if the duties are performed at the employer's convenience.

(6) In situations other than those described in paragraphs (c)(4) and (c)(5) of this section, other factors, such as the nature of the duties performed, may establish a taxpayer's ability to engage in substantial gainful activity.

(d) *Examples.* The following examples illustrate the application of the definition in paragraph (b) of this section and the rules in paragraph (c) of this section in specific factual situations. In examples 1 through 5, the facts establish that the taxpayers are able to engage in substantial gainful activity and, therefore, are not entitled to claim the disability income exclusion of section 105(d). In examples 6 through 9, the facts do not, of themselves, establish the taxpayers' ability or inability to engage in substantial gainful activity. In these situations, all the facts and circumstances must be examined to determine whether the taxpayers are able to engage in substantial gainful activity.

*Example (1).* Before retirement on disability, taxpayer worked for a hotel as night desk clerk. After retirement, the taxpayer is hired by another hotel as night desk clerk at a rate of pay exceeding the minimum wage. Since the taxpayer regularly performs duties in a full-time competitive work situation at a rate of pay at or above the minimum wage, he or she is able to engage in substantial gainful activity.

*Example (2).* A taxpayer who retired on disability from employment as a sales clerk is employed as a full-time babysitter at a rate of pay equal to the minimum wage. Since the taxpayer regularly performs duties in a full-time, competitive work situation at a rate of pay at or above the minimum wage, he or she is able to engage in substantial gainful activity.

*Example (3).* A taxpayer retired on disability from employment as a teacher because of terminal cancer. The taxpayer's physician recommended continuing employment for therapeutic reasons and taxpayer accepted employment as a part-time teacher at a rate of pay in excess of the minimum wage. The part-time teaching work is done at the employer's convenience. Even though the taxpayer's illness is terminal, the employment was recommended for therapeutic reasons, and the work is part-time, the fact that the work is done at the employer's convenience demonstrates that the taxpayer is able to engage in substantial gainful activity.

*Example (4).* A taxpayer who retired on disability, is employed full-time in a competitive work situation that is less demanding than his or her former position. The rate of pay exceeds the minimum wage but is about half of the taxpayer's rate of pay in the former position. It is immaterial that the new work activity is less demanding or less gainful than the work in which the taxpayer was engaged before his or her retirement on disability. Since the taxpayer regularly performs duties in a full-time, competitive work situation at a rate of pay at or above the minimum wage, he or she is able to engage in substantial gainful activity.

*Example (5).* A taxpayer who retired on disability from employment as a bookkeeper drives trucks for a charitable organization at the taxpayer's convenience. The taxpayer receives no compensation, but duties of this

nature generally are performed for remuneration or profit. Some weeks the taxpayer works 10 hours, some weeks 40 hours, and over the year the taxpayer works an average of 20 hours per week. Even though the taxpayer receives no compensation, works part-time, and at his or her convenience, the nature of the duties performed and the average number of hours worked per week conclusively establish the taxpayer's ability to engage in substantial gainful activity.

*Example (6).* A taxpayer who retired on disability was instructed by a doctor that uninterrupted bedrest was vital to the treatment of his or her disability. However, because of financial need, the taxpayer secured new employment in a sedentary job. After attempting the new employment for approximately two months, the taxpayer was physically unable to continue the employment. The fact that the taxpayer attempted to work and did, in fact, work for two months, does not, of itself, conclusively establish the taxpayer's ability to engage in substantial gainful activity.

*Example (7).* A taxpayer who retired on disability accepted employment with a former employer on a trial basis. The purpose of the employment was to determine whether the taxpayer was employable. The trial period continued for an extended period of time and the taxpayer was paid at a rate equal to the minimum wage. However, because of the taxpayer's disability only light duties of a nonproductive make-work nature were assigned. Unless the activity is both substantial and gainful, the taxpayer is not engaged in substantial gainful activity. The activity was gainful because the taxpayer was paid at a rate at or above the minimum wage. However, the activity was not substantial because the duties were of a nonproductive, make-work nature. Accordingly, these facts do not, of themselves, establish the taxpayer's ability to engage in substantial gainful activity.

*Example (8).* A taxpayer who retired on disability from employment as a bookkeeper lives with a relative who manages several motel units. The taxpayer assisted the relative for one or two hours a day by performing duties such as washing dishes, answering phones, registering guests, and bookkeeping. The taxpayer can select the times during the day when he or she feels most fit to perform the tasks undertaken. Work of this nature, performed off and on during the day at the taxpayer's convenience, is not activity of a ''substantial and gainful'' nature even if the individual is paid for the work. The performance of these duties does not, of itself, show that the taxpayer is able to engage in substantial gainful activity.

*Example (9).* A taxpayer who retired on disability because of a physical or mental impairment accepts sheltered employment in a protected environment under an institutional program. Sheltered employment is offered in sheltered workshops, hospitals and similar institutions, homebound programs, and Veterans Administration domiciliaries. Typically, earnings are lower in sheltered employment than in commercial employment. Consequently, impaired workers normally do not seek sheltered employment if other employment is available. The acceptance of sheltered employment by an impaired taxpayer does not necessarily establish his or her ability to engage in substantial gainful activity.

(Secs. 105(d) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1566; 68A Stat. 917; 26 U.S.C. 105(d); 7805))

[T.D. 7544, 43 FR 19656, May 8, 1978]

### § 7.367(b)–1 Other transfers.

(a) [Reserved] For guidance relating to transfers occurring on or after July 20, 1998, see § 1.367(b)–1(a) of this chapter.

(b) *General rule.* If section 367(b) applies to an exchange, a foreign corporation shall be considered to be a corporation in respect of that exchange except to the extent otherwise provided in this section and in §§ 7.367(b)–4 through 7.367(b)–12. Unless otherwise provided, if a taxpayer fails to comply with §§ 7.367(b)–1 through 7.367(b)–12, the Commissioner shall make a determination whether a foreign corporation will be considered to be a corporation based on all the facts and circumstances surrounding failure to comply. In making this determination the Commissioner may conclude that:

(1) A foreign corporation will be considered to be a corporation despite the failure to comply;

(2) A foreign corporation will be considered to be a corporation provided that the conditions imposed under §§ 7.367(b)–4 through 7.367(b)–12 are fulfilled; or

(3) A foreign corporation will not be considered to be a corporation only for purposes of determining the extent to which gain shall be recognized on such exchange but that any gain recognized by reason of the Commissioner's determination to disregard the corporate status of a foreign corporation will be taken into account for purposes of applying the provisions of section 334, 358 or 362.

See, §§ 7.367(b)–5(b), 7.367(b)–6(c), 7.367(b)–7(c)(2), and 7.367(b)–10(j) for specific provisions which override the provisions of paragraph (b)(3) of this section.

(c)(1) [Reserved] For guidance relating to transfers occurring on or after July 20, 1998, see § 1.367(b)–1(c) of this chapter.

(2) *Information required.* The notice shall contain:

(i) A statement that the exchange is one to which section 367(b) applies;

(ii) A complete description of the exchange;

(iii) A description of any stock or securities received in the exchange;

(iv) A statement which describes any amount required, under §§ 7.367(b)–4 through 7.367(b)–12 to be included in gross income or added to the earnings and profits or deficit of an exchanging foreign corporation for the person's taxable year in which the exchange occurs;

(v) A statement which describes any amount of earnings and profits attributed by reason of the exchange under §§ 7.367(b)–4 through 7.367(b)–12, to stock owned by any United States person;

(vi) Any information which is or would be required to be furnished with a Federal income tax return pursuant to regulations under sections 332, 351, 354, 355, 356, 361, or 368 (whether or not a Federal income tax return is required to be filed) if such information has not otherwise been provided;

(vii) Any information required to be furnished under section 6038 or 6046 if such information has not otherwise been provided; and

(viii) If applicable, a statement that the taxpayer is making the election permitted under paragraph (d) of § 7.367(b)–3 relating to earnings and profits of a less developed country corporation.

(ix) If applicable, a statement that all relevant shareholders are making the election provided in paragraph (c)(1)(iii) of § 7.367(b)–7, in paragraph (f) of § 7.367(b)–9, in paragraph (i)(3)(ii)(C) of § 7.367(b)–10, or in paragraph (f) of § 7.367(b)–10 in order to obtain the increase in basis of stock provided in paragraph (c)(1)(iii) of § 7.367(b)–7, paragraph (i)(3)(ii)(C) of § 7.367(b)–10, paragraph (e)(1) of § 7.367(b)–9, or paragraph (e) of § 7.367(b)–10.

(3) *Failure to provide notice.* If a person required to give notice under pagraph (c)(1) of this section fails to provide, in a timely manner, information sufficent to apprise the Commissioner of the occurrence and nature of an exchange to which section 367(b) applies, the taxpayer will be considered to have failed to comply with the provisions of §§ 7.367(b)–1 through 7.367(b)–12 only if the taxpayer fails to establish reasonable cause for the failure.

(d) *Records to be kept*—(1) *Adjustments to earnings and profits.* Any corporation whose earnings and profits are required to be adjusted under §§ 7.367(b)–4 through 7.367(b)–12 must keep records adequate to establish the adjustment.

(2) *Amounts attributed to stock.* If, under §§ 7.367(b)–4 through 7.367(b)–12, an amount is attributable to stock in a foreign corporation which is owned by a United States person, that person must keep records to establish the amount so attributed. If the person fails to maintain such records, and an inclusion in gross income of such amount is required by reason of section 1248 or §§ 7.367(b)–4 through 7.367(b)–12, the district director shall make a reasonable determination of the amount attributed.

(e) *Close of taxable year in certain section 368(a)(1)(F) reorganizations.* If a foreign corporation is the transferor corporation in a reorganization described in section 368(a)(1)(F) after March 30, 1987, in which the acquiring corporation is a domestic corporation, then the taxable year of the transferor corporation shall end with the close of the date of the transfer and the taxable year of the acquiring corporation shall end with the close of the date on which the transferor's taxable year would have ended but for the occurrence of the transfer. If a foreign corporation, with effectively connected earnings and profits or non-previously taxed accumulated effectively connected earnings and profits (as defined in the regulations under section 884), is the transferor corporation in a reorganization described in section 368(a)(1)(F) in a taxable year beginning after February 15, 1990 (or in a taxable year beginning

after December 31, 1986, and on or before February 15, 1990 to which the transferor corporation chooses to apply this rule), in which the acquiring corporation is a foreign corporation, then the taxable year of the transferor corporation shall end with the close of the date of the transfer and the taxable year of the acquiring corporation shall end with the close of the date on which the transferor's taxable year would have ended but for the occurrence of the transfer. With regard to the consequences of the closing of the taxable year, see section 381 and the regulations thereunder.

(f) *Exchanges under sections 354(a) and 361(a) in certain section 368(a)(1)(F) reorganizations.* In every reorganization under section 368(a)(1)(F), where the transferor corporation is a foreign corporation, there is considered to exist—

(1) A transfer of assets by the transferor corporation to the acquiring corporation under section 361(a) in exchange for stock of the acquiring corporation and the assumption by the acquiring corporation of the transferor corporation's liabilities;

(2) A distribution of the stock (or stock and securities) of the acquiring corporation by the transferor corporation to the shareholders (or shareholders and security holders) of the transferor corporation; and

(3) An exchange by the transferor corporation's shareholders (or shareholders and security holders) of the stock (or stock and securities) of the transferor corporation for stock (or stock and securities) of the acquiring corporation under section 354(a).

For this purpose, it shall be immaterial that the applicable foreign or domestic law treats the acquiring corporation as a continuance of the transferor corporation.

[T.D. 7530, 42 FR 65157, Dec. 30, 1977, as amended by T.D. 8087, 51 FR 17960, May 16, 1986; T.D. 8280, 55 FR 1417, Jan. 16, 1990; T.D. 8770, 63 FR 33570, June 19, 1998]

### § 7.367(b)–2 Definitions.

(a) *Controlled foreign corporation.* The term ''controlled foreign corporation'' means a controlled foreign corporations as defined in section 957 and the regulations thereunder.

(b) *United States shareholder.* The term ''United States shareholder'' means any United States person who satisfies the ownership requirements of section 1248(a)(2) or of section 1248(c)(2) with respect to a foreign corporation.

(c) *Section 1246 amount.* In the case of an exchange of stock in a foreign investment company (as defined in section 1246(b)) to which section 367(b) applies, the term ''section 1246 amount'', means the earning and profits, if any, of the foreign investment company, which would have been attributable under section 1246 and the regulations thereunder to the stock exchanged if the stock had been sold in a transaction to which section 1246 applied.

(d) *Section 1248 amount.* See § 1.367 (b)–2 (d) of this chapter.

(e) *Section 1248(c)(2) amount.* In the case of an exchange of stock in a lower-tier foreign corporation to which section 367(b) applies and which is made by another foreign corporation, the term ''section 1248(c)(2) amount'' means the earnings and profits or deficit in earnings and profits which would have been attributable under section 1248(c)(2) and the regulations thereunder to the stock of the foreign corporation exchanged (including stock in other lower-tier corporations owned by reason of ownership of the stock exchanged). The determination shall be made as if stock in any first-tier corporation by reason of the ownership of which the United States shareholder owns the stock exchanged had been sold in a transaction to which section 1248(a) applied.

(f) *All earnings and profits amount.* See § 1.367e(b)–2(f) of this chapter.

(g) *Additional earnings and profits amount.* The term ''additional earnings and profits amount'' means the earnings and profits or deficit in earnings and profits for taxable years beginning before Janurary 1, 1963, which are attributable under the principles of section 1248 and the regulations thereunder to the stock of the foreign corporation exchanged. The determination shall be made by applying section 1248 as modified by §§ 7.367(b)–2 through 7.367(b)–12 as if there were no distinction in those sections between earnings and profits accumulated before of after December 31, 1962.

(h) *All earnings and profits amount or additional earnings and profits amount.* In computing an ''all earnings and profits amount'' or ''additional earnings and profits amount'' under the principles of section 1248, if the stock exchanged is:

(1) Stock in a first-tier corporation, then section 1248(c)(2) (inclusion of earnings and profits of subsidiaries) does not apply.

(2) Stock in a lower-tier corporation, then section 1248(c)(2) shall be applied to determine the earnings and profits of that lower-tier corporation which are attributable to the stock exchanged but that section shall not be applied with respect to any other lower-tier corporations.

(i) *Inclusion of earnings and profits described in section 1248(d).* For purposes of computing any of the amounts defined in paragraphs (d) through (g) of this section, the exclusions from earnings and profits provided for under section 1248(d) shall not apply. See, however, paragraph (c) of §7.367(b)–3 (relating to amounts retaining character as exclusions under section 1248(d)).

(j) *Corporations organized under laws of Puerto Rico or United States possessions corporations.* For purposes of computing the amounts defined in paragraphs (f) and (g) of this section, if, for a taxable year, a corporation organized in or under the laws of the Commonwealth of Puerto Rico or a possessions of the United States meets the requirements of section 957(c) (or would have met such requirement if the Revenue Act of 1962 had been in effect) then:

(1) Earnings and profits accumulated by the corporations during such a taxable year which begins before January 1, 1978, are not required to be taken into account, and

(2) Earnings and profits accumulated by the corporation during such a taxable year which begins after December 31, 1977, are required to be taken into account only to the extent such earnings would not qualify for the credit of section 936(a) had the corporation been a domestic corporation which met the requirements of section 936(a)(1) and which had elected the credit under that section.

A corporation which, during its first taxable year beginning after December 31, 1962, meets the requirements of section 957(c) will be considered to have met such requirements during taxable years beginning prior to January 1, 1963.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65158, Dec. 30, 1977, as amended by T.D. 8243, 54 FR 9201, Mar. 6, 1989, T.D. 8397, 57 FR 6556, Feb. 26, 1992]

### §7.367(b)–3 Special rules.

(a) *Character of section 1246 amount.* If, under §7.367(b)–6, an amount attributable to stock in a foreign investment company (as defined in section 1246(b)) is required to be taken into gross income of its shareholders, such earnings and profits will be included in income as—

(1) Gain from the sale of an asset which is not a capital asset to the extent attributable to earnings and profits accumulated in taxable years beginning after December 31, 1962; and

(2) A dividend deemed paid in money to the extent attrubutable to earnings and profits accumulated in taxable years beginning before January 1, 1963, and required to be included as part of the ''all earnings and profits amount''.

(b) *Character of amounts computed under the principles of section 1248.* If, under §7.367(b)–5 or §§7.367(b)–7 through 7.367(b)–12, any amount is required to be included in the gross income of a United States person, that amount shall be considered to have been distributed as a dividend paid in money immediately prior to the exchange and taxable under section 301 as a dividend formally declared in the same amount.

(c) *Amounts retaining character as exclusions under section 1248(d).* (1) Amounts described in paragraphs (d) through (g) of §7.367(b)–2 which must be included in gross income of a United States person shall be reduced—

(i) In all cases, by earnings and profits retaining their character as exclusions under section 1248(d) (1), (2), (4), and (5), and

(ii) If the inclusion in gross income is required by a provision other than paragraph (b) of §7.367(b)–5, paragraph (c)(2) of §7.367(b)–7, or paragraph (j) of §7.367(b)–10, by earnings and profits retaining their character as exclusions

under section 1248(d)(3). See, however, paragraph (d) of this section.

(2) Amounts described in paragraph (e) or (g) of § 7.367(b)–2 which must be added to the earnings and profits or deficit of an exchanging foreign corporation shall not be reduced by earnings and profits retaining their character as exclusions under section 1248(d).

(d) *Less developed country corporation election.* This paragraph applies to all earnings and profits of a character described in section 1248(d)(3). Any such earnings and profits which are required to be included in gross income of a domestic corporate shareholder as part of an all earnings and profits amount may, at the election of such taxpayer, be taxed as gain from the sale of a capital asset. Such election shall be made in the notice required under paragraph (c) of § 7.367(b)–1. A corporation which during its first taxable year beginning after December 31, 1962, meets the requirements of section 902(d), as in effect before the enactment of the Tax Reduction Act of 1975, will be considered to have met such requirements during taxable years beginning prior to January 1, 1963.

(e) *Character of certain earnings and profits.* Earnings and profits or a deficit in earnings and profits to which a corporation succeeds under section 381(a)(1) or amounts which are attributed to stock under §§ 7.367(b)–9, 7.367(b)–10, and 7.367(b)–12 shall retain their character. Earnings and profits or deficits shall be considered as if accumulated or incurred by the corporation which succeeds to such earnings and profits or deficits.

This paragraph applies for all purposes, including but not limited to sections 901 to 908, 959, 960, 1248, and §§ 7.367(b)–1 through 7.367(b)–12.

(f) *Foreign tax credit.* If an amount of earnings and profits of a foreign corporation which is considered to have been distributed as a dividend is included in gross income of a United States person, the foreign tax credit provisions (sections 78, and 901 through 908) shall apply as if such earnings and profits were actually distributed by a foreign corporation as a dividend.

(g) *Treatment of section 1248 amounts and section 1248(c)(2) amounts where attribution is not made.* (1) The portion of the section 1248 amount included in gross income of a United States person which is attributable to each particular foreign corporation shall be determined as follows. First, the total gross earnings and profits (determined without regared to any deficit) attributable to each particular corporation shall be determined as if it were the only corporation included in the section 1248 amount. In situations to which § 7.367(b)–10 applies, the determination shall be made without regard to the allocation under paragraph (d) of that section. Next, that amount shall be multiplied by the amount included in gross income. Finally, the product shall be divided by the section 1248 amount. The result will be the amount of earnings and profits from that particular corporation which are included in gross income.

(2) The section 1248 amount included in gross income by a United States person which is attributable to the earnings and profits of a foreign corporation shall be considered as if distributed directly to the United States person by the foreign corporation. A section 1248(c)(2) amount which is added to the earnings and profits or deficit of an exchanging foreign corporation shall be considered as if accumulated or incurred directly by the exchanging foreign corporation.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65158, Dec. 30, 1977]

### § 7.367(b)–4 Certain exchanges described in more than one Code provision.

(a) and (b) [Reserved]. For guidance relating to transfers occurring on or after July 20, 1998, see § 1.367(b)–4(a) and (b) of this chapter.

(c) *Precedence of section 1036 over section 354.* If an exchange of stock in a foreign corporation pursuant to a reorganization is described both in sections 354 and 1036, the exchange will be considered to be described in section 1036, unless the stock surrendered is stock to which an amount h as been attributed under §§ 7.367(b)–5 through 7.367(b)–12. In that event, the provisions of

these regulations shall apply to the attributed amounts as if section 1036 did not apply to the subsequent exchange.

(d) *Special definition of reorganization described in section 368(a)(1)(F).* For purposes of section 367(b) and §§ 7.367(b)–1 through 7.367(b)–12, a reorganization will be considered to be described in section 368(a)(1)(F) only if it involves a mere change in identity, form, or place of organization, however effected, of a single corporate entity.

[T.D. 7530, 42 FR 65159, Dec. 30, 1977, as amended by T.D. 7863, 47 FR 57490, Dec. 27, 1982; T.D. 8087, 51 FR 17961, May 16, 1986; T.D. 8770, 63 FR 33570, June 19, 1998]

### § 7.367(b)–5 Complete liquidation of foreign subsidiary.

(a) *Scope.* This section applies to an exchange described in section 332 which involves receipt of a distribution in complete liquidation of a foreign corporation.

(b) *Receipt of distribution by a domestic corporation.* If a domestic corporation which receives a distribution in complete liquidation of a foreign corporation includes in its gross income the all earnings and profits amount attributable to its stock in the distributor foreign corporation, the foreign corporation will be considered to be a corporation for purposes of applying Subchapter C of Chapter I of Subtitle A of the Code. The domestic corporation must include the all earnings and profits amount in gross income for the taxable year in which occurs the date of distribution (within the meaning of section 381(b)(2) and the regulations thereunder). If the domestic corporation does not include this amount in gross income, for the purpose of determining the extent to which gain is recognized on the exchange, the foreign corporation will not be considered to be a corporation. However, the provisions of the Code other than section 332 shall apply as if the foreign corporation were considered a corporation. For example, sections 334(b)(1) and 381(a)(1) shall apply where applicable.

(c) *Receipt of distribution by a foreign corporation.* If a foreign corporation receives a distribution in complete liquidation of another foreign corporation, a foreign corporation will be treated as a corporation for purposes of section 332 and other applicable sections such as section 381.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65159, Dec. 30, 1977]

### § 7.367(b)–6 Exchange of stock in a foreign investment company.

(a) *Scope.* This section applies to an exchange of stock in a foreign investment company (as defined in section 1246(b)) if:

(1) The exchange is described in section 354 or 356 pursuant to any reorganization described in subparagraph (B), (C), (D), or (F) of section 368(a)(1) and in section 368(a)(2)(F) (if applicable), and

(2) Stock in a domestic corporation is received pursuant to the exchange. In the case of an exchange to which stock in a foreign corporation is received see section 1246(c).

(b) *General rule.* Except as provided in paragraph (c) of this section, a taxpayer who makes an exchange to which this section applies shall include in gross income for its taxable year in which the exchange occurs the section 1246 amount attributable to the stock in the foreign investment company which was exchanged to the extent of the excess of the fair market value of such stock over its adjusted bases.

(c) *Exchange pursuant to certain asset acquisitions.* (1) If the exchange to which this section applies is made pursuant to a reorganization described in section 368(a)(1) (C), (D), or (F) involving the acquisition of assets of a foreign investment company (the ''acquired corporation'') by a domestic corporation, and the exchanging taxpayer is a domestic corporation, such taxpayer shall include in gross income for its taxable year in which the exhange occurs the all earnings and profits amount with respect to that stock computed in accordance with the principles of section 1246.

(2) If the domestic corporation does not include the amount referred to in paragraph (c)(1) of this section in gross income, for the purpose of determining the extent to which gain is recognized on the exchange, the foreign corporation will not be considered to be a corporation. However, the provisions of the Code other than section 354 or 356

shall apply as if the foreign corporation were considered a corporation. For example, sections 358, 362, and 381 (if applicable) shall apply as if no gain had been recognized.

(d) *Adjustment to basis.* Any amount included in gross income under paragraph (b) or (c)(1) of this section which is characterized as gain from the sale of an asset which is not a capital asset shall be treated as gain recognized for purposes of applying sections 358 and 362.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65159, Dec. 30, 1977]

### § 7.367(b)–7 Exchange of stock described in section 354.

(a) [Reserved] For guidance relating to transfers occurring on or after July 20, 1998, see § 1.367(b)–7(a) of this chapter.

(b) *Receipt of stock in a controlled foreign corporation.* If an exchanging shareholder receives stock of a controlled foreign corporation in an exchange to which this section applies (other than in an exchange pursuant to a reorganization described in section 368(a)(1) (E) or (F)), § 7.367(b)–9 applies if, with respect to such corporation, immediately after the exchange—

(1) The exchanging shareholder is a United States shareholder of that controlled foreign corporation, or

(2) All United States shareholders of the exchanging foreign corporate shareholder are United States shareholders of that controlled foreign corporation.

(c) *Receipt of other stock*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, if an exchanging shareholder receives stock of a domestic corporation, or stock of a foreign corporation which is not a controlled foreign corporation, or stock of a controlled foreign corporation as to which the exchanging United States shareholder or any United States shareholder of the exchanging foreign corporation is not a United States shareholder, then—

(i) An exchanging United States shareholder shall include in gross income the section 1248 amount attributable to the stock exchanged, to the extent that the fair market value of the stock exchanged exceeds its adjusted basis, or

(ii) See § 1.367 (b)–7 (c)(1)(ii) of this chapter.

(iii) See § 1.367 (b)–7 (c)(1)(iii) of this chapter.

(iv) In situations to which paragraph (c)(1)(ii) of this section applies, the basis of the stock received by the exchanging shareholder shall be increased by the earnings and profits added to the earnings and profits of the exchanging foreign corporation under paragraph (c)(1)(ii) of this section. Correspondingly, the basis of such exchanging shareholder shall be decreased by any deficits added to deficits of the exchanging foreign corporation under paragraph (c)(1)(ii) of this section. Any increase in basis attributable to earnings and profits included in the section 1248(c)(2) amount referred to in paragraph (c)(1)(ii) of this section shall be made only if all United States shareholders of the exchanging corporation consent to treat amounts added to the earnings and profits of the exchanging foreign corporation as a dividend. Such consent shall be given in the notice required by paragraph (c) of § 7.367(b)–1. See paragraph (f)(1) of § 7.367(b)–9 for the effect of such election. The adjustment to basis in respect of earnings and profits or deficit accumulated or incurred in taxable years beginning before January 1, 1963, shall be taken into account only for purposes of computing an all earnings and profits amount and additional earnings and profits amount, where such amounts must be computed after an exchange of stock the basis of which has been adjusted under this paragraph (c)(1)(iii).

(2) *Exchange of stock by certain domestic corporations.* (i) A United States person shall include in gross income the all earnings and profits amount if:

(A) Pursuant to a reorganization described in section 368(a)(1) (C), (D), or (F), assets of a foreign corporation are acquired by a domestic corporation;

(B) The exchanging United States person is a domestic corporation; and

(C) Such United States person receives stock of a domestic corporation in exchange for its stock in the acquired corporation.

(ii) If the domestic corporation does not include this amount in gross income, for the purpose of determining the extent to which gain is recognized on the exchange, the foreign corporation will not be considered to be a corporation. However, the applicable provisions of the Code other than section 354 or 356 shall apply as if the foreign corporation were considered a corporation. For example, sections 358, 362, and 381, if applicable, shall apply as if no gain had been recognized.

[T.D. 7530, 42 FR 65160, Dec. 30, 1977, as amended by T.D. 8243, 54 FR 9202, Mar. 6, 1989, T.D. 8397, 57 FR 6556, Feb. 26, 1992; T.D. 8770, 63 FR 33570, June 19, 1998]

### §7.367(b)–8 Transfer of assets by a foreign corporation in an exchange described in section 351.

(a) *Scope.* This section applies to a transfer of property pursuant to an exchange described in section 351, regardless of whether the transfer is also described in section 361, if:

(1) The transferor of property is a foreign corporation; and

(2) In the case of a transfer also described in section 361, the transferor remains in existence immediately after the transaction.

(b) *Section 381 inapplicable.* If this section applies to a transfer described in section 361, section 381(a)(2) shall not apply with respect to items described in section 381(c)(2).

(c) *Transfer of stock in controlled foreign corporation.* If the transferor corporation transfers stock in a foreign corporation of which there is a United States shareholder immediately before the exchange, and the transferor receives stock—

(1) Of a controlled foreign corporation as to which all United States shareholders of the transferor corporation remain United States shareholders, §7.367(b)–9 shall apply.

(2) See §1.367(b)–8(c)(2) of this chapter.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65160, Dec. 30, 1977, as amended by T.D. 8397, 57 FR 6556, Feb. 26, 1992]

### §7.367(b)–9 Attribution of earnings and profits on an exchange described in section 351, 354, or 356.

(a) *Scope.* This section applies to a transaction involving an exchange of stock in a foreign corporation to which paragraph (b) of §7.367(b)–7 or paragraph (c)(1) of §7.367(b)–8 applies.

(b) *General rule.* Upon an exchange of stock to which this section applies:

(1) The section 1248 amount, the section 1248(c)(2) amount, the all earnings and profits amount and the additional earnings and profits amount shall be computed with respect to each United States shareholder and to each foreign corporation as to which there is a United States shareholder who exchanges stock in the transaction. The amounts so computed shall be attributed to the stock received by each exchanging shareholder in the exchange in accordance with the principles of §§1.1248–2 and 1.1248–3. For the effect of attribution, see §7.367(b)–12.

(2) Earnings and profits or deficit of the corporation whose stock is received in the exchange shall be increased as provided in paragraph (c) of this section.

(3) Earnings and profits or deficit of the corporation whose stock is exchanged and of any lower-tier corporations whose earnings and profits would be taken into account under section 1248(c)(2) shall be reduced as provided in paragraph (d) of this section.

(4) See §1.367(b)–9(b)(4) of this chapter.

(c) *Earnings and profits or deficits of the corporation whose stock is received.* (1) Earnings and profits or deficit of the corporation whose stock is received in the exchange shall be increased by the earnings and profits or deficit to which it would succeed if:

(i) That corporation were the acquiring corporation, within the meaning of paragraph (b)(2) of §1.381(a)–1, in a transaction to which section 381 applies (whether or not section 381 applies or that corporation would be considered the acquiring corporation); and

(ii) The corporation whose stock is exchanged, and each lower-tier corporation whose earnings and profits would be taken into account in calculating a section 1248 or section 1248(c)(2) amount, were a transferor

corporation for purposes of section 381(a)(2).

A corporation which actually is the acquiring corporation in a transaction to which section 381(a)(2) applies shall not succeed to an item of the transferor described in section 381(c)(2) by reason of section 381(a)(2). However, that corporation shall succeed to all other items described in section 381(c).

(2) To the extent that the corporation whose stock is received does not acquire, either directly or through other entities, all the stock of the corporation whose stock is exchanged or of any lower-tier corporation whose earnings and profits would be taken into account in calculating a section 1248(c)(2) amount, paragraph (c)(1) of this section shall apply only to the proportion of earnings and profits or deficits attributable to the stock acquired. Such proportion shall be determined as if the earnings and profits or deficits were section 1248 or section 1248(c)(2) amounts. The earnings and profits or deficit to which the corporation whose stock is received does not succeed by reason of this paragraph shall be considered entirely attributable to the stock not acquired by the corporation whode stock is received.

(d) *Earnings and profits of corporation whose stock is exchanged and of lower-tier corporation.* The earnings and profits or deficit of the corporation whose stock is exchanged and of any lower-tier corporation whose earnings and profits or deficit would be taken into account under section 1248 shall be reduced to the extent that the adjustment required under paragraph (c) of this section is attributable to earnings and profits or deficit of that corporation.

(e) *Adjustment to basis.* (1) This paragraph (e)(1) applies to increases and decreases to basis of stock in corporations which as to the corporation whose stock is exchanged are lower-tier corporations. To the extent that earnings and profits of corporations (other than the corporations whose stock is exchanged) are reduced under paragraph (d) of this section, the basis in stock of each corporation whose earnings and profits are so reduced shall, in the hands of its immediate shareholder, be increased. The increase shall equal the total reduction in earnings and profits in respect of all corporations which as to such immediate shareholder are lower-tier corporations. Correspondingly, the basis to such immediate shareholder of stock in a corporation (other than the corporation whose stock is exhanged) whose deficit is reduced shall be decreased by the total reduction in deficits in respect of the corporations which as to that shareholder are lower-tier corporations.

(2) This paragraph (e)(2) applies to increases and decreases to basis of stock in corporations which are not lower-tier corporations as to the corporation whose stock is exchanged but are lower-tier corporations of the corporation whose stock is received. In the case of a reorganization described in section 368(a)(1)(B) or of a reorganization in which the acquiring corporation, within the meaning of § 1.381(a)–1(b)(2), is a lower-tier corporation as to the corporation whose stock is received, the basis of stock shall be adjusted as provided in this paragraph (e)(2). To the extent that earnings and profits of the corporation whose stock is exchanged and of its lower-tier corporations are reduced under paragraph (d) of this section, the basis to the immediate corporate shareholder:

(i) Of stock in the corporation whose stock is exchanged, or

(ii) Of stock in a corporation (other than the corporation whose stock is received) which is the acquiring corporation of the corporation whose stock is exchanged,

shall be increased by the total reduction in earnings and profits under paragraph (d) of this section, except to the extent that the basis of such stock is determined by reference to the basis of the assets of the corporation whose stock is exchanged. The basis in such stock to each immediate corporate shareholder shall be similarly increased, and such increase shall in turn be made at each successive tier. The basis of the stock of the corporation whose stock is received, however, shall not be increased. Correspondingly, the basis of such stock to each immediate corporate shareholder, and at each successive higher tier, shall be decreased by the total reduction in deficits under

paragraph (d) of this section, except to the extent that the basis of such stock is determined by reference to the basis of the assets of the corporation whose stock is exchanged.

(3) Any adjustment to basis in respect of earnings and profits or deficit accumulated or incurred in taxable years beginning before January 1, 1963, shall be taken into account only for purposes of computing all the earnings and profits and additional earnings and profits amounts.

(f) *Election as condition of increase in basis with respect to post-1962 earnings and profits.* (1) An increase in basis under paragraph (e)(1) of this section attributable to earnings and profits for taxable years beginning after December 31, 1962, shall be made only if all United States shareholders of the corporation whose corporation whose stock is exchanged make a consent dividend election in the notice required by paragraph (c) of §7.367(b)–1. If such consent is made, the portion of such earnings and profits attributable to each particular corporation shall be treated as if, immediately prior to the reorganization, it had been distributed as a dividend through any intervening corporations to the corporation whose stock is exchanged.

(2) An increase in basis under paragraph (e)(2) of this section attributable to earnings and profits for taxable years beginning after December 31, 1962, shall be made only if:

(i) An election has been made under paragraph (f)(1) of this section, and

(ii) All United States shareholders of the corporation whose stock is received make a consent dividend election as provided in section 565 for the taxable year in which the reorganization occurs.

If such consent is made, such earnings and profits attributable to the corporation whose stock is exchanged and of its lower-tier corporations whose earnings and profits were reduced under paragraph (d) of this section shall be treated as if immediately after the reorganization, it had been distributed as a dividend through any intervening corporations to the corporation whose stock is received.

(3) See sections 553, 951 and 959 as to the possible effect of an election under this section.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65160, Dec. 30, 1977, as amended by T.D. 8243, 53 FR 9202, Mar. 6, 1989, T.D. 8397, 57 FR 6556, Feb. 26, 1992]

### §7.367(b)–10 Distribution of stock described in section 355.

(a) *Scope.* This section provides rules relating to a distribution described in section 355 to which section 367(b) applies. For purposes of this section, the terms ''distributing corporation'' and ''controlled corporation'' have the meaning of those terms as used in section 355.

(b) *Distribution by a domestic corporation.* If a domestic corporation distributes stock in a controlled corporation which is a controlled foreign corporation as to which the distributing corporation is a United States shareholder, section 1248(f) applies to such distribution. After earnings and profits attributable to the stock have been determined under section 1248(f), paragraphs (d) through (f) of this section apply. With respect to subsequent transactions involving the distributing group, the allocation described in paragraph (d) of this section shall not increase or decrease the amounts described in paragraphs (d) through (g) of §7.367(b)–2.

(c) *Distribution of stock by a foreign corporation.* If a foreign corporation having a United States shareholder distributes stock in another corporation, paragraphs (d) through (j) of this section apply.

(d) *Allocation of earnings and profits.* Earnings and profits or deficit accumulated or incurred by the distributing corporation, the controlled corporation (or corporations), and by corporations which directly or indirectly are controlled by either, shall be allocated among those corporations immediately after the distribution. For purposes of making this allocation:

(1) Section 1.312–10 shall not apply.

(2) The sum of the earnings and profits accumulated prior to the distribution by each corporation shall be determined.

(3) The sum of the deficits in earnings and profits incurred prior to the distribution by each corporation shall be determined.

(4) The total gross earnings and profits and deficits shall be allocated between the distributing corporation and any corporations controlled by it after the distribution (the ''distributing group'') and the controlled corporation (or corporations) and any corporations controlled by them after the distribution (the ''controlled group''). Such allocation shall be made in accordance with the net fair market value of the assets of each group. In determining the fair market value of the assets of a group, the fair market value of stock in a corporation controlled by another corporation in a group shall not be taken into account.

(5) For purposes of allocating earnings and profit or deficits to either the distributing group or the controlled group:

(i) Earnings and profits or deficit of only the distributing corporation or of the controlled corporation shall be increased;

(ii) No allocation shall be made from one member to another member of the same group;

(iii) The earnings and profits allocated from a particular corporation shall be the proportion of total earnings and profits allocated from its group to the other group which earnings and profits of that particular corporation prior to the allocation bears to the total gross earnings and profits of all corporations in that group having earnings and profits prior to the allocation; and

(iv) The deficit in earnings and profits allocated from a particular corporation shall be the proportion of the total deficits allocated from its group to the other group which the deficit of that particular corporation prior to the allocation bears to the total gross deficit of all corporations in that group having deficits prior to the allocation.

(6) To the extent that there is not distributed all the stock of the controlled corporation, or of any lower-tier corporation of the controlled corporation whose earnings and profits would be taken into acccount in calculating a section 1248(c)(2) amount, paragraph (d) (1) through (5) of this section shall apply only to the proportion of the earnings and profits or deficits attributable to the stock distributed. Such proportion shall be determined as if the earnings and profits were section 1248 or section 1248(c)(2) amounts. The earnings and profits or deficits not allocated by reason of this paragraph shall be considered entirely attributable to the stock not distributed.

(e) *Adjustment to basis.* (1) Except as provided in paragraph (f) of this section, to the extent earnings and profits are allocated from a corporation other than the distributing or controlled corporations, the basis of the stock of that corporation in the hands of its immediate shareholder shall be increased by the amount of earnings and profits allocated from it and from members of the group which as to that corporation are lower-tier corporations. Correspondingly, to the extent deficits are allocated from a corporation other than the distributing or controlled corporation, the basis of the stock of that corporation in the hands of its immediate shareholder shall be decreased by the amount of deficit allocated from it and from members of the group which as to that corporation are lower-tier corporations.

(2) Any adjustment to basis in respect of earnings and profits or deficit accumulated or incurred in taxable years beginning before January 1, 1963, shall be taken into account only for purposes of computing the all earnings and profits and additional earnings and profits amounts.

(f) *Election as condition of increase in basis.* An increase in basis attributable to allocation of earnings and profits for taxable years beginning after December 31, 1962, of a corporation to the other group shall be made only if all United States shareholders of the group from which the allocation is made (determined after the distribution) make a consent dividend election in the notice required by paragraph (c) of § 7.367(b)–1. If such consent is made, such earnings and profits, allocated from each particular corporation shall be treated as if, immediately after the distribution, they had been distributed as a dividend through any intervening

corporations to the distributing corporation or controlled corporation as the case may be. See sections 553, 951, and 959 for the possible effect of an election under this section.

(g) *Computation of certain amounts.* Upon a distribution described in paragraph (c) of this section, the section 1248 or section 1248(c)(2) amount, the all earnings and profits amount, and the additional earnings and profits amount shall be computed with respect to each United States shareholder and to each foreign corporation as to which there is a United States shareholder. The computation shall be made with reference to stock owned by the shareholder in the distributing corporation prior to the distribution and shall be made regardless of whether the shareholder is an exchanging shareholder.

(h) *Attribution to stock owned after the distribution.* (1) The amounts described in paragraph (g) of this section shall be attributed to all stock owned after the distribution except stock owned after the distribution except stock received in the distribution and to which paragraph (i) or (j) or this section applies.

(2) Attribution of an amount shall be made to stock of a corporation in the proportion that the value of such stock bears to all stock owned after the distribution, including for this purpose stock to which paragraph (i) or (j) of this section applies and to which no attribution is made.

(3) If after the distribution the distributing foreign corporation is no longer controlled foreign corporation as to a United States shareholder, see section 1248(a)(2) with respect to stock disposed of within five years after a change in status.

(i) *Receipt of other stock.* Except as provided in paragraph (j) of this section, if an exchanging shareholder receives—

(1) Stock of a domestic corporation,

(2) Stock of a foreign corporation which is not a controlled foreign corporation, or

(3) Stock of a controlled foreign corporation as to which the exchanging United States shareholder or any United States shareholder of the exchanging foreign corporation is not a United States shareholder, then—

(i) An exchanging United States shareholder shall include in gross income the excess of—

(A) The section 1248 amount computed under paragraph (g) of this section, over

(B) The section 1248 amount attributed to stock under paragraph (h) of this section,

to the extent that the fair market value of stock in the distributing corporation owned by the shareholder prior to the distribution exceeds its adjusted basis; or

(ii) There shall be added to the earnings and profits or deficit of an exchanging foreign corporation the excess of;

(A) The section 1248(c)(2) amount computed under paragraph (g) of this section, over

(B) The section 1248(c)(2) amount attributed to stock under paragraph (h) of this section. The amount added shall not be considered a dividend.

(C) In situations to which subdivision (B) of this subparagraph applies, the basis adjustment and election rules of § 7.367(b)–7(c)(1)(iii) shall apply.

(j) *Receipt of stock by certain domestic corporations.* A United States person shall include in its gross income the excess of the all earnings and profits amount computed under paragraph (g) of this section over the all earnings and profits amount attributed under paragraph (h) of this section if—

(1) The distribution is made pursuant to a reorganization described in section 368(a)(1)(D) and involving the acquisition of assets of the foreign distributing corporation by a domestic corporation; and

(2) The United States person is a domestic corporation.

If the domestic corporation does not include this amount in gross income, for purposes of determining the extent to which gain is recognized on the exchange, the foreign corporation will not be considered to be a corporation. However, the applicable provisions of the Code other than section 35, 356, or 361 shall apply as if the foreign corporation were considered a corporation. For example, sections 358 and 362,

if applicable, shall apply as if no gain had been recognized.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65161, Dec. 30, 1977]

### § 7.367(b)–11 Deficit in earnings and profits.

(a) *Scope.* This section provides rules relating to the manner in which a deficit in earnings and profits of a corporation may be used after certain exchanges to which section 367(b) applies.

(b) *Limitation on deficits allocated to a corporation.* Any deficit in earnings and profits incurred prior to the distribution which are allocated to a corporation under paragraph (c) of § 7.367(b)–9 or allocated under paragraph (d) of § 7.367(b)–10 shall be used only in the manner prescribed under section 381(c)(2)(B) and the regulations thereunder.

(c) *Deficit in earnings and profits.* If section 382 would apply to a net operating loss of a corporation in respect of a transaction to which section 367(b) applies, the percentage reduction provided in section 382 with respect to net operating losses shall reduce a deficit in earnings and profits allocated to that corporation.

(d) *Computation of allocated amounts.* If paragraph (c) of this section applies, a deficit attributed to stock under §§ 7.367(b)–5 through 7.367(b)–11 shall be adjusted in accordance with the rule of paragraph (b).

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65162, Dec. 30, 1977]

### § 7.367(b)–12 Subsequent treatment of amounts attributed or included in income.

(a) *Application.* This section applies to distributions with respect to, or a disposition of, stock—

(1) To which an amount has been attributed pursuant to § 7.367(b)–9, or § 7.367(b)–10; or

(2) In respect of which an amount has been included in income or added to earnings and profits pursuant to § 7.367(b)–7 or § 7.367(b)–10.

(b) *Successor in interest.* A subsequent United States shareholder of stock to which this section applies—

(1) Whose holding period is considered to include the period during which such stock was held by the prior United States shareholder, and

(2) Who acquired the stock other than by means of a transfer to which §§ 7.367(b)–1 through 7.367(b)–12 apply,

shall be considered to be the ''successor in interest'' to the prior United States shareholder. The successor in interest will succeed to the earnings and profits or deficit which the regulations under section 367(b) attribute to the stock in the hands of the prior United States shareholder.

(c) *Distributions after attribution.* Distributions with respect to stock made after an amount has been attributed to the stock under § 7.367(b)–9 or § 7.367(b)–10 shall be considered to be made in accordance with the following rules:

(1) Distributions shall be considered to be made first out of earnings and profits accumulated since the attribution.

(2) To the extent that as of the close of a taxable year distributions have exceeded earnings and profits accumulated since the attribution, excess distributions during that years shall be considered to be made out of earnings and profits previously attributed to the stock (but will not increase a deficit attributed to the stock). Solely for this purpose, amounts which would have been attributed to stock under § 7.367(b)–9 or § 7.367(b)–10 had such stock been owned by a United States shareholder or by an exchanging foreign corporation as to which there is a United States shareholder shall be attributed to such stock.

(3) Distributed earnings and profits considered under paragraph (c)(2) of this section to be made out of attributed amounts shall be considered as if distributed from each of the corporations from which amounts have been attributed, in the proportion that amounts attributed from that corporation bear to amounts attributed from all corporations from which amounts have been attributed. Such amounts shall retain their character for all purposes, including sections 901 through 908 and 959.

(4) When all earnings and profits attributed have been distributed, the distributions shall be considered to have

been made from earnings and profits accumulated by the distributing corporation, whether before or after the attribution.

(d) *Distributions after an inclusion in income or addition to earnings and profits.* Amounts included in gross income of a United States person pursuant to §7.367(b)–7 or §7.367(b)–10 shall be treated for purposes of this section in the same manner as amounts previously included in income under section 951. Thus—

(1) Subsequent distributions of amounts which would but for this section be treated as dividends shall be considered first to consist of amounts previously included in income and shall be excluded in the same manner as under section 959.

(2) In the case of an inclusion under §7.367(b)–10, this paragraph shall apply only with respect to distributions from the corporations described in paragraph (i) or (j) of that section.

(3) Amounts of which an election applies under §7.367(b)–7(c)(1)(iii) or §7.367(b)–10(i)(3)(ii)(C) shall be treated in the same manner as amounts described in paragraph (d)(1) of this section but only to the extent distributed to the exchanging foreign shareholder.

(e) *Disposition after an attribution or inclusion in income.* Upon a disposition of stock to which section 1248 or §7.367(b)–1 through §7.367(b)–12 apply, amounts described in §7.367(b)–2 (d) through (g) shall be determined in the following manner:

(1) In the case of amounts to which a corporation succeeds under section 381(a)(1), the rules of section 1248 will apply.

(2) In the case of amounts attributed under §§7.367(b)–9 and 7.367(b)–10:

(i) There shall first be determined earnings and profits or deficits attributed to the stock disposed of,

(ii) The earnings and profits described in paragraph (e)(2)(i) of this section shall be reduced (but deficits shall not be increased) by distributions referred to in paragraph (c)(2) of this section.

(iii) To the amount determined after applying paragraph (e)(2)(ii) of this section there shall be added amounts attributable to the stock without regard to the attribution; however, earnings and profits or deficits accumulated or incurred prior to the attribution shall not be taken into account.

Moreover, deficits incurred after the attribution shall not be taken into account to the extent they would occur by reason of distributions of previously attributed earnings and profits. For example, distributions described in paragraph (c)(2) of this section shall not be taken into account in computing a deficit under §1.1248–3(b)(3); and no part of any deficit attributable to distributions described in paragraph (c)(2) of this section shall be allocated to stock until after the earnings and profits previously attributed have been distributed.

(iv) Amounts to which paragraph (d)(1) or (d)(3) of this section apply shall increase the basis of stock in the same manner as under section 961, and distributions attributable to those amounts shall correspondingly decrease the basis of stock.

(v) Earnings and profits distributed out of accumulated amounts shall be considered as if distributed from each of the corporations from which earnings and profits have been attributed, in the ratio that earnings and profits attributed from that corporation bear to earnings and profits attributed from the corporations from which earnings and profits have been attributed. Such distributions shall reduce the amounts previously attributed and shall retain their character for all purposes, including sections 901 through 908 and section 959.

(vi) When all attributed amounts have been distributed, the distributions shall be considered to have been made from earnings and profits accumulated by the distributing corporation, whether before or after the distribution.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65163, Dec. 30, 1977]

### §7.367(b)–13 Examples.

The following examples illustrate the application of §§7.367(b)–1 through 7.367(b)–12, inclusive. Unless otherwise indicated, no foreign corporation in any of these examples is a person referred to in section 6012.

*Example (1).* F, F1, and F2 are foreign corporations that were organized on January 1, 1960. At all times since this date, A, a domestic corporation, has owned 100 percent of the outstanding stock in F, F has owned 100 percent of the outstanding stock in F1, and F1 has owned 100 percent of the outstanding stock in F2. A, F, F1, and F2 each uses the calendar year as its taxable year. For each taxable year since their date of organization, F, F1, and F2 each has earnings and profits of $1,000. None of these earnings and profits is of a character described in section 1248(d). On January 1, 1980, F1 is liquidated into F in an exchange to which section 332 would apply if the status of F and F1 as corporations is recognized. A complies with the reporting requirements of § 7.367(b)–1(c) (with respect to the foreign personal holding company income realized by F on the liquidation).

Under § 7.367(b)–5(c), F and F1 are considered to be corporations for purposes of section 332 and other applicable sections. Under section 381(a)(1), F succeeds to F1's $20,000 of earnings and profits. These earnings and profits are considered to have been accumulated by F and retain their character as provided in § 7.367(b)–3(e) (*e.g.*, $3,000 retains its character as pre-1963 earnings and profits). F's basis in the stock in F2 received in the liquidating distribution is determined under section 334(b)(1).

*Example (2).* After the completion of the transaction in example (1), F has earnings and profits of $2,000 for its taxable year 1980, which, when added to the $20,000 of earnings and profits previously accumulated by F and the $20,000 of earnings and profits accumulated by F1 to which F succeeded under section 381(a)(1), gives a total of $42,000. F2 has earnings and profits of $1,000 for its taxable year 1980, giving F2 a total of $21,000 of earnings and profits. A's basis in its stock in F is $25,000.

(a) On January 1, 1981, A sells all its stock in F to an unrelated person for $100,000 in a transaction to which section 1248(a) applies. A recognizes gain of $75,000 ($100,000 − $25,000) on this sale.

As provided in § 7.367(b)–12(e)(1), the rules of section 1248 apply in determining the portion of gain recognized by A that must be treated as a dividend. Under section 1248 and the regulations thereunder, the gain recognized by A must be treated as a dividend to the extent of the earnings and profits of F and F2 attributable to A's stock in F which were accumulated in taxable years beginning after December 31, 1962. The earnings and profits of F1 to which F succeeded under section 381(a)(1) by reason of the transaction in example (1) are considered to have been accumulated by F under § 7.367(b)–3(e). The earnings and profits of F1 accumulated in taxable years beginning before January 1, 1963, retain their character as pre-1963 earnings in the hands of F. Thus, the earnings and profits attributable to A's stock in F (the ''section 1248 amount'') total $54,000. This total consists of $19,000 actually accumulated during taxable years of F ($22,000 − $3,000 of pre-1963 earnings and profits), $18,000 actually accumulated during taxable years of F2 ($21,000 − $3,000 of pre-1963 earnings and profits) and $17,000 of the earnings and profits of F1 to which F succeeded under section 381(a)(1) by reason of the transaction in example (1) ($20,000 − $3,000 of pre-1963 earnings and profits). For its taxable year 1981, A must include in its gross income $54,000 as a dividend and $21,000 ($75,000 gain − $54,000) as capital gain.

(b) On January 1, 1981, instead of A selling the stock of F as in example (2)(a), F is liquidated into A in an exchange to which section 332 would apply if the status of F as a corporation is recognized. F's basis in its assets is $20,000.

The all earnings and profits amount of A with respect to F is $42,000. This amount includes $20,000 of the earnings and profits of F1 to which F succeeded under section 381(a)(1) by reason of the transaction in example (1) since, under § 7.367(b)–3(e), the $20,000 is considered as if accumulated by F. It also includes the $22,000 actually accumulated during taxable years of F. As provided in § 7.367(b)–2(f) and (h)(1), however, it does not include the $21,000 of earnings and profits of F2. A complies with the reporting requirements of § 7.367(b)–1 (c).

(i) A includes in gross income for its taxable year 1981 the all earnings and profits amount of $42,000.

The $42,000 included in income is considered to be a dividend as provided in § 7.367(b)–3(b). This amount increases the earnings and profits of A and decreases the earnings and profits of F to zero. Under § 7.367(b)–5(b), F is considered to be a corporation. A's basis in F's assets, determined under section 334(b)(1), is $20,000.

(ii) A does not include the all earnings and profits amount in gross income for its taxable year 1981.

Under § 7.367(b)–5(b), solely for the purpose of determining the extent to which gain is recognized on the exchange, F is not considered to be a corporation, and A must include in gross income $75,000 ($100,000 fair market value of assets received − $25,000 basis in the stock in F). For all other purposes, F is a corporation. Thus, section 1248 applies to A's exchange of its stock in F and $54,000 is included in A's gross income as a dividend and $21,000 is included as capital gain. See example (2)(a). A succeeds to F's earnings and profits under section 381(a)(1). Pursuant to § 7.367(b)–5(b), A's basis in F's assets is $20,000 under section 334(b)(1).

(iii) A makes a computational error in determining the all earnings and profits amount to include in gross income for its taxable year 1981. If A demonstrates that the

error was made in good faith and agrees to correct the error, the Commissioner shall conclude under § 7.367(b)–1(b)(2) that F will be considered to be a corporation for purposes of applying section 332.

(c) The facts are the same as in example (2)(b) except that F is a corporation organized under the laws of Puerto Rico, which in all relevant years has met the requirements of section 957(c) or would have met such requirements if the Revenue Act of 1962 had been in effect. Neither F1 nor F2 meets or has ever met the requirements of section 957(c). Of the $4,000 in earnings accumulated by F after December 31, 1977, $450 would not have qualified for the credit of section 936(a) had F been a domestic corporation which met the requirements of section 936(a)(1) and which had elected the credit under that section.

The all earnings and profits amount of A with respect to F is $20,450. This amount includes the $20,000 of earnings and profits to which F succeeded under section 381(a)(1) upon the liquidation of F1. See example (2)(b). This $20,000 retains its character as earnings and profits which do not meet the requirements of section 957(c). Under § 7.367(b)–2(j), the all earnings and profits amount also includes the $450 of earnings and profits accumulated by F, after December 31, 1977, which would not have qualified for the credit of section 936(a).

(i) A includes in gross income for its taxable year 1981, the all earnings and profits amount of $20,450 pursuant to the liquidation of F on January 1, 1981.

The $20,450 included in income is considered to be a dividend as provided in § 7.367(b)–3(b). This amount increases the earnings and profits of A and decreases the earnings and profits of F. A succeeds under section 381(a)(1) to the remaining $21,550 ($22,000+$20,000−$20,450) of F's earnings and profits. A's basis in F's assets, determined under section 334(b)(1), is $20,000.

(ii) A does not include the all earnings and profits amount in gross income for its taxable year 1981.

Under § 7.367(b)–5(b), solely for the purpose of determining the extent to which gain is recognized on the exchange pursuant to the liquidation of F on January 1, 1981, F is not considered to be a corporation. Thus, A must include in its gross income $75,000 ($100,000 fair market of assets received−$25,000 basis in the stock in F). Section 1248(a) does not apply because F never has been a controlled foreign corporation. See section 957(c). Thus, the entire $75,000 is capital gain. The other consequences of A's election not to include the all earnings and profits amount in gross income are the same as those illustrated in example (2)(b)(ii).

(d) The facts are the same as in example (2)(b) except that, of the $22,000 of earnings and profits actually accumulated during taxable years of F, the $16,000 accumulated in taxable years beginning before January 1, 1976, is of a character described in section 1248(d)(3).

As explained in example (2)(b), the all earnings and profits amount of A with respect to F is $42,000. This amount is not reduced by the $16,000 of earnings and profits of F which are of a character described in section 1248(d)(3). See § 7.367(b)–3(c)(1)(ii). Pursuant to the liquidation of F on January 1, 1981, A includes $42,000 in gross income as provided in § 7.367(b)–5(b). In the notice required under § 7.367(b)–1(c), A elects to treat the $16,000 of earnings and profits of a character described in section 1248(d)(3) as capital gain. See § 7.367(b)–3(d). Thus, of the $42,000, $26,000 is considered to be a dividend under § 7.367(b)–3(b), and the remaining $16,000 is considered to be capital gain.

*Example (3).* On July 1, 1980, A, a domestic corporation, purchased all the outstanding stock of F, a foreign corporation, from B, an unrelated person, for $5,000. At all times since this date, A has owned all of the outstanding stock in F. A and F each uses the calendar year as its taxable year. On January 1, 1982, F is liquidated into A pursuant to a plan of liquidation adopted on July 15, 1980, in an exchange to which section 332 would apply if the status of F as a corporation is recognized. A complies with the reporting requirements of § 7.367(b)–1(c). On the date of the liquidation, F's assets have an aggregate fair market value of $6,000. No distributions were made with respect to A's stock in F during the period from July 1, 1980, to and including January 1, 1982. A's all earnings and profits amount under § 7.367(b)–2(f) with respect to F is $150, the earnings and profits accumulated by F during this period. None of the these earnings and profits is of a character described in section 1248(d).

(a) A includes in gross income for its taxable year 1982 the all earnings and profits amount of $150.

The $150 included in income is considered to be a dividend as provided in § 7.367(b)–3(b). This amount increases the earnings and profits of A and decreases the earnings and profits of F. Under § 7.367(b)–5(b), F is considered to be a corporation. A's basis in F's assets is determined under section 334(b)(2) and § 1.334–1(c). Thus, A's basis in F's assets is determined by allocating $5,150 (A's basis of $5,000 in the F stock increased, as provided in § 1.334–1(c)(4)(v)(*a*)(2), by F's earnings and profits of $150 for the period between July 1, 1980 and January 1, 1982) among the assets distributed as provided in § 1.334–1(c).

(b) A does not include the all earnings and profits amount in gross income for its taxable year 1982.

Under § 7.367(b)–5(b), solely for the purpose of determining the extent to which gain is recognized on the exchange, F is not considered to be a corporation, and A must include

in gross income $1,000 ($6,000 fair market value of assets received − $5,000 basis in the stock in F). For all other purposes, F is a corporation. Thus, section 1248 applies to A's exchange of its stock in F and $150 (the earnings and profits attributable to A's stock in F) is included in A's gross income as a dividend, and $850 ($1,000 − $150) is included as capital gain. Pursuant to § 7.367(b)–5(b), A's basis in F's assets is determined under section 334(b)(2) and § 1.334–1(c). Thus, the basis of these assets will be determined by allocating $5,150 among these assets in the manner described in example (3)(a).

*Example (4).* F is a foreign investment company (as defined in section 1246(b)) that was organized on January 1, 1960, and uses the calendar year as its taxable year. A, a domestic corporation, has owned all the outstanding stock of F since F's organization. For each of its taxable years, F has $100 of earnings and profits. A's basis in its stock in F is $200. F's basis in its assets is $250.

(a) On January 1, 1980, foreign corporation X, which is not an ''investment company'' within the meaning of section 368(a)(2)(F)(iii), acquires all of A's stock in F. In exchange for this stock, A receives 10 percent of the voting stock in X having a fair market value of $5,000. Section 354 would apply to the exchange of stock by A, and the transaction would qualify as a reorganization described in section 368(a)(1)(B), if the status of F and X as corporations is recognized. A complies with the reporting requirements of § 7.367(b)–1 (c).

Section 7.367(b)–6 does not apply to the exchange because X is a foreign corporation. Section 7.367(b)–7 does not apply because F is a foreign investment company. F and X are considered to be corporations and A does not recognize the gain of $4,800 ($5,000 fair market value of X stock received − $200 basis in F stock exchanged) realized on the exchange. A's stock in X is treated as stock of a foreign investment company held by A throughout the period that A held stock in F. See section 1246(c). A's basis in the stock in X and X's basis in the stock in F are each $200 under sections 358 and 362, respectively.

(b) The facts are the same as in example (4)(a), except that X is a domestic corporation.

A's section 1246 amount with respect to F is $1,700. As provided in section 1246 and §7.367(b)–2(c), this amount takes into account only the earnings and profits of F accumulated in its 17 taxable years beginning after December 31, 1962. Pursuant to the exchange on January 1, 1980, of A's stock in F for stock in X, A, as provided in § 7.367(b)–6(b), includes the Section 1246 amount of $1,700 in gross income for its taxable year 1980 as gain from the sale of an asset which is not a capital asset under § 7.367(b)–3(a)(1). This amount increases the earnings and profits of A but does not decrease the earnings and profits of F. F is considered to be a corporation. As provided in § 7.367(b)–6(d), the $1,700 is treated as gain recognized for purposes of applying sections 358 and 362. Thus, A's basis in the stock in X received in the exchange, as determined under section 358, is $1,900 (A's basis of $200 in the stock in F increased by its $1,700 gain). X's basis in the stock in F acquired in the exchange, as determined under section 362, is $1,900 (the $200 basis of the stock in F in the hands of A increased by A's $1,700 gain).

(c) The facts are the same as in example (4)(b), except that on January 1, 1980, A receives the stock in X (a domestic corporation) pursuant to the acquisition by X of all of F's assets and the liquidation of F, rather than pursuant to the acquisition by X of all of A's stock in F. Section 354 would apply to the exchange of stock in F by A pursuant to the liquidation of F, and the transaction would qualify as a reorganization described in section 368(a)(1)(C), if the status of F as a corporation is recognized. A's all earnings and profits amount with respect to its stock in F, determined under § 7.367(b)–2(f), is $2,000 ($100 × 20 years beginning with January 1, 1960, the date of organization of F).

(i) Pursuant to § 7.367(b)–6(c)(1), A includes the all earnings and profits amount of $2,000 in gross income for its taxable year 1980.

As provided in § 7.367(b)–3(a), the $1,700 of earnings and profits accumulated in taxable years beginning after December 31, 1962, is included in income as gain from the sale of an asset which is not a capital asset, and the $300 of earnings and profits accumulated in taxable years beginning before January 1, 1963, is included in income as a dividend. These amounts increase the earnings and profits of A but do not decrease the earnings and profits of F. F is considered to be a corporation. A's basis in the stock in X received in the exchange, determined under section 358, is $2,200 (A's basis of $200 in the F stock increased by the $1,700 gain, under § 7.367(b)–6(d), and by the $300 included in income as a dividend, under section 358(a)(1), X's basis in the assets of F acquired in the exchange, determined under section 362, is $250 (F's basis in those assets), since no gain was recognized to F, the transferor. X succeeds to F's earnings and profits under section 381(a)(2).

(ii) A does not include the all earnings and profits amount in gross income as required by § 7.367(b)–6(c)(1).

Under § 7.367(b)–6(c)(2), solely for the purpose of determining the extent to which gain is recognized on the exchange, F is not considered to be a corporation and A must recognize gain of $4,800 ($5,000 fair market value

of X stock received − $200 basis in F stock exchanged). For all other purposes, F is a corporation. Thus, section 1246 applies to A's exchange of its stock in F and $1,700 (the section 1246 amount) is included in A's gross income as ordinary income and $3,100 is included as capital gain. As provided in § 7.367(b)–6(c)(2), A's basis in the stock in X received is $200, determined under section 358. X's basis in the assets of F which were acquired is $250, determined under section 362. X succeeds to F's earnings and profits under section 381(a)(2).

*Example. (5).* F, F1, and F2 are foreign corporations that were organized on January 1, 1960. At all times since this date, A, a domestic corporation, has owned 60 percent of the outstanding stock of F, and X, a foreign corporation which is unrelated to A and not subject to tax under subtitle A of the Code, has owned 40 percent of the outstanding stock of F. At all times since this date, F has owned 100 percent of the outstanding stock in F1, and F1 has owned 100 percent of the outstanding stock in F2. A, F, F1, and F2 each uses the calendar year as its taxable year.

(a) For each taxable year since their date of organization, F, F1, and F2 each has earnings and profits of $100. For each taxable year beginning with 1963, F has $40 of subpart F income. For each such taxable year, A includes in its income $24 ($40 × 60 percent of the stock in F) by reason of section 951(a)(1)(A). For each of these years, $24 of F's earnings and profits are attributable to amounts thus included in income by A and therefore are of a character described in section 1248(d)(1). None of the earnings and profits of F1 or F2 is of a character described in section 1248(d). A's basis in its stock in F was $324 on January 1, 1960. As of January 1, 1980, A has included $408 ($24 × 17 years beginning with 1963) in gross income as subpart F income. Thus, under section 961(a), A's basis in its stock in F is $732 ($324 + $408) on that date. F's basis in its assets is $250.

On January 1, 1980, foreign corporation Y acquires all the assets of F in return for Y's voting stock. A and X exchange all their stock in F for stock in Y, and F is liquidated. The Y stock received by A has a fair market value of $6,000 so that A realizes gain of $5,268 ($6,000–$732 basis in the F stock exchanged). Section 354 would apply to the exchange of the stock in F by A, and the transaction would qualify as a reorganization described in section 368(a)(1)(C), if the status of F and Y as corporations is recognized.

(i) In the exchange on January 1, 1980, by A of its stock in F, A receives 20 percent of the voting stock in Y. After the exchange Y is a controlled foreign corporation. Since A is a United States shareholder of Y under § 7.367(b)–2(b), the attribution rules of § 7.367(b)–9 apply, as provided in § 7.367(b)–7(b). A's section 1248 amount with respect to F is $3,060. This amount, determined as provided in § 7.367(b)–2 (d) and (i), consists of $1,020 ($100 × 17 years beginning with 1963 × 60 percent of the F stock) of earnings and profits of F, F1, and F2, respectively. Of the $1,020 of earnings and profits of F, $408 ($24 × 17 years beginning with 1963) is of a character described in section 1248(d)(1). A's all earnings and profits amount with respect to F, determined as provided in § 7.367(b)–2(f) and (h)(1), is $1,200 ($100 × 20 years beginning with 1960 × 60 percent of the F stock). A's additional earnings and profits amount with respect to F is $180 ($100 × 3 years ending with 1962 × 60 percent of the F stock).

Under § 7.367(b)–9(b)(1), A's section 1248 amount, A's all earnings and profits amount, and A's additional earnings and profits amount are attributed to the stock in Y which A receives in the exchange. Under § 7.367(b)–9(b)(2) and § 7.367(b)–9(c), the earnings and profits of Y are increased by $6,000 ($2,000 of earnings and profits of F, F1, and F2, respectively). Under § 7.367(b)–9(b)(3) and (d), the earnings and profits of F, F1, and F2, respectively, are reduced by $2,000. A complies with the reporting requirements of § 7.367(b)–1(c), and Y, F, F1, and F2 comply with the recordkeeping requirements of § 7.367(b)–1(d). F and Y are considered to be corporations and section 354 applies to the exchange of the stock in F by A.

In the notice required under § 7.367(b)–1(c), A makes the consent dividend election provided for in § 7.367(b)–9(f)(1). Thus, the $1,700 of post-1962 earnings and profits of F2 is treated as if, immediately prior to the reorganization, it had been distributed as a dividend through F1 to F. The $1,700 of post-1962 earnings and profits of F1 is treated as if, immediately prior to the reorganization, it had been distributed as a dividend to F. These earnings and profits treated as if distributed must be included in A's gross income to the extent, if any, required under section 551 or 951. If A includes under section 951 its full pro-rata share of the amount treated as distributed, the amount attributed to A's stock in Y which is of a character described in section 1248(d)(1) will be $2,448 ($3,400 × 60 percent of the F stock + $408 of F's earnings and profits which otherwise are of a character described in section 1248(d)(1)).

A's basis in its stock in F immediately prior to the reorganization is increased under section 961(a) by $2,040 from $732 to $2,772. Thus, A's basis in the Y stock received, determined under section 358, is $2,772. In addition, under § 7.367(b)–9(e)(1), the basis of Y's stock in F1 is increased by $4,000 ($600 of pre-1963 earnings and profits + 3,400 of post-1962 earnings and profits), and the basis of F1's stock in F2 is increased by $2,000 ($300 of pre-1963 earnings and profits +$1,700 of post-1962 earnings and profits). However, the increases in respect of pre-1963 earnings and profits are made only for purposes of

computing the all earnings and profits amount and the additional earnings and profits amount with respect to subsequent transactions. See § 7.367(b)–9(e)(3).

(ii) In the exchange on January 1, 1980, by A of its stock in F, A receives 5 percent of the voting stock in Y (rather than 20 percent as in example (5)(a)(i)).

Since A is not a United States shareholder of Y as defined in § 7.367(b)–2(b) immediately after the exchange, § 7.367(b)–7(c)(1)(i) applies. A complies with the reporting requirements of § 7.367(b)–1(c). As required by § 7.367(b)–7(c)(1)(i), A includes in gross income for its taxable year 1980 $2,652, which is the section 1248 amount of $3,060 (computed as in example (5)(a)(i)) reduced, as provided in § 7.367(b)–3(c)(1), by the $408 of earnings and profits of F retaining their character as earnings and profits described in section 1248(d)(1). F and Y are considered to be corporations for purposes of applying section 354 to the exchange of the stock in F by A. Accordingly, no gain is recognized by A. Y succeeds to the $2,000 of earnings and profits of F under section 381(a)(2). In addition, A's basis in the stock in Y received in the exchange, determined under section 358, is $3,384 ($732 basis in F stock exchanged + $2,652 included in gross income in the manner provided in section 961). See § 7.367(b)–12(d). Y's basis in the assets of F, determined under section 362, is $250 (F's basis in those assets), since no gain was recognized to F.

Under § 7.367(b)–3 (b) and (f), the foreign tax credit provisions (sections 78 and 901 through 908) apply as if the $2,652 included in gross income by A were actually distributed to A as a dividend immediately before the exchange. A will be deemed to have paid the proportion of the foreign taxes paid or deemed paid by F, F1, and F2, determined as provided in section 902 and the regulations thereunder. For this purpose, the portions of the section 1248 amount included in gross income by A which are attributable, respectively, to F, F1, and F2 are determined as provided in § 7.367(b)–3(g)(1). Thus, $612 ($612 × $2,652/$2,652) is attributable to F and $1,020 ($1,020 × $2,652/$2,652) is attributable to F1 and F2, respectively. (The first factor in the numerator is the section 1248 amount determined as if the corporation in question were the only corporation, and reduced under § 7.367(b)–3(c)(1)(i) by the amount of earnings and profits retaining its character as earnings and profits described in section 1248(d)(1). The second factor in the numerator is the amount included in A's gross income as a dividend. The denominator is the section 1248 amount reduced under § 7.367(b)–3(c)(1)(i) by the amount of earnings and profits retaining its character as earnings and profits described in section 1248(d)(1).) As provided in § 7.367(b)–3(g)(2), the amounts thus determined to be attributable to F1 and F2 are treated as if distributed directly to A by F1 and F2, respectively, for purposes of applying section 902. These amounts increase the earnings and profits of A but do not decrease the earnings and profits of F, F1, or F2.

(b) The facts are the same as in example (5)(a)(ii) except that A's basis in its F stock was $3,824 on January 1, 1960 (rather than $324) and, by reason of section 961(a), is $4,232 ($3,824+$408 earnings and profits of F previously included in A's gross income under section 951(a)(1)(A)) on January 1, 1980. On the exchange on January 1, 1980 of its stock in F for 5 percent of the voting stock in Y, A realizes a gain of $1,768 ($6,000 fair market value of the Y stock received −$4,232 basis in the F stock exchanged).

As required by §§ 7.367(b)–3(c)(1)(i) and 7.367(b)–7(c)(1)(i), A includes in gross income as a dividend the realized gain of $1,768 since that amount is less than $2,652 ($3,060 section 1248 amount − $408 of earnings and profits of F retaining their character as earnings and profits described in section 1248(d)(1)). For the purpose of determining the proportion of the foreign taxes paid or deemed paid by F, F1, and F2 which A will be deemed to have paid under section 902 and the regulations thereunder, the portions of the amount included in gross income by A which are attributable, respectively, to F, F1, and F2 are determined as provided in § 7.367(b)–3(g)(1). Thus, $408 ($612 × $1,768/$2,652) is attributable to F and $680 ($1,020 × $1,768/$2,652) is attributable to F1 and F2, respectively.

(c) The facts are the same as in example (5)(b), except that, since January 1, 1963, F1 has earnings and profits of $100 for each of five taxable years and deficits of ($100) for each of the other twelve taxable years, and F2 has deficits of ($100) for each of four taxable years and earnings and profits of $100 for each of the other thirteen taxable years (rather than F1 and F2 having earnings and profits of $100 for each taxable year). On the exchange, on January 1, 1980, of its stock in F for 5 percent of the voting stock in Y, A realizes a gain of $1,768 ($6,000 − $4,232) as in example (5)(b). A's section 1248 amount with respect to F is $1,140. This amount, determined as provided in § 7.367(b)–2(d) and (i), consists of $1,020 of earnings and profits of F ($100 × 17 years beginning with 1963 × 60 percent of the F stock), ($420) of deficit of F1 ($100 × 5 profitable years × 60 percent × 100 percent of the F1 stock − ($100) × 12 deficit years × 60 percent × 100 percent), and $540 of earnings and profits of F2 ($100 × 13 profitable years × 60 percent × 100 percent × 100 percent of the F2 stock—($100) X 4 deficit years X 60 percent X 100 percent X 100 percent).

As required by §§ 7.367(b)–3(c)(1)(i) and 7.367(b)–7(c)(1)(i), A includes in gross income as a dividend, $732 ($1,140 section 1248 amount − $408 of earnings and profits retaining its character as earnings and profits described in section 1248(d)(1)). For the purpose of determining the proportion of the foreign

taxes paid or deemed paid by F, F1, and F2 which A will be deemed to have paid under section 902 and the regulations thereunder, the portions of the amount included in gross income by A which are attributable respectively to F, F1, and F2 are determined as provided in § 7.367(b)–3(g)(1). (Deficits are disregarded in computing the first factor in the numerator of each fraction. They are not, however, disregarded for any other purpose.) Thus, $612 ($612 × $732/$732) is attributable to F, $500 ($500 × $732/$732) is attributable to F1, and $1,300 ($1,300 × $732/$732) is attributable to F2.

*Example (6).* On January 1, 1981, one year after the transaction described in example (5)(a)(ii), Y makes a pro-rata distribution of $10,000 with respect to its stock. As of January 1, 1981, Y has $10,000 of earnings and profits, including the $2,000 of F's earnings and profits to which Y succeeded under section 381(a)(2) pursuant to the earlier transaction. None of the $8,000 of earnings and profits actually accumulated by Y is of a character described in section 1248(d). A, which owns the 5 percent of the Y voting stock received in the earlier transaction, receives $500 as its pro-rata share of the distribution from Y.

As provided in § 7.367(b)–12(d), the $2,652 that was included in gross income by A under § 7.367(b)–7 pursuant to the earlier transaction is treated in the same manner as amounts previously included in A's gross income under section 951. By virtue of succeeding to F's earnings and profits, Y has $1,020 of earnings and profits which have previously been included in A's gross income. This amount consists of the $408 of F's subpart F income and the $612 of the section 1248 amount attributable to F which was included in A's gross income pursuant to the earlier transaction. Under § 7.367(b)–12(d)(1), the $500 distributed by Y to A shall be excluded from A's gross income in the same manner as under section 959. A's basis in its stock in Y shall be decreased by $500 in the manner provided in section 961 (b) from $3,384 to $2,884. After the distribution, Y has $520 ($1,020 − $500) of earnings and profits which have previously been included in A's gross income. (F1 and F2 each has $1,020 of such earnings and profits.)

*Example (7).* On January 1, 1981, one year after the transaction described in example (5)(a)(i), Y makes a pro-rata distribution of $10,000 with respect to its stock. As of January 1, 1981, Y has $10,000 of earnings and profits. This amount consists of the $6,000 of earnings and profits of F, F1, and F2 by which the earnings and profits of Y were increased under § 7.367(b)–9 (b)(2) and (c) pursuant to the earlier transaction, $1,000 actually accumulated by Y after the earlier transaction (in its taxable year 1980), and $3,000 actually accumulated by Y before the earlier transaction. None of the $4,000 of earnings and profits actually accumulated by Y is of a character described in section 1248(d). Pursuant to the earlier transaction, A's section 1248 amount of $3,060, A's all earnings and profits amount of $1,200, and A's additional earnings and profits amount of $180 have been attributed to A's stock in Y under § 7.367(b)–9(b)(1). Of the $3,060 section 1248 amount so attributed, $408 of the earnings and profits from F (A's pro-rata share of the subpart F income actually derived by F), and $1,020 of the earnings and profits from F1 and F2, respectively (pursuant to the § 7.367(b)–9(f)(1) consent dividend election), are of a character described in section 1248(d)(1).

Since the amount of the distribution does not exceed Y's earnings and profits (including the earnings and profits of F, F1, and F2 by which the earnings and profits of Y were increased), the entire distribution is a dividend except to the extent provided in § 7.367(b)–12. A, which owns 20 percent of the Y voting stock received in the earlier transaction, receives $2,000 as its pro-rata share of the distribution from Y. Under § 7.367(b)–12(c), this distribution is considered to be made first out of $200 of the $1,000 of earnings and profits accumulated by Y since the attribution pursuant to the earlier transaction and is a dividend to A. The remaining $1,800 is considered to be made out of the earnings and profits attributed to A's stock in Y. Under § 7.367(b)–12(c)(3), $600 of this $1,800 is considered as if distributed from the earnings and profits of F, F1, and F2, respectively ($1,800 × $1,020 of section 1248 amount attributed from each corporation/$3,060 section 1248 amount attributed to A's stock in Y). These amounts retain their character as amounts described in section 1248(d)(1). Since $408 of the earnings and profits attributed from F, and all $1,020 of the earnings and profits attributed from F1 and F2, respectively, are of such a character, only $192 [($600 − $408) + ($600 − $600) + ($600 − $600)] of the $1,800 distributed out of attributed earnings and profits is considered to be a dividend. the $1,608 ($408 + $600 + $600) distribution of earnings and profits of a character described in section 1248(d)(1), which otherwise would be treated as a dividend, is excluded from gross income under section 959. Thus, $392 of the $2,000 distributed to A is considered to be a dividend, of which $200 is from earnings and profits of Y for its taxable year 1980 and $192 is from earnings and profits accumulated by F prior to its acquisition by Y.

A's basis in its stock in Y is reduced, under section 961(b), by the $1,608 excluded from gross income under section 959(a) from $2,772 to $1,164. A's section 1248 amount attributed to its stock in Y is reduced, under § 7.367(b)–12(c)(2), by $1,800 from $3,060 to $1,260, of which $840 [($1,020 − $600) + ($1,020 − $600)] is of a character described in section 1248(d)(1). A's all earnings and profits amount is reduced from $1,200 to $600, none of which is of

a character described in section 1248(d)(1). A's additional earnings and profits amount is not affected by the distribution. See section 316.

*Example (8).* On January 1, 1982, 2 years after the transaction described in example (5)(a)(i), and 1 year after the distribution described in example (7), A sells all its stock in Y for $7,000 realizing a gain of $5,836 ($7,000 − $1,164). During 1981, Y had $1,000 of earnings and profits. Under § 7.367(b)–12(e), the section 1248 amount attributable to A's stock in Y is $1,460. This amount consists of $200 of the $1,000 of Y's earnings and profits for 1981 (A owns 20 percent of the stock in Y), plus the $3,060 section 1248 amount attributed to A's stock in Y, reduced as provided in § 7.367(b)–12(e)(2)(ii) by the $1,800 considered distributed in example (7) out of the section 1248 amount so attributed. (See § 7.367(b)–12(c)(2).) Of this section 1248 amount of $1,460, the $840 [($1,020 − $600) + ($1,020 − $600)] of the earnings and profits attributed from F1 and F2 that remain after the distribution described in example (7) are of a character described in section 1248(d)(1). Thus, $620 ($1,460 Section 1248 amount −$840 section 1248(d)(1) earnings and profits) of the gain on the sale of the Y stock is treated as a dividend under section 1248(a) and the remaining $5,216 ($5,836 − $620) is recognized as capital gain.

*Example (9).* F, F1, F2, and F3 are foreign corporations that were organized on January 1, 1975. At all times since this date, A, a domestic corporation, has owned 60 percent of the outstanding stock in F, and X, a foreign corporation unrelated to A and not subject to tax under subtitle A of the Code, has owned 40 percent of the outstanding stock in F. At all times since this date, F has owned 100 percent of the outstanding stock in F1, F1 has owned 100 percent of the outstanding stock in F2, and F2 has owned 100 percent of the outstanding stock in F3. A, F, F1, F2, and F3 each uses the calendar year as its taxable year. For each taxable year since their date of organization, F, F1, and F3 each has earnings and profits of $100. For each taxable year since its date of organization, F2 has a deficit of ($100). None of the earnings and profits of F, F1, or F3 is of a character described in section 1248(d). A's basis in its stock in F is $620.

On January 1, 1980, A and X exchange all of their stock in F. As sole consideration for the stock exchanged, A receives 20 percent of the voting stock in foreign corporation Y, and X receives 13.3 percent of the voting stock in Y. The Y stock received by A has a fair market value of $4,000. Section 354 would apply to the exchange of stock in F by A, and the transaction would qualify as a reorganization described in section 368(a)(1)(B), if the status of F and Y as corporations is recognized. After the transaction, Y is a controlled foreign corporation but is not a foreign personal holding company.

A realizes gain of $3,380 ($4,000 fair market value of the Y stock received—$620 basis in the F stock exchanged). Since A owns 20 percent of the voting stock in Y immediately after the exchange, A is a United States shareholder of Y as defined in § 7.367(b)–2(b). Accordingly, the attribution rules of § 7.367(b)–9 apply, as provided in § 7.367(b)–7(b)(1). Under § 7.367(b)–9(b)(1), A's section 1248 amount of $600 is attributed to the stock in Y which A received in the exchange. This amount consists of $300 of earnings and profits of F, F1, and F3, respectively ($100×5 years×60 percent of the stock in F), and ($300) of deficit of F2 (($100)×5 years×60 percent). Under § 7.367(b)–9(b)(2) and § 7.367(b)–9(c), the earnings and profits of Y are increased by $1,500 ($500 of earnings and profits of F, F1 and F3, respectively). Any deficit of Y is increased by the ($500) deficit of F2, subject to § 7.367(b)–11, relating to the manner in which such deficit may be used. These earnings and profits and deficit retain their character as provided in § 7.367(b)–3(e). Under § 7.367(b)–9(b)(3) and § 7.367(b)–9(d), the earnings and profits of F, F1, and F3, and the deficit of F2 are each correspondingly reduced by $500. A complies with the reporting requirements of § 7.367(b)–1(c), and Y, F, F1, F2, and F3 comply with the recordkeeping requirement of § 7.367(b)–1(d). F and Y are considered to be corporations and section 354 applies to the exchange of stock by A. A's basis in the stock in Y determined under section 358 is $620.

(a) In the notice required under § 7.367 (b)–1(c), A does not make the consent dividend election provided for § 7.367 (b)–9(f)(1).

Under § 7.367–9(e)(1), F1's basis in its stock in F2 and F's basis in its stock in F1 are each reduced by $500. These reductions are made on account of the $500 reduction in F2's deficit. Since A did not make the election under § 7.367(b)–9(f)(1), no basis adjustment on account of F1 and F3's earnings and profits is permitted under § 7.367(b)–9(e)(1). Under § 7.367(b)–9(e)(2), Y's basis in its stock in F is reduced by $500 on account of the $500 reduction F2's deficit. Since A did not make the election under § 7.367(b)–9(f)(1), no adjustment to Y's basis in F is permitted on account of earnings and profits accumulated in taxable years beginning after December 31, 1962, even if the election provided for in § 7.367(b)–9(f)(2)(ii) is made. See § 7.367(b)–9(f)(2). Thus, Y's basis in its F stock, determined under section 362 and § 7.367(b)–9(e), is $120 ($620–$500).

(b) The facts are the same as in example (9)(a), except that in the notice required under § 7.367(b)–1(c), A makes the consent dividend election provided for in § 7.367(b)–9(f)(1). In addition, all the United States shareholders of Y make a consent dividend election as provided in section 565 for 1980

(the taxable year in which the reorganization occurred). See § 7.367(b)–9(f)(2)(ii).

Under § 7.367(b)–9(f)(1), the $500 of earnings and profits of F3 is treated as if, immediately prior to the reorganization, it had been distributed as a dividend through F2 and F1 (unreduced by the deficit of F2) to F. The $500 of earnings and profits of F1 is treated as if, immediately prior to the reorganization, it had been distributed as a dividend to F. Accordingly, under § 7.367(b)–9(e)(1), F2's basis in the F3 stock is increased by $500; F1's basis in the F2 stock is decreased by the ($500) deficit from F2 (see example (9)(a)) and increased by the $500 of earnings and profits from F3 for a net adjustment of zero; and F's basis in the F1 stock is decreased by the ($500) deficit from F2 (see example (9)(a)) and increased by the $1,000 of earnings and profits from F3 and F1 for a net increase of $500. For the consequences to A of making the consent dividend election provided for in § 7.367(b)–9(f)(1), see example (5)(a).

Under § 7.367(b)–9(f)(2), the $500 of earnings and profits of F3 is treated as if, immediately after the reorganization, it had been distributed as a dividend through F2, F1 and F (unreduced by the deficit of F2) to Y. The $500 of earnings and profits of F1 is treated as if, immediately after the reorganization, it had been distributed as a dividend through F to Y. The $500 of earnings and profits of F is treated as if, immediately after the reorganization, it had been distributed as a dividend to Y. Accordingly, under § 7.367(b)–9(e)(2), Y's basis in the F stock is increased by the $1,500 total of the earnings and profits treated as if distributed to Y and is decreased by the ($500) deficit of F2 (see example (9)(a)). Thus, the net increase in Y's basis in the F stock is $1,000 and this basis, determined under section 362 and § 7.367(b)–9(e), is $1,620 ($620 + $1,000). For the consequences to the United States shareholders of Y of the consent dividend to Y, see sections 951 and 959.

*Example (10).* F, F1, and F2 are foreign corporations that were organized on January 1, 1975. At all times since this date, A, a domestic corporation, has owned 100 percent of the outstanding stock in F, F has owned 90 percent of the outstanding stock in F1, X, a foreign corporation unrelated to A and not subject to tax under subtitle A of the Code, has owned 10 percent of the outstanding stock in F1, and F1 has owned 100 percent of the outstanding stock in F2. F, F1, and F2 each uses the calendar year as its taxable year. For each taxable year since their date of organization, F, F1, and F2 each has earnings and profits of $100. None of the earnings and profits of F, F1, or F2 is of a character described in section 1248(d). F's basis in its stock in F1 is $620.

On January 1, 1980, F exchanges all of its stock in F1. X retains its stock in F1. As sole consideration for the stock exchanged, F receives 20 percent of the voting stock in foreign corporation Y. The Y stock received by F has a fair market value of $4,000. Section 354 would apply to the exchange of the stock in F1 by F, and the transaction would qualify as a reorganization described in section 368(a)(1)(B), if the status of F1 and Y as corporations is recognized. After the transaction Y is a controlled foreign corporation. Y uses the calendar year as its taxable year.

F realizes gain of $3,380 ($4,000 fair market value of the Y stock received—$620 basis in the F1 stock exchanged). Since A is a United States shareholder of Y after the exchange, the attribution rules of § 7.367(b)–9 apply, as provided in § 7.367(b)–7(b). Under § 7.367(b)–9(b)(1), A's section 1248(c)(2) amount of $900 is attributed to the stock in Y which F receives in the exchange. This amount consists of $450 ($100 × 5 years × 90 percent of the stock in F1) of the earnings and profits of F1 and F2, respectively. The earnings and profits of Y are increased by the $450 of earnings and profits of F1 and the $450 of earnings and profits of F2, in accordance with §§ 7.367(b)–9(b)(2) and 7.367(b)–9(c). The earnings and profits of F1 and F2, respectively, are correspondingly reduced by $450 under §§ 7.367(b)–9(b)(3) and 7.367(b)–9(d). In addition, under § 7.367(b)–9(c)(2), the $50 of earnings and profits of F1 and F2, respectively, which do not increase the earnings and profits of Y, is considered to be entirely attributable to the stock not acquired by Y (*i.e.*, the stock owned by X). A complies with the reporting requirements of § 7.367(b)–1(c), and Y, F, F1, and F2 comply with the recordkeeping requirements of § 7.367(b)–1(d). F1 and Y are considered to be corporations and section 354 applies to the exchange of F1 stock by F.

In the notice required in § 7.367(b)–1(c), A does not make the consent dividend election provided for in § 7.367(b)–9(f)(1). Accordingly, no adjustment to basis is made under § 7.367(b)–9(e).

*Example (11).* On January 1, 1981, after the transaction described in example (10), A sells all its stock in F. In taxable year 1980, Y, F, F1, and F2 each has $100 of earnings and profits. Upon A's sale of its stock in F, A's section 1248 amount is $1,556. This amount consists of $600 of earnings and profits of F ($100 × 6 years beginning with 1975 × 100 percent of the stock in F) under section 1248(a), and, under § 7.367(b)–12(e)(2), the section 1248(c)(2) amount of $900 attributed to the stock in Y received by F pursuant to the earlier transaction, $20 of earnings and profits accumulated by Y in 1980 ($100 × 100 percent × 20 percent of the stock in Y), and $18 of earnings and profits accumulated by F1 and F2, respectively, in 1980 ($100 × 100 percent × 20 percent × 90 percent of the stock in F1).

*Example (12).* On December 31, 1980, after the transaction described in example (10), F1 makes a pro-rata distribution of $180, no part

of which is subpart F income, to Y and X. Without regard to this distribution Y, F, F1, and F2 each has $100 of earnings and profits in 1980. On December 31, 1980, F1 has $100 of current earnings and profits and $50 of accumulated earnings and profits ($500 accumulated between 1975 and 1979—$450 by which the earnings and profits of F1 were reduced pursuant to the transaction in example (10)). Thus, $135 ($150 × 90 percent of the stock in F1) of the distribution to Y is a dividend. Y's basis in the stock in F1 is reduced under section 301(c)(2) by $27.

On January 1, 1981, A sells all its stock in F. Upon this sale, A's section 1248 amount is $1,565. This amount consists of $600 of earnings and profits of F ($100 × 6 years beginning with 1975 × 100 percent of the stock in F), the section 1248(c)(2) amount of $900 attributed to the stock in Y received by F pursuant to the earlier transaction, $47 of the $235 of earnings and profits accumulated by Y in 1980 ($100 plus the $135 dividend from F1) and $18 of the $100 of earnings and profits accumulated by F2 in 1980. (After the $180 distribution, F1 has no earnings and profits attributable to the stock in F sold by A. See §§ 1.1248–2(d)(1) and 1.1248–3(b)(3).)

*Example (13).* On December 31, 1980, after the transaction described in example (10), Y sells all its stock in F1 and recognizes gain of $1,200. Without regard to this sale, Y, F, F1, and F2 each has $100 of earnings and profits in 1980. On January 1, 1981, A sells all its stock in F. Upon this sale, A's section 1248 amount is $1,760. This amount consists of $600 of earnings and profits of F, the section 1248(c)(2) amount of $900 attributed to the stock in Y received by F pursuant to the earlier transaction, and $260 of the $1,300 of earnings and profits accumulated by Y in 1980 ($100 plus the $1,200 gain on the sale of the stock in F1). (The earnings and profits accumulated by F1 and F2 in 1980 have been otherwise taken into account under section 1248, within the meaning of section 1248(c)(2)(C), by virtue of the inclusion in Y's earnings and profits of Y's gain on the sale of the stock in F1.)

*Example (14).* (a) F is a foreign corporation that was organized in country C on January 1, 1978. At all times since that date, A, a domestic corporation, has owned 100 percent of the outstanding stock of F. All of F's assets are used in a manufacturing business. The F stock does not comprise substantially all of A's assets. On January 1, 1983, A exchanges all of its stock of F for 80 percent of the outstanding voting stock of Y, an unrelated foreign corporation organized in country C. At the time of the exchange, A's Y stock received in the exchange has a fair market value of $600, A's adjusted basis in its F stock is $300, and A's section 1248 amount attributable to its F stock is $200. The exchange of stock of F by A would be described in section 351 if the status of Y as a corporation is recognized. This exchange would also be described in section 354 (a reorganization described in section 368(a)(1)(B)) if the status of F and Y as corporations is recognized. Under § 7.367(b)–4(b)(1)(i)(A), the exchange is considered to be one to which § 7.367(b)–7 applies. Under § 7.367(b)–7(b), the exchange is treated as one to which § 7.367(b)–9 applies, and under that latter section the section 1248 amount of $200 must be attributed to the Y stock received in the exchange. If § 7.367(b)–4(b)(2)(i) or (ii) did not apply, then under § 7.367(b)–4(b)(1)(i)(B), A would have to include $100 in gross income as gain from the exchange of the F stock. This amount is equal to the excess of the gain realized, or $300 ($600 minus $300), over the section 1248 amount taken into account under § 7.367(b)–4(b)(1)(i)(A), or $200. However, since Y is a controlled foreign corporation after the transfer and since A is a United States shareholder (within the meaning of § 7.367(b)–2(b)) of F both before and after the transfer and of Y after the transfer, by reason of § 7.367(b)–4(b)(2)(ii) no gain is recognized on the transfer under § 7.367(b)–4(b)(1)(i)(B), but the section 1248 amount of $200 must be attributed to the Y stock received in the exchange under § 7.367(b)–4(b)(1)(i)(A).

(b) The facts are the same as in paragraph (a) of this example, except that A receives only 30 percent of the Y stock, unrelated foreign persons receive an additional 50 percent of the Y stock in exchange for their contribution of property to Y, and Y is not a controlled foreign corporation after the exchange. Under § 7.367(b)–7(c)(1)(i), A must include in gross income the $200 section 1248 amount attributable to the F stock exchanged. Unless § 7.367(b)–4(b)(2)(i) applies, under § 7.367(b)–4(b)(1)(i)(B) of this section, A must also include $100 in gross income as gain from the exchange of the F stock.

(c) The facts are the same as in paragraph (b) of this example, except that under § 7.367(b)–4(b)(2)(i)(A), A receives a favorable ruling that the exchange is not considered to be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. As a result, A is only required to include in gross income the $200 section 1248 amount determined pursuant to § 7.367(b)–4(b)(1)(i)(A) and is not required to include in gross income the $100 determined pursuant to § 7.367(b)–4(b)(1)(i)(B).

(d) The facts are the same as in paragraph (a) of this example, except that A owns only five percent of the outstanding F stock, B (an unrelated domestic corporation) owns 75 percent of the outstanding F stock, and both A and B exchange their F stock for 5 and 75 percent, respectively, of the outstanding stock in Y. Although A is a United States person at the time of the exchange, A is not and has never been a United States shareholder (within the meaning of § 7.367(b)–2(b)) of F. Therefore, A's section 1248 amount with

respect to its F stock is zero. Unless § 7.367(b)–4(b)(2)(i) applies, under § 7.367(b)–4(b)(1)(ii) A must include $300 in gross income as gain from the exchange of its F stock.

(e) The facts are the same as in paragraph (a) of this example, except that the F stock does comprise substantially all of A's assets, A transfers all of its stock in F to Y in exchange for 70 percent of Y's outstanding stock, and A remains in existence and does not distribute the Y stock received in the exchange to its shareholders. The exchange of stock of F by A would be described in section 361 (a reorganization described in section 368(a)(1)(C)) if the status of Y as a corporation is recognized. This exchange would also be described in section 354 (a reorganization described in section 368(a)(1) (B)) if the status of F and Y as corporations is recognized. Under § 7.367(b)–4(b), the exchange is considered to be one to which section 367(b) applies. The remaining tax consequences of this exchange are the same as the consequences illustrated in paragraph (a) of this example.

(f) The facts are the same as in paragraph (a) of this example, except that on January 1, 1982, A sells 60 percent of the voting stock of F to a foreign corporation at a gain and reports such gain as required under the Code. At the time of the January 1, 1983 exchange of F stock by A for Y stock, A's adjusted basis in the retained stock of F is $300 and A's section 1248 amount attributable to the retained stock of F is $200. While F is no longer a controlled foreign corporation, A is treated as a United States shareholder of F for five years following the sale of F stock under § 7.367(b)–2(b). Therefore, § 7.367(b)–4(b)(1)(i)(A) and the exception of § 7.367(b)–4(b)(2)(ii) apply to the January 1, 1983 exchange of F stock by A for Y stock, and the tax consequences of that exchange are the same as the consequences illustrated in paragraph (a) of this example.

*Example (15).* F is a foreign corporation that was organized on January 1, 1979. At all times since this date, A, a domestic corporation, has owned all of the outstanding stock in F. On December 31, 1981, foreign corporation Y acquires all the assets of F in return for voting stock in Y. A exchanges all of its stock in F for the stock in Y and F is liquidated. After the transaction, A is a United States shareholder of Y, and Y is a controlled foreign corporation. Section 354 would apply to the exchange of the stock in F by A, and the transaction would qualify as a reorganization described in section 368(a)(1)(C), if the status of F and Y as corporations is recognized. As of December 31, 1981, F has a deficit in earnings and profits of ($300). A's section 1248 amount with respect to F is also ($300). Assume F had a net operating loss carryover that section 382(b)(2) required to be reduced by 20 percent.

Since A is a United States shareholder of controlled foreign corporation Y, § 7.367(b)–9 applies to the exchange as provided in § 7.367(b)–7(b). Thus, A's section 1248 amount is attributed to the stock in Y received by A. Pursuant to § 7.367(b)–11(c), the amount of the deficit in earnings and profits of F by which the deficit in earnings and profits of Y is increased under § 7.367–9(b)(2) and (c), is reduced by 20 percent from ($300) to ($240). As provided in § 7.367(b)–11 (b) and (d), this deficit and the section 1248 amount attributed to the stock in Y received by A shall be used only in the manner prescribed in section 381(c)(2)(B) and the regulations thereunder.

*Example (16).* F and G are foreign corporations engaged in the same business activity that were organized on January 1, 1975. At all times since this date, A and B, domestic corporations, have each owned 50 percent of the outstanding stock in F and G, respectively. On January 1, 1980, G acquires all the assets of F in return for G's voting stock. A and B exchange all their stock in F for stock in G, and F is liquidated. After the transaction, G continues the business activity of F and G unchanged. Section 354 would apply to the exchange of the stock in F by A and B, and the transaction would qualify as a reorganization described in section 368(a)(1)(D), if the status of F and G as foreign corporations is recognized. Under § 7.367(b)–4(d), the transaction is not considered to be a reorganization described in section 368(a)(1)(F) for purposes of section 367 and §§ 7.367(b)–1 through 7.367(b)–12, even though it might be considered to be a reorganization described in section 368(a)(1)(F) for other purposes. Thus, the attribution rules of § 7.367(b)–9 apply by reason of § 7.367(b)–7(b).

*Example (17).* F and F1 are foreign corporations that were organized on January 1, 1960. X is a domestic corporation that was organized on the same date. At all times since this date, X has owned 100 percent of the outstanding stock in F, and F has owned 100 percent of the outstanding stock in F1. D is a domestic corporation that was organized on January 1, 1976. At all times since this date, X has owned 100 percent of the outstanding stock in D. From January 1, 1960 until January 1, 1974, A, a domestic corporation, owned 100 percent of the outstanding stock in X. On January 1, 1974, B, a domestic corporation, purchased stock in X from A in a taxable sale, and, at all times since this date, A and B each has owned 50 percent of the outstanding stock in X. F, F1, X, D, A, and B each uses the calendar year as its taxable year. As of January 1, 1978, X, F, F1, and D have earnings and profits or deficits as follows:

| | X | | F | | F1 | | D | |
|---|---|---|---|---|---|---|---|---|
| | E&P | Deficit | E&P | Deficit | E&P | Deficit | E&P | Deficit |
| 1960 | ..... | (200) | ..... | (100) | ..... | (200) | ..... | ..... |
| 1961 | ..... | (200) | ..... | (100) | ..... | (200) | ..... | ..... |
| 1962 | ..... | (200) | ..... | (100) | ..... | (200) | ..... | ..... |
| 1963 | ..... | (200) | 100 | ..... | ..... | (200) | ..... | ..... |
| 1964 | ..... | (200) | 100 | ..... | ..... | (200) | ..... | ..... |
| 1965 | 100 | ..... | 100 | ..... | 100 | ..... | ..... | ..... |
| 1966 | 100 | ..... | 100 | ..... | 100 | ..... | ..... | ..... |
| 1967 | 100 | ..... | 100 | ..... | 100 | ..... | ..... | ..... |
| 1968 | 100 | ..... | 100 | ..... | 100 | ..... | ..... | ..... |
| 1969 | 100 | ..... | 100 | ..... | 100 | ..... | ..... | ..... |
| 1970 | 100 | ..... | 100 | ..... | 100 | ..... | ..... | ..... |
| 1971 | 100 | ..... | 100 | ..... | 100 | ..... | ..... | ..... |
| 1972 | 100 | ..... | 100 | ..... | 100 | ..... | ..... | ..... |
| 1973 | 100 | ..... | 100 | ..... | 100 | ..... | ..... | ..... |
| 1974 | 100 | ..... | 100 | ..... | 100 | ..... | ..... | ..... |
| 1975 | 100 | ..... | 100 | ..... | 100 | ..... | ..... | ..... |
| 1976 | 100 | ..... | 100 | ..... | 100 | ..... | ..... | (100) |
| 1977 | 100 | ..... | 100 | ..... | 100 | ..... | ..... | (100) |
| Total | 1,300 | (1,000) | 1,500 | (300) | 1,300 | (1,000) | ..... | (200) |

On January 1, 1978, X distributes all of its stock in F to A in exchange for half of A's stock in X. A's basis in the stock in X that A exchanged is $1,000, and the fair market value of the stock in F that A receives is $2,000. After the distribution, A owns 33 percent and B owns 67 percent of the stock in X.

(a) Section 1248(f) applies to the distribution by X of its stock in F since X is a domestic corporation. See § 7.367(b)–10(b). Thus, X must include the amount computed under section 1248(f)(1) in its gross income as a dividend for 1978. After the distribution, the net fair market value of the assets of the distributing group, X and D, exclusive of the stock in D, equals the net fair market value of the assets of the controlled group, F and F1, exclusive of the stock in F1. Section 355 would apply to the distribution (assuming the conditions of section 355(a)(1) (B) and (C) are met) if the status of F as a corporation is recognized. A and X comply with the reporting requirements of § 7.367(b)–1(c), and X, F, and F1 comply with the recordkeeping requirement of § 7.367(b)–1(d).

The provisions of § 7.367(b)–10(d) through (f) apply to the distribution of the stock in F by reason of § 7.367(b)–10(b). In accordance with § 7.367(b)–10(d), the earnings and profits and deficits of X, F, F1, and D are allocated so that, after the distribution, the distributing group and the controlled group each has total gross earnings and profits of $2,050 ($4,100 total gross earnings and profits of X, F, F1, F1,and D/2), and a total deficit of ($1,250) (($2,500) total gross deficit of X, F, and D/2), as follows:

| | E&P | Deficit |
|---|---|---|
| Distributing Group: | | |
| X | $2,050 | ($1,050) |
| D | ..... | (200) |
| Total | 2,050 | (1,250) |
| Controlled Group: | | |
| F | 1,098 | (288) |
| F1 | 952 | (962) |
| Total | 2,050 | (1,250) |

X's earnings and profits consist of $1,300 actually accumulated by X, $402 allocated from F ($750 allocated from the controlled group X $1,500 earnings and profits of F/$2,800 gross earnings and profits of the controlled group), and $348 allocated from F1 ($750 X $1,300/$2,800). X's deficit consists of ($1,000) acutally incurred by X, ($12) allocated from F (($50) X ($300)/($1,300)), and ($38) allocated from F1 (($50) X ($1,000)/($1,300)). The ($50) deficit allocated to X from F and F1 may be used only as provided in § 7.637(b)–11(b).

A, the only United States shareholder (determined after the distribution) of the controlled group (the group from which in this case the allocation of earnings and profits was made), makes a consent dividend election, described in § 7.367(b)–10(f), in the notice required by § 7.367(b)–1(c). Thus, the $348 of earnings and profits allocated from F1 to X is treated as if, immediately after the distribution of the stock in F, it had been distributed as a dividend to F. (See sections 551 and 951 for possible consequences to A of the consent dividend election.) Since the election under § 7.367(b)–10(f) is made, the basis of F in the stock in F1 is increased by $348 under § 7.367(b)–10(e)(1). In addition, whether or not this election is made, the basis of F in the stock in F1 is decreased under § 7.367(b)–10(e)(1) by the ($38) deficit allocated from F1 to X. Of this decrease, $23 (($38)×($600) pre-1963 gross deficit of F1/($1,000) gross deficit of F) is in respect of pre-1963 deficits and so

shall be taken into account, as provided in § 7.367(b)–10(e)(2), only for purposes of computing the all earnings and profits and additional earnings and profits amounts with respect to subsequent transactions.

F is considered to be a corporation and section 355 applies to the distribution by X of the stock in F.

(b) The facts are the same as in example 17(a) except that X is a foreign corporation instead of a domestic corporation. After the distribution by X to A of the stock in F in exchange for half of A's stock in X, the fair market value of the stock in F owned by A equals the fair market value of the stock in X owned by A. Section 355 would apply to the distribution (assuming the conditions of section 355(a)(1) (B) and (C) are met) if the status of F and X as corporations is recognized. A complies with the reporting requirements of § 7.367(b)–1(c), and X, F, and F1 comply with the recordkeeping requirements of § 7.367(b)–1(d).

The application of § 7.367(b)–10 (d) through (f) results in the same allocation of earnings and profits and deficits and adjustments to basis as in example 17(a). In addition, under § 7.367(b)–10 (g), the following amounts are computed with reference to A's and B's stock in X prior to the distribution.

| | A | B |
|---|---|---|
| Section 1248 amount | $1,650 | $600 |
| All earnings and profits amount | 150 | 200 |
| Additional earnings and profits amount | (300) | 0 |

Under § 7.367(b)–10(h), half of each of these amounts of A is attributed to the stock in X and F, respectively, owned by A after the distribution. All of each of these amounts of B is attributed to the stock in X owned by B after the distribution.

X and F are considered to be corporations and section 355 applies to the distribution by X of the stock in F.

(c) The facts are the same as in example (17)(b) except that X distributes its stock in D (rather than its stock in F) to A in exchange for half of A's stock in X. Section 355 would apply to the distribution (assuming the conditions of section 355(a)(1) (B) and (C) are met) if the status of X as a corporation is recognized. A's basis in the stock in X which A exchanges is $1,000 and the fair market value of the stock in D that A receives is $2,000. After the distribution, the net fair market value of the assets of the distributing group, X, F, and F1, exclusive of the stock in F and F1, equals the net fair market value of the assets of the controlled group, D. The value of the stock in D owned by A equals the value of the stock in X owned by A. A complies with the reporting requirements of § 7.367(b)–1(c), and X, F, F1, and D comply with the recordkeeping requirements of § 7.367(b)–1(d).

After the allocation required by § 7.367(b)–10(d), the earnings and profits and deficits of the groups are as follows:

| | E & P | Deficit |
|---|---|---|
| Distributing Group: | | |
| X | $650 | ($543.50) |
| F | 750 | (163.00) |
| F1 | 650 | (543.50) |
| Total | 2,050 | (1,250.00) |
| Controlled Group: | | |
| D | 2,050 | (1,250) |

D's earnings and profits consist of $650 allocated from X ($2,050 allocated from distributing group X $1,300 gross earnings and profits of X/$4,100 gross earnings and profits of distributing group), $750 allocated from F ($2,050 X $1,500/$4,100), and $650 allocated from F1 ($2,050 X $1,300/$4,100). D's deficit consists of ($200) actually incurred by D, ($137) allocated from F (($1,050) allocated from Distributing group X ($300) gross deficit of F/($2,300) gross deficit of distributing group), and ($456.50) allocated from X and F1, respectively (($1,050) X ($1,000)/($2,300)).

A and B, the United States shareholders (determined after the distribution) of the distributing group (the group from which in this case the allocation of earnings and profits was made), make a consent dividend election, described in § 7.367(b)–10(f), in the notice required by § 7.367(b)–1(c). Thus, the $650 of earnings and profits of F1 allocated to D is treated as if, immediately after the distribution of the stock in D, it had been distributed as a dividend through F to X. The $750 of earnings and profits of F allocated to D is treated as if, immediately after the distribution, it had been distributed as a dividend to X. See sections 551 and 951 for possible consequences to A and B of the consent dividend election. Since this election is made, the basis of F in the stock in F1 is increased by $650, and the basis of X in the stock in F is increased by $1,400 ($650 + $750) under § 7.367(b)–10(e)(1). In addition, whether or not this election is made, the basis of F in the stock in F1 is decreased by the ($456.50) deficit allocated from F1 to D. Of this decrease, $273.90 (($456.50 X ($600) pre-1963 gross deficit of F1/($1,000) gross deficit of F1) is in respect of a pre-1963 deficit and so shall be taken into account only for purposes of computing the all earnings and profits and additional earnings and profits amounts with respect to subsequent transactions. The basis of X in the stock in F is decreased by $593.50 (($456.50) + ($137) deficit allocated from F to D). Of this decrease, $410.90 (($273.90) + ($137)) is in respect of a pre–1963 deficit and so shall be taken into account only for purposes of computing the all earnings and profits and additional earnings and profits amounts with respect to subsequent transactions.

Under § 7.367(b)–10(h), half of A's section 1248 amount of $1,650, all earnings and profits amount of $150, and additional earnings and profits amount of ($300) is attributed to the stock in X owned by A after the distribution of the stock in D. No amounts are attributed to the stock in D owned by A after the distribution. See § 7.367–10(i)(1). All of B's section 1248 amount of $600, all earnings and profits amount of $200, and additional earnings and profits amount of $0 is attributed to the stock in X owned by B after the distribution. Section 7.367(b)–10(i) applies since A received stock in D, a domestic corporation. Accordingly, A includes in gross income as a dividend $825 ($1,650 section 1248 amount—$825 attributed to stock in X owned by A after the distribution). This amount increases the earnings and profits of A but does not decrease the earnings and profits of X, F, F1, or D.

X is considered to be a corporation and section 355 applies to the distribution by X of the stock in D.

(Secs. 367(b) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1634 and 68A Stat. 917; 26 U.S.C. 367(b) and 7805))

[44 FR 57390, Oct. 5, 1979, as amended by T.D. 7863, 47 FR 57491, Dec. 27, 1982; 48 FR 1710, Jan. 14, 1983]

### § 7.367(c)–1 Section 355 distribution treated as an exchange.

(a) *General rule.* For purposes of section 367 as in effect both before and after October 4, 1976, any distribution which is described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is in exchange.

(b) *Ruling required.* In the case of any distribution to which this section applies which begins (within the meaning of § 7.367(a)–1(b)(2)) before January 1, 1978, a foreign corporation shall not be considered to be a corporation for purposes of determining the extent to which gain shall be recognized on such distribution unless, pursuant to a ruling request timely filed in accordance with the provisions of § 7.367(a)–1(d), it is established to the satisfaction of the Commissioner at the applicable time that such distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

(c) *Application of section 367(b) regulations.* In the case of any distribution to which this section applies which begins on or after January 1, 1978, and in connection with which there is no transfer described in section 367(a)(1) (as defined in § 7.367(a)–1(b)(3)), the provisions of section 367(b), as amended by the Tax Reform Act of 1976, apply. Accordingly, a foreign corporation shall be considered to be a corporation on such distribution to the extent provided in §§ 7.367(b)–1 through 7.367(b)–12.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65163, Dec. 30, 1977]

### § 7.367(c)–2 Contribution of capital to controlled corporations.

(a) *General rule.* For purposes of Chapter I of Subtitle A of the Internal Revenue Code of 1954, any transfer of property to a foreign corporation as a contribution to the capital of such corporation which is made after December 31, 1970, by one or more persons who immediately after the transfer, own (within the meaning of section 318) stock possessing at least 80 percent of the total combined voting power of all classes of stock of such corporation entitled to vote shall, except as provided in paragraph (b) of this section, be treated as an exchange of such property for stock of such foreign corporation equal in value to the fair market value of the property transferred.

(b) *Treatment as contribution to capital.* In the case of a transfer of property referred to in paragraph (a) of this section which begins before October 10, 1975, such transfer shall not be treated as an exchange if, prior to the transfer, it is established that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

(c) *Ruling required.* In the case of a transfer of property which begins after October 9, 1975, and which is treated as an exchange under paragraph (a) of this section, a ruling is required if section 367(a)(1) applies. For example, if after October 9, 1975 and before January 1, 1978, a foreign corporation transfers property to its wholly owned foreign subsidiary as a contribution to capital, the exchange which is considered to occur is described in section 351 and section 367(a)(1) applies to such transfer.

(d) *Application of section 367(b) regulations.* In the case of a transfer of property which (i) begins after December 31, 1977, (ii) is treated as an exchange as provided in paragraph (a) of this section, and (iii) is not a transfer described in section 367(a)(1), if such a transfer is an exchange described in section 367(b) or made in connection with an exchange described in that section, a foreign corporation shall be considered to be a corporation on such transfer to the extent and upon fulfillment of any applicable conditions specified in §§ 7.367(b)–1 through 7.367(b)–12.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634; 26 U.S.C. 367))

[T.D. 7530, 42 FR 65163, Dec. 30, 1977]

### § 7.465–1 Amounts at risk with respect to activities begun prior to effective date; in general.

Section 465 provides that a taxpayer (other than a corporation which is not a subchapter S corporation or a personal holding company) engaged in certain activities may not deduct losses from such activity to the extent the losses exceed the amount the taxpayer is at risk with respect to the activity. For the types of activities to which section 465 applies and for determining what constitutes a separate activity, see section 465(c). Section 465 generally applies to losses attributable to amounts paid or incurred in taxable years beginning after December 31, 1975. For the purposes of applying the at risk limitation to activities begun before the effective date of the provision (and which were not excepted from application of the provision), it is necessary to determine the amount at risk as of the first day of the first taxable year beginning after December 31, 1975. The amount at risk in an activity as of the first day of the first taxable year of the taxpayer beginning after December 31, 1975, (for the purposes of § 7.465–1 through 7.465–5 such first day shall be referred to as the effective date) shall be determined according to the rules provided in §§ 7.465–2 through 7.465–5.

[T.D. 7504, 42 FR 42197, Aug. 22, 1977]

### § 7.465–2 Determination of amount at risk.

(a) *Initial amount.* The amount a taxpayer is at risk on the effective date with respect to an activity to which section 465 applies shall be determined in accordance with this section. The initial amount the taxpayer is at risk in the activity shall be the taxpayer's initial basis in the activity as modified by disregarding amounts described in section 465(b) (3) or (4) (relating generally to amounts protected against loss or borrowed from related persons).

(b) *Succeeding adjustments.* For each taxable year ending before the effective date, the initial amount at risk shall be increased and decreased by the items which increased and decreased the taxpayer's basis in the activity in that year as modified by disregarding the amounts described in section 465(b) (3) or (4).

(c) *Application of losses and withdrawals.* (1) Losses described in section 465(d) which are incurred in taxable years beginning prior to January 1, 1976 and deducted in such taxable years, will be treated as reducing first that portion of the taxpayer's basis which is attributable to amounts not at risk. On the other hand, withdrawals made in taxable years beginning before January 1, 1976, will be treated as reducing the amount which the taxpayer is at risk.

(2) Therefore, if in a taxable year beginning prior to January 1, 1976 there is a loss described in section 465(d), it shall reduce the amount at risk only to the extent it exceeds the amount of the taxpayer's basis which is not at risk. For the purposes of this paragraph the taxpayer's basis which is not at risk is that portion of the taxpayer's basis in the activity (as of the close of the taxable year and prior to reduction for the loss) which is attributable to amounts described in section 465(b) (3) or (4).

(d) *Amount at risk shall not be less than zero.* If, after determining the amount described in paragraph (a), (b), and (c) of this section, the amount at risk (but for this paragraph) would be less than zero, the amount at risk on the effective date shall be zero.

[T.D. 7504, 42 FR 42197, Aug. 22, 1977]

### § 7.465–3 Allocation of loss for different taxable years.

If the taxable year of the entity conducting the activity differs from that of the taxpayer, the loss attributable to the activity for the first taxable year of the entity ending after the beginning of the first taxable year of the taxpayer beginning after December 31, 1975, shall be allocated in the following manner. That portion of the loss from the activity for such taxable year of the entity which bears the same ratio as the number of days in such taxable year before January 1, 1976, divided by the total number of days in the taxable year, shall be attributable to taxable years of the taxpayer beginning before January 1, 1976. Consequently, that portion shall be treated in accordance with § 7.465–2.

[T.D. 7504, 42 FR 42198, Aug. 22, 1977]

### § 7.465–4 Insufficient records.

If sufficient records do not exist to accurately determine under § 7.465–2 the amount which a taxpayer is at risk on the effective date, the amount at risk shall be the taxpayer's basis in the activity reduced (but not below zero) by the taxpayer's share of amounts described in section 465(b) (3) or (4) with respect to the activity on the day before the effective date.

[T.D. 7504, 42 FR 42198, Aug. 22, 1977]

### § 7.465–5 Examples.

The provisions of § 7.465–1 and § 7.465–2 may be illustrated by the following examples:

*Example (1).* J and K, as equal partners, form partnership JK on January 1, 1975. Partnership JK is engaged solely in an activity described in section 465(c)(1). On January 1, 1975, each partner contributes $10,000 in cash from personal assets to JK. On July 1, 1975, JK borrows $40,000 (of which J's share is $20,000) from a bank under a nonrecourse financing arrangement secured only by the new equipment (for use in the activity) purchased with the $40,000. On September 1, 1975, JK reduces the amount due on the loan to $36,000 (of which J's share is $18,000). On October 1, 1975, JK distributes $3,000 to each partner. For taxable year 1975, JK has no income or loss. Although J's basis in the activity is $25,000 ($10,000+$18,000—$3,000) J's amount at risk on the effective date is $7,000 determined as follows:

| | |
|---|---|
| Initial amount at risk | $10,000 |
| Plus: Items which increased basis other than amounts described in sec. 465(b) (3) or (4) | 0 |
| Total | 10,000 |
| Less: Distribution | 3,000 |
| J's amount at risk on effective date | 7,000 |

*Example (2).* Assume the same facts as in Example (1) except that JK has a loss (as described in section 465(d) for 1975 of which J's share is $12,000. Although J's basis in the activity is $13,000 ($10,000+$18,000—($3,000+$12,000)) J's amount at risk on the effective date is $7,000 determined as follows:

| | |
|---|---|
| Initial amount at risk | $10,000 |
| Plus: Items which increased basis other than amounts described in sec. 465(b) (3) or (4) | 0 |
| Total | 10,000 |
| Less: Distribution | 3,000 |
| Portion of loss ($12,000) in excess of portion of basis not at risk ($18,000) | 0 |
| Total | 3,000 |
| J's amount at risk on effective date | 7,000 |

*Example (3).* Assume the same facts as in Example (1) except that JK has a loss (as described in section 465(d) for 1975, and J's share is $23,000. J's basis in the activity is $2,000 ($10,000+$18,000—($3,000+$23,000)). The amount at risk on the effective date is determined as follows:

| | |
|---|---|
| Initial amount at risk | $10,000 |
| Plus: Items which increased basis other than amounts described in sec. 465(b) (3) or (4) | 0 |
| Total | 10,000 |
| Less: Distribution | 3,000 |
| Portion of loss ($23,000) in excess of portion of basis not at risk ($18,000) | 5,000 |
| Total | 8,000 |
| J's amount at risk on the effective date | 2,000 |

[T.D. 7504, 42 FR 42198, Aug. 22, 1977]

### § 7.704–1 Partner's distributive share.

(a)–(c) [Reserved]

(d) *Limitation on allowance of losses.*

(1)–(2) [Reserved]

(3)(i) Section 213(e) of the Tax Reform Act of 1976 amended section 704(d) of the Internal Revenue Code relating to the deductions by partners of losses incurred by a partnership. A partner is entitled to deduct the share of partnership loss to the extent of the adjusted basis of the partner's interest in the partnership. As amended, section 704(d) provides, in general, that the adjusted basis of a partner's interest in the partnership for the purpose of deducting

partnership losses shall not include any portion of a partnership liability for which the partner has no personal liability. This restriction, however, does not apply to any activity to the extent that section 465 of the Code applies nor to any partnership whose principal activity is investing in real property, other than mineral property. Section 465 does not apply to corporations other than a subchapter S corporation or a personal holding company.

(ii) The restrictions in the amendment to section 704(d) will not apply to any corporate partner with respect to liabilities incurred in an activity described in section 465(c)(1). In all other respects the restrictions in the amendment will apply to all corporate partners unless the partnership's principal activity is investment in real property, other than mineral property.

[T.D. 7445, 41 FR 55344, Dec. 20, 1976]

### § 7.936–1 Qualified possession source investment income.

For purposes of this section, interest earned after September 30, 1976 (less applicable deductions), by a domestic corporation, engaged in the active conduct of a trade or business in Puerto Rico, which elects the application of section 936 with respect to deposits with certain Puerto Rican financial institutions will be treated as qualified possession source investment income within the meaning of section 936(d)(2) if (1) the interest qualifies for exemption from Puerto Rican income tax under regulations issued by the Secretary of the Treasury of Puerto Rico, as in effect on September 28, 1976, under the authority of section 2(j) of the Puerto Rico Industrial Incentive Act of 1963, as amended, (2) the interest is from sources within Puerto Rico (within the meaning of section 936(d)(2)(A)), and (3) the funds with respect to which the interest is earned are derived from the active conduct of a trade or business in Puerto Rico or from investment of funds so derived.

[T.D. 7452, 41 FR 56794, Dec. 30, 1976]

### § 7.999–1 Computation of the international boycott factor.

(a) *In general.* Sections 908(a), 952(a)(3), and 995(b)(1)(F) provide that certain benefits of the foreign tax credit, deferral of earnings of foreign corporations, and DISC are denied if a person or a member of a controlled group (within the meaning of section 993(a)(3)) that includes that person participates in or cooperates with an international boycott (within the meaning of section 999(b)(3)). The loss of tax benefits may be determined by multiplying the otherwise allowable tax benefits by the ''international boycott factor.'' Section 999(c)(1) provides that the international boycott factor is to be determined under regulations prescribed by the Secretary. The method of computing the international boycott factor is set forth in paragraph (c) of this section. A special rule for computing the international boycott factor of a person that is a member of two or more controlled groups is set forth in paragraph (d). Transitional rules for making adjustments to the international boycott factor for years affected by the effective dates are set forth in paragraph (e). The definitions of the terms used in this section are set forth in paragraph (b).

(b) *Definitions.* For purposes of this section:

(1) *Boycotting country.* In respect of a particular international boycott, the term ''boycotting country'' means any country described in section 999(a)(1)(A) or (B) that requires participation in or cooperation with that particular international boycott.

(2) *Participation in or cooperation with an international boycott.* For the definition of the term ''participation in or cooperation with an international boycott'', see section 999(b)(3) and Parts H through M of the Treasury Department's International Boycott Guidelines.

(3) *Operations in or related to a boycotting country.* For the definitions of the terms ''operations'', ''operations in a boycotting country'', ''operations related to a boycotting country'', and ''operations with the government, a company, or a national of a boycotting

country'', see Part B of the Treasury Department's International Boycott Guidelines.

(4) *Clearly demonstrating clearly separate and identifiable operations.* For the rules for ''clearly demonstrating clearly separate and identifiable operations'', see Part D of the Treasury Department's International Boycott Guidelines.

(5) *Purchase made from a country.* The terms ''purchase made from a boycotting country'' and ''purchases made from any country other than the United States'' mean, in respect of any particular country, the gross amount paid in connection with the purchase of, the use of, or the right to use:

(i) Tangible personal property (including money) from a stock of goods located in that country,

(ii) Intangible property (other than securities) in that country,

(iii) Securities by a dealer to a beneficial owner that is a resident of that country (but only if the dealer knows or has reason to know the country of residence of the beneficial owner),

(iv) Real property located in that country, or

(v) Services performed in, and the end product of services performed in, that country (other than payroll paid to a person that is an officer or employee of the payor).

(6) *Sales made to a country.* The terms ''sales made to a boycotting country'' and ''sales made to any country other than the United States'' mean, in respect of any particular country, the gross receipts from the sale, exchange, other disposition, or use of:

(i) Tangible personal property (including money) for direct use, consumption, or disposition in that country,

(ii) Services performed in that country,

(iii) The end product of services (wherever performed) for direct use, consumption, or disposition in that country,

(iv) Intangible property (other than securities) in that country,

(v) Securities by a dealer to a beneficial owner that is a resident of that country (but only if the dealer knows or has reason to know the country of residence of the beneficial owner), or

(vi) Real property located in that country.

To determine the country of direct use, consumption, or disposition of tangible personal property and the end product of services, see paragraph (b)(10) of this section.

(7) *Sales made from a country.* The terms ''sales made from a boycotting country'' and ''sales made from any country other than the United States'' mean, in respect of a particular country, the gross receipts from the sale, exchange, other disposition, or use of:

(i) Tangible personal property (including money) from a stock of goods located in that country,

(ii) Intangible property (other than securities) in that country, or

(iii) Services performed in, and the end product of services performed in, that country.

However, gross receipts from any such sale, exchange, other disposition, or use by a person that are included in the numerator of that person's international boycott factor by reason of paragraph (b)(6) of this section shall not again be included in the numerator by reason of this subparagraph.

(8) *Payroll paid or accrued for services performed in a country.* The terms ''payroll paid or accrued for services performed in a boycotting country'' and ''payroll paid or accrued for services performed in any country other than the United States'' mean, in respect of a particular country, the total amount paid or accrued as compensation to officers and employees, including wages, salaries, commissions, and bonuses, for services performed in that country.

(9) *Services performed partly within and partly without a country*—(i) *In general.* Except as provided in paragraph (b)(9)(ii) of this section, for purposes of allocating to a particular country:

(A) The gross amount paid in connection with the purchase or use of,

(B) The gross receipts from the sale, exchange, other disposition or use of, and

(C) The payroll paid or accrued for services performed, or the end product of services performed, partly within and partly without that country, the amount paid, received, or accrued to be allocated to that country, unless the facts and circumstances of a particular

case warrant a different amount, will be that amount that bears the same relation to the total amount paid, received, or accrued as the number of days of performance of the services within that country bears to the total number of days of performance of services for which the total amount is paid, received, or accrued.

(ii) *Transportation, telegraph, and cable services.* Transportation, telegraph, and cable services performed partly within one country and partly within another country are allocated between the two countries as follows:

(A) In the case of a purchase of such services performed from Country A to Country B, fifty percent of the gross amount paid is deemed to be a purchase made from Country A and the remaining fifty percent is deemed to be a purchase made from Country B.

(B) In the case of a sale of such services performed from Country A to Country B, fifty percent of the gross receipts is deemed to be a sale made from Country R and the remaining fifty percent is deemed to be a sale made to Country B.

(10) *Country of use, consumption, or disposition.* As a general rule, the country of use, consumption, or disposition of tangible personal property (including money) and the end product of services (wherever performed) is deemed to be the country of destination of the tangible personal property or the end product of the services. (Thus, if legal services are performed in one country and an opinion is given for use by a client in a second country, the end product of the legal services is used, consumed, or disposed of in the second country.) The occurrence in a country of a temporary interruption in the shipment of the tangible personal property or the delivery of the end product of services shall not constitute such country the country of destination. However, if at the time of the transaction the person providing the tangible personal property or the end product of services knew, or should have known from the facts and circumstances surrounding the transaction, that the tangible personal property or the end product of services probably would not be used, consumed, or disposed of in the country of destination, that person must determine the country of ultimate use, consumption or disposition of the tangible personal property or the end product of services. Notwithstanding the preceding provisions of this subparagraph, a person that sells, exchanges, otherwise disposes of, or makes available for use, tangible personal property to any person all of whose business except for an insubstantial part consists of selling from inventory to retail customers at retail outlets all within one country may assume at the time of such sale to such person that the tangible personal property will be used, consumed, or disposed of within such country.

(11) *Controlled group taxable year.* The term ''controlled group taxable year'' means the taxable year of the controlled group's common parent corporation. In the event that no common parent corporation exists, the members of the group shall elect the taxable year of one of the members of the controlled group to serve as the controlled group taxable year. The taxable year election is a binding election to be changed only with the approval of the Secretary of his delegate. The election is to be made in accordance with the procedures set forth in the instructions to Form 5713, the International Boycott Report.

(c) *Computation of international boycott factor*—(1) *In general.* The method of computing the international boycott factor of a person that is not a member of a controlled group is set forth in paragraph (c)(2) of this section. The method of computing the international boycott factor of a person that is a member of a controlled group is set forth in paragraph (c)(3) of this section. For purposes of paragraphs (c) (2) and (3), purchases and sales made by, and payroll paid or accrued by, a partnership are deemed to be made or paid or accrued by a partner in that proportion that the partner's distributive share bears to the purchases and sales made by, and the payroll paid or accrued by, the partnership. Also for purposes of paragraphs (c) (2) and (3), purchases and sales made by, and payroll paid or accrued by, a trust referred to in section 671 are deemed to be made both by the trust (for purposes of determining

the trust's international boycott factor), and by a person treated under section 671 as the owner of the trust (but only in that proportion that the portion of the trust that such person is considered as owning under sections 671 through 679 bears to the purchases and sales made by, and the payroll paid and accrued by, the trust).

(2) *International boycott factor of a person that is not a member of a controlled group.* The international boycott factor to be applied by a person that is not a member of a controlled group (within the meaning of section 993(a)(3)) is a fraction.

(i) The numerator of the fraction is the sum of the—

(A) Purchases made from all boycotting countries associated in carrying out a particular international boycott.

(B) Sales made to or from all boycotting countries associated in carrying out a particular international boycott, and

(C) Payroll paid or accrued for services performed in all boycotting countries associated in carrying out a particular international boycott by that person during that person's taxable year, minus the amount of such purchases, sales, and payroll that is clearly demonstrated to be attributable to clearly separate and identifiable operations in connection with which there was no participation in or cooperation with that international boycott.

(ii) The denominator of the fraction is the sum of the—

(A) Purchases made from any country other than the United States,

(B) Sales made to or from any country other than the United States, and

(C) Payroll paid or accrued for services performed in any country other than the United States by that person during that person's taxable year.

(3) *International boycott factor of a person that is a member of a controlled group.* The international boycott factor to be applied by a person that is a member of a controlled group (within the meaning of section 993(a)(3)) shall be computed in the manner described in paragraph (c)(2) of this section, except that there shall be taken into account the purchases and sales made by, and the payroll paid or accrued by, each member of the controlled group during each member's own taxable year that ends with or within the controlled group taxable year that ends with or within that person's taxable year.

(d) *Computation of the international boycott factor of a person that is a member of two or more controlled groups.* The international boycott factor to be applied under sections 908(a), 952(a)(3), and 995(b)(1)(F) by a person that is a member of two or more controlled groups shall be determined in the manner described in paragraph (c)(3), except that the purchases, sales, and payroll included in the number and denominator shall include the purchases, sales, and payroll of that person and of all other members of the two or more controlled groups of which that person is a member.

(e) *Transitional rules*—(1) *Pre-November 3, 1976 boycotting operations.* The international boycott factor to be applied under sections 908(a), 952(a)(3), and 995(b)(1)(F) by a person that is not a member of a controlled group, for that person's taxable year that includes November 3, 1976, or a person that is a member of a controlled group, for the controlled group taxable year that includes November 3, 1976, shall be computed in the manner described in paragraphs (c)(2) and (c)(3), respectively, of this section. However, that the following adjustments shall be made:

(i) There shall be excluded from the numerators described in paragraphs (c)(2)(i) and (c)(3)(i) of this section purchases, sales, and payroll clearly demonstrated to be attributable to clearly separate and identifiable operations—

(A) That were completed on or before November 3, 1976, or

(B) In respect of which it is demonstrated that the agreements constituting participation in or cooperation with the international boycott were renounced, the renunciations were communicated on or before November 3, 1976, to the governments or persons with which the agreements were made and the agreements have not been reaffirmed after November 3, 1976, and

(ii) The international boycott factor resulting after the numerator has been modified in accordance with paragraph (e)(1)(i) of this section shall be further

modified by multiplying it by a fraction. The numerator of that fraction shall be the number of days in that person's taxable year (or, if applicable, in that person's controlled group taxable year) remaining after November 3, 1976, and the denominator shall be 366.

The principles of this subparagraph are illustrated in the following example:

*Example.* Corporation A, a calendar year taxpayer, is not a member of a controlled group. During the 1976 calendar year, Corporation DA had three operations in a boycotting country under three separate contracts, each of which contained agreements constituting participation in or cooperation with an international boycott. Each contract was entered into on or after September 2, 1976. Operation (1) was completed on November 1, 1976. The sales made to a boycotting country in connection with Operation (1) amounted to $10. Operation (2) was not completed during the taxable year, but on November 1, 1976, Corporation A communicated a renunciation of the boycott agreement covering that operation to the government of the boycotting country. The sales made to a boycotting country in connection with Operation (2) amounted to $40. Operation (3) was not completed during the taxable year, nor was any renunciation of the boycott agreement made. The sales made to a boycotting country in connection with Operation (3) amounted to $25. Corporation A had no purchases made from, sales made from, or payroll paid or accrued for services performed in, a boycotting country. Corporation A had $500 of purchases made from, sales made from, sales made to, and payroll paid or accrued for services performed in, countries other than the United States. Company A's boycott factor for 1976, computed under paragraph (c)(2) of this section (before the application of this subparagraph) would be:

$$(\$10 + \$40 + \$25) / \$500 = (\$75 / \$500)$$

However, the $10 is eliminated from the numerator by reason of paragraph (e)(1)(i)(A) of this section, and the $40 is eliminated from the numerator by reason of paragraph (e)(1)(i)(B) of this section. Thus, before the application of paragraph (e)(1)(ii) of this section, Corporation A's international boycott factor is $25/$500. After the application of paragraph (e)(1)(ii), Corporation A's international boycott factor is:

$$(\$25 / \$500) \times (58 / 366)$$

(2) *Pre-December 31, 1977 boycotting operations.* The international boycott factor to be applied under sections 908(a), 952(a)(3), and 995(b)(1)(F) by a person that is not a member of a controlled group, for that person's taxable year that includes December 31, 1977, or by a person that is a member of a controlled group, for the controlled group taxable year that includes December 31, 1977, shall be computed in the manner described in paragraphs (c)(2) and (c)(3), respectively, of this section. However, the following adjustments shall be made:

(i) There shall be excluded from the numerators described in paragraphs (c)(2)(i) and (c)(3)(i) of this section purchases, sales, and payroll clearly demonstrated to be attributable to clearly separate and identifiable operations that were carried out in accordance with the terms of binding contracts entered into before September 2, 1976, and—

(A) That were completed on or before December 31, 1977, or

(B) In respect of which it is demonstrated that the agreements constituting participation in or cooperation with the international boycott were renounced, the renunciations were communicated on or before December 31, 1977, to the governments or persons with which the agreements were made, and the agreements were not reaffirmed after December 31, 1977, and

(ii) In the case of clearly separate and identifiable operations that are carried out in accordance with the terms of binding contracts entered into before September 2, 1976, but that do not meet the requirements of paragraph (e)(2)(i) of this section, the numerators described in paragraphs (c)(2)(i) and (c)(3)(i) of this section shall be adjusted by multiplying the purchases, sales, and payroll clearly demonstrated to be attributable to those operations by a fraction, the numerator of which is the number of days in such person's taxable year (or, if applicable, in such person's controlled group taxable year) remaining after December 31, 1977, and the denominator of which is 365.

The principles of this subparagraph are illustrated in the following example:

*Example.* Corporation A is not a member of a controlled group and reports on the basis of a July 1–June 30 fiscal year. During the 1977–1978 fiscal year, Corporation A had 2 operations carried out pursuant to the terms of

separate contracts, each of which had a clause that constituted participation in or cooperation with an international boycott. Neither operation was completed during the fiscal year, nor were either of the boycotting clauses renounced. Operation (1) was carried out in accordance with the terms of a contract entered into on November 15, 1976. Operation (2) was carried out in accordance with the terms of a binding contract entered into before September 2, 1976. Corporation A had sales made to a boycotting country in connection with Operation (1) in the amount of $50, and in connection with Operation (2) in the amount of $100. Corporation A had sales made to countries other than the United States in the amount of $500. Corporation A had no purchases made from, sales made from, or payroll paid or accrued for services performed in, any country other than the United States. In the absence of this subparagraph, Corporation A's international boycott factor would be

$$(\$50 + \$100) / \$500.$$

However, by reason of the application of this subparagraph, Corporation A's international boycott factor is reduced to

$$\left[(\$50 + \$100)(181 / 365)\right] / \$500$$

(3) *Incomplete controlled group taxable year.* If, at the end of the taxable year of a person that is a member of a controlled group, the controlled group taxable year that includes November 3, 1976 has not ended, or the taxable year of one or more members of the controlled group that includes November 3, 1976 has not ended, then the international boycott factor to be applied under sections 908(a), 952(a)(3) and 995(b)(1)(F) by such person for the taxable year shall be computed in the manner described in paragraph (c)(3) of this section. However, the numerator and the denominator in that paragraph shall include only the purchases, sales, and payroll of those members of the controlled group whose taxable years ending after November 3, 1976 have ended as the end of the taxable year of such person.

(f) *Effective date.* This section applies to participation in or cooperation with an international boycott after November 3, 1976. In the case of operations which constitute participation in or cooperation with an international boycott and which are carried out in accordance with the terms of a binding contract entered into before September 2, 1976, this section applies to such participation or cooperation after December 31, 1977.

[T.D. 7467, 42 FR 11833, Mar. 1, 1977]

### § 7.6039A–1 Information regarding carryover basis property acquired from a decedent.

(a) *Information for Internal Revenue Service.* In the case of a decedent who dies after December 31, 1976, the executor (as defined in section 2203) shall furnish to the Internal Revenue Service the following information, as applicable—

(1) If an estate tax return is required to be filed under section 6018 of the Internal Revenue Code of 1954, as amended, and if the return form contains questions relating to carryover basis property, the executor must answer those questions.

(2) If no estate tax return is required to be filed under section 6018 of the Internal Revenue Code of 1954, as amended, or if a return is required to be filed but the return form used does not contain questions relating to carryover basis property, the executor must file the form prescribed by the Commissioner. This form may be attached to the estate tax return or the decedent's final individual income tax return. If this form is not attached to the estate

tax return or the decedent's final individual income tax return, it must be filed with the Internal Revenue Service office where the decedent's final income tax return would be filed if one were required within 9 months after the date of the decedent's death or by December 31, 1978, whichever is later.

(b) *Information to be furnished to beneficiaries.* Any executor required under paragraph (a) of this section to furnish information to the Internal Revenue Service relating to carryover basis property must furnish in writing to the distributee of each piece of carryover basis property—

(1) A description of the property,

(2) The adjusted basis of the property as computed under section 1023 (a), (c), and (d),

(3) The amount of the increase in the basis of the property determined under section 1023(h),

(4) The value of the property for Federal estate tax purposes, and

(5) A notice that the beneficiary should keep this information as part of permanent records.

(c) *Time for furnishing information to beneficiaries.* The information which an executor is required to furnish to the beneficiaries under this paragraph must be furnished on or before the latest of—

(1) The date the property is distributed to the beneficiary,

(2)(i) In the case of an executor who is required to file an estate tax return, 6 months after the due date (including extensions) of such return,

(ii) In the case of an executor who is not required to file an estate tax return, 15 months from the date of death of the decedent, or

(3) December 31, 1978.

(d) *Subsequent adjustments to carryover basis.* In the event subsequent adjustments are made which relate to the carryover basis of any piece of property included in a decedent's gross estate, whether by reason of an adjustment resulting from an examination of the estate tax return or otherwise, any executor required under paragraph (a) of this section to furnish information to the Internal Revenue Service shall, within 3 months of a determination, as defined in section 1313 (a), of such adjustments, provide to the recipient of each item of carryover basis property the information set forth in paragraph (b) of this section recomputed as required by such adjustments.

(e) *Effective date.* This section is effective in respect of decedents dying after December 31, 1976.

(Secs. 7805 and 6039A of the Internal Revenue Code of 1954 (68A Stat. 917, 90 Stat. 1878; 26 U.S.C. 7805, 6039A))

[T.D. 7540, 43 FR 16735, Apr. 20, 1978, as amended by T.D. 7559, 43 FR 36244, Aug. 16, 1978]

### § 7.6041–1 Return of information as to payments of winnings from bingo, keno, and slot machines.

(a) *In general.* On or after May 1, 1977, every person engaged in a trade or business and making a payment in the course of such trade or business of winnings (including winnings which are exempt from withholding under section 3402(q)(5)) of $1,200 or more from a bingo game or slot machine play or of $1,500 or more from a keno game shall make an information return with respect to such payment.

(b) *Special rules.* For purposes of paragraph (a) of this section, in determining whether such winnings equal or exceed the $1,200 or $1,500 amount—

(1) In the case of a bingo game or slot machine play, the amount of winnings shall not be reduced by the amount wagered;

(2) In the case of a keno game, the amount of winnings from one game shall be reduced by the amount wagered in that one game;

(3) Winnings shall include the fair market value of a payment in any medium other than cash;

(4) All winnings by the winner from one bingo or keno game shall be aggregated; and

(5) Winnings and losses from any other wagering transaction by the winner shall not be taken into account.

(c) *Prescribed form.* The return required by paragraph (a) of this section shall be made on Form W–2G and shall be filed with the Internal Revenue Service Center serving the district in which is located the principal place of business of the person making the return on or before February 28 of the calendar year following the calendar year in which the payment of winnings

is made. Each Form W–2G shall contain the following:

(1) Name, address, and employer identification number of the person making the payment;

(2) Name, address, and social security number of the winner;

(3) General description of two types of identification *(e.g.,* ''driver's license'', ''social security card'', or ''voter registration card'') furnished to the maker of the payment for verification of the winner's name, address, and social security number;

(4) Date and amount of the payment; and

(5) Type of wagering transaction.

In addition, in the case of a bingo or keno game, Form W–2G shall show any number, color, or other designation assigned to the game with respect to which the payment is made. In the case of a slot machine play, Form W–2G shall show the identification number of the slot machine.

[T.D. 7457, 42 FR 1471, Jan. 7, 1977, as amended by T.D. 7492, 42 FR 33286, June 30, 1977]

## PART 8—TEMPORARY INCOME TAX REGULATIONS UNDER SECTION 3 OF THE ACT OF OCTOBER 26, 1974 (PUB. L. 93–483)

AUTHORITY: Secs. 2055(e)(3) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

### § 8.1 Charitable remainder trusts.

(a) *Certain wills and trusts in existence on September 21, 1974.* In the case of a will executed before September 21, 1974, or a trust created (within the meaning of applicable local law) after July 31, 1969, and before September 21, 1974, which is amended pursuant to section 2055(e)(3) and § 24.1 of this chapter (Temporary Estate Tax Regulations), a charitable remainder trust resulting from such amendment will be treated as a charitable remainder trust from the date it would be deemed created under § 1.664–1(a) (4) and (5) of this chapter (Income Tax Regulations), whether or not such date is after September 20, 1974.

(b) *Certain transfers to trusts created before August 1, 1969.* Property transferred to a trust created (within the meaning of applicable local law) before August 1, 1969, whose governing instrument provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust shall be deemed transferred to a trust created on the date of such transfer, provided that the transfer occurs after July 31, 1969 and prior to October 18, 1971, and pursuant to an amendment provided in § 24.1 of this chapter (Temporary Estate Tax Regulations), the transferred property and any undistributed income therefrom is severed and placed in a separate trust as of the date of the amendment.

[T.D. 7393, 40 FR 58853, Dec. 19, 1975]

## PART 9—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REDUCTION ACT OF 1975

Sec.

9.1 Investment credit—public utility property elections.
9.2 [Reserved]
9.3 Temporary TRASOP requirements for 1-percent additional investment credit.

### § 9.1 Investment credit—public utility property elections.

(a) *Applicability of prior election under section 46(f)*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, an election made before March 10, 1972 (hereinafter referred to as a 1972 election) under section 46(f) (redesignated from section 46(e) by the Tax Reduction Act of 1975) applies to the credit allowable for a taxable year with respect to public utility property described in section 46(f)(5) by reason of sections 301 and 302 of the Tax Reduction Act of 1975.

(2) *1972 immediate flow-through election.* A 1972 election under section 46(f)(3) (hereinafter referred to as an election for immediate flow-through) does not apply to the additional credit allowed under section 38 with respect to limited property (public utility property described in section 46(c)(3)(B) to which section 167(1)(2)(C) applies, other than nonregulated communication property of the type described in the last sentence of section 46(c)(3)(B) by reason of the Tax Reduction Act of 1975. However, a 1972 election for immediate flow-through does apply to the

additional credit allowed for a taxable year with respect to property described in section 46(f)(5)(B). See paragraph (b) of this section for a new election under section 46(f)(3) with regard to the additional credit with respect to limited property allowed by reason of the Tax Reduction Act of 1975. See paragraph (a)(3) of this section for determination of additional credit. For purposes of this section the phrase ''determined as if the Tax Reduction Act had not been enacted'' means the following amendments shall be disregarded in determining credit allowable or allowed:

(i) The increase in the amount of credit from 7 percent to 10 or 11 percent under section 46(a)(1) (A), (B), and (D),

(ii) The increase in the amount of qualified investment from 4/7 to 7/7 under section 46(a)(1)(C) and (c)(3)(A),

(iii) The increase in the dollar limitation from $50,000 to $100,000 on used property under section 48(c)(2), and

(iv) The increase in the limitation based on tax under section 46(a)(6) for certain public utilities.

In determining the amount of credit attributable to limited property possible disallowance under section 46(f) shall be disregarded.

(3) *Additional credit allowed*—(i) *Credit earned in taxable year.* The amount of additional credit allowed for credit earned for limited property for taxable year is an amount equal to the excess of—

(A) The credit allowed by section 38 for the taxable year (determined without regard to section 46(b)) multiplied by a fraction, the numerator of which is the amount of credit earned for limited property for the taxable year and the denominator of which is the amount of credit earned for all section 38 property for the taxable year, over

(B) The amount of normal credit allowed for limited property for the taxable year (determined without regard to section 46(b)). The amount of normal credit allowed for limited property is the amount of credit that would be allowed for the taxable year determined as if the Tax Reduction Act had not been enacted multiplied by a fraction, the numerator of which is the amount of credit earned for limited property for the taxable year determined as if the Tax Reduction Act had not been enacted and the denominator of which is the credit earned for all section 38 property for the taxable year determined as if the Tax Reduction Act had not been enacted.

(ii) *Carryover or carryback to taxable year.* The amount of additional credit allowed for limited property attributable to a carryover or a carryback of any unused credit to any taxable year in an amount equal to the excess of—

(A) The amount of credit allowed by section 38 for the taxable year by reason of section 46(b) multiplied by the fraction contained in paragraph (a)(3)(i)(A) of this section for the unused credit year, over

(B) The amount of unused normal credit allowed for limited property for the taxable year. The amount of unused normal credit allowed for limited property is the amount of unused credit that would be allowed for the taxable year under section 38 by reason of section 46(b), taking into account the amount of unused credit that would be allowed for any preceding year, determined as if the Tax Reduction Act had not been enacted, multiplied by the fraction contained in paragraph (a)(3)(i)(B) of this section for the unused credit year.

(b) *New election*—(1) *In general.* A taxpayer who made a 1972 election for immedite flow-through under section 46(f)(3) with respect to limited property may elect to apply section 46(f)(3) to the additional credit allowed by the Tax Reduction Act of 1975 with respect to such property, or, if eligible, may make the election in paragraph (b)(2) of this section to apply section 46(f)(2) to such additional credit. The election to apply section 46(f) (2) or (3) must be made before June 28, 1975, in the manner provided in paragraph (c) of this section. If the taxpayer does not make a new election, section 46(f)(1) shall apply to additional credit for limited property. However, if the taxpayer made a 1972 election under section 46(f)(2) with respect to property to which section 46(f)(3) does not apply, then section 46(f)(2) shall apply to such additional credit notwithstanding any prohibition in section 46(f)(3) to the contrary.

(2) *Special section 46(f)(2) election.* A taxpayer who:

(i) Made a 1972 election under section 46(f)(3),

(ii) Did not make an election to apply section 46(f)(2) with respect to property to which section 46(f)(3) does not apply, and

(iii) Did not acquire property to which section 46(f)(1) applied in any taxable year ending before January 1, 1975, may elect to apply section 46(f)(2) to the additional credit allowed by the Tax Reduction Act of 1975 with respect to limited property notwithstanding any prohibition in section 46(f)(3) to the contrary.

(c) *Method of making election.* A taxpayer may make an election described in paragraph (b) of this section by filing a statement before June 28, 1975, with the district director or director of the internal revenue service center with whom the taxpayer ordinarily files its income tax return. For rules with respect to taxpayers filing consolidated returns, see §1.1502–77(a) of part 1 of this chapter. The statement shall contain the following information: (1) The name, address, and taxpayer identification number of the taxpayer, and (2) the election which the taxpayer is making under paragraph (b) of this section. If a taxpayer is electing flow-through under section 46(f)(3), the statement shall also contain a written recitation that the election is made at the taxpayer's own option and without regard to any requirement imposed by an agency described in section 46(c)(3)(B) having jurisdiction over the taxpayer. The recitation shall be verified by a written declaration that it is made under the penalties of perjury.

(Secs. 46(f) and 7805 of the Internal Revenue Code of 1954 (85 Stat. 503, 68A Stat. 917; 26 U.S.C. 46, 7805))

[T.D. 7360, 40 FR 25472, June 16, 1975]

### § 9.2 [Reserved]

### § 9.3 Temporary TRASOP requirements for 1-percent additional investment credit.

The provisions listed in §1.46–8 (a)(4)(i)—(ix) (Income Tax Regulations) are deemed effective only as temporary regulations under this section.

(Sec. 301(d)(2)(C) and (10) of the Tax Reduction Act of 1975 and sec. 7805 of the Internal Revenue Code of 1954 (89 Stat. 38, 68A Stat. 917 (26 U.S.C. 7805)))

[T.D. 7589, 44 FR 4145, Jan. 16, 1979; 44 FR 6715, Feb. 2, 1979]

## PART 11—TEMPORARY INCOME TAX REGULATIONS UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

Sec.

11.401(a)–11 Qualified joint and survivor annuities.
11.401(a)–19 Nonforfeitability in case of certain withdrawals.
11.401(b)–1 Certain retroactive changes in plan.
11.401(d)(1)–1 Nonbank trustees of trusts benefiting owner-employees.
11.402(e)(4)(A)–1 Lump sum distributions in the case of an employee who has separated from service.
11.402(e)(4)(B)–1 Election to treat an amount as a lump sum distribution.
11.404(a)(6)–1 Time when contributions to ''H.R. 10'' plans considered made.
11.408(a)(2)–1 Trustee of individual retirement accounts.
11.410–1 Election by church to have participation, vesting, funding, etc., provisions apply.
11.410(b)–1 Minimum coverage requirements.
11.412(c)–7 Election to treat certain retroactive plan amendments as made on the first day of the plan year.
11.412(c)–11 Election with respect to bonds.
11.412(c)–12 Extension of time to make contributions to satisfy requirements of section 412.
11.415(c)(4)–1 Special elections for section 403(b) annuity contracts purchased by educational institutions, hospitals and home health service agencies.

AUTHORITY: Sec. 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805), unless otherwise noted.

### § 11.401(a)–11 Qualified joint and survivor annuities.

(a) *In general*—(1) *General rule.* A trust, which is a part of a plan providing for the payment of benefits in any form of a life annuity (*i.e.*, an annuity requiring survival of the participant or his spouse as a condition for payment), shall not constitute a qualified trust under section 401(a)(11) and

this section unless such plan provides that these benefits must be paid in a form having the effect of a qualified joint and survivor annuity. Therefore, any benefits which may be paid in any form of a life annuity must be paid in a form having the effect of a qualified joint and survivor annuity unless the participant makes the election, described in paragraph (c) of this section, not to receive benefits in this form. A plan will not fail to meet the requirements of section 401(a)(11) and this section merely because it provides that the spouse of a deceased participant may elect to have benefits paid in a form other than a qualified joint and survivor annuity. Section 401(a)(11) and this section shall apply only in the case of a plan to which section 411 (relating to minimum vesting standards) applies without regard to section 411(e)(2). Without regard to the election provided under paragraph (d)(3) of this section, unless an election has been made under paragraph (c) of this section, a plan to which this section applies must provide that a survivor annuity shall be payable on the death of an active participant after normal retirement age.

(2) *Illustration*. The provisions of this paragraph may be illustrated by the following example:

*Example.* The X Corporation Defined Contribution Plan was established in 1960. As in effect on January 1, 1974, the plan provided that, upon his retirement, a participant could elect to receive the balance of his individual account in the form of (1) a lump-sum cash payment, (2) a lump-sum distribution consisting of X Corporation stock, (3) five equal annual cash payments, (4) a life annuity, or (5) a combination of options (1) through (4). The plan also provided that, if a participant did not elect another form of distribution, the balance of his individual account would be distributed to him in the form of a lump-sum cash payment upon his retirement. Assume that section 401(a)(11) and this section first become applicable to the plan as of its plan year beginning January 1, 1976, with respect to persons who were active participants in the plan on such date (see paragraph (h) of this section). Unless the X Corporation Defined Contribution Plan either discontinues the life annuity payment option or is amended to provide that the balance of a participant's individual account will be paid to him in a form having the effect of a qualified joint and survivor annuity unless the participant elects another form of benefit payment, the trust established under the plan will fail to qualify under section 401(a).

(b) *Definitions.* As used in this section—

(1) *Qualified joint and survivor annuity*. The term ''qualified joint and survivor annuity'' means an annuity for the life of the participant with a survivor annuity for the life of his spouse which is neither (i) less than one-half of, nor (ii) greater than, the amount of the annuity payable during the joint lives of the participant and his spouse. A qualified joint and survivor annuity must be at least the actuarial equivalent of the normal form of annuity or any optional form of benefit offered under the plan. Equivalence may be determined, on the basis of consistently applied reasonable actuarial factors, for each participant or for all participants or reasonable groupings of participants, if such determination does not result in discrimination in favor of employees who are officers, shareholders, or highly compensated. An annuity is not a qualified joint and survivor annuity if payments to the spouse of a deceased participant are terminated because of such spouse's remarriage.

(2) *Annuity starting date.* The term ''annuity starting date'' means the first day of the first period with respect to which an amount is received as an annuity, whether by reason of retirement or by reason of disability.

(3) *Earliest retirement age.* The term ''earliest retirement age'' means the earliest date on which, under the plan, the participant could elect to receive retirement benefits, including any benefit the participant is entitled to receive on account of disability.

(c) *Election not to take joint and survivor annuity form*—(1) *In general.* A plan shall not be treated as satisfying the requirements of this section unless each participant has the right to elect in writing not to take a joint and survivor annuity during a reasonable period before the annuity starting date. However, if a plan provides that a qualified joint and survivor annuity is the only form of benefit payable under the plan, no election need be provided.

(2) *Information to be provided to the participant.* (i) The plan administrator

must furnish to the participant a written notification, in nontechnical terms, of the availability of the election provided by this paragraph, within a reasonable amount of time after the first day of the election period. This notification shall also inform the participant of the availability of the information specified in subdivision (ii) of this subparagraph.

(ii) The plan administrator must furnish to the participant a written explanation in nontechnical language of the terms and conditions of the joint and survivor annuity and the financial effect upon the participant's annuity (in terms of dollars per annuity payment) of making an election under this paragraph. This explanation must be provided to the participant within a reasonable amount of time from the date of the participant's request during the election period.

(3) *Form of election.* The election shall be in writing and clearly indicate that the participant is electing to receive his benefits under the plan in a form other than that of a joint and survivor annuity.

(4) *Election is revocable.* This election may be revoked in writing during the election period. After an election is revoked another election under this paragraph may be made during the election period.

(d) *Plans providing for early retirement*—(1) *Period during which qualified joint and survivor annuity not required.* Notwithstanding the provisions of paragraph (a) of this section, in the case of a plan which provides for the payment of benefits before the normal retirement age (as defined in section 411(a)(8)), the plan is not required to provide for the payment of annuity benefits in a form having the effect of a qualified joint and survivor annuity during the period beginning on the date on which the employee enters into the plan as a participant and ending on the later of—

(i) The date the employee reaches the earliest retirement age under the plan (as defined in paragraph (b)(3) of this section), or

(ii) The first day of the 120th month beginning before the date on which the employee reaches normal retirement age.

(2) *Period during which qualified joint and survivor annuity required.* (i) If a participant terminates employment and begins to receive retirement benefits during the period described in subparagraph (1) of this paragraph, he and his spouse must receive, after the termination of such period (or after the date such period would have terminated if the participant had survived), benefits having the effect of a qualified joint and survivor annuity, unless the participant has made an election under paragraph (c) of this section.

(ii) If a participant terminates employment and begins to receive retirement benefits after the period described in subparagraph (1) of this paragraph, he and his spouse must receive benefits having the effect of a qualified joint and survivor annuity, unless the participant has made an election under paragraph (c) of this section.

(iii) The provisions of this subparagraph may be illustrated by the following example:

*Example.* A plan which provides a benefit in the form of a life annuity also provides that a participant may retire before the normal retirement age of 65 and receive a benefit, if he has completed 30 years of service. A, an employee, became a participant at the age of 18. A retires and begins to receive retirement benefits at the age of 48. Unless A otherwise elects, the plan must provide a qualified joint and survivor annuity to A and his spouse after A reaches age 55 (the later of the earliest retirement age (age 48) or 10 years before normal retirement age (age 55)) or after the date A would have reached age 55, if he had survived. The survivor annuity paid to the spouse must satisfy the requirements of paragraph (b)(1) of this section. The plan may, but is not required to, provide the survivor annuity before age 55 if the participant dies between age 48 and age 55.

(3) *Election of survivor annuity*—(i) *In general.* (A) A plan described in subparagraph (1) of this paragraph does not meet the requirements of paragraph (a) of this section unless, under the plan, a participant may elect, during a reasonable period, a survivor annuity to be payable on his death during the period beginning on the date on which the period described in subparagraph (1) of this paragraph ends and ending on the date on which he reaches normal retirement age if he continues

his employment during that period. Breaks in service during that period will neither invalidate a previous election or revocation nor prevent an election from being made or revoked during the election period.

(B) If a plan provides that a survivor annuity is the only form of benefit payable under the plan, no election need be provided.

(ii) *Example.* The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

*Example.* A plan which provides a life annuity also provides that a participant may retire before the normal retirement age of 65 and receive a benefit, if he has completed 30 years of service. Under this plan, an employee who became a participant at the age of 18 will be eligible to receive retirement benefits at the age of 48. This plan must allow a participant who continues his employment to elect a survivor annuity, described in subdivision (v) of this subparagraph, to be payable on the death of the participant if death occurs after age 55 (the later of the date the participant reaches the earliest retirement age (age 48) or 10 years before normal retirement age (age 55)) but before the date the participant reaches normal retirement age (age 65).

(iii) *Information to be provided by plan administrator.* (A) The plan administrator must furnish to the participant a written notification in nontechnical terms of the availability of the election provided by this subparagraph, within a reasonable amount of time after the first day of the election period. This notification shall also inform the participant of the availability of the information specified in subdivision (iii)(B) of this subparagraph.

(B) During the election period, the plan administrator must furnish to the participant, within a reasonable amount of time from the date of his request, a written explanation in nontechnical language of the terms and conditions of the survivor annuity and the financial effect upon the participant's annuity (in terms of dollars per annuity payment) of an election or of a revocation of an election under this subparagraph.

(iv) *Payments under the survivor annuity.* In order to meet the requirements of this subparagraph, if an election is made, the payments under the survivor annuity must not be less than the payments which would have been made under the joint and survivor annuity to which the surviving spouse would have been entitled if the participant had made the election described in this subparagraph immediately prior to his retirement and if his retirement had occurred on the day before his death and within the period during which an election can be made. For example, if a participant is entitled to a single life annuity of $100 per month or a reduced amount under a qualified joint and survivor annuity of $80 per month, regardless of when he makes a valid election under subparagraph (2) of this paragraph, his spouse is entitled to a payment of at least $40, but not more than $80 per month, under the survivor annuity.

(v) *Form of election.* The election shall be in writing and clearly indicate that the participant is electing the joint and survivor annuity form.

(vi) *Election is revocable.* An election under this subparagraph may be revoked in writing during the election period. After an election has been revoked, another election under this subparagraph may be made during the election period. See paragraph (c) of this section, relating to the right to elect not to take the joint and survivor annuity form.

(e) *Marriage requirements.* (1) A plan shall be treated as satisfying the requirements of this section even though it requires the participant and his spouse to have been married to each other on the annuity starting date.

(2) A plan shall be treated as satisfying the requirements of this section even though it provides that the spouse of the participant is not entitled to receive a survivor annuity (whether or not the election described in paragraph (d)(3) of this section has been made) unless the participant and his spouse have been married to each other throughout the 1-year period ending on the date of such participant's death.

(f) *Effect of participant's death on an election or revocation of an election under paragraph (c)* or *(d)(3).* A plan shall not be treated as not satisfying the requirements of this section merely because the plan contains a provision

that any election made under paragraph (c) or (d)(3) of this section and any revocation of any such election does not become effective or ceases to be effective if the participant dies within a period, not in excess of 2 years, beginning on the date of such election or revocation. A plan containing a provision described in the preceding sentence shall not satisfy the requirements of this section unless it also provides that any such election and any revocation of any such election will be given effect in any case in which—

(1) The participant dies from accidental causes,

(2) A failure to give effect to the election or revocation would deprive the participant's survivor of a survivor annuity, and

(3) Such election or revocation is made before such accident occurred.

(g) *Costs of providing joint and survivor annuity form.* A plan may take into account in any equitable manner consistent with generally accepted actuarial principles applied on a consistent basis any increased costs resulting from providing joint and survivor annuity benefits.

(h) *Application and effective date.* (1) Section 401(a)(11) and this section shall apply to a plan only with respect to plan years to which section 411 (relating to minimum vesting standards) is applicable to the plan.

(2) Section 401(a)(11) and this section shall apply if—

(i) The participant's annuity starting date falls within a plan year beginning after December 31, 1975, and

(ii) The participant was an active participant in the plan on or after the first day of the first plan year beginning after December 31, 1975.

For purposes of this paragraph, the term ''active participant'' means a participant for whom benefits are being accrued under the plan on his behalf, the employer is obligated to contribute to or under the plan on his behalf, or the employer would have been obligated to contribute to or under the plan on his behalf if any contributions were made to or under the plan.

(Sec. 401(a)(11) of the Internal Revenue Code of 1954, 88 Stat. 935 (26 U.S.C. 401(a)(11)))

[T.D. 7379, 40 FR 45810, Oct. 3, 1975; 40 FR 49326, Oct. 22, 1975]

### § 11.401(a)–19 Nonforfeitability in case of certain withdrawals.

(a) *Application of section.* Section 401(a)(19) and this section apply to a plan to which section 411(a) applies. (See section 411(e) and § 11.411(a)–2 for applicability of section 411.)

(b) *Prohibited forfeitures*—(1) *General rule.* A plan to which this section applies is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if, under such plan, any part of a participant's accrued benefit derived from employer contributions is forfeitable solely because a benefit derived from the participant's contributions under the plan is voluntarily withdrawn by him after he has become a 50 percent vested participant.

(2) *50 percent vested participant.* For purposes of paragraph (b)(1) of this section, a participant is a 50 percent vested participant when he has a nonforfeitable right (within the meaning of section 411 and the regulations thereunder) to at least 50 percent of his accrued benefit derived from employer contributions.

(3) *Certain forfeitures.* Paragraph (b)(1) of this section does not apply in the case of a forfeiture permitted by section 411(a)(3)(D)(iii) and § 11.411(a)–4(b)(5)(i) (relating to forfeitures of certain benefits accrued before September 2, 1974).

[T.D. 7387, 40 FR 51421, Nov. 5, 1975]

### § 11.401(b)–1 Certain retroactive changes in plan.

(a) *General rule.* (1) Under section 401(b), a stock bonus, pension, profit-sharing or annuity plan or bond purchase plan which does not satisfy the requirements of section 401(a) on any day solely as a result of a disqualifying provision (as defined in paragraph (b) of this section) shall be considered to have satisfied such requirements on such day if there is adopted during the

remedial amendment period (as determined under paragraphs (c) and (d) of this section) with respect to such disqualifying provision an amendment which causes the plan to satisfy all such requirements of section 401(a), 403(a) or 405(a) for the whole of the remedial amendment period (including extension thereof).

(2) This section shall not apply to any disqualifying provision if the remedial amendment period (as determined under paragraphs (c) and (d)(1) of this section determined without regard to paragraph (d)(2) of this section) with respect to such disqualifying provision ends prior to September 2, 1974.

(b) *Disqualifying provisions.* For purposes of this section, with respect to a plan described in paragraph (a) of this section the term ''disqualifying provision'' means any provision of—

(1) A plan as adopted,

(2) A plan amendment, or

(3) The Employee Income Security Act of 1974 (Pub. L. 93–406, 88 Stat. 829), which causes such plan to fail to satisfy the requirements of section 401(a), 403(a), or 405(a).

(c) *Remedial amendment period.* (1) The remedial amendment period with respect to a disqualifying provision begins on the effective date of the disqualifying provision. For purposes of this section, the effective date of a disqualifying provision is—

(i) In the case of a disqualifying provision in a plan as adopted, the date the plan is put into effect,

(ii) In the case of a plan amendment, the date the plan amendment is adopted or put into effect (whichever is earlier), or

(iii) In the case of a statutory provision described in paragraph (b)(3) of this section, the effective date of such provision.

(2) Unless extended as provided by paragraph (d) of this section, the remedial amendment period ends with the time prescribed by law (including extensions) for filing the return of the employer for the employer's taxable year in which falls—

(i) With respect to a disqualifying provision in a plan as adopted, or a plan amendment, the later of the date on which such provision was adopted or put into effect.

(ii) With respect to a statutory provision described in paragraph (b)(3) of this section, the effective date of such provision.

(d) *Extension for determination letters*—(1) *In general.* If, before the end of the remedial amendment period (determined without regard to this paragraph) with respect to a disqualifying provision, the employer or plan administrator files a request pursuant to § 601.210(o) of this chapter (Statement of Procedural Rules) for a determination letter with respect to the initial qualifications of the plan or the effect of such disqualifying provision on the qualified status of the plan (or a trust which is part of a plan) under section 401(a), 403(a), or 405(a), then except as provided in subparagraph (3) of this paragraph, such remedial amendment period may be extended for a period not to exceed 150 days, beginning on the day after the last day of the employers taxable year in which falls the dates described in subdivisions (i) and (ii) of paragraph (c)(2) of this section. The 150-day period does not include any day on which there is pending before the Internal Revenue Service a request for a determination letter described in this subparagraph. For this purpose, such a request is considered to be pending before the Internal Revenue Service from the date it is filed with the Internal Revenue Service to the date on which notice of the final determination with respect to the request is issued by the Internal Revenue Service, the request is withdrawn, or the request is otherwise finally disposed of by the Internal Revenue Service.

(2) *Special rules.* Except as provided in subparagraph (3) of this paragraph, the period provided by subparagraph (1) of this paragraph shall not end prior to the later of December 31, 1975, or the expiration of 30 days after—

(i) The date on which a notice of final determination with respect to a request described in that subparagraph is issued by the Internal Revenue Service, or, where applicable,

(ii) The date on which a judgment pursuant to section 7476 (relating to declaratory judgments) by the United States Tax Court in a case or controversy involving such determination becomes final.

(3) *Overall limitation.* The period provided by subparagraph (1) of this paragraph shall not expire later than the last day (determined under section 6501) for assessment of any tax imposed by the Internal Revenue Code with respect to the taxable year of the employer immediately preceding the first day of such period.

(Sec. 401(b), Internal Revenue Code of 1954, 88 Stat. 943 (26 U.S.C. 401(b)))

[T.D. 7377, 40 FR 44544, Sept. 29, 1975]

### § 11.401(d)(1)–1 Nonbank trustees of trusts benefiting owner-employees.

(a) *Effective dates*—(1) *General rule.* For a plan not in existence on January 1, 1974, this section shall apply to the first plan year commencing after September 2, 1974, and all subsequent plan years.

(2) *Existing plans.* For a plan in existence on January 1, 1974, this section shall apply to the first plan year commencing after December 31, 1975, and all subsequent plan years.

(b) *In general.* For plan years to which this section applies, the trustee of a trust described in § 1.401–12(c)(1)(i) may (notwithstanding § 1.401–12(c)) be a person other than a bank (within the meaning of section 401(d)(1)) if he demonstrates to the satisfaction of the Commissioner that the manner in which he will administer trusts will be consistent with the requirements of section 401. Such demonstration must be made by a written application to the Commissioner of Internal Revenue, Attention: E:EP, Internal Revenue Service, Washington, DC 20224. Such application must meet the requirements set forth in paragraphs (c) to (g) of this section.

(c) *Fiduciary ability.* The applicant must demonstrate in detail his ability to act within the accepted rules of fiduciary conduct. Such demonstration must include the following elements of proof:

(1) *Continuity.* (i) The applicant must assure the uninterrupted performance of its fiduciary duties notwithstanding the death or change of its owners. Thus, for example, there must be sufficient diversity in the ownership of the applicant to ensure that the death or change of its owners will not interrupt the conduct of its business. Therefore, the applicant cannot be an individual.

(ii) Sufficient diversity in the ownership of an incorporated applicant means that individuals each of whom owns more than 20 percent of the voting stock in the applicant own, in the aggregate, no more than 50 percent of such stock.

(iii) Sufficient diversity in the ownership of an applicant which is a partnership means that—

(A) Individuals each of whom owns more than 20 percent of the profits interest in the partnership own, in the aggregate, no more than 50 percent of such profits interest, and

(B) Individuals each of whom owns more than 20 percent of the capital interest in the partnership own, in the aggregate, no more than 50 percent of such capital interest.

(iv) For purposes of this subparagraph, the ownership of stock and of capital and profits interests shall be determined in accordance with the rules for constructive ownership of stock provided in section 1563(e) and (f)(2). For this purpose, the rules for constructive ownership of stock provided in section 1563(e) and (f)(2). For this purpose, the rules for constructive ownership of stock provided in section 1563(e) and (f)(2) shall apply to a capital or profits interest in a partnership as if it were a stock interest.

(2) *Established location.* The applicant must have an established place of business in the United States where he is accessible during every business day.

(3) *Fiduciary experience.* The applicant must have fiduciary experience or expertise sufficient to ensure that he will be able to perform his fiduciary duties. Evidence of fiduciary experience must include proof that a significant part of the business of the applicant consists of exercising fiduciary powers similar to those he will exercise if his application is approved. Evidence of fiduciary expertise must include proof that the applicant employs personnel experienced in the administration of fiduciary powers similar to those he will exercise if his application is approved.

(4) *Fiduciary responsibility.* The applicant must assure compliance with the rules of fiduciary conduct set out in paragraph (f) of this section.

(5) *Financial responsibility.* The applicant must exhibit a high degree of solvency commensurate with the obligations imposed by this section. Among the factors to be taken into account are the applicant's net worth, his liquidity, and his ability to pay his debts as they come due.

(d) *Capacity to account.* The applicant must demonstrate in detail his experience and competence with respect to accounting for the interests of a large number of individuals (including calculating and allocating income earned and paying out distributions to payees). Examples of accounting for the interests of a large number of individuals include accounting for the interests of a large number of shareholders in a regulated investment company and accounting for the interests of a large number of variable annuity contract holders.

(e) *Fitness to handle funds*—(1) *In general.* The applicant must demonstrate in detail his experience and competence with respect to other activities normally associated with the handling of retirement funds.

(2) *Examples.* Examples of activities normally associated with the handling of retirement funds include:

(i) To receive, issue receipts for, and safely keep securities;

(ii) To collect income;

(iii) To execute such ownership certificates, to keep such records, make such returns, and render such statements as are required for Federal tax purposes;

(iv) To give proper notification regarding all collections;

(v) To collect matured or called principal and properly report all such collections;

(vi) To exchange temporary for definitive securities;

(vii) To give proper notification of calls, subscription rights, defaults in principal or interest, and the formation of protective committees;

(viii) To buy, sell, receive, or deliver securities on specific directions.

(f) *Rules of fiduciary conduct*—(1) *Administration of fiduciary powers.* The applicant must demonstrate that under applicable regulatory requirements, corporate or other governing instruments, or its established operating procedures:

(i)(A) The owners or directors of the applicant will be responsible for the proper exercise of fiduciary powers by the applicant. Thus, all matters pertinent thereto, including the determination of policies, the investment and disposition of property held in a fiduciary capacity, and the direction and review of the actions of all employees utilized by the applicant in the exercise of his fiduciary powers, will be the responsibility of the owners or directors. In discharging this responsibility, the owners or directors may assign to designated employees, by action duly recorded, the administration of such of the applicant's fiduciary powers as may be proper to assign.

(B) A written record will be made of the acceptance and of the relinquishment or closing out of all fiduciary accounts, and of the assets held for each account.

(C) At least once during each period of 12 months all the assets held in or for each fiduciary account where the applicant has investment responsibilities will be reviewed to determine the advisability of retaining or disposing of such assets.

(ii) All employees taking part in the performance of the applicant's fiduciary duties will be adequately bonded. Nothing in this subdivision shall require any person to be bonded in contravention of section 412(d) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1112(d)).

(iii) The applicant will designate, employ, or retain legal counsel who will be readily available to pass upon fiduciary matters and to advise the applicant.

(iv) In order to segregate the performance of his fiduciary duties from other business activities, the applicant will maintain a separate trust division under the immediate supervision of an individual designated for that purpose. The trust division may utilize the personnel and facilities of other divisions of the applicant, and other divisions of the applicant may utilize the personnel and facilities of the trust division, as long as the separate identity of the trust division is preserved.

(2) *Adequacy of net worth.* (i) Not less frequently than once during each calendar year the applicant will determine the value of the assets held by him in trust. Such assets will be valued at their current value, except that the assets of an employee benefit plan to which section 103(b)(3)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1023(b)(3)(A)) applies will be considered to have the value stated in the most recent annual report of the plan.

(ii) No fiduciary account will be accepted by the applicant unless his net worth (determined as of the end of the most recent taxable year) exceeds the greater of—

(A) $100,000, or

(B) Four percent of the value of all of the assets held by the applicant in trust (determined as of the most recent valuation date).

(iii) The applicant will take whatever lawful steps are necessary (including the relinquishment of fiduciary accounts) to ensure that his net worth (determined as of the close of each taxable year) exceeds the greater of—

(A) $50,000, or

(B) Two percent of the value of all of the assets held by the applicant in trust (determined as of the most recent valuation date).

(3) *Audits.* (i) The applicant will at least once during each period of 12 months cause detailed audits of the fiduciary books and records to be made by an independent qualified public accountant, and at such time will ascertain whether the fiduciary accounts have been administered in accordance with law, this section, and sound fiduciary principles. Such audits shall be conducted in accordance with generally accepted auditing standards, and shall involve such tests of the fiduciary books and records of the applicant as are considered necessary by the independent qualified public accountant.

(ii) In the case of an applicant who is regulated, supervised, and subject to periodic examination by a State or Federal agency, such applicant may adopt an adequate continuous audit system in lieu of the periodic audits required by paragraph (f)(3)(i) of this section.

(iii) A report of the audits and examinations required under this subparagraph, together with the action taken thereon, will be noted in the fiduciary records of the applicant.

(4) *Funds awaiting investment or distribution.* Funds held in a fiduciary capacity by the applicant awaiting investment or distribution will not be held uninvested or undistributed any longer than is reasonable for the proper management of the account.

(5) *Custody of investments.* (i) Except for investments pooled in a common investment fund in accordance with the provisions of paragraph (f)(6) of this section, the investments of each account will not be commingled with any other property.

(ii) Fiduciary assets requiring safekeeping will be deposited in an adequate vault. A permanent record will be kept of fiduciary assets deposited in or withdrawn from the vault.

(6) *Common investment funds.* Where not in contravention of local law the assets of an account may be pooled in a common investment fund (as defined in paragraph (f)(8)(iii) of this section) which must be administered as follows:

(i) Each common investment fund must be established and maintained in accordance with a written agreement, containing appropriate provisions as to the manner in which the fund is to be operated, including provisions relating to the investment powers and a general statement of the investment policy of the applicant with respect to the fund; the allocation of income, profits and losses; the terms and conditions governing the admission or withdrawal of participations in the fund; the auditing of accounts of the applicant with respect to the fund; the basis and method of valuing assets in the fund, setting forth specific criteria for each type of asset; the minimum frequency for valuation of assets of the fund; the period following each such valuation date during which the valuation may be made (which period in usual circumstances may not exceed 10 business days); the basis upon which the fund may be terminated; and such other matters as may be necessary to define clearly the rights of participants in the fund. A

copy of the agreement must be available at the principal office of the applicant for inspection during all business hours, and upon request a copy of the agreement must be furnished to any interested person.

(ii) All participations in the common investment fund must be on the basis of a proportionate interest in all of the assets.

(iii) Not less frequently than once during each period of 3 months applicant must determine the value of the assets in the fund as of the date set for the valuation of assets. No participation may be admitted to or withdrawn from the fund except (A) on the basis of such valuation and (B) as of such valuation date. No participation may be admitted to or withdrawn from the fund unless a written request for or notice of intention of taking such action has been entered on or before the valuation date in the fiduciary records of the applicant. No request or notice may be canceled or countermanded after the valuation date.

(iv)(A) The applicant must at least once during each period of 12 months cause an adequate audit to be made of the common investment fund by a qualified public accountant.

(B) The applicant must at least once during each period of 12 months prepare a financial report of the fund which, based upon the above audit, must contain a list of investments in the fund showing the cost and current market value of each investment; a statement for the period since the previous report showing purchases, with cost; sales, with profit or loss and any other investment changes; income and disbursements; and an appropriate notation as to any investments in default.

(C) The applicant must transmit and certify the accuracy of the financial report to the administrator of each plan participating in the common investment fund within 120 days after the end of the plan year.

(v) When participations are withdrawn from a common investment fund, distributions may be made in cash or ratably in kind, or partly in cash and partly in kind, provided that all distributions as of any one valuation date must be made on the same basis.

(vi) If for any reason an investment is withdrawn in kind from a common investment fund for the benefit of all participants in the fund at the time of such withdrawal and such investment is not distributed ratably in kind, it must be segregated and administered or realized upon for the benefit ratably of all participants in the common investment fund at the time of withdrawal.

(7) *Books and records.* (i) The applicant must keep his fiduciary records separate and distinct from other records. All fiduciary records must be so kept and retained for as long as the contents thereof may become material in the administration of any internal revenue law. The fiduciary records must contain full information relative to each account.

(ii) The applicant must keep an adequate record of all pending litigation to which he is a party in connection with the exercise of fiduciary powers.

(8) *Definitions.* For purposes of this paragraph and paragraph (c)(5) of this section—

(i) The term ''account'' or ''fiduciary account'' means a trust described in section 401(a) (including a custodial account described in section 401(f)), a custodial account described in section 403(b)(7), or an individual retirement account described in section 408(a) (including a custodial account described in section 408(h)).

(ii) The term ''administrator'' means an administrator as defined in section 3(16)(A) of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1002(16)(A).

(iii) The term ''common investment fund'' means a trust which satisfied the following requirements:

(A) The trust consists of all or part of the assets of several accounts which have been established with the applicant, and

(B) The trust is described in section 401(a) and exempt from tax under section 501(a), or is a common investment fund described in §1.408–2(b)(5) (as published with notice of proposed rulemaking in the FEDERAL REGISTER on February 21, 1975, at 40 FR 7661), or both.

(iv) The term ''employee benefit plan'' means an employee benefit plan as defined in section 3(2) of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1002(2).

(v) The term ''fiduciary records'' means all matters which are written, transcribed, recorded, received or otherwise come into the possession of the applicant and are necessary to preserve information concerning the acts and events relevant to the fiduciary activities of the applicant.

(vi) The term ''qualified public accountant'' means a qualified public accountant as defined in section 103(a)(3)(D) of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1023(a)(3)(D).

(vii) The term ''net worth'' means the amount of the applicant's assets less the amount of his liabilities, as determined in accordance with generally accepted accounting principles.

(g) *Special rules*—(1) *Passive trustee.* (i) An applicant who undertakes to act only as a passive trustee may be relieved of one or more of the requirements of this section upon clear and convincing proof that such requirements are not germane, under all the facts and circumstances, to the manner in which he will administer any trust. A trustee is a passive trustee only if under the written trust instrument he has no discretion to direct the investment of the trust funds or any other aspect of the business administration of the trust, but is merely authorized to acquire and hold particular investments specified by the trust instrument. Thus, for example, in the case of an applicant who undertakes merely to acquire and hold the stock of a single regulated investment company, the requirements of paragraphs (f)(1)(i)(C), (1)(iv), and (6) of this section shall not apply and no negative inference shall be drawn from the applicant's failure to demonstrate his experience or competence with respect to the activities described in paragraph (e)(2)(v) to (viii) of this section.

(ii) The determination letter issued to an applicant who is approved by reason of this subparagraph shall state that the applicant is authorized to act only as a passive trustee.

(2) *Federal or State regulation.* Evidence that an applicant is subject to Federal or State regulation with respect to one or more relevant factors shall be given weight in proportion to the extent that such regulatory standards are consonant with the requirements of section 401.

(3) *Savings account.* (i) An applicant will be approved to act as trustee under this subparagraph if the following requirements are satisfied:

(A) The applicant is a credit union, industrial loan company, savings and loan association, or other financial institution designated by the Commissioner;

(B) The investment of the trust assets will be solely in deposits in the applicant;

(C) Deposits in the applicant are insured (up to the dollar limit prescribed by applicable law) by an agency or instrumentality of the United States or a State.

(ii) Any applicant who satisfies the requirements of this subparagraph is hereby approved, and (notwithstanding paragraph (b) of this section) is not required to submit a written application. This approval takes effect on the first day after December 22, 1976, on which the applicant satisfies the requirements of this subparagraph, and continues in effect for so long as the applicant continues to satisfy those requirements.

(4) *Notification of Commissioner.* The applicant must notify the Commissioner in writing of any change which affects the continuing accuracy of any representation made in the application required by this section, whether the change occurs before or after the applicant receives a determination letter. Such notification must be addressed to Commissioner of Internal Revenue, Attention: E:EP, Internal Revenue Service, Washington, DC 20224.

(5) *Substitution of trustee.* No applicant shall be approved unless he undertakes to act as trustee only under trust instruments which contain a provision to the effect that the employer is to substitute another trustee upon notification by the Commissioner that such substitution is required because the applicant has failed to comply with the requirements of this section or is not

keeping such records, or making such returns, or rendering such statements as are required by forms or regulations.

(6) *Revocation.* Approval of the application required by this section may be revoked for any good and sufficient reason.

(Sec. 401(d)(1) and Internal Revenue Code of 1954 (88 Stat. 939 26 U.S.C. 401))

[T.D. 7383, 40 FR 48509, Oct. 16, 1975 as amended by T.D. 7448, 41 FR 55510, Dec. 21, 1976]

### § 11.402(e)(4)(A)–1 Lump sum distributions in the case of an employee who has separated from service.

(a) *Balance to the credit of an employee.* Section 402(e)(4)(A) provides that in order for a distribution or payment from a qualified plan to be a lump sum distribution, the distribution or payment must represent the employee's balance under the plan. The employee's balance does not include any amount which is forfeited under the plan (even though the amount may be reinstated) as of the close of the taxable year of the recipient within which the distribution is made. In addition, in the case of an employee who has separated from service, the employee's balance does not include an amount which is subject to forfeiture not later than the close of the plan year within which the employee incurs a one-year break in service (within the meaning of section 411) if—

(1) By reason of the break in service, the amount is actually forfeited at or prior to the close of that plan year, and

(2) The break in service occurs within 25 months after the employee's separation from service. In the case of a plan which uses the elapsed time method of crediting service, the break in service may occur within 25 months of the employee's severance from service. See Department of Labor regulations relating to the elapsed time method for the date an employee severs from service.

An employee may assume that an amount subject to forfeiture will be treated as forfeited by the date prescribed in paragraphs (a) (1) and (2) of this section if, under the plan, forfeiture will occur not later than that date. Therefore, he may assume that a distribution is a lump sum distribution at the time it is made, if the other requirements for lump sum distributions are satisfied. However, if the amount is not forfeited by that date, the amount will be taken into account in determining the balance to the credit of the employee. Accordingly, the distribution will not be a lump sum distribution because it did not include the employee's entire balance under the plan.

(b) *Rollover contribution.* As described in paragraph (a) of this section, an employee may assume that a distribution is a lump sum distribution even though part of the balance of his account has not been forfeited at the time the distribution is made. He may then roll the distribution over as a contribution to an individual retirement arrangement pursuant to section 402(a)(5) or 403(a)(4). It may be subsequently determined that the distribution was not a lump sum distribution because an amount subject to forfeiture was not in fact forfeited within the time required in paragraph (a) of this section. In that case, the contribution will be an excess contribution to the individual retirement arrangement, deemed made in the first taxable year of the employee in which it can be determined that an amount subject to forfeiture will not be forfeited.

(c) *Effective date.* This section is effective for distributions made in taxable years of recipients beginning after December 31, 1973.

[T.D. 7488, 42 FR 27882, June 1, 1977]

### § 11.402(e)(4)(B)–1 Election to treat an amount as a lump sum distribution.

(a) *In general.* For purposes of sections 402, 403, and this section, an amount which is described in section 402(e)(4)(A) and which is not an annuity contract may be treated as a lump sum distribution under section 402(e)(4)(A) only if the taxpayer elects for the taxable year to have all such amounts received during such year so treated. Not more than one election may be made under this section with respect to an employee after such employee has attained age 59½.

(b) *Taxpayers eligible to make the election.* Individuals, estates, and trusts are the only taxpayers eligible to make the election provided by this section. In the case of a lump sum distribution made with respect to an employee to 2 or more trusts, the election provided

by this section shall be made by the employee or by the personal representative of a deceased employee.

(c) *Procedure for making election*—(1) *Time and scope of election.* An election under this section shall be made for each taxable year to which such election is to apply. The election shall be made before the expiration of the period (including extension thereof) prescribed in section 6511 for making a claim for credit or refund of the assessed tax imposed by Chapter I of Subtitle A of the Code for such taxable year.

(2) *Manner of making election.* An election by the taxpayer with respect to a taxable year shall be made by filing Form 4972 as a part of the taxpayer's income tax return or amended return for the taxable year.

(3) *Revocation of election.* An election made pursuant to this section may be revoked within the time prescribed in subparagraph (1) of this paragraph for making an election, only if there is filed, within such time, an amended income tax return for such taxable year, which includes a statement revoking the election and is accompanied by payment of any tax attributable to the revocation. If an election for a taxable year is revoked, another election may be made for that taxable year under subparagraphs (1) and (2) of this paragraph.

(Sec. 402(e)(4)(B) of the Internal Revenue Code of 1954 (88 Stat. 989, 26 U.S.C. 402(e)(4)(B)))

[T.D. 7339, 40 FR 1016, Jan. 6, 1975]

### § 11.404(a)(6)–1 Time when contributions to "H.R. 10" plans considered made.

(a) *In general.* Section 404(a)(6), as amended by section 1013(c)(2) of the Employee Retirement Income Security Act of 1974, provides that for purposes of paragraphs (1), (2), and (3) of section 404(a), a taxpayer shall be deemed to have made a payment on the last day of the preceding taxable year if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). Under section 1017(b) of the Employee Retirement Income Security Act of 1974 (prior to its amendment by the Tax Reduction Act of 1975), in the case of a plan which was in existence on January 1, 1974, the foregoing provision generally applies for contributions on account of taxable years of an employer ending with or within plan years beginning after December 31, 1975. In the case of a plan not in existence on January 1, 1974, the foregoing provision generally applies for contributions on account of taxable years of an employer ending with or within plan years beginning after September 2, 1974. See § 11.410(a)–2(c) for time a plan is considered in existence. See also § 11.410(a)–2(d), which provides that a plan in existence on January 1, 1974 may elect to have certain provisions, including the amendment to section 404(a)(6) contained in section 1013 of the Employee Retirement Income Security Act of 1974, apply to a plan year beginning after September 2, 1974, and before the otherwise applicable effective date contained in that section.

(b) *''H.R. 10'' plans may elect new provision.* Under section 402 of the Tax Reduction Act of 1975 (89 Stat. 47), in the case of a plan which was in existence on January 1, 1974, and which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1) of the Code and § 1.401–10(b), the provision described in paragraph (a) of this section shall apply for taxable years of an employer ending with or within plan years beginning after December 31, 1974, but only if the employer (within the meaning of section 401(c)(4) of the Code and § 1.401–10(e)) elects to have such provisions apply as provided in paragraph (c) of this section.

(c) *Manner of election.* The election described in paragraph (b) of this section shall be considered to be made if the employer (as described in paragraph (b) of this section)—

(1) Makes a contribution which relates to his preceding taxable year within the time prescribed in paragraph (a) of this section to a plan described in paragraph (b) of this section, and

(2) Claims a deduction for such contribution on his tax return for such year (or, in the case of a contribution by a partnership on behalf of a partner, the contribution is shown on Schedule

K of the partnership tax return for such year); no formal statement is necessary. In the case of an employer whose income tax return for the year on account of which the payment is made is required to be filed (determined without regard to extensions of time) on or before April 15, 1976, and who made a payment within the time prescribed in paragraph (a) of this section, the election also may be made by filing an amended return or claim for refund with respect to such year on or before September 30, 1976.

(d) *Election is irrevocable.* Any election made under paragraph (c) of this section, once made, shall be irrevocable.

(e) *Examples.* The rules of this section are illustrated by the following examples.

*Example (1).* On October 15, 1976, the ABC Partnership made a contribution to the ABC Profit Sharing Plan and Trust on behalf of partners and common-law employees with respect to the plan year ending December 31, 1975. The ABC Profit Sharing Trust was exempt under section 501 (a) throughout 1975. The contribution for both partners and employees was reflected on the partnership return for the calendar year 1975 which was filed on October 10, 1976; proper extensions of the due date of the partnership return had been received, extending the due date to October 15, 1976. The election is valid since all requirements of this section have been met.

*Example (2).* The XYZ Partnership made a plan contribution on April 10, 1976, with respect to the plan year ending December 31, 1975, but the amount contributed for 1975 was not reflected in the partnership return filed for the calendar year 1975 on April 15, 1976. However, the XYZ Partnership filed an amended partnership return for the year 1975 on September 30, 1976, claiming a deduction for the employee-related contribution and setting forth on Schedule K the contribution relating to partners. The election is valid, since the contribution on account of 1975 was made within the time required, and was shown on the amended tax return of the employer for 1975 filed within the time prescribed in paragraph (c)(2) of this section.

*Example (3).* Mr. Smith, a sole proprietor whose taxable year is the calendar year, made a contribution to the Smith Profit Sharing Plan and Trust on April 15, 1976, for the plan year which began December 1, 1974, and ended November 30, 1975. The plan was in existence on January 1, 1974. Since the contribution was made within the time prescribed by this section and was on account of a taxable year of the employer ending within a plan year which began after December 31, 1974, the contribution may be deducted on Mr. Smith's return for 1975, even though the contribution was for a plan year beginning before December 31, 1974.

*Example (4).* The DEF Partnership, reporting its income on the basis of a fiscal year ending June 30, made a contribution to its ''H.R. 10'' plan which was in existence on January 1, 1974, and whose plan year was the calendar year. The contribution was made on September 30, 1975, and was on account of the taxable year of the partnership ending June 30, 1975. The contribution was properly reflected in the partnership return for the fiscal year ending June 30, 1975. The partnership's election to have section 404(a)(6), as amended, apply to its fiscal year ending June 30, 1975, is valid since that year ended with or within a plan year beginning after December 31, 1974.

[T.D. 7402, 41 FR 5633, Feb. 9, 1976]

### § 11.408(a)(2)–1 Trustee of individual retirement accounts.

A person may demonstrate to the satisfaction of the Commissioner that the manner in which he will administer the trust will be consistent with the requirements of section 408 only upon the filing of a written application to the Commissioner of Internal Revenue, Attention: E:EP, Internal Revenue Service, Washington, D.C. 20224. Such application must meet the applicable requirements of the regulations under section 401(d)(1) relating to nonbank trustees of pension and profit-sharing trusts benefiting owner-employees.

(Sec. 408(a)(2) of the Internal Revenue Code of 1954 (88 Stat. 959, 26 U.S.C. 408(a)(2)))

[T.D. 7390, 40 FR 53580, Nov. 19, 1975]

### § 11.410–1 Election by church to have participation, vesting, funding, etc., provisions apply.

(a) *In general.* If a church or convention or association of churches which maintains any church plan, as defined in section 414(e), makes an election under this section, certain provisions of the Code and Title I of the Employee Retirement Income Security Act of 1974 (the ''Act'') shall apply to such church plan as if such plan were not a church plan. The provisions of the Code referred to are section 410 (relating to minimum participation standards), section 411 (relating to minimum vesting standards), section 412 (relating to minimum funding standards), section

4975 (relating to prohibited transactions), and paragraphs (11), (12), (13), (14), (15), and (19) of section 401(a) (relating to joint and survivor annuities, mergers and consolidations, assignment or alienation of benefits, time of benefit commencement, certain social security increases, and withdrawals of employee contributions, respectively).

(b) *Election is irrevocable.* An election under this section with respect to any church plan shall be binding with respect to such plan and, once made, shall be irrevocable.

(c) *Procedure for making election*—(1) *Time of election.* An election under this section may be made for plan years for which the provisions of section 410(d) of the Code apply to the church plan. By reason of section 1017(b) of the Act section 410(d) does not apply to a plan in existence on January 1, 1974, for plan years beginning before December 31, 1975. Section 1017(d) of the Act permits a plan administrator to elect to have certain provisions of the Code (including section 410(d)) apply to a plan before the otherwise applicable effective dates of such provisions. See § 420.0–1 of the regulations in this chapter (Temporary Regulations on Procedure and Administration under the Employee Retirement Income Security Act of 1974). Therefore, an election under section 410(d) of the Code may be made for a plan year beginning before December 31, 1975, only if an election has been made under section 1017(d) of the Act with respect to that plan year.

(2) *By whom election is to be made.* The election provided by this section may be made only by the plan administrator of the church plan.

(3) *Manner of making election.* The plan administrator may elect to have the provisions of the Code described in paragraph (a) of this section apply to the church plan as if it were not a church plan by attaching the statement described in subparagraph (5) of this paragraph to either (i) the annual return required under section 6058(a) (or an amended return) with respect to the plan which is filed for the first plan year for which the election is effective or (ii) a written request for a determination letter relating to the qualification of the plan under section 401(a), 403(a), or 405(a) of the Code and, if trusteed, the exempt status under section 501(a) of the Code of a trust constituting a part of the plan.

(4) *Conditional election.* If an election is made with a written request for a determination letter, the election may be conditioned upon issuance of a favorable determination letter and will become irrevocable upon issuance of such letter.

(5) *Statement.* The statement described in subparagraph (3) of this paragraph shall indicate (i) that the election is made under section 410(d) of the Code and (ii) the first plan year for which it is effective.

(Sec. 410(d), Internal Revenue Code, 1954 (88 Stat. 901; 26 U.S.C. 410(d)))

[T.D. 7363, 40 FR 27217, June 27, 1975]

### § 11.410(b)–1 Minimum coverage requirements.

(a)–(c) [Reserved]

(d) *Special rules.* (1) [Reserved]

(2) *Discrimination.* The determination as to whether a plan discriminates in favor of employees who are officers, shareholders, or highly compensated, is made on the basis of the facts and circumstances of each case, allowing a reasonable difference between the percentage of such employees benefited by the plan to all employees benefited by the plan and the percentage of all such employees of the employer to all employees of the employer. A showing that a specified percentage of employees covered by a plan are not officers, shareholders, or highly compensated, without a showing that the difference (if any) between such percentage and the percentage of all employees who are not officers, shareholders, or highly compensated is reasonable, is not sufficient to establish that the plan does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

(Sec. 410, Internal Revenue Code of 1954 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7380, 40 FR 45816, Oct. 3, 1975, as amended by T.D. 7508, 42 FR 47197, Sept. 20, 1977]

**§11.412(c)–7 Election to treat certain retroactive plan amendments as made on the first day of the plan year.**

(a) *General rule.* Under section 412(c)(8), a plan administrator may elect to have any amendment which is adopted after the close of the plan year to which it applies deemed to have been made on the first day of such plan year if the amendment—

(1) Is adopted no later than 2 and one-half months after the close of such plan year (or, in the case of a multiemployer plan, no later than 2 years after the close of such plan year),

(2) Does not reduce the accrued benefit of any participant determined as of the beginning of such plan year, and

(3) Does not reduce the accrued benefit of any participant determined as of the time of adoption of the amendment, or, if it does so reduce such accrued benefit, it is shown that the plan administrator filed a notice with the Secretary of Labor notifying him of the amendment, and—

(i) The Secretary of Labor approved the amendment, or

(ii) The Secretary of Labor failed to disapprove the amendment within 90 days after the date on which the notice was filed.

(b) *Time and manner of making election.* (1) The election under section 412(c)(8) shall be made by the plan administrator by a statement of election described in subparagraph (3) of this paragraph, attached to the annual return relating to minimum funding standards required to be filed under section 6058 with respect to the plan year to which the election relates.

(2) In the event that an amendment to which paragraph (a) of this section applies is adopted after the filing of the annual return required under section 6058, the plan administrator may make the election under section 412(c)(8) by attaching a statement of election, described in paragraph (b)(3) of this section, to a copy of such annual return, and filing such copy no later than the time allowed for the filing of such returns under section 6058. (In the case of multiemployer plans, such copy may be filed within a 24 month period beginning with the date prescribed for the filing of such returns.)

(3) The statement of election filed by or on behalf of the plan administrator shall—

(i) State the date of the close of the first plan year to which the amendment applies and the date on which the amendment was adopted;

(ii) Contain a statement that the amendment does not reduce the accrued benefit of any participant determined as of the beginning of the plan year preceding the plan year in which the amendment is adopted; and

(iii) Contain either—

(A) A statement that the amendment does not reduce the accrued benefit of any participant determined as of the time of adoption of such amendment, or

(B) A copy of the notice filed with the Secretary of Labor under section 412(c)(8) and a statement that either the Secretary of Labor has approved the amendment or he has failed to act within 90 days after notification of the amendment.

[T.D. 7338, 39 FR 44751, Dec. 27, 1974]

**§11.412(c)–11 Election with respect to bonds.**

(a) *In general.* Section 412(c)(2)(B) provides that, at the election of the administrator of a plan which includes a trust qualified under section 401(a) or of a plan which satisfies the requirements of section 403(a) or section 405(a), the value of a bond or other evidence of indebtedness which is held by the plan and which is not in default as to principal or interest may be determined on an amortized basis running from initial cost at purchase to the amount payable at maturity (or, in the case of a bond which is callable prior to maturity, the earliest call date). So long as this election is in effect, the value of any such evidence of indebtedness shall, for purposes of section 412, be determined on such an amortized basis rather than on a method taking into account fair market value as described in section 412(c)(2)(A).

(b) *Manner of making election.* The election to value evidences of indebtedness in accordance with paragraph (a) of this section shall be made by a statement to that effect attached to and filed as a part of the annual return

of the plan required under section 6058 of the Code.

(c) *Effect of election.* The election provided by section 412(c)(2)(B), once made, will affect the valuation of all evidences of indebtedness, not in default as to principal or interest, which are held by the plan for the plan year for which the election is made and any evidences of indebtedness which are subsequently acquired by the plan. The value of any evidence of indebtedness which is in default as of the valuation date for the plan year must be determined on the basis of any reasonable actuarial method of valuation which takes into account fair market value in accordance with section 412(c)(2)(A) and must continue to be so valued until the indebtedness is no longer in default.

(d) *Consent to revoke required*—(1) *In general.* An election made in accordance with paragraph (a) of this section may be revoked only if consent to revoke the election is obtained from the Secretary or his delegate.

(2) *Manner of obtaining permission for revocation.* [Reserved]

(Secs. 302(c)(2)(B), 412(c)(2)(B) of the Internal Revenue Code of 1954 (88 Stat. 871, 914))

[T.D. 7335, 39 FR 44009, Dec. 20, 1974]

### § 11.412(c)–12 Extension of time to make contributions to satisfy requirements of section 412.

(a) *In general.* Section 412(c)(10) of the Internal Revenue Code of 1954 provides that for purposes of section 412 a contribution for a plan year made after the end of such plan year but not later than two and one-half months after the last day of such plan year shall be deemed to have been made on such last day. Section 412(c) (10) further provides that the two and one-half month period may be extended for not more than six months under regulations.

(b) *Six month extension of two and one-half month period.* (1) For purposes of section 412 a contribution for a plan year to which section 412 applies that is made not more than eight and one-half months after the end of such plan year shall be deemed to have been made on the last day of such year.

(2) The rules of this section relating to the time a contribution to a plan is deemed made for purposes of the minimum funding standard under section 412 are independent from the rules contained in section 404(a) (6) relating to the time a contribution to a plan is deemed made for purposes of claiming a deduction for such contribution under section 404.

(Sec. 412(c)(10), Internal Revenue Code of 1954 (88 Stat. 917; 26 U.S.C. 412(c)(10)))

[T.D. 7439, 41 FR 46597, Oct. 22, 1976]

### § 11.415(c)(4)–1 Special elections for section 403(b) annuity contracts purchased by educational institutions, hospitals and home health service agencies.

(a) *Limitations applicable to contributions for section 403(b) annuity contracts*—(1) *In general.* An annuity contract described in section 403(b) which is treated as a defined contribution plan (as defined in section 414(i)) is subject to the rules regarding the amount of annual additions (as defined in section 415(c)(2)) that may be made to a participant's account in a defined contribution plan for any limitation year (as defined in subparagraph (2) of this paragraph) under section 415(c)(1) and Revenue Ruling 75–481, 1975–2 C.B. 188. An annual addition to the account of an individual under a section 403(b) annuity contract in excess of such limitation for a limitation year is includible in the gross income of the individual for the taxable year with or within which such limitation year ends and reduces the exclusion allowance under section 403(b)(2) for such taxable year to the extent of the excess. Such annuity contracts are, of course, also subject to the limitation imposed by section 403(b)(2) with respect to the amount that may be contributed by the employer for the purchase of an annuity contract described in section 403(b) and be excluded from the gross income of the employee on whose behalf such annuity contract is purchased. In general, the excludable contribution for such an annuity contract for a particular taxable year is the lesser of the exclusion allowance computed under section 403(b)(2) for such taxable year or the limitation imposed by section 415(c)(1) for the limitation year ending with or within such taxable year. For purposes of the limitation imposed by section 415(c)(1), the

amount contributed toward the purchase of an annuity contract described in section 403(b) is treated as allocated to the employee's account as of the last day of the limitation year ending with or within the taxable year during which such contribution is made.

(2) *Limitation year.* For purposes of this section—

(i) Except as provided in subdivision (ii) of this subparagraph, the limitation year applicable to an individual on whose behalf an annuity contract described in section 403(b) has been purchased by an employer shall be the calendar year unless such individual elects to change the limitation year to another 12-month period and attaches a statement to his income tax return filed for the taxable year in which such change is made.

(ii) The limitation year applicable to an individual described in subdivision (i) of this subparagraph who is in control (within the meaning of section 414 (b) or (c) as modified by section 415(h)) of any employer shall be the same as the limitation year of such employer.

(3) *Special elections.* Under section 415(c)(4), special elections are permitted with respect to section 403(b) annuity contracts (including custodial accounts treated as section 403(b) annuity contracts under section 403(b)(7)) purchased by educational institutions (as defined in section 151(e)(4) and the regulations thereunder), home health service agencies (as defined in subparagraph (4) of this paragraph) and hospitals. In lieu of the limitation described in section 415(c)(1)(B) otherwise applicable to the annual addition (as defined in section 415(c)(2)) that may be made to the account of a participant in a qualified defined contribution plan for a particular limitation year, an individual for whom an annuity contract described in this subparagraph is purchased may elect, in accordance with the provisions of paragraph (b) of this section, to have substituted for such limitation the amounts described in subparagraph (5)(i) or (5)(ii) of this paragraph. In lieu of the exclusion allowance determined under section 403(b)(2) and the regulations thereunder otherwise applicable for the taxable year with or within which the limitation year ends to an individual on whose behalf an annuity contract described in this subparagraph is purchased, such an individual may elect, in accordance with the provisions of paragraph (b) of this section, to have substituted for such exclusion allowance the amount described in subparagraph (5)(iii) of this paragraph.

(4) *Definition.* For purposes of this section, a home health service agency is an organization described in section 501(c)(3) which is exempt from taxation under section 501(a) and which has been determined by the Secretary of Health, Education, and Welfare to be a home health agency under section 1395(x)(o) of Title 42 of the United States Code.

(5) *Elections.* (i) For the limitation year that ends with or within the taxable year in which an individual separates from the service of his employer (and only for such limitation year), the ''(A) election limitation'' shall be the exclusion allowance computed under section 403(b)(2)(A) and the regulations thereunder (without regard to section 415) for the taxable year in which such separation occurs taking into account such individual's years of service (as defined in section 403(b)(4) and the regulations thereunder) for the employer and contributions described in section 403(b)(2)(A)(ii) and the regulations thereunder during the period of years (not exceeding 10) ending on the date of separation. For purposes of the preceding sentence, all service for the employer performed within such period must be taken into account. However, the ''(A) election limitation'' shall not exceed the amount described in section 415(c)(1)(A) (as adjusted under section 415(d)(1)(B)) applicable to such individual for such limitation year.

(ii) For any limitation year, the ''(B) election limitation'' shall be equal to the least of the following amounts—

(A) $4,000, plus 25 percent of the individual's includable compensation (as defined in section 403(b)(3) and the regulations thereunder) for the taxable year with or within which the limitation year ends,

(B) The amount of the exclusion allowance determined under section 403(b)(2)(A) and the regulations thereunder for the taxable year with or within which such limitation year ends, or

(C) $15,000.

(iii) For any taxable year, the ''(C) election limitation'' shall equal the lesser of the amount described in section 415(c)(1)(A) (as adjusted under section 415(d)(1)(B)) or the amount described in section 415(c)(1)(B) applicable to the individual for the limitation year ending with or within such taxable year. For purposes of the preceding sentence, compensation described in section 415(c)(1)(B) taken into account for a particular limitation year does not include amounts contributed toward the purchase of an annuity contract described in section 403(b) during such limitation year (whether or not includable in the gross income of the individual on whose behalf such contribution is made).

(b) *Special rules for elections and salary reduction agreements for years before final regulations are published*—(1) *Election.* (i) For a limitation year which ends before or with or within the taxable year in which applicable final regulations under section 415 are first published in the FEDERAL REGISTER, an individual may wish to take advantage of the alternative limitations described in section 415(c)(4). One way of doing this is to attach a statement of intention to his individual tax return for the taxable year. The statement should provide that the individual intends to elect one of those alternative limitations. It should also specify which alternative he intends to elect. No form is prescribed for the statement of intention, but it must include the individual's name, address and Social Security number. If the individual is not required to file an income tax return for the taxable year to which the statement of intention is to apply, the statement of intention may still be filed at the Internal Revenue Service Center where that individual would file the return if he were required to file. It should be filed by the time he would have filed his return. The Internal Revenue Service will treat the statement of intention as an actual election for all taxable years through the taxable year in which applicable final regulations under section 415 are first published in the FEDERAL REGISTER for all purposes, except that it will not be irrevocable. If, pursuant to this subdivision, an individual takes advantage of an alternative limitation for a taxable year, then, except as provided in paragraph (b)(1)(iii) of this section, the individual may not take advantage of any other alternative limitation pursuant to this subdivision for any taxable year. If an individual does not file a statement of intention, he will still be able to take advantage of the alternative limitations for these taxable years. He will be able to do this if he determines his income tax liability for the taxable year in a way which is consistent with one of the alternative limitations.

(ii) The actual election for all taxable years through the taxable year in which applicable final regulations under section 415 are first published in the FEDERAL REGISTER will be made by filing the election with the Internal Revenue Service at the time and in the manner to be described by final regulations under section 415.

(iii) When an individual makes the actual election for any taxable year through the taxable year in which applicable final regulations under section 415 are published in the FEDERAL REGISTER, he may choose any of the alternative limitations, even if his choice is inconsistent with the alternative limitation which he used in determining his income tax liability for that taxable year. He may also choose not to elect any of the alternative limitations, even if he used one of them in determining his income tax liability for that taxable year. However, if his choice is different from the choice which he used in determining his income tax liability for the taxable year, there may be an adjustment in his tax for that year. For purposes of section 6654 (relating to failure of an individual to pay estimated tax), a difference in tax for such a year resulting from a difference in these choices will not be treated as an underpayment. This rule applies to the extent the difference in tax is due to the actual election of one of the alternative limitations or to a final decision not to use one of the alternative limitations for the taxable year.

(2) *Salary reduction agreements for 1976 and 1977.* (i) An individual who is employed by an organization described in

paragraph (a)(3) may make a salary reduction agreement for his taxable year beginning in 1976 or 1977 at any time before the end of the 1976 or 1977 taxable year, respectively, without the agreement's being considered a new agreement within the meaning of § 1.403(b)–1(b)(3)(i). The agreement for 1976 may be made on or before June 15, 1977, if that date is later than the end of the individual's 1976 taxable year. The agreement for 1977 may be made on or before April 17, 1978, if that date is later than the end of the individual's 1977 taxable year.

(ii) This subparagraph applies only if the individual actually elects one of the alternative limitations under section 415(c)(4) for 1976 or 1977 (as the case may be).

(iii) The salary reduction agreement for 1976 may be made effective with respect to any amount earned during the taxpayer's most recent one-year period of service (as described in § 1.403(b)–1(f)) ending not later than the end of the 1976 taxable year, notwithstanding § 1.403(b)–1(b)(3)(i). Similarly, the salary reduction agreement for 1977 may be made effective with respect to such period of service ending not later than the end of the 1977 taxable year.

(iv) If the salary reduction agreement for 1976 is entered into at any time after December 31, 1976, or if the salary reduction agreement for 1977 is entered into at any time after December 31, 1977, an amended Form W–2 must be filed on behalf of the individual.

(3) *Election is irrevocable.* The election described in paragraph (a)(3) of this section, once made in accordance with the provisions of subparagraph (1) of this paragraph, shall be irrevocable with respect to the limitation years or taxable years to which such election relates.

(4) *Limitations.* With respect to any limitation or taxable year, an election by an individual pursuant to subparagraph (1) of this paragraph to have any subdivision of paragraph (a)(5) of this section apply to contributions made on his behalf by his employer with respect to any section 403(b) annuity contract will preclude an election to have any other subdivision of paragraph (a)(5) apply for any future limitation or taxable year with respect to any section 403(b) annuity contract contributions made by any employer of such individual. With respect to any limitation year, an election by an individual to have paragraph (a)(5)(i) of this section apply to contributions made on his behalf by his employer with respect to any section 403(b) annuity contract will preclude an election to have any subdivision of paragraph (a)(5) apply for any future limitation or taxable year with respect to any section 403(b) annuity contract contributions made by any employer of such individual.

(5) *Aggregation rules*—(i) *Annuity contracts described in section 403(b).* For purposes of applying the limitations of this section for a particular limitation or taxable year, all contributions toward the purchase of annuity contracts described in section 403(b) made on behalf of an individual by his employer and any related employer (as defined in subdivision (ii) of this subparagraph) must be aggregated without regard to:

(A) Whether such individual makes any election pursuant to subparagraph (1) of this paragraph for such year; and

(B) Whether such individual files a statement of intention pursuant to subparagraph (1) of this paragraph, for such year. In addition, any other aggregation required by Revenue Ruling 75–481, 1975–2 C.B. 188, must be made to the extent applicable.

(ii) *Definition.* For purposes of this section, with respect to a particular employer, a related employer is any other employer which is a member of a controlled group of corporations (as defined in section 414(b), and the regulations thereunder and as modified by section 415(h)) or a group of trades or business (whether or not incorporated) under common control (as defined in section 414(c) and the regulations thereunder and as modified by section 415(h)) in which such particular employer is a member.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

*Example (1).* Doctor M is an employee of H Hospital (an organization described in section 501(c)(3) and exempt from taxation under section 501(a)) for the entire 1976 calendar year. M is not in control of H within the meaning of section 414 (b) or (c), as modified by section 415(h). M uses the calendar

year as the taxable year and M uses the calendar year as the limitation year. M has includible compensation (as defined in section 403(b)(3) and the regulations thereunder) and compensation (as defined in section 415(c)(3)) for taxable year 1976 of $30,000, and M has 4 years of service (as defined in § 1.403(b)–1(f)) with H as of December 31, 1976. During M's prior service with H, H had contributed a total of $12,000 on M's behalf for annuity contracts described in section 403(b), which amount was excludable from M's gross income for such prior years. Thus, for the limitation year ending with or within taxable year 1976, M's exclusion allowance determined under section 403(b)(2)(A) is $12,000 ((.20×$30,000×4) −$12,000). The limitation imposed by section 415(c)(1) that is applicable to M for limitation year 1976 is the lesser of $26,825 (the amount described in section 415(c)(1)(A) adjusted under section 415(d)(1)(B) for limitation year 1976) or $7,500 (the amount described in section 415(c)(1)(B)). Absent the special elections provided in section 415(c)(4), $7,500 would be the maximum contribution H could make for annuity contracts described in section 403(b) on M's behalf for limitation year 1976 without increasing M's gross income for taxable year 1976. However, because H is an organization described in section 415(c)(4), M may make a special election with respect to amounts contributed by H on M's behalf for section 403(b) annuity contracts for 1976. Assume that M does not separate from the service of H during 1976 and that, therefore, the ''(A) election limitation'' described in section 415(c)(4)(A) is not available to M. If M elects the ''(B) election limitation'' for 1976, H could contribute $11,500 on M's behalf for annuity contracts described in section 403(b) for that year (the least of $11,500 (the amount described in section 415(c)(4) (B)(i)); $12,000 (the amount described in section 415(c)(4)(B)(ii)), and $15,000 (the amount described in section 415(c)(4)(B)(iii))). If M elects the ''(C) election limitation'' for 1976, H could only contribute up to $7,500 (the lower of the amounts described in section 415(c)(1) (A) or (B)) for section 403(b) annuity contracts on M's behalf for 1976 without increasing M's gross income for that year.

*Example (2).* Assume the same facts as in example (1) except that H had contributed a total of $18,000 on M's behalf for annuity contracts in prior years, which amount was excludable from M's gross income for such prior years. Accordingly, for 1976, M's exclusion allowance determined under section 403(b)(2)(A) is $6,000 ((.20×$30,000×4) −$18,000). The limitation imposed by section 415(c)(1) applicable to M for 1976 is $7,500 (the lesser of the amount described in section 415(c)(1) (A) or (B)). Absent the special elections provided in section 415(c)(4), $6,000 would be the maximum amount H could contribute for annuity contracts described in section 403(b) on M's behalf for 1976 without increasing M's gross income for that year. However, if M elects the ''(C) election limitation'' for 1976, H may contribute up to $7,500 without increasing M's gross income for that year.

*Example (3).* G, a teacher, is an employee of E, an educational institution described in section 151(e)(4). G uses the calendar year as the taxable year and G uses the 12-month consecutive period beginning July 1 as the limitation year. G has includible compensation (as defined in section 403(b)(3) and the regulations thereunder) for taxable year 1976 of $12,000 and G has compensation (as defined in section 415(c)(3)) for the limitation year ending with or within taxable year 1976 of $12,000. G has 20 years of service (as defined in § 1.403(b)–1(f)) as of May 30, 1976, the date G separates from the service of E. During G's service with E before taxable year 1976, E had contributed $34,000 toward the purchase of a section 403(b) annuity contract on G's behalf, which amount was excludable from G's gross income for such prior years. Of this amount, $19,000 was so contributed and excluded during the 10 year period ending on May 30, 1976. For the taxable year 1976, G's exclusion allowance determined under section 403(b)(2)(A) is $14,000 ((.20×$12,000×20) −$34,000). Absent the special elections described in section 415(c)(4), $3,000 (the lesser of G's exclusion allowance for taxable year 1976 or the section 415(c)(1) limitation applicable to G for the limitation year ending with or within such taxable year) would be the maximum excludable contribution E could make for section 403(b) annuity contracts on G's behalf for the limitation year ending with or within taxable year 1976. However, because E is an organization described in section 415(c)(4), G may make a special election with respect to amounts contributed on G's behalf by E for section 403(b) annuity contracts for the limitation year ending with or within taxable year 1976. Because G has separated from the service of E during such taxable year, G may elect the ''(A) election limitation'' as well as the ''(B) election limitation'' or the ''(C) election limitation''. If G elects the ''(A) election limitation'' for the limitation year ending with or within taxable year 1976, E could contribute up to $5,000 ((.20×$12,000×10) −$19,000) on G's behalf for section 403(b) annuity contracts for such limitation year without increasing G's gross income for the taxable year with or within which such limitation year ends. If G elects the ''(B) election limitation'' for such limitation year, E could contribute $7,000 (the least of $7,000 (the amount described in section 415(c)(4)(B)(i)); $14,000 (the amount described in section 415(c)(4)(B)(ii)); and $15,000 (the amount described in section 415(c)(4)(B)(iii))). If G elects the ''(C) election limitation'' for taxable year 1976, E could contribute $3,000 (the lesser of the amounts described in section 415(c)(1) (A) or (B)).

(d) *Plan year.* For purposes of section 415 and this section, an annuity contract described in section 403(b) shall be deemed to have a plan year coinciding with the taxable year of the individual on whose behalf the contract has been purchased unless that individual demonstrates that a different 12-month period should be considered to be the plan year.

(e) *Effective date.* The provisions of this section are applicable for taxable years beginning in and for limitation years ending with or within taxable years beginning in 1976.

(Sec. 415(c)(4)(D) of the Internal Revenue Code of 1954 (88 Stat. 983; 26 U.S.C. 415(c)(4)(D)))

[T.D. 7442, 41 FR 52296, Nov. 29, 1976, as amended by T.D. 7531, 43 FR 1065, Jan. 6, 1978]

## PART 12—TEMPORARY INCOME TAX REGULATIONS UNDER THE REVENUE ACT OF 1971

Sec.
12.3 Investment credit, public utility property elections.
12.4 Election of Class Life Asset Depreciation Range System (ADR).
12.7 Election to be treated as a DISC.
12.8 Elections with respect to net leases of real property.
12.9 Election to postpone determination with respect to the presumption described in section 183(d).

AUTHORITY: 26 U.S.C. 167, 263, and 7805.

### § 12.3 Investment credit, public utility property elections.

(a) *Elections*—(1) *In general.* Under section 46(e), three elections may be made on or before March 9, 1972, with respect to section 46(e) property (as defined in subparagraph (3) of this paragraph). An election made under the provisions of section 46(e) shall be irrevocable.

(2) *Applicability of elections.* (i) Any election under section 46(e) shall be made with respect to all of the taxpayer's property eligible for the election whether or not the taxpayer is regulated by more than one regulatory body.

(ii)*(a)* Paragraph (1) of section 46(e) shall apply to all of the taxpayer's section 46(e) property in the absence of an election under paragraph (2) or (3) of section 46(e). If an election is made under paragraph (2) of section 46(e), paragraph (1) of such section shall not apply to any of the taxpayer's section 46(e) property.

*(b)* An election made under the last sentence of section 46(e)(1) shall apply to that portion of the taxpayer's section 46(e) property to which paragraph (1) of section 46(e) applies and which is short supply property within the meaning of § 1.46–5(b)(2) of this chapter (Income Tax Regulations) as set forth in a notice of proposed rule making published in 37 FR 3526 on February 17, 1971.

(iii) If a taxpayer makes an election under paragraph (2) of section 46(e), and makes no election under paragraph (3) of such section, the election under paragraph (2) of section 46(e) shall apply to all of its section 46(e) property.

(iv) If a taxpayer makes an election under paragraph (3) of section 46(e), such election shall apply to all of the taxpayer's section 46(e) property to which section 167(l)(2)(C) applies. Paragraph (1) or (2) of section 46(e) (as the case may be) shall apply to that portion of the taxpayer's section 46(e) property which is not property to which section 167(l)(2)(C) applies. Thus, for example, if a taxpayer makes an election under paragraph (2) of section 46(e), and also makes an election under paragraph (3) of section 46(e), paragraph (3) shall apply to all of the taxpayer's section 46(e) property to which section 167(l)(2)(C) applies and paragraph (2) shall apply to the remainder of the taxpayer's section 46(e) property.

(3) *Section 46(e) property.* ''Section 46(e) property'' is section 38 property which is both property described in section 50 and is—

(i) Public utility property within the meaning of section 46(c)(3)(B) (other than nonregulated communication property of the type described in the last sentence of section 46(c)(3)(B)), or

(ii) Property used predominantly in the trade or business of the furnishing or sale of *(a)* steam through a local distribution system or *(b)* the transportation of gas or steam by pipeline, if the rates for such furnishing or sale are established or approved by a governmental unit, agency, instrumentality,

or commission described in section 46(c)(3)(B).

(b) *Method of making elections.* A taxpayer may make the elections described in section 46(e) by filing a statement, on or before March 9, 1972, with the district director or director of the internal revenue service center with whom the taxpayer ordinarily files its income tax return. For rules in the case of taxpayers filing consolidated returns, see § 1.1502–77(a) of this chapter (Income Tax Regulations). Such statement shall contain the following information:

(1) The name, address, and taxpayer identification number of the taxpayer,

(2) The paragraph (or paragraphs) of section 46(e) under which the taxpayer is making the election,

(3) If an election is made under the last sentence of section 46(e)(1), the name and address of all regulatory bodies which have jurisdiction over the taxpayer with respect to the section 46(e) property covered by such election and a statement setting forth the type of the public utility activity described in section 46(e)(5)(B) in which the taxpayer engages, and

(4) If an election is made under paragraph (3) of section 46(e), a statement indicating whether an election has been made by the taxpayer under section 167(l)(4)(A).

[T.D. 7161, 37 FR 3511, Feb. 17, 1972]

### § 12.4 Election of Class Life Asset Depreciation Range System (ADR).

(a) *Elections filed before February 1, 1972.* No election or tax return shall be filed which does not conform to section 109 of the Revenue Act of 1971 (Pub. L. 92–178, 85 Stat. 508). If a taxpayer has before February 1, 1972 filed an election and a tax return in accordance with § 1.167(a)–11 of this chapter (relating to depreciation allowances using the Asset Depreciation Range System published in the FEDERAL REGISTER for June 23, 1971), such election will be treated as an election under the Class Life Asset Depreciation Range System (ADR) as contained in section 109 of the Revenue Act of 1971 and the proposed amendments to § 1.167(a)–11 of this chapter published in the FEDERAL REGISTER for January 27, 1972, provided that the election conforms with the provisions of the Class Life Asset Depreciation Range System (ADR) contained in section 109 of the Revenue Act of 1971 and the amendments to the regulations as finally adopted. Such an election and the determination of tax liability on the tax return are subject to the terms and conditions of section 109 of the Revenue Act of 1971 and the final regulations prescribing the Class Life Asset Depreciation Range System (ADR). (For revocation of an election, see paragraph (c) of this section.) An election and tax return filed before February 1, 1972, which does not conform with the final regulations prescribing the Class Life Asset Depreciation Range System (ADR) is an invalid election unless corrected by an amended tax return and election filed no later than the time permitted by paragraph (c) of this section. If a valid election under § 1.167(a)–11 of this chapter is not filed for a taxable year, the taxpayer is required to file or amend his tax return and determine tax liability for the taxable year without regard to § 1.167(a)–11 of this chapter.

(b) *Elections filed after January 31, 1972.* No election or tax return shall be filed which does not conform with section 109 of the Revenue Act of 1971. An election and tax return filed under § 1.167(a)–11 of this chapter after January 31, 1972, and before the final amendments to the regulations are published in the FEDERAL REGISTER, should be filed in accordance with section 109 of the Revenue Act of 1971 and the proposed amendments to § 1.167(a)–11 of this chapter relating to the Class Life Asset Depreciation Range System (ADR). Such election and the determination of tax liability on the tax return are subject to the terms and conditions of section 109 of the Revenue Act of 1971 and the final regulations prescribing the Class Life Asset Depreciation Range System (ADR). An election and tax return filed after January 31, 1972, which does not conform with the final regulations prescribing the Class Life Asset Depreciation Range System (ADR), is not a valid election unless corrected by an amended tax return and election filed no later than the time permitted by paragraph (c) of this section. (For revocation of election, see paragraph (c) of this section.)

If a valid election under § 1.167(a)–11 of this chapter is not filed for a taxable year the taxpayer is required to file or amend his tax return and determine tax liability for the taxable year without regard to § 1.167(a)–11 of this chapter.

(c) *Special rule for election and revocation.* Notwithstanding the rules of § 1.167(a)–11 of this chapter, a taxpayer is permitted to make, amend or revoke an election under § 1.167(a)–11 of this chapter at any time before the latest of (1) the time the taxpayer files his first return for the taxable year of election, (2) 120 days after the final regulations prescribing the Class Life Asset Depreciation Range System (ADR) are published in the FEDERAL REGISTER, or (3) the time prescribed by law (including extensions thereof) for filing the return for the taxable year of election. The notification of amendment or revocation of an election shall be made by filing an amended tax return with the Internal Revenue Service Center with which the election was filed. The election should be filed in the manner specified in the Class Life Asset Depreciation Range System (ADR) regulations as finally prescribed.

(d) *Examples.* The principles of this section may be illustrated by the following examples:

*Example (1).* Taxpayer A filed an election under § 1.167(a)–11 before February 1, 1972. A elected to use the modified half-year convention by treating all assets as placed in service on the first day of the second quarter of the taxable year, excluded section 1250 property (as defined in section 1250(c)) and property used predominantly outside the United States from the election, and included ''subsidiary assets'' (as defined in § 1.167(a)–11(b)(5)(vii) of the proposed amendments to the regulations) in the election. A's election does not conform with the regulations under § 1.167(a)–11 as proposed to be amended. A should file an amended return and election within 120 days after the publication of the final Class Life Asset Depreciation Range System (ADR) regulations under § 1.167(a)–11. Such amended return and election must conform to the final amendments to the regulations. In the amended election, A must adopt one of the conventions permitted by the final amendments. Assuming the proposed amendments are finally adopted, A may exclude his subsidiary assets from the election provided the conditions of paragraph (b)(5)(vii) of § 1.167(a)–11 of the regulations, as proposed to be amended, are met, and A must include property used predominantly outside the United States in the election unless paragraph (b)(5)(iii), (v), or (vi) of § 1.167(a)–11, as proposed to be amended, permit the exclusion of the property. Generally, A must include section 1250 property in the election unless paragraph (b)(5)(vi) of § 1.167(a)–11, as proposed to be amended, permits the exclusion of the property.

*Example (2).* Taxpayer B filed an election to compute depreciation under § 1.167(a)–11 before February 1, 1972. B elected to use the half-year convention and has no assets used predominantly outside the United States. B excluded section 1250 property from the election and included his subsidiary assets in the election. Assume that the provisions of paragraph (b)(5)(vi) of § 1.167(a)–11, as proposed to be amended, apply and permit the exclusion of section 1250 property and that B does not elect to exclude subsidiary assets pursuant to paragraph (b)(5)(vii), as proposed to be amended. B has no assets which were excluded from the election under paragraph (b)(5)(v) of § 1.167(a)–11, as proposed to be amended. The election which was filed before February 1, 1972, will be treated as a valid election under the Class Life Asset Depreciation Range System (ADR) as contained in the final amendments to the regulations, if it conforms with those amendments. B need not file an amended election provided his election conforms to the final regulations under § 1.167(a)–11. However, B may file an amended election within 120 days after the final regulations under § 1.167(a)–11 are published in the FEDERAL REGISTER in order to include section 1250 property, or to exclude subsidiary assets, or to make other changes, or to revoke the election.

[T.D. 7159, 37 FR 1469, Jan. 29, 1972]

### § 12.7 Election to be treated as a DISC.

(a) *Manner and time of election*—(1) *Manner*—(i) *In general.* A corporation can elect to be treated as a DISC under section 992(b) for a taxable year beginning after December 31, 1971. Except as provided in subdivision (ii) of this subparagraph, the election is made by the corporation filing Form 4876 with the service center with which it would file its income tax return if it were subject for such taxable year to all the taxes imposed by subtitle A of the Internal Revenue Code of 1954, and a copy of the completed Form 4876 with the Commissioner of Internal Revenue (attention: ACTS:A:AO), Washington, D.C. 20224. The form shall be signed by any person authorized to sign a corporation return under section 6062, and shall contain the information required by such form.

Except as provided in paragraphs (b)(3) and (c) of this section, such election to be treated as a DISC shall be valid only if the consent of every person who is a shareholder of the corporation as of the beginning of the first taxable year for which such election is effective is on or attached to such Form 4876 when filed with the service center.

(ii) *Transitional rule for corporations electing during 1972.* If the first taxable year for which an election by a corporation to be treated as a DISC is a taxable year beginning after December 31, 1971, and on or before December 31, 1972, such election may be made either in the manner prescribed in subdivision (i) of this subparagraph or by filing, at the place prescribed in subdivision (i) of this subparagraph, a statement captioned ''Election to be Treated as a DISC''. Such statement of election shall be valid only if the consent of each shareholder is filed with the service center in the form, and at the time, prescribed in paragraph (b) of this section. Such statement shall be signed by any person authorized to sign a corporation return under section 6062 and shall include the name, address, and employer identification number (if known) of the corporation, the beginning date of the first taxable year for which the election is effective, the number of shares of stock of the corporation issued and outstanding as of the earlier of the beginning of the first taxable year for which the election is effective or the time the statement is filed, the number of shares held by each shareholder as of the earlier of such dates, and the date and place of incorporation. As a condition of the election being effective, a corporation which elects to become a DISC by filing a statement in accordance with this subdivision must furnish (to the service center with which the statement was filed) such additional information as is required by Form 4876 by March 31, 1973.

(2) *Time of making election*—(i) *In general.* In the case of a corporation making an election to be treated as a DISC for its first taxable year, such election shall be made within 90 days after the beginning of such taxable year. In the case of a corporation which makes an election to be treated as a DISC for any taxable year beginning after March 31, 1972 (other than the first taxable year of such corporation), the election shall be made during the 90-day period immediately preceding the first day of such taxable year.

(ii) *Transitional rules for certain corporations electing during 1972.* In the case of a corporation which makes an election to be treated as a DISC for a taxable year beginning after December 31, 1971, and on or before March 31, 1972 (other than its first taxable year), the election shall be made within 90 days after the beginning of such taxable year.

(b) *Consent by shareholders*—(1) *In general*—(i) *Time and manner of consent.* Under paragraph (a)(1)(i) of this section, subject to certain exceptions, the election to be treated as a DISC is not valid unless each person who is a shareholder as of the beginning of the first taxable year for which the election is effective signs either the statement of consent on Form 4876 or a separate statement of consent attached to such form. A shareholder's consent is binding on such shareholder and all transferees of his shares and may not be withdrawn after a valid election is made by the corporation. In the case of a corporation which files an election to become a DISC for a taxable year beginning after December 31, 1972, if a person who is a shareholder as of the beginning of the first taxable year for which the election is effective does not consent by signing the statement of consent set forth on Form 4876, such election shall be valid (except in the case of an extension of the time for filing granted under the provisions of subparagraph (3) of this paragraph or paragraph (c) of this section) only if the consent of such shareholder is attached to the Form 4876 upon which such election is made.

(ii) *Form of consent.* A consent other than the statement of consent set forth on Form 4876 shall be in the form of a statement which is signed by the shareholder and which sets forth *(a)* the name and address of the corporation and of the shareholder and *(b)* the number of shares held by each such shareholder as of the time the consent is made and (if the consent is made after the beginning of the corporation's

taxable year for which the election is effective) as of the beginning of such year. If the consent is made by a recipient of transferred shares pursuant to paragraph (c) of this section, the statement of consent shall also set forth the name and address of the person who held such shares as of the beginning of such taxable year and the number of such shares. Consent shall be made in the following form: ''I (insert name of shareholder), a shareholder of (insert name of corporation seeking to make the election) consent to the election of (insert name of corporation seeking to make the election) to be treated as a DISC under section 992(b) of the Internal Revenue Code. The consent so made by me is irrevocable and is binding upon all transferees of my shares in (insert name of corporation seeking to make the election).'' The consents of all shareholders may be incorporated in one statement.

(iii) *Who may consent.* Where stock of the corporation is owned by a husband and wife as community property (or the income from such stock is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in such stock or the income therefrom and each tenant in common, joint tenant, and tenant by the entirety must consent to the election. The consent of a minor shall be made by his legal guardian or by his natural guardian if no legal guardian has been appointed. The consent of an estate shall be made by the executor or administrator thereof. The consent of a trust shall be made by the trustee thereof. The consent of an estate or trust having more than one executor, administrator, or trustee may be made by any executor, administrator, or trustee authorized to make a return of such estate or trust pursuant to section 6012(b)(5). The consent of a corporation or partnership shall be made by an officer or partner authorized pursuant to section 6062 or 6063, as the case may be, to sign the return of such corporation or partnership. In the case of a foreign person, the consent may be signed by any individual (whether or not a U.S. person) who would be authorized under sections 6061 through 6063 to sign the return of such foreign person if he were a U.S. person.

(2) *Transitional rule for corporations electing during 1972.* In the case of a corporation which files an election to be treated as a DISC for a taxable year beginning after December 31, 1971, and on or before December 31, 1972, such election shall be valid only if the consent of each person who is a shareholder as of the beginning of the first taxable year for which such election is effective is filed with the service center with which the election was filed within 90 days after the first day of such taxable year or within the time granted for an extension of time for filing such consent. The form of such consent shall be the same as that prescribed in subparagraph (1) of this paragraph. Such consent shall be attached to the statement of election or shall be filed separately (with such service center) with a copy of the statement of election. An extension of time for filing a consent may be granted in the manner, and subject to the conditions, described in subparagraph (3) of this paragraph.

(3) *Extension of time to consent.* An election which is timely filed and would be valid except for the failure to attach the consent of any shareholder to the Form 4876 upon which the election was made or to comply with the 90-day requirement in subparagraph (2) of this paragraph or paragraph (c)(1) of this section, as the case may be, will not be invalid for such reason if it is shown to the satisfaction of the service center that there was a reasonable cause for the failure to file such consent, and if such shareholder files a proper consent to the election within such extended period of time as may be granted by the Internal Revenue Service. In the case of a late filing of a consent, a copy of the Form 4876 or statement of election shall be attached to such consent and shall be filed with the same service center as the election. The form of such consent shall be the same as that set forth in paragraph (b)(1)(ii) of this section. In no event can any consent be made pursuant to this paragraph on or after the last day of the first taxable year for which a corporation elects to be treated as a DISC.

(c) *Consent by holder of transferred shares*—(1) *In general.* If a shareholder of a corporation transfers—

(i) Prior to the first day of the first taxable year for which such corporation elects to be treated as a DISC, some or all of the shares held by him without having consented to such election, or

(ii) On or before the 90th day after the first day of the first taxable year for which such corporation elects to be treated as a DISC, some or all of the shares held by him as of the first day of such year (or if later, held by him as of the time such shares are issued), without having consented to such election, then consent may be made by any recipient of such shares on or before the 90th day after the first day of such first taxable year. If such recipient fails to file his consent on or before such 90th day, an extension of time for filing such consent may be granted in the manner, and subject to the conditions, described in paragraph (b)(3) of this section. In addition, if the transfer occurs more than 90 days after the first day of such taxable year, an extension of time for filing such consent may be granted to such recipient only if it is determined under paragraph (b)(3) of this section that an extension of time would have been granted the transferor for the filing of such consent if the transfer had not occurred. A consent which is not attached to the original Form 4876 or statement of election (as the case may be) shall be filed with the same service center as the original Form 4876 or statement of election and shall have attached a copy of such original form or statement of election. The form of such consent shall be the same as that set forth in paragraph (b)(1)(ii) of this section. For the purposes of this paragraph, a transfer of shares includes any sale, exchange, or other disposition, including a transfer by gift or at death.

(2) *Requirement for the filing of an amended form 4876 or statement of election.* In any case in which a consent to a corporation's election to be treated as a DISC is made pursuant to subparagraph (1) of this paragraph, such corporation must file an amended form 4876 or statement of election (as the case may be) reflecting all changes in ownership of shares. Such form must be filed with the same service center with which the original form 4876 or statement of election was filed by such corporation.

(d) *Effect of election*—(1) *Effect on corporation.* A valid election to be treated as a DISC remains in effect (without regard to whether the electing corporation qualifies as a DISC for a particular year) until terminated by any of the methods provided in paragraph (e) of this section. While such election is in effect, the electing corporation is subject to sections 991 through 997 and other provisions of the code applicable to DISC's for any taxable year for which it qualifies as a DISC (or is treated as qualifying as a DISC pursuant to section 992(a)(2)). Such corporation is also subject to such provisions for any taxable year for which it is treated as a former DISC as a result of qualifying or being treated as a DISC for any taxable year for which such election was in effect.

(2) *Effect on shareholders.* A valid election by a corporation to be treated as a DISC subjects the shareholders of such corporation to the provisions of section 995 (relating to the taxation of the shareholders of a DISC or former DISC) and to all other provisions of the code relating to the shareholders of a DISC or former DISC. Such provisions of the code apply to any person who is a shareholder of a DISC or former DISC whether or not such person was a shareholder at the time the corporation elected to become a DISC.

(e) *Termination of election*—(1) *In general.* An election to be treated as a DISC is terminated only as provided in subparagraph (2) or (3) of this paragraph.

(2) *Revocation of election*—(i) *Manner of revocation.* An election by a corporation to be treated as a DISC may be revoked by the corporation for any taxable year of the corporation after the first taxable year for which the election is effective. Such revocation shall be made by the corporation filing a statement that the corporation revokes its election under section 992(b) to be treated as a DISC. Such statement shall indicate the corporation's name, address, employer identification number, and the first taxable year of

the corporation for which the revocation is to be effective. The statement shall be signed by any person authorized to sign a corporation return under section 6062. Such revocation shall be filed with the service center with which the corporation filed its election, except that, if it filed an annual information return under section 6011(e)(2), the revocation shall be filed with the service center with which it filed its last such return.

(ii) *Years for which revocation is effective.* If a corporation files a statement revoking its election to be treated as a DISC during the first 90 days of a taxable year (other than the first taxable year for which such election is effective), such revocation will be effective for such taxable year and all taxable years thereafter. If the corporation files a statement revoking its election to be treated as a DISC after the first 90 days of a taxable year, the revocation will be effective for all taxable years following such taxable year.

(3) *Continued failure to be a DISC.* If a corporation which has elected to be treated as a DISC does not qualify as a DISC (and is not treated as a DISC pursuant to section 992(a)(2)) for each of any 5 consecutive taxable years, such election terminates and will not be effective for any taxable year after such 5th taxable year. Such termination will be effective automatically, without notice to such corporation or to the Internal Revenue Service. If, during any 5-year period for which an election is effective, the corporation should qualify as a DISC (or be treated as a DISC pursuant to section 992(a)(2)) for a taxable year, a new 5-year period shall automatically start at the beginning of the following taxable year.

(4) *Election after termination.* If a corporation has made a valid election to be treated as a DISC and such election terminates in either manner described in subparagraph (2) or (3) of this paragraph, such corporation is eligible to reelect to be treated as a DISC at any time by following the procedures described in paragraphs (a) through (c) of this section. If a corporation terminates its election and subsequently reelects to be treated as a DISC, the corporation and its shareholders continue to be subject to sections 995 and 996 with respect to the period during which its first election was in effect. Thus, for example, distributions upon disqualification includible in the gross incomes of shareholders of a corporation pursuant to section 995(b)(2) continue to be so includible for taxable years for which a second election of such corporation is in effect without regard to the second election.

[T.D. 7237, 37 FR 28626, Dec. 28, 1972]

### § 12.8 Elections with respect to net leases of real property.

(a) *In general.* The elections described in this section are available for determining whether real property held by the taxpayer is subject to a net lease for purposes of section 57 (relating to items of tax preference for purposes of the minimum tax for tax preferences) or 163(d) (relating to limitation on interest on investment indebtedness). Under sections 57(c)(1)(A) and 163(d)(4)(A)(i), property will be considered to be subject to a net lease for a taxable year where the sum of the deductions of the lessor with respect to the property for the taxable year allowable solely by reason of section 162 (other than rents and reimbursed amounts with respect to the property) is less than 15 percent of the gross income from rents produced by the property (hereinafter referred to as the ''expense test''). Under sections 57(c)(2) and 163(d)(7)(A), where a parcel of real property of the taxpayer is leased under two or more leases, the taxpayer may elect to apply the expense test set forth in sections 57(c)(1)(A) and 163(d)(4)(A)(i) by treating all leased portions of such property as subject to a single lease. Under sections 57(c)(3) and 163(d)(7)(B), at the election of the taxpayer, the expense test set forth in sections 57(c)(1)(A) and 163(d)(4)(A)(i) shall not apply with respect to real property of the taxpayer which has been in use for more than 5 years.

(b) *Election with respect to multiple leases of single parcel of real property.* If a parcel of real property of the taxpayer is leased under two or more leases, the expense test referred to in paragraph (a) of this section shall, at the election of the taxpayer, be applied by treating all leased portions of such property as subject to a single lease.

For purposes of this paragraph, the term ''parcel of real property'' includes adjacent properties each of which is subject to lease.

(c) *Election with respect to real property in use for more than 5 years.* At the election of the taxpayer, the expense test referred to in paragraph (a) of this section shall not apply with respect to real property of the taxpayer which has been in use for more than 5 years. For this purpose, real property is in use only during the period that such property is both owned and used for commercial purposes by the taxpayer. If an improvement to the property was made during the time such property was owned by the taxpayer, and if, as a result of such improvement, the adjusted basis of such property was increased by 50 percent or more, use of such property for commercial purposes shall be deemed to have commenced for purposes of this paragraph as of the date such improvement was completed. An election under this paragraph shall apply to all real property of the taxpayer which has been in use for more than 5 years.

(d) *Procedure for making election*—(1) *Time and scope of election.* An election under paragraph (b) or (c) of this section shall be made for each taxable year to which such election is to apply. The election must be made before the later of (i) the time prescribed by law for filing the taxpayer's return for the taxable year for which the election is made (determined with regard to any extension of time) or (ii) August 31, 1973, but the election may not be made after the expiration of the time prescribed by law for the filing of a claim for credit or refund of tax with respect to the taxable year for which the election is to apply.

(2) *Manner of making election.* Except as provided in the following sentence, an election by the taxpayer with respect to a taxable year shall be made by a statement containing the information described in paragraph (d)(3) of this section which is—

(i) Attached to the taxpayer's return or amended return for such taxable year,

(ii) Attached to a timely filed claim by the taxpayer for credit or refund of tax for such taxable year, or

(iii) Filed by the taxpayer with the director of the Internal Revenue Service Center where the return for such taxable year was filed.

In the case of a taxable year ending before July 1, 1973, no formal statement of election is necessary if the taxpayer's return took into account an election under paragraph (b) or (c) of this section; the taxpayer will be considered to have made an election in accordance with the manner in which leases with respect to parcels of real property described in paragraph (b) of this section, or leases of property which has been in use for more than 5 years as described in paragraph (c) of this section, are treated in the return.

(3) *Statement.* The statement described in paragraph (d)(2) of this section shall contain the following information:

(i) The name, address, and taxpayer identification number of the taxpayer;

(ii) The taxable year to which the election is to apply if the statement is not attached to the return or a claim for credit or refund;

(iii) A description of any leases which are to be treated as a single lease; and

(iv) A description of any real property in use for more than 5 years to which the expense test is not to apply.

(4) *Revocation of election.* An election made pursuant to this paragraph may be revoked within the time prescribed in paragraph (d)(1) of this section for making an election and may not be revoked thereafter. Any such revocation shall be made in the manner prescribed by paragraph (d)(2) of this section for the making of an election.

(e) *Election by members of partnership.* Under section 703(b) (as amended by section 304(c) of the Revenue Act of 1971), any election under section 57(c) or 163(d)(7) with respect to property held by a partnership shall be made by each partner separately, rather than by the partnership. If an election made by a taxpayer under paragraph (b) of this section applies in whole or in part to property held by a partnership, the taxpayer shall, in applying the expense test referred to in paragraph (a) of this section, take into account his distributive share of the deductions of the partnership with respect to the property for the taxable year allowable

solely by reason of section 162 (other than rents and reimbursed amounts with respect to the property) and also his distributive share of the partnership's rental income from such property for the taxable year.

[T.D. 7271, 38 FR 9296, Apr. 13, 1973]

### § 12.9 Election to postpone determination with respect to the presumption described in section 183(d).

(a) *In general.* An individual, electing small business corporation, trust or estate may elect in accordance with the rules set forth in this section to postpone a determination whether the presumption described in section 183(d) applies with respect to any activity in which the taxpayer engages until after the close of the fourth taxable year (sixth taxable year, in the case of an activity described in § 1.183–1(c)(3)) following the taxable year in which the taxpayer first engages in such activity. The election must be made in accordance with the applicable requirements of paragraphs (b), (c) and (d) of this section. Except as otherwise provided in paragraphs (c) and (e) of this section, an election made pursuant to this section shall be binding for the first taxable year in which the taxpayer first engages in the activity and for all subsequent taxable years in the five (or seven) year period referred to in the first sentence of this paragraph. For purposes of this section, a taxpayer shall be treated as not having engaged in an activity during any taxable year beginning before January 1, 1970.

(b) *Period to which an election applies.* An individual, trust, estate, or small business corporation may make the election. The five year presumption period (seven year presumption period in the case of an activity described in § 1.183–1(c)(3)) to which the election shall apply shall be the five (or seven) consecutive taxable years of such taxpayer beginning with the taxable year in which such taxpayer first engages in the activity. For purposes of this section, a taxpayer who engages in an activity as a partner, engages in it in each of his taxable years with or within which ends a partnership year during which the activity was carried on by the partnership.

(c) *Time for making an election.* A taxpayer who is an individual, trust, estate or small business corporation may make the election provided in § 183(e) by filing the statement and consents required by paragraph (d) of this section within—

(1) 3 years after the due date of such taxpayer's return (determined without extensions) for the taxable year in which such taxpayer first engages in the activity, but not later than

(2) 60 days after such taxpayer receives a written notice (if any) from a district director that the district director proposes to disallow deductions attributable to an activity not engaged in for profit under section 183.

The provisions of paragraph (c)(2) of this section shall in no event be construed to extend the period described in (c)(1) of this section for making such election. Notwithstanding the time periods prescribed in paragraph (c) (1) and (2) of this section, if no election has been made before a suit or proceeding described in section 7422(a) is maintained or a petition is filed in the Tax Court for a redetermination of a deficiency for any taxable year within the presumption period to which the election would apply, no election may be made except with the consent of the Commissioner which will not be given unless no appreciable delay in the suit or proceeding will be caused.

(d) *Manner of making election.* (1) The election shall be made by the individual, trust, estate, or electing small business corporation, as the case may be, engaged in the activity, by filing a statement which sets forth the following information—

(i) The name, address, and taxpayer identification number of such taxpayer, and, if applicable, of the partnership in which he engages in the activity,

(ii) A declaration stating that the taxpayer elects to postpone a determination as to whether the presumption described in section 183(d) applies until after the close of the taxpayer's fourth taxable year (sixth taxable year, in the case of an activity described in § 1.183–1(c)(3)) following the taxable year in which the taxpayer first engaged in such activity and identifying that first such taxable year, and,

(iii) A description of each activity (as defined in § 1.183–1(d)(1)) with respect to which the election is being made.

(2) For an election to be effective, there must be attached to the statement properly executed consents, in the form prescribed by the Commissioner, extending the period prescribed by section 6501 for the assessment of any tax to a date which is not earlier than 18 months after the due date of the return (determined without extensions) for the final year in the presumption period to which the election applies, as follows:

(i) Consents for each of the taxpayer's taxable years in the presumption period to which the election applies,

(ii) If the election is made by an electing small business corporation, a consent of each person who is a shareholder during any taxable year to which the election applies, for each of such shareholder's taxable years with or within which end each of the corporation's taxable years in the presumption period,

(iii) If a taxpayer referred to in paragraph (d)(2)(i) of this section or shareholder referred to in paragraph (d)(2)(ii) of this section is married at the time of the election, in the case of his present spouse, a consent for each of such spouse's taxable years which correspond to the taxable years (other than prior years of the shareholder during no part of which he was a shareholder) for which consents are required by paragraph (d)(2) (i) or (ii) of this section as the case may be.

Such consents shall not be construed to shorten the period described in section 6501 for any taxable year within the presumption period to which the election applies.

(3) The statement, with the required consents attached, shall be filed—

(i) With the service center at which the taxpayer making the election is required to file his return, or

(ii) If the taxpayer is notified by a district director that, pursuant to section 183 he is proposing to disallow deductions with respect to an activity not engaged in for profit, with such district director.

(e) *Subsequent invalidations.* If, after a timely election has been made, but still within the presumption period, a suit or proceeding (as described in section 7422(a)) is maintained by the electing taxpayer, a shareholder referred to in paragraph (d)(2)(ii) of this section, or spouse referred to in paragraph (d)(2)(iii) of this section for any taxable year for which a consent is required by this section and the taxpayer, shareholder, or spouse has not been issued a notice of deficiency (as described in section 6212(a)) with respect to such taxable year, such election shall not be effective to postpone the determination whether the presumption applies, for such taxable year, but the consents extending the statute of limitations filed with the election shall not thereby be invalidated. The immediately preceding sentence shall not apply to a suit or proceeding maintained by the spouse of an electing taxpayer for a taxable year for which such spouse has filed a separate return, or a suit or proceeding maintained by a shareholder for a taxable year in which he was not such a shareholder. An election by an individual taxpayer or electing small business corporation, shall be subsequently invalidated for all years in the presumption period to which it had applied if—

(1) The electing taxpayer or shareholder taxpayer files a joint return for one of the first three (five, in the case of an activity described in § 1.183–1(c)(3)) taxable years in such presumption period, and

(2) The spouse with whom he files such joint return has not previously executed a consent described in paragraph (d)(2)(iii) of this section, and

(3) Within one year after the filing of such joint return (or, if later, 90 days after March 14, 1974), such spouse has not filed a consent described in paragraph (d)(2) of this section.

An election by an electing small business corporation shall be invalidated for all years in the presumption period to which it applies if a person who was not a shareholder on the date of election becomes a shareholder during the first three (or five) years of the presumption period to which the election applies and does not, within 90 days after the date on which he becomes a shareholder (or, if later, 90 days after March 14, 1974), file a consent required

by paragraph (d)(2) of this section. Invalidation of the election by operation of this paragraph will in no case affect the validity of the consents filed with such election.

(f) *Extension of time for filing election in hardship cases.* The Commissioner may upon application by a taxpayer, consent to an extension of time prescribed in this section for making an election if he finds that such an extension would be justified by hardship incurred by reason of the time at which this section is published. The burden will be on the taxpayer to establish that under the relevant facts the Commissioner should so consent.

[T.D. 7308, 39 FR 9947, Mar. 15, 1974]

## PART 13—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1969

Sec.
13.0–13.3 [Reserved]
13.4 Arbitrage bonds; temporary rules.
13.5–13.9 [Reserved]
13.10 Distribution of money in lieu of fractional shares.
13.11 Revocation of election to report income on the installment basis.

AUTHORITY: 26 U.S.C. 7805.

### §§ 13.0–13.3 [Reserved]

### § 13.4 Arbitrage bonds; temporary rules.

(a) *In general*—(1) *Arbitrage bonds.* Section 103(d)(1) provides that any arbitrage bond (as such term is defined in section 103(d)(2)) shall be treated as an obligation not described in section 103(a)(1). Thus, the interest on an obligation which would have been excluded from gross income pursuant to the provisions of section 103(a)(1) will be included in gross income and subject to Federal income taxation if such obligation is an arbitrage bond. Under section 103(d)(2), an obligation is an arbitrage bond if it is issued by a governmental unit as part of an issue of obligations (for purposes of this section referred to as ''governmental obligations'') all or a major portion of the proceeds of which are (i) reasonably expected to be used directly or indirectly to acquire certain obligations or securities (for purposes of this section referred to as ''acquired obligations'') which may reasonably be expected, at the time of issuance of such governmental obligations, to produce a yield over the term of the issue of such governmental obligations which is materially higher (taking into account any discount or premium) than the yield on such issue, or (ii) reasonably expected to be used to replace funds which were used directly or indirectly to acquire such acquired obligations. For rules as to industrial development bonds, see section 103(c).

(2) *Definitions.* (i) For purposes of this section, the term ''governmental unit'' means a State, the District of Columbia, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing.

(ii) For purposes of this section, the term ''securities'' has the same meaning as in section 165(g)(2) (A) and (B).

(3) *Materially higher.* For purposes of this section, the yield produced by acquired obligations is not ''materially higher'' than the yield produced by an issue of governmental obligations if it is reasonably expected, at the time of issue of such governmental obligations, that the adjusted yield (computed in accordance with subparagraphs (4) and (5) of this paragraph) to be produced by the acquired obligations will not exceed the adjusted yield (computed in accordance with subparagraphs (4) and (5) of this paragraph) to be produced by the issue of governmental obligations by more than one-eighth of 1 percentage point. In the case of an issue of governmental obligations issued on or before July 1, 1972, the percentage specified in the preceding sentence shall be one-half of 1 percentage point.

(4) *Yield.* (i) For purposes of this section, ''yield'' shall be computed using the ''interest cost per annum'' method in accordance with subdivision (ii) or (iii) of this subparagraph (as the case may be) or any other method satisfactory to the Commissioner which is consistent with generally accepted principles of computing yield. In the case of acquired obligations, the yield to be produced by such obligations shall be computed as if all acquired obligations comprised a single issue of obligations. Thus, for example, if the governmental

unit acquires two blocks of Federal obligations, with different interest rates and maturity periods for each block, the yield on such acquired obligations shall be computed as if one issue of obligations with different interest rates and maturity periods had been acquired. The maturity period of each acquired obligation shall be the period that the governmental unit reasonably expects to hold such obligation.

(ii) If all the governmental or acquired obligations of an issue have a single interest rate (expressed in dollars per $1,000 of face amount of bonds), yield shall be computed using the following 4 steps:

*(a) Step (1).* Compute the total number of bond years for the issue by multiplying the number of bonds (treating each $1,000 of face value as one bond for purposes of this computation) of each maturity by the length of the maturity period (expressed in years and fractions thereof) and then adding together the amounts determined for each maturity period.

*(b) Step (2).* Compute the total interest payable on the issue by multiplying the total number of bond years (as computed in step (1)) by the amount payable, expressed in dollars, as interest on each $1,000 of bonds for 1 year.

*(c) Step (3).* Compute the net interest in dollars for the issue by adding the amount, in dollars, of any discount to, or by subtracting the amount, in dollars, of any premium from, the total interest payable on the issue.

*(d) Step (4).* Compute yield by dividing the net interest by the product obtained by multiplying the total number of bond years for the issue by 10.

(iii) If governmental or acquired obligations of an issue have different interest rates (expressed in dollars per $1,000 of face amount of bonds), yield shall be computed using the following 4 steps:

*(a) Step (1).* Compute the total number of bond years for each group of bonds bearing the same interest rate (treating each $1,000 of face value as one bond for purposes of this computation) in the manner described in step 1 of subdivision (ii) of this subparagraph.

*(b) Step (2).* Compute the total interest payable on the issue by multiplying the total number of bond years for each group of bonds bearing the same interest rate (as computed in step (1)) by the amount payable, expressed in dollars, as interest on each $1,000 of bonds for 1 year, and then adding together the amounts determined for each group.

*(c) Step (3).* Compute net interest in the manner described in step (3) of subdivision (ii) of this subparagraph.

*(d) Step (4).* Compute the yield produced by the issue in the manner described in step (4) of subdivision (ii) of this subparagraph.

(iv) For purposes of this section, the same method of computing yield shall be used to compute the yield to be produced by an issue of governmental obligations and to compute the yield to be produced by acquired obligations acquired with the proceeds of such issue of governmental obligations.

(v) The following example illustrates the provisions of this subparagraph:

*Example.* Assume an issue of $200,000 ($1,000 per bond) with a stated interest (expressed in dollars per bond) of $50 on bonds maturing in 1, 2, or 3 years, a stated interest of $60 on bonds maturing in 4, 5, 6, or 7 years and a stated interest of $70 on bonds maturing in 8, 9, or 10 years. Assume also that a price of $101 has been bid for the issue. The yield on the issue is determined in accordance with the table below:

| Amount | Rate | Years to maturity | Bond years | Total bond years at interest rate | × | Interest rate | = | Interest cost |
|---|---|---|---|---|---|---|---|---|
| $10,000 | $50 | 1 | | | | | | |
| 5,000 | 50 | 2 | | | | | | |
| 25,000 | 50 | 3 | | | | | | |
| | | | | 95 | | | | $4,750 |
| 10,000 | 60 | 4 | 40 | | | | | |
| 10,000 | 60 | 5 | 50 | | | | | |
| 30,000 | 60 | 6 | 180 | | | | | |
| 50,000 | 60 | 7 | 350 | | | | | |
| | | | | 620 | | | | 37,200 |

| | Amount | Rate | Years to maturity | Bond years | Total bond years at interest rate | × | Interest rate | = | Interest cost |
|---|---|---|---|---|---|---|---|---|---|
| | 20,000 | 70 | 8 | 160 | | | | | |
| | 25,000 | 70 | 9 | 225 | | | | | |
| | 15,000 | 70 | 10 | 150 | | | | | |
| | | | | | 535 | | 70 | | 37,450 |
| Totals | 200,000 | | | | 1,250 | | | | 79,400 |
| Less premium | | | | | | | | | 2,000 |
| Net interest cost | | | | | | | | | 77,400 |
| Divide by: Product of total bond years (1,250), multiplied by 10 | | | | | | | | | 12,500 |
| Yield (Percent) | | | | | | | | | 6,192 |

(5) *Adjusted yield.* (i) For purposes of this section, ''adjusted yield'' shall be computed in accordance with subparagraph (4) of this paragraph, except that in the case of—

*(a)* Acquired obligations, an amount equal to the sum of the administrative costs reasonably expected to be incurred in purchasing, carrying, and selling or redeeming such obligations shall be treated as a premium on the purchase price of such acquired obligations.

*(b)* An issue of governmental obligations, an amount equal to the sum of the reasonably expected administrative costs of issuing, carrying, and repaying such issue of obligations shall be treated as a discount on the selling price of such issue of governmental obligations.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

*Example (1).* State Z issues $15 million of obligations all of which will mature in 10 years. The obligations are sold at $1,000 each (par) to yield 6 percent interest. The adjusted yield produced by such issue of obligations will be determined as follows, assuming the following administrative expenses of issuing, carrying, and repaying such issue of obligations are reasonably expected:

| | | |
|---|---|---|
| Issuing costs: | | |
| Printing | $12,500 | |
| Financial advisors | 25,000 | |
| Counsel fees | 12,500 | |
| Total | | $50,000 |
| Carrying costs, paying agent and trustees fees | | 10,000 |
| Repaying costs, paying agent | | 3,000 |
| Total administrative costs | | 63,000 |
| Bond years (15,000×10 years) | | 150,000 |
| Interest cost per $1,000 bond per year | | 60 |
| Total interest cost | | 9,000,000 |
| Discount or premium | | 0 |
| Plus adjustments | | 63,000 |
| Net interest cost | | 9,063,000 |
| Divide by product of bond years (150,000) multiplied by 10 | | 1,500,000 |
| Adjusted yield | | 6.042% |

*Example (2).* State Z uses the net proceeds of the issue of obligations described in Example (1) to acquire $14,922,000 of student's notes at par of $1,000 each under a student loan program. The students' notes will all mature in 10 years, and all have a stated interest of 7½ percent. Expenses of the program including printing of forms ($5,000), financial advisors' fees ($11,000), counsel fees ($12,000), trustees' fees ($5,000), fees for the collecting agents and various banks which administer the loans ($100,000), advertising expenses ($10,000), credit reference checks ($20,000), and general office overhead ($5,000). Of the expenses listed in the preceding sentence, only those indicated on the following table constitute adjustments to yield in order to determine the adjusted yield to be produced by the students' notes:

| | | |
|---|---|---|
| Purchasing costs: | | |
| Printing forms | $5,000 | |
| Financial advisors | 11,000 | |
| Counsel fees | 12,000 | |
| Total | | $28,000 |
| Carrying costs, trustees fees | | 5,000 |
| Total administrative costs | | 33,000 |
| Bond years (14,922×10 years) | | 149,220 |
| Interest receivable per $1,000 note per year | | 75 |
| Total interest receivable | | 11,191,500 |
| Discount or premium | | 0 |
| Minus adjustments | | 33,000 |
| Net interest receivable | | 11,158,500 |
| Divide by product of bond years (149,220) multiplied by 10 | | 1,492,200 |
| Adjusted yield | | 7.478% |

(b) *Rule with respect to certain governmental programs*—(1) *General rule.* Subject to the limitations of subparagraph (3) of this paragraph, any obligations which are part of an issue of governmental obligations the proceeds of which are reasonably expected to be used to finance certain governmental programs (described in subparagraph (2) of this paragraph) are not arbitrage obligations.

(2) *Governmental programs.* A governmental program is described in this subparagraph if—

(i) The program involves the acquisition of acquired purpose obligations to carry out the purposes of such program (which obligations, for purposes of this paragraph, are referred to as ''acquired program obligations'');

(ii) At least 90 percent of all such acquired program obligations, by amount of cost outstanding, are evidences of loans to a substantial number of persons representing the general public, loans to exempt persons within the meaning of section 103(c)(3), or loans to provide housing and related facilities, or any combination of the foregoing;

(iii) At least 90 percent of all of the amounts received by the governmental unit with respect to acquired program obligations shall be used for one or more of the following purposes: To pay the principal or interest or otherwise to service the debt on governmental obligations relating to the governmental program; to reimburse the governmental unit, or to pay, for administrative costs of issuing such governmental obligations; to reimburse the governmental unit, or to pay, for administrative and other costs and anticipated future losses directly related to the program financed by such governmental obligations; to make additional loans for the same general purposes specified in such programs; or to redeem and retire governmental obligations at the next earliest possible date of redemption; and

(iv) Requires that any person (or any related person, as defined in section 103(c)(6)(C)) from whom the governmental unit may, under the program, acquire acquired program obligations shall not, pursuant to an arrangement, formal or informal, purchase the governmental obligations in an acquired program obligations to be acquired from such person by the governmental unit.

(3) *Limitation.* The provisions of subparagraph (1) of this paragraph shall apply only if it is reasonably expected that—

(i) A major portion of the proceeds of such issue of governmental obligations, including proceeds represented by repayments of principal and interest received by the governmental unit with respect to acquired program obligations, shall not be invested for more than a temporary period (within the meaning of section 103(d)(4)(A)), in acquired obligations (other than acquired program obligations) which produce a materially higher yield than the yield produced over the term of the issue by such governmental obligations, and

(ii)*(a)* The adjusted yield (computed in accordance with paragraphs (a) (4) and (5) of this section) to be produced by acquired program obligations shall not exceed the adjusted yield (computed in accordance with paragraphs (a) (4) and (5) of this section) to be produced by such issue of governmental obligations by more than 1½ percentage points, or

*(b)* Where the difference in the adjusted yields described in subdivision (ii)*(a)* of this subparagraph is expected to exceed 1½ percentage points, the amounts to be obtained as a result of the difference in such adjusted yields shall not exceed the amount necessary to pay expenses (including losses resulting from bad debts) reasonably expected to be incurred as a direct result of administering the program to be financed with the proceeds of such issue of governmental obligations, to the extent that such amounts are not payable with funds appropriated from other sources.

(4) *Examples.* The following examples illustrate governmental programs described in subparagraph (2) of this paragraph:

*Example (1).* State A issues obligations the proceeds of which are to be used to purchase certain home mortgage notes from commercial banks. The purpose of the governmental program is to encourage the construction of low income residential housing by creating a secondary market for mortgage notes and

thereby increasing the availability of mortgage money for low income housing. The legislation provides that the adjusted yield produced by the mortgage notes to be acquired will not exceed the adjusted yield produced by such issue of obligations by more than 1½ percentage points. Amounts received as interest and principal payments on the mortgage notes are to be used for one or more of the following purposes: (1) To service the debt on the governmental obligations, (2) to retire such obligations at their earliest possible date of redemption, (3) to purchase additional mortgage notes. The governmental program is one which is described in subparagraph (2) of this paragraph and the governmental obligations are not arbitrage bonds.

*Example (2).* State B issues obligations the proceeds of which are to be used to make loans directly to students and to purchase from commercial banks promissory notes made by students as the result of loans made to them by such banks. The legislation authorizing the student loan program provides that the purpose of the program is to enable financially disadvantaged students to continue their studies. The legislation also provides that purchases will be made from banks only where such banks agree that an amount at least equal to the purchase price will be devoted to new or additional student loans. It is reasonably expected that the difference in adjusted yields between the issue of governmental obligations by State B and the students' notes will be 1¾ percentage points. It is also reasonably expected that the amount necessary to pay the expenses (other than expenses taken into account in computing adjusted yield) enumerated in subparagraph (3)(ii)*(b)* of this paragraph, directly incurred as a result of administering State B's student loan program, such as, for example, losses resulting from bad debts, insurance costs, bookkeeping expenses, advertising expenses, credit reference checks, appraisals, title searches, general office overhead, service fees for collecting agents and various banks which administer the loans, and salaries of employees not paid from other sources, will not require a difference in adjusted yields in excess of 1½ percentage points. The governmental program is one which is described in subparagraph (2) of this paragraph. Since, however, the difference in adjusted yields produced by the students' notes and the issue of State B obligations is reasonably expected to exceed 1½ percentage points, and since State B cannot show that 1¾ percentage points is necessary to cover such expenses, the provisions of subparagraph (1) of this paragraph shall not apply to the issue of State B obligations. If, however, State B reasonably expected that 1¾ percentage points would be necessary to cover such expenses, the provisions of subparagraph (1) of this paragraph would apply and the governmental obligations would not be arbitrage bonds.

*Example (3).* Authority C issues obligations the proceeds of which are to be used to purchase land to be sold to veterans. The governmental unit will receive purchase-money mortgage notes secured by mortgages on the land from the veterans in return for such land. The purpose of the program is to enable veterans to acquire land at reduced cost. The adjusted yield produced by the mortgage notes is not reasonably expected to exceed the adjusted yield produced by the issue of obligations issued by Authority C by more than 1½ percentage points. Amounts received as interest and principal payments on the mortgage notes are to be used for one or more of the following purposes: (1) To pay the administrative costs directly related to the program, (2) to service the debt on the governmental obligations, (3) to retire such governmental obligations at their earliest possible call date, (4) to purchase additional land to be sold to veterans. The governmental program is one which is described in subparagraph (2) of this paragraph and the governmental obligations are not arbitrage bonds.

(c) *Effective date.* The provisions of this section will apply with respect to obligations issued after October 9, 1969, and before final regulations are promulgated.

[T.D. 7072, 35 FR 17406, Nov. 13, 1970; 35 FR 18524, Dec. 5, 1970, as amended by T.D. 7174, 37 FR 10932, June 1, 1972; T.D. 7273, 38 FR 10927, May 3, 1973]

### §§ 13.5–13.9 [Reserved]

### § 13.10 Distribution of money in lieu of fractional shares.

(a) *In general.* (1) Under the general rule of section 305, as amended by section 421(a) of the Tax Reform Act of 1969, gross income does not include the amount of any distribution of the stock (or rights to acquire the stock) of a corporation made by such corporation to its shareholders with respect to its stock. Under an exception to the general rule, a distribution by a corporation of its stock or rights to acquire its stock is treated as a distribution of property to which section 301 applies if the distribution (or a series of distributions of which such distribution is one) has the result of (i) the receipt of money or other property by some shareholders, and (ii) an increase in the proportionate interests of other shareholders in the assets or earnings

and profits of the corporation. Also, the Secretary or his delegate is directed to prescribe regulations under which a redemption which is treated as a distribution to which section 301 applies, or any other transaction having a similar effect on the interest of any shareholder, shall be treated as a distribution with respect to any shareholder whose proportionate interest in the assets or earnings and profits of the corporation is increased by such redemption or transaction.

(2) The general rule, and not the exception, applies in the case where cash is distributed in lieu of fractional shares to which the shareholders would otherwise be entitled, provided the purpose in distributing the cash is to save the distributing corporation the trouble, expense, and inconvenience of issuing and transferring fractional shares (or scrip representing fractional shares), or issuing full shares representing the sum of fractional shares, and not to give any particular group of shareholders an increased interest in the assets or earnings and profits of the corporation.

(b) *Illustration*. The application of paragraph (a) of this section may be illustrated by the following example:

*Example.* Corporation X is a large corporation whose stock is widely held by the public, no one shareholder owning more than 10 percent of the outstanding stock. The stock is listed on a recognized exchange and is currently selling at less than $75 per share. During the year the corporation pays a 3-percent stock dividend. Cash is paid to each shareholder in lieu of a fractional share to which he would otherwise be entitled. The distribution of cash in lieu of fractional shares is not intended to give any particular group of shareholders an increased interest in the assets or earnings and profits of the corporation, but is intended to save the corporation the trouble, expense, and inconvenience of issuing and transferring scrip representing fractional shares. The general rule, and not the exception, applies in this situation.

(Sec. 305(c), 83 Stat. 614; 26 U.S.C. 305(c))

[T.D. 7039, 35 FR 7012, May 2, 1970]

### § 13.11 Revocation of election to report income on the installment basis.

(a) *In general.* Under section 453(c)(4) taxpayers who are dealers in personal property and who elected installment-basis income reporting, subject to the provisions of section 453(c)(1) (relating to change from accrual to installment basis), may revoke their previously made election.

(b) *Time and manner of revoking election.* The revocation by a taxpayer may be made by filing an amended return on an appropriate form or forms, such as Form 1040X for an individual taxpayer, for the year of change (the first year for which income was computed using the installment basis) and for each subsequent year for which a return was filed using the installment basis. The taxpayer should indicate on such amended returns that he is revoking an election to report income on the installment basis. Such revocation must be made within 3 years from the last date prescribed for the filing of the return for the year of change including any extension of time granted the taxpayer. In reporting income on the amended returns described in this section, the taxpayer shall use the accrual method of accounting.

[T.D. 7044, 35 FR 8823, June 6, 1970]

## PART 14a—TEMPORARY INCOME TAX REGULATIONS RELATING TO INCENTIVE STOCK OPTIONS

AUTHORITY: 26 U.S.C. 7805.

### § 14a.422A–1 Questions and answers relating to incentive stock option transitional rules.

The following questions and answers relate to the application of incentive stock option (ISO) treatment to certain previously granted stock options, pursuant to section 422A of the Internal Revenue Code of 1954, as added by section 251 of the Economic Recovery Tax Act of 1981 (95 Stat. 172) (ERTA):

GENERAL DESCRIPTION OF SECTION 422A AND ITS TRANSITIONAL RULES

*Q–1: What is the significance of new section 422A of the Code entitled ''Incentive Stock Options?''*

A–1: Prior to the enactment of section 422a, the tax treatment of employee stock options generally was governed by section 83 of the Code and the regulations thereunder. Under those rules, the value of a stock option constituted ordinary income to the employee when granted only if the option itself had a readily ascertainable fair market value at

that time. If the option did not have a readily ascertainable value when granted, it did not constitute ordinary income at that time. Instead, when the option was exercised, the difference between the value of the stock at exercise and the option price constituted ordinary income to the employee. An employer who granted a stock option generally was allowed a business expense deduction equal to the amount includible in the employee's income in its corresponding taxable year.

Section 422A provides for incentive stock options (ISO's). Under this new provision there will be no tax consequences when an ISO is either granted or exercised, and the employee generally will be taxed at capital gains rates when and if the stock received on exercise of the option is sold. Similarly, no business expense deduction will be allowed to the employer with respect to an ISO.

*Q–2: What requirements must be met for ISO treatment under section 422A?*

A–2: (a) Section 422A provides that the employee, in order to receive ISO treatment, must not dispose of the stock within two years after the option is granted, and must hold the stock itself for at least one year. If all requirements other than these holding period rules are met, tax is deferred until disposition of the stock, but gain (in an amount equal to the lesser of (1) the fair market value of the stock on the date of exercise minus the option price or (2) the amount realized on disposition minus the option price) is treated as ordinary income and the employer is allowed a deduction at that time.

(b) In addition, for the entire time from the date of granting the option until three months before the date of exercise (expanded to 12 months if employment ceased due to permanent and total disability), the option holder must be an employee either of the company granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of that corporation) which has assumed the option of another corporation as a result of a corporate reorganization, liquidation, etc. This requirement and the holding period requirement are waived in the case of the death of the employee.

(c) For an option to qualify as an ISO, the following conditions must be met:

(1) The option must be granted under a plan specifying the aggregate number of shares of stock which may be issued and the employees or class of employees eligible to receive the options. This plan must be approved by the stockholders of the granting corporation within 12 months before or after the plan is adopted.

(2) The option must be granted within ten years from the date the plan is adopted or the date the plan is approved by the stockholders, whichever is earlier.

(3) The option must by its terms be exercisable only within ten years of the date it is granted.

(4) The option price must equal or exceed the fair market value of the stock at the time the option is granted. This requirement will be deemed satisfied if there has been a good faith attempt to value the stock accurately, even if the option price is less than the stock value.

(5) The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by the employee.

(6) The employee must not, at the time the option is granted, own stock representing more than ten percent of the voting power of all classes of stock of the employer corporation or its parent or subsidiary. However, the stock ownership limitation will not apply if the option price is at least 110 percent of the fair market value (at the time the option is granted) of the stock subject to the option and the option by its terms is not exercisable more than five years from the date it is granted.

(7) The option by its terms is not exercisable while there is outstanding any ISO which was granted to the employee at an earlier time. For this purpose, an option which has not been exercised in full is outstanding until the expiration of the period which under its initial terms it could have been exercised. Thus, the cancellation of an earlier option will not enable a subsequent option to be exercised any sooner.

(8) In the case of options granted after 1980 the terms of the plan must limit the amount of aggregate fair market value of the stock (determined at the time of the grant of the option) for which any employee may be granted ISO's in any calendar year to not more than $100,000 plus a carryover amount. The carryover amount for an employee from any year after 1980 is one-half of the amount by which $100,000 exceeds the value at time of grant of the stock for which ISO's were granted in such prior year. Amounts may be carried over three years. Options granted in any year use up the $100,000 current year limitation first and then the carryover from the earliest year.

(d) Section 422A also provides that:

(1) Stock acquired on exercise of an ISO may be paid for with stock of the corporation granting the option.

(2) The difference between the option price and the fair market value of the stock at the exercise of an ISO is not an item of tax preference.

(3) The employee may have the right to receive additional compensation (in cash or property) at the time of exercise of the ISO so long as the additional amount is subject to inclusion in income under the provisions of sections 61 and 83 of the Code.

(4) An ISO will not be disqualified because of the inclusion of any condition not inconsistent with the qualification requirements.

*Q–3: What are the transitional rules relating to ISO treatment under section 422A?*

A–3: ERTA § 251(c) provides the transitional rules relating to ISO treatment. That section initially limits the applicability of section 422A to options originally granted on or after January 1, 1976.

In the case of an option granted during the years 1976 through 1980, section 422A will apply only if (1) the option was exercised on or after January 1, 1981, or was outstanding on that date, and (2) the employer elects (in such manner as the Treasury Department provides) to have the option treated as an ISO (see A–4). (See A–12 for necessary section 422A qualification requirements.) The aggregate fair market value (determined at time of grant) of stock for which an employee may be granted ISO's prior to 1981 may not exceed $50,000 per calendar year and $200,000 in the aggregate for the five-year period 1976–1980.

In the case of an option granted on or after January 1, 1976, and outstanding on August 13, 1981, paragraph (1) of section 425(h) of the Code shall not apply to either any change in the option terms (or the terms of the plan under which the option was granted) or the obtaining of shareholder approval, to permit such option to qualify as an ISO, provided such change and/or shareholder approval occurs on or before August 13, 1982. (Section 425(h) of the Code requires that if an option is changed, so that it is modified, extended, or renewed, the option shall be treated as newly granted as of the date of such change.)

ELECTION PROCEDURE AND SELECTION OF OPTIONS

*Q–4: What is the procedure for electing ISO treatment for options granted during the years 1976 through 1980 and outstanding on January 1, 1981?*

A–4: NOTE: The following procedure preempts the election procedure set forth in Temporary Regulation § 301.9100–4T(d) of this chapter (TD 7793, 46 FR 54538 (November 3, 1981)). If, prior to December 21, 1981, a corporation has filed an election statement that conforms to the requirements of § 301.9100–4T(d) of this chapter, such an election statement will be considered to have been properly filed. An election statement filed prior to December 21, 1981, that does not meet the requirements of either § 301.9100–4T(d) of this chapter or this A–4, will not be considered to have been properly filed. In any event, a corporation may re-file the election statement, conforming it to the requirements of this A–4, and such re-filing will then constitute the only election (see A–9, regarding timely rescissions, for a possible reason a corporation may want to re-file).

A corporation may file only one election statement and that statement must include all options that are to receive ISO treatment. Thus a corporation that makes an election with respect to certain options granted before 1981 may not make any subsequent election with respect to other options granted before 1981. An election shall be made by attaching a statement to the employer's income tax return (or amended return) for the first taxable year during which either an option subject to the election or an option qualifying under the rules of section 422A is exercised. An election shall be made no later than the due date (including extensions) of the income tax return for such year, except that if the due date occurs before August 14, 1982, the employer will be permitted to make the election at any time prior to August 14, 1982, on a statement attached to an amended return. In any event, no election will be permitted after the due date (taking extensions into account) of the income tax return for the taxable year including December 31, 1982.

The statement must—

(a) Contain the name, address, and taxpayer identification number of the corporation.

(b) Identify the election as an election under section 251(c)(1)(B) of the Economic Recovery Tax Act of 1981.

(c) Specify, by employee, the options to which the election applies. For each option so elected, the filing must state the option's date of original grant (and, if applicable, date of most recent modification) and total exercise price (*i.e.*, the total number of shares subject to the option multiplied by the price per share).

All options that are subject to the election must meet the section 422A qualification requirements (see A–2(c)) at the time the election statement is filed. The only exception to this rule is the requirement, when necessary, of securing shareholder approval (see A–32 and A–34).

*Q–5: In electing ISO treatment for options granted during the years 1976 through 1980 and outstanding on January 1, 1981, may a corporation select only those options that it wants to receive ISO treatment?*

A–5: Yes. However the original grant dates—or later grant dates for options with section 425(h) amendments (see A–9)—of the options selected for ISO treatment will determine the new sequencing order for purposes of the ISO sequential exercise restriction (see A–2(c)(7)). For example consider the case of options granted in 1977, 1978, and 1979, and assume that in 1980 the 1978 option was modified to add a term beneficial to the employee (a modification which under 425(h) would be treated as the granting of a new option). If the 1977, 1978 (as modified), and 1979 options are now elected as ISO's, the sequencing order is as follows: the 1977 option

must be exercised first, the 1979 option second, and the 1978 option (as modified) third. See also A–9 and A–38.

*Q–6: In electing ISO treatment for options granted during the years 1976 through 1980 and outstanding on January 1, 1981, may a corporation select options on an option-by-option basis and/or an employee-by-employee basis?*

A–6: Yes. Subject to the $50,000 per year and $200,000 aggregate limits (see A–3), a corporation may select for ISO treatment any or all options granted to any or all employees, subject only to plan requirements as to who must be benefited under a plan, as among different classes of employees.

*Q–7: In electing ISO treatment for options granted during the years 1976 through 1980 and outstanding on January 1, 1981, may a corporation select only a portion of the elected option to receive such treatment?*

A–7: Yes. Subject to the $50,000 per year and $200,000 aggregate limits (see A–3), a corporation may select for ISO treatment any portion of any option. If the option is not exercised prior to January 21, 1982, the option must be amended so that the ISO portion is clearly identified. When such a ''split'' option is exercised, separate stock certificates must be issued (or reissued)—one for the ISO stock and one for the non-ISO stock. See also A–15 and A–18.

ELIGIBILITY REQUIREMENTS AND ISSUES INVOLVING PRE-ENACTMENT MODIFICATIONS, DOLLAR LIMITATIONS, AND DUAL PLANS

*Q–8: Is an option originally granted prior to January 1, 1976, and amended on or after January 1, 1976, eligible for ISO treatment?*

A–8: No. For purposes of ISO eligibility, the controlling date is the date of original grant. A modification, extension, or renewal on or after January 1, 1976, of any option originally granted before that date, will not make such option eligible for ISO treatment, regardless of whether or not the option, as so modified, extended, or renewed, would be treated as newly granted within the meaning of section 425(h).

*Q–9: If an option granted on or after January 1, 1976, was amended between its date of grant and August 13, 1981, will such an amendment affect the option's eligibility for ISO treatment?*

A–9: An amendment to an otherwise eligible option (or plan) prior to August 13, 1981, will be subject to the rules of section 425(h). If, pursuant to section 425(h), the amendment is a modification, extension, or renewal of the option, such amendment shall be considered as the granting of a new option. In order for such an option to be eligible for ISO treatment, the option (and plan) must comply with the section 422A qualification requirements (see A–2(c)). The option will be deemed to have been granted on the date it was amended. Thus, the option price cannot be less than the fair market value of the stock on that date. If the corporation wishes to retain the original grant price (and grant date) of the option, the corporation may do so by rescinding the amendment that was either a modification, extension, or renewal pursuant to section 425(h), so long as such rescission occurs prior to the earliest of the exercise of the option, the election of ISO treatment, and August 14, 1982. To be effective, such rescission must apply to the entire option. For example, in the case of a $100,000 option granted in 1978 and amended in 1980, the corporation could not rescind the modification as to only half of the option, and then elect for ISO treatment both $50,000 of the option granted in 1978 and $50,000 of the option as amended in 1980.

*Q–10: An option granted during 1978 was amended during 1980 to add the following features: An alternative stock appreciation right, the right to exercise the option with previously-acquired corporate stock, and the right to receive a cash bonus upon the exercise of the option. At the same time, the exercise period of the option was extended from five to ten years and the post-employment exercise period was extended from 3 to 18 months. If the option is to* be elected as an ISO, which of the above amendments is either a modification, extension, or renewal within the meaning of section 425(h) so that the option will be treated as newly granted on the date it was amended?

A–10: Any one of the above amendments will cause the option, pursuant to section 425(h), to be treated as newly granted on the date it was amended.

*Q–11: An option granted during 1978 was amended during 1980 to add the right to exercise the option with previously acquired corporate stock. During 1981, the corporation properly elected ISO treatment for the amended option and, pursuant to section 425(h), adjusted the option price upward so that it equaled the fair market value of the stock subject to the option as of the date of the 1980 amendment. During 1982, the employee intends to exercise the option and will pay cash. Under these circumstances, is the employee entitled to exercise the option at the 1978 option price?*

A–11: No. The option price, as amended in 1980, is the option price. The application of section 425(h) to option amendments is not affected by whether or not the employee actually benefits from such amendments (but see A–9 regarding timely rescissions).

*Q–12: Is an option granted on or after January 1, 1976, and exercised on or after January 1, 1981, eligible for ISO treatment, if, at the time of exercise, the option (or plan) did not meet all of the qualification requirements of section 422A and the transitional rules (see A–2(c) and A–3, respectively)?*

A–12: No. Except in cases described in A–13 through A–15, and A–34, in order for an option to be eligible for ISO treatment it must, at the time of exercise, conform to all of the qualification requirements of section 422A

and the transition rules. It is not possible to amend an exercised option retroactively, in order to correct non-conforming or missing terms, or to rescind an improper exercise.

*Q–13: Is an option granted on or after January 1, 1976, and exercised on or after January 1, 1981, eligible for ISO treatment if, at the time of exercise, the terms of the option did not contain the ISO sequential exercise restriction (see A–2(c)(7))?*

A–13: If the option was exercised prior to January 21, 1982, without containing the ISO sequential exercise restriction, such option may still be eligible for ISO treatment. The absence of the restriction will not disqualify an option if the employee in fact had no prior outstanding ISO's at the time the option in question was exercised. If the option was exercised on or after January 21, 1982, the absence of the ISO sequential exercise restriction will not disqualify an option if the employee in fact had no prior outstanding ISO's at the time the option in question was granted. In order to identify prior outstanding ISO's, it will be necessary to take into account all options either elected or qualifying for ISO treatment (see A–5, A–9, and A–38).

*Q–14: Is an option granted and exercised during 1981 eligible for ISO treatment if, at the time of exercise, the terms of the plan pursuant to which the option was granted did not contain the $100,000 per year limit on ISO grants (see A–2(c)(8))?*

A–14: If the option was exercised prior to January 21, 1982, the absence from the plan of the $100,000 per year limit will not disqualify the option. ISO treatment will only be available, however, for exercised amounts that do not exceed the $100,000 limit. Those amounts in excess of the limit will be treated as non-ISO's. If it is necessary to ''split'' an exercised option because the $100,000 limit has been exceeded, separate stock certificates must be issued (or reissued) no later than January 21, 1982, one for the ISO stock and one for the non-ISO stock. If the option was not exercised prior to January 21, 1982, the rules of A–18 will apply.

*Q–15: Is an option granted during the years 1976 through 1980, and exercised during 1981, eligible for ISO treatment if, at the time of exercise, the option, either alone or in conjunction with similarly granted options, exceeded the $50,000 per year limit (or the $200,000 aggregate limit) on ISO grants (see A–3)?*

A–15: If the option was exercised prior to January 21, 1982, the fact that the aggregate fair market value of the stock exceeded the $50,000 per year limit (or the $200,000 aggregate limit) will not prevent the election of up to $50,000 of the option as an ISO (subject to the $200,000 aggregate limit). Those amounts in excess of the applicable dollar limits cannot be elected as ISO's. If it is necessary to ''split'' an exercised option because the applicable dollar limits have been exceeded, separate stock certificates must be issued (or reissued) no later than January 21, 1982, one for the ISO stock and one for the non-ISO stock (see also A–7). If the option was not exercised prior to January 21, 1982, the rules of A–18 will apply.

*Q–16: Do the $100,000 per year limit (see A–2(c)(8)), and the $50,000 per year and $200,000 aggregate limits (see A–3) apply to all options granted to an employee or only to elected and qualifying ISO's?*

A–16: All three limits apply only to elected and qualifying ISO's.

*Q–17: Do the $100,000 per year limit (see A–2(c)(8)), and the $50,000 per year and $200,000 aggregate limits (see A–3) apply to the fair market value of the stock granted, or to the option price of the options granted?*

A–17: The dollar limits apply to the fair market value of the stock granted. Thus, an employee who is also a 10 percent shareholder would be permitted to receive an ISO grant to purchase $100,000 worth of stock at an option price of $110,000 (see A–2(c)(6)).

*Q–18: How do the $100,000 per year limit (see A–2(c)(8)), and the $50,000 per year and $200,000* aggregate limits (see A–3) apply to an option granted on or after January 1, 1976, and not exercised prior to January 21, 1982?

A–18: Such an option will not qualify for ISO treatment if, at the time it is exercised, the option amount is in excess of the applicable dollar limit. In order for such an option to qualify for ISO treatment, it must be ''split'' into an ISO and a non-ISO portion so that the ISO portion of the option does not exceed the applicable dollar limit. This option ''split'' must be accomplished prior to the exercise of the original option and the ISO portion of the option must be clearly identified. Any ''split'' option that was required, by its original terms, to be exercised in full, will still be required to be exercised in full after it is ''split.'' Upon the exercise of a ''split'' option, separate stock certificates must be issued—one for the ISO stock and one for the non-ISO stock. Additionally, if the option was granted on or after January 1, 1981, the terms of the plan pursuant to which the option was granted must be amended to add the $100,000 per year limit—before the option is exercised.

*Q–19: How does the $50,000 per year limit (see A–3) apply to the case of an employee who was granted $100,000 of options in 1979, and who proposes to exercise these options $50,000 in 1982 and $50,000 in 1983?*

A–19: Only $50,000 (valued as of the date of grant) of the stock for which options were granted in 1979 will be eligible for ISO treatment. The $50,000 per year limit relates only to the year of grant, not to the year of vesting (as in the case of installment options) or exercise. Additionally, no carryover provision applies to the $50,000 per year limit. Thus, even if the employee had not been

granted any options in prior years, the result described above would not change.

*Q–20: Is it permissible for a corporation to grant ISO's and non-ISO's under the same plan, or must such options be granted pursuant to separate plans?*

A–20: Both ISO's and non-ISO's may be granted pursuant to one plan so long as such plan, by its terms, meets all of the ISO qualification requirements (see A–2 (c)). Additionally, each option granted pursuant to such a ''dual'' plan must be clearly identified as to its status, *i.e.*, ISO or non-ISO.

*Q–21: May a single option agreement, issued pursuant to a plan, grant both ISO's and non-ISO's, or must such option agreements grant either only ISO's or only non-ISO's?*

A–21: Both ISO's and non-ISO's may be granted pursuant to a single option agreement, so long as each option is clearly identified as to its status, *i.e.*, ISO or non-ISO, and none of the options are subject to a ''tandem'' exercise arrangement (see A–39).

*Q–22: When either amending an existing plan or creating a new plan that is to grant ISO's, is it necessary under the ISO qualification requirements (see A–2(c)) to specify only the aggregate number of total shares issuable under the plan, or must the aggregate numbers of ISO's and non-ISO's be specified?*

A–22: Only the aggregate number of total shares issuable under the plan must be specified.

*Q–23: Must either an option, or the plan pursuant to which the option is granted, contain a specific provision restricting the exercise of any ISO to within 3 months of termination of the employee's employment (see A–2(b))?*

A–23: No. An otherwise eligible option will receive ISO treatment if it is, in fact, exercised within 3 months of termination of the employee's employment (except in cases of disability or death). Moreover, an option term that permits exercise beyond 3 months after termination of employment, will not disqualify an option from receiving ISO treatment.

*Q–24: In order for an option to be eligible for ISO treatment, the option price must equal or exceed the fair market value of the stock subject to the option when the option is granted. This requirement will be deemed to have been satisfied if, at the time of grant, there was a good faith attempt to accurately value the stock—even if such valuation should subsequently prove to be in error (see A–2(c)(4)). Do similar good faith rules apply to the $100,000 per year and 50 percent carryover limits (see A–2(c)(8)), and the $50,000 per year and $200,000 aggregate limits (see A–3) relating to the value of ISO options granted per employee?*

A–24: Yes.

REQUIRED OPTION AND PLAN AMENDMENTS

*Q–25: What types of amendments, under the transitional rule governing changes in the terms of options and plans (see A–3), will not invoke the application of section 425(h)?*

A–25: The transitional rule waives the applicability of section 425(h) only with respect to amendments which are necessary in order to permit an option or plan to meet the minimum qualification requirements of section 422A (see A–2(c)). Amendments to add or delete permissible terms (such as the right to use previously acquired corporate stock to exercise the option) do not fall within the waiver of section 425(h).

*Q–26: Is an option granted after August 13, 1981, under a plan (or option terms) which fails to meet the qualification requirements of section 422A (see A–2(c)), eligible for ISO treatment?*

A–26: No. However, prior to being exercised, such an option (or its plan) may be amended to meet the qualification requirements of section 422A and thus become eligible for ISO treatment. All such amendments, where an option is granted after August 13, 1981, will be subject to the rules of section 425(h) (see A–3). Thus, for example, if an option is granted on September 1, 1981, it may qualify as an ISO only if it is amended, and the option price is at least equal to the fair market value of the stock as of the amendment date.

*Q–27: May the terms of an outstanding option that was granted on or after January 1, 1981, and that automatically qualified for ISO treatment, be selectively amended so as to disqualify the option from receiving ISO treatment? May the option be cancelled?*

A–27: Yes. However, despite either the cancellation of the option or any disqualifying amendment to the option (or the plan pursuant to which the option was granted), the original option will, for purposes of the ISO sequential exercise restriction, be treated as an outstanding ISO until such option, by its original terms, expires by reason of lapse of time (see A–2(c)(7)).

*Q–28: May a non-ISO plan be amended so as to qualify only prospectively granted options for ISO treatment?*

A–28: Yes. Amendments to a non-ISO plan, so as to meet the section 422A qualification requirements (see A–2(c)), will only apply to previously granted and outstanding options when such amendments, by their terms, are clearly intended to have retroactive effect.

*Q–29: If a corporation grants new ISO's in exchange for the cancellation of outstanding non-ISO's, will such an exchange violate either the 422A qualification requirements (see A–2(c)) or the transition rules (see A–3)?*

A–29: No, so long as such an exchange does not constitute a ''tandem'' exercise arrangement (see A–39).

SHAREHOLDER APPROVAL ISSUES

*Q–30: If a plan received shareholder approval within 12 months before or after the date such plan was originally adopted and it is being*

*amended to conform to the qualification requirements of section 422A (see A–2(c)), will new shareholder approval be required?*

A–30: For purposes of the section 422A qualification requirements, new shareholder approval will be required only if the original plan did not specify the aggregate number of issuable shares or identify the eligible employees (or class of employees).

*Q–31: Does the amendment of a plan to add the $100,000 per year and 50 percent carryover limits (see A–2(c)(8)), relating to options granted on or after January 1, 1981, require new shareholder approval?*

A–31: No.

*Q–32: If a plan never received shareholder approval, or did not receive such approval within 12 months before or after the plan was adopted, will such plan conform to the qualification requirements of section 422A (see A–2(c)) if shareholder approval is obtained prior to August 14, 1982?*

A–32: Yes, but only if an option granted pursuant to the plan was outstanding on August 13, 1981 (see A–3). If no option granted pursuant to the plan was outstanding on August 13, 1981, such plan must be re-adopted by the granting corporation and, if necessary, amended to meet the section 422A qualification requirements. Shareholder approval must be obtained within 12 months before or after the date the plan is re-adopted. Consequently, any option granted after August 13, 1981, and before the date the plan is re-adopted, will be treated as newly granted on the date of re-adoption of the plan.

*Q–33: If an option was granted pursuant to no plan at all and the option was outstanding on August 13, 1981, may a plan now be instituted and shareholder approval obtained, as part of the amendments permitted under the transitional rules (see A–3)?*

A–33: Yes.

*Q–34: Assuming that shareholder approval is required with respect to certain amendments made to conform an option outstanding on August 13, 1981 (or its plan), to the qualification requirements of section 422A (see A–2(c)), may such option be exercised prior to securing shareholder approval and still be eligible for ISO treatment?*

A–34: Yes, so long as shareholder approval is secured within the one-year period specified by the transitional rules (see A–3).

SEQUENTIAL EXERCISE ISSUES

*Q–35: Will the existence (or exercise) of prior stock options which are neither elected nor qualified to receive ISO treatment, ever prevent the exercise of an ISO under the 422A sequential exercise restriction (see A–2)?*

A–35: No. However, if an option that is either elected or qualified to receive ISO treatment, contains sequencing restrictions that refer to options other than ISO's, the option will continue to be burdened by such restrictions. The deletion of such non-ISO sequencing restrictions from the option is not an amendment necessary in order to qualify an option for ISO treatment as permitted by the transitional rules (see A–3). Consequently, section 425(h) would be applicable to such an amendment.

*Q–36: Under the sequencing rules applicable to section 422 qualified stock options, an option was permitted to be exercised out of sequence so long as it was issued at a higher price than prior outstanding options (section 422(c)(6)). Will a similar exception to the sequencing restriction be applicable to ISO's?*

A–36: No. Section 422A does not contain such an exception to the sequencing restriction.

*Q–37: How does the section 422A sequential exercise restriction (see A–2(c)(7)) apply to an ISO granted in one year that, by its terms, can only be exercised in installments over a period of years?*

A–37: Such an installment ISO is the grant of a single option. The section 422A sequential exercise restriction would restrict the exercise of any later-granted ISO until either the exercise or expiration of all installments of this earlier-granted ISO.

*Q–38: Assume that an option granted and exercised during January of 1982 automatically qualifies, by its terms, for ISO treatment. During February of 1982, the same employee exercised a second option, one that had been granted during 1978. Prior to the exercise of the 1978 option, it was amended under the transitional rules (see A–3) so that it would conform to the section 422A qualification requirements (see A–2(c)). If the 1978 option is properly elected to receive ISO treatment (see A–4), will such an election adversely affect the 1982 option's status as an ISO?*

A–38: Yes. The election of the 1978 option to receive ISO treatment will automatically disqualify the 1982 option. If the 1982 option is to qualify as an ISO, it cannot be exercised prior to the exercise or expiration of all ISO's previously granted and outstanding on the 1982 option's date of grant (see A–2(c)(7)). When the 1982 option was granted during January of 1982, the 1978 option was already granted and outstanding for purposes of the section 422A sequential exercise restriction.

RECEIPT OF PROPERTY OR CASH UPON EXERCISE OF AN ISO

*Q–39: Section 422A provides that ISO treatment will be available even though the employee has the right to receive cash or other property at the time of the exercise of the option, so long as such property is subject to inclusion in income under section 83 (see A–2(d)(3)). To what extent does section 422A permit the use of tandem options and stock appreciation rights (SARs) in connection with ISO's?*

A–39: A tandem stock option, wherein two options are issued together and the exercise of one affects the right to exercise the other,

is not permitted because such a tandem option arrangement may be used to evade the section 422A qualification requirements (see A–2(c)).

A tandem ISO–SAR, wherein an ISO and an SAR are granted together and the exercise of one affects the right to exercise the other, is permitted so long as the SAR, by its terms, meets the following requirements:

(a) The SAR will expire no later than the expiration of the underlying ISO.

(b) The SAR may be for no more than 100% of the spread, *i.e.*, the difference between the exercise price of the underlying option and the market price of the stock subject to the underlying option at the time the SAR is exercised.

(c) The SAR is transferable only when the underlying ISO is transferable, and under the same conditions.

(d) The SAR may be exercised only when the underlying ISO is eligible to be exercised.

(e) The SAR may be exercised only when there is a positive spread, *i.e.*, when the market price of the stock subject to the option exceeds the exercise price of the option.

If all of the above requirements are met, for purposes of the 422A sequential exercise restriction (see A–2(c)(7)), a tandem ISO–SAR will be considered exercised in full when either the underlying ISO or the SAR is exercised. Additionally, SAR's may be paid in either cash or property, or a combination thereof, so long as the section 83 income inclusion rule applies to any property so transferred.

[T.D. 7799, 46 FR 61840, Dec. 21, 1981, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

## PART 15—TEMPORARY INCOME TAX REGULATIONS RELATING TO EXPLORATION EXPENDITURES IN THE CASE OF MINING

Sec.
15.0–1 Scope of regulations in this part.
15.1–1 Elections to deduct.
15.1–2 Revocation of election to deduct.
15.1–3 Elections as to method of recapture.
15.1–4 Special rules.

AUTHORITY: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805.

SOURCE: T.D. 6907, 31 FR 16776, Dec. 31, 1966, unless otherwise noted.

### § 15.0–1 Scope of regulations in this part.

The regulations in this part relate to expenditures of the type described in section 615(a) or in section 617(a)(1) paid or incurred after September 12, 1966. The regulations in this part do not apply to the income tax treatment of mining exploration expenditures paid or incurred before September 13, 1966, and no election made pursuant to the provisions of the regulations in this part shall have any effect on the income tax treatment of exploration expenditures paid or incurred before such date. See § 15.1–4 for rules relating to treatment of exploration expenditures paid or incurred during taxable years beginning before September 13, 1966, and ending after September 12, 1966.

### § 15.1–1 Elections to deduct.

(a) *Manner of making election*—(1) *Election to deduct under section 617(a).* The election to deduct exploration expenditures as expenses under section 617(a) may be made by deducting such expenditures in the taxpayer's income tax return for the first taxable year ending after September 12, 1966, for which the taxpayer desires to deduct exploration expenditures which are paid or incurred by him during such taxable year and after September 12, 1966. This election may be exercised by deducting such expenditures either in the taxpayer's return for such taxable year or in an amended return filed before the expiration of the period for filing a claim for credit or refund of income tax for such taxable year. Where the election is made in an amended return for a taxable year prior to the most recent year for which the taxpayer has filed a return, the taxpayer shall file amended income tax returns, reflecting any increase or decrease in tax attributable to the election, for all taxable years affected by the election. See section 617(a)(2)(C) for provisions relating to the tolling of the statute of limitations for the assessment of any deficiency for any taxable year, to the extent the deficiency is attributable to an election under section 617(a). In applying the election to the years affected there shall be taken into account the effect that any adjustments resulting from the election shall have on other items affected thereby, such as the deduction for charitable contributions, the foreign tax credit, net operating loss and other deductions or credits the amount of which is limited

by the taxpayer's taxable income, and the effect that adjustments of any such items have on other taxable years. Amended returns filed for taxable years subsequent to the taxable year for which the election under section 617(a) is made by amended return shall apply the recapture provisions of subsections (b)(1)(B), (c), and (d) of section 617.

(2) *Election to deduct under section 615*—(i) *General rule.* The election to deduct exploration expenditures under section 615 shall be made in a statement filed with the district director, or director of the regional service center, with whom the taxpayer's income tax return is required to be filed. If the election is made within the time period prescribed for filing an income tax return (including extensions thereof) for the first taxable year ending after September 12, 1966, during which the taxpayer pays or incurs expenditures which are within the scope of section 615 and which are paid or incurred by him after September 12, 1966, this statement shall be attached to the taxpayer's income tax return for such taxable year. If the election is made after the time prescribed for filing such return but before the expiration of the period (described in paragraph (d)(1) of this section) for making the election under section 615(e), the statement must be signed by the taxpayer or his authorized representative. The statement shall be filed even though the taxpayer charges to capital account all such expenditures paid or incurred by him during such taxable year after such date. The statement shall clearly indicate that the taxpayer elects to have section 615 apply to all amounts deducted by him with respect to mining exploration expenditures paid or incurred after September 12, 1966. If the taxpayer desires, he may file this statement by attaching it to his return for a taxable year prior to the first taxable year ending after September 12, 1966, in which he pays or incurs mining exploration expenditures. Except as provided, in subdivision (ii) of this subparagraph, if the taxpayer does not file such a statement within the period prescribed by section 615(e) and paragraph (d)(1) of this section, any amounts deducted by him with respect to exploration expenditures paid or incurred by him after September 12, 1966, will be deemed to have been deducted pursuant to an election under section 617(a).

(ii) *Exception.* The last sentence of subdivision (i) of this subparagraph shall not apply if all mining exploration expenditures which are paid or incurred by the taxpayer after September 12, 1966, and which are deducted by him in his income tax return for the first taxable year ending after September 12, 1966, during which he pays or incurs such expenditures are outside the scope of section 617(a). For example, assume that, in his return for his first taxable year ending after September 12, 1966, a taxpayer deducts mining exploration expenditures paid or incurred after September 12, 1966, and does not attach to his return the statement described in subdivision (i) of this subparagraph. However, all of the exploration expenditures paid or incurred by the taxpayer after September 12, 1966, and before the end of the taxable year were paid or incurred with respect to minerals located neither in the United States nor on the Outer Continental Shelf. The taxpayer will be deemed to have made an election under section 615(e) by deducting all or part of those expenditures as expenses in his income tax return.

(b) *Information to be furnished.* A taxpayer who makes or has made an election under either section 615(e) or section 617(a) to deduct expenditures paid or incurred after September 12, 1966, shall indicate clearly on his income tax return for each taxable year for which he deducts any such expenditures the amount of the deduction claimed under section 615 (a) or (b) or section 617(a) with respect to each property or area of interest. Such property or area of interest shall be identified by a description sufficiently adequate to permit application of the recapture rules of section 617 (b), (c), and (d) and the rules of section 615(g) (relating to effect of transfer of mineral property).

(c) *Effect of election.* A taxpayer who has made an election under section 615(e) may never make an election under section 617(a) unless, within the period set forth in section 615(e) and paragraph (b)(1) of § 15.1–2, he revokes

his election under section 615(e). A taxpayer who has made an election under section 617(a) may never make an election under section 615(e) unless, within the period set forth in section 615(e) and paragraph (b)(1) of § 15.1–2, he revokes his election under section 617(a). A taxpayer who has made, and has not revoked, an election under section 617(a) may not, in his return for the taxable year for which the election is made or for any subsequent taxable year, charge to capital account any expenditures which are within the scope of section 617(a), and he must deduct all such expenditures as expenses. Except as provided in paragraph (a)(2) of § 1.615–2 of this chapter (Income Tax Regulations), a taxpayer who makes an election under 615(e) may not change his treatment of exploration expenditures deducted, deferred, or capitalized pursuant to such election unless he revokes the election made under section 615(e).

(d) *Time for making election*—(1) *Election under section 615(e).* A taxpayer may not make an election under section 615(e) after the expiration of the 3-year period beginning with the date prescribed by section 6072 or other provision of law for filing the taxpayer's income tax return for the first taxable year ending after September 12, 1966, in which the taxpayer pays or incurs expenditures to which section 615(a) would apply if an election were made under section 615(e). This 3-year period shall be determined without regard to any extension of time for filing the taxpayer's income tax return. An election under section 615(e) may not be made after the expiration of the 3-year period even though the taxpayer charged to capital account, or erroneously deducted as development expenditures under section 616, all mine exploration expenditures paid or incurred by him after September 12, 1966, and before the end of his first taxable year ending after September 12, 1966, in which he paid or incurred such expenditures.

(2) *Election under section 617(a).* The election under section 617(a) may be made at any time before the expiration of the period prescribed for filing a claim for credit or refund of the tax imposed by chapter 1 for the first taxable year for which the taxpayer desires to deduct exploration expenditures under section 617.

(3) *Timely mailing treated as timely filing.* Section 7502 (relating to timely mailing treated as timely filing) shall apply in determining the date when an election under either section 615(e) or section 617(a) is made.

### § 15.1–2 Revocation of election to deduct.

(a) *Manner of revoking election.* A taxpayer may revoke an election made by him under section 615(e) or section 617(a) by filing with the internal revenue officer with whom the taxpayer's income tax return is required to be filed, within the periods set forth in paragraph (b) of this section, a statement, signed by the taxpayer or his authorized representative, which sets forth that the taxpayer is revoking the election previously made by him with respect to the deduction of mining exploration expenditures paid or incurred after September 12, 1966, and states with whom the document making the election was filed. A taxpayer revoking such an election shall file amended income tax returns, reflecting any increase or decrease in tax attributable to the revocation of election, for all taxable years affected by the revocation of election. See section 617(a)(2)(C) for provisions relating to the tolling of the statute of limitations for the assessment of any deficiency for any taxable year, to the extent the deficiency is attributable to an election or revocation of election under section 617(a). In applying the revocation of an election to the years affected there shall be taken into account the effect that any adjustments resulting from the revocation of election shall have on other items affected thereby, such as the deduction for charitable contributions, the foreign tax credit, net operating loss, and other deductions or credits the amount of which is limited by the taxpayer's taxable income, and the effect that adjustments of any such items have on other taxable years.

(b) *Time for revoking election*—(1) *Election under section 615(e).* An election under section 615(e) may be revoked at any time before the expiration of the 3-year period described in paragraph

(d)(1) of § 15.1–1. Such an election may not be revoked after the expiration of the 3-year period.

(2) *Election under section 617(a).* An election under section 617(a) may be revoked before the expiration of the last day of the third month following the month in which the final regulations issued under the authority of section 617 are published in the FEDERAL REGISTER. After the expiration of this period, a taxpayer who has made an election under section 617(a) may not revoke that election unless he obtains the consent of the Secretary or his delegate in the manner to be set forth in the final regulations under section 617.

(c) *Additional information to be furnished by a transferor of mineral property.* If, before revoking his election, the taxpayer has transferred any mineral property with respect to which he deducted exploration expenditures paid or incurred after September 12, 1966, to another person in a transaction as a result of which the basis of such property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, the statement submitted pursuant to paragraph (a) of this section shall state that such property has been so transferred and shall identify the transferee, the property transferred, and the date of the transfer.

### § 15.1–3 Elections as to method of recapture.

(a) *In general.* If the taxpayer so elects with respect to all mines with respect to which deductions have been allowed under section 617(a) and which reach the producing stage during a taxable year, he shall include in gross income for the taxable year an amount equal to the adjusted exploration expenditures with respect to such mines (determined under section 617(f)(1)). The amount so included in income shall be treated for purposes of Subtitle A of the Internal Revenue Code as expenditures which are paid or incurred on the respective dates on which the mines reach the producing stage and which are properly chargeable to capital account. If the taxpayer does not make this election for a taxable year during which any mine with respect to which deductions have been allowed under section 617(a) reaches the producing stage, the deduction for depletion under section 611 with respect to the property (whether determined under § 1.611–2 of this chapter (Income Tax Regulations) or under section 613) shall be disallowed until the amount of depletion which would be allowable but for section 617(b)(1)(B) equals the amount of the adjusted exploration expenditures with respect to the mine. The fact that a taxpayer does not make the election described in the first sentence of this paragraph for a taxable year during which mines with respect to which deductions have been allowed under section 617(a) reach the producing stage shall not preclude the taxpayer from making the election with respect to other mines which reach the producing stage during a subsequent taxable year. However, an election may not be made for any taxable year with respect to any mines which reached the producing stage during a preceding taxable year.

(b) *Manner of making elections.* A taxpayer will be considered to have made an election in accordance with the manner in which the adjusted exploration expenditures with respect to the mines reaching the producing stage during a taxable year are treated in his return for such taxable year.

(c) *Time for making election.* The election described in paragraph (a) of this section may be made, or changed by filing an amended return, not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year.

### § 15.1–4 Special rules.

(a) *Taxable years beginning before September 13, 1966, and ending after September 12, 1966*—(1) *General rule.* An election made under section 615(e) or section 617(a) applies only to expenditures paid or incurred after September 12, 1966. The income tax treatment of exploration expenditures paid or incurred before September 13, 1966, will be determined in accordance with the provisions of section 615 prior to its amendment by the Act of September 12, 1966 (Pub. L. 89–570, 80 Stat. 759). If a taxpayer makes an election under section 615(e) in his income tax return for a

taxable year beginning before September 13, 1966, and ending after September 12, 1966, amounts deducted under section 615 with respect to expenditures paid or incurred during such taxable year but before September 13, 1966, will be taken into account in determining whether the $100,000 limitation set forth in section 615(a) is reached during 1966. Similarly, a taxpayer making an election under section 615(e) shall take into account expenditures deducted under section 615 for periods prior to September 13, 1966, in determining when the $400,000 overall limitation set forth in section 615(c) is reached. The fact that a taxpayer deducts under section 615 expenditures paid or incurred prior to September 13, 1966, shall not affect his right to make an election under section 617(a) to deduct under section 617 expenditures paid or incurred after September 12, 1966.

(2) *Allocation in case of inadequate records.* If a taxpayer pays or incurs exploration expenditures during a taxable year beginning before September 13, 1966, and ending after September 12, 1966, but his records as to any mine or property are inadequate to permit a determination of the amount paid or incurred during the portion of the year ending after September 12, 1966, and the amount paid or incurred on or before such date, the exploration expenditures as to which the records are inadequate paid or incurred with respect to the mine or property during the taxable year shall be allocated to each part year (that is, the part occurring before September 13, 1966, and the part occurring after September 12, 1966) in the ratio which the number of days in such part year bears the number of days in the entire taxable year. For example, if the records of a calendar year taxpayer for 1966 are inadequate to permit a determination of the amount of exploration expenditures paid or incurred with respect to a certain mine or property after September 12, 1966, and the amount paid or incurred before September 13, 1966, $^{255}/_{365}$ of the total exploration expenditures paid or incurred by the taxpayer with respect to the mine or property during 1966 shall be allocated to the period beginning January 1, 1966, and ending September 12, 1966, and $^{110}/_{365}$ of the total exploration expenditures paid or incurred with respect to the mine or property during 1966 shall be allocated to the period beginning September 13, 1966, and ending December 31, 1966.

(3) *Partnership elections.* With respect to exploration expenditures paid or incurred by a partnership before September 13, 1966, the option to deduct under section 615(a) and the election to defer under section 615(b) shall be made by the partnership, rather than by the individual partners. All elections under sections 615(e), 617(a), or 617(b) as to the tax treatment of a partner's distributive share of exploration expenditures paid or incurred by any partnership of which he is a member shall be made by the individual partner, rather than by the partnership.

(b) *Effect of transfer of mineral property.* The binding effect of a taxpayer's election under section 615(e) shall not be affected by his receiving property with respect to which deductions have been allowed under section 617(a). The binding effect of a taxpayer's election under section 617(a) shall not be affected by his receiving property with respect to which deductions have been allowed under section 615 pursuant to an election made under section 615(e). However, see section 615(g)(2) for rules under which amounts deducted under section 615 by a transferor may be subject to recapture in the hands of a transferee who has made an election under section 617(a).

## PART 15a—TEMPORARY INCOME TAX REGULATIONS UNDER THE INSTALLMENT SALES REVISION ACT

Sec.

15a.453–0 Taxable years affected.
15a.453–1 Installment method reporting for sales of real property and casual sales of personal property.
15a.453–2 Installment obligations received as liquidating distribution. [Reserved]

AUTHORITY: 26 U.S.C. 453(i) and 7805.

### §15a.453–0 Taxable years affected.

(a) *In general.* Except as otherwise provided, the provisions of §15a.453–1 (a) through (e) generally apply to installment method reporting for sales of

real property and casual sales of personal property occurring after October 19, 1980. See 26 CFR §1.453–1 (rev. as of April 1, 1980) for the provisions relating to installment method reporting for sales of real property and casual sales before October 20, 1980 (except as provided in paragraph (b) of this section) and for provisions relating to installment sales by dealers in personal property occurring before October 20, 1980.

(b) *Certain limitations.* The provisions of prior law (section 453(b) of the Internal Revenue Code of 1954, in effect as of October 18, 1980) which required that the buyer receive no more than 30 percent of the selling price in the taxable year of the installment sale and that at least two payments be received shall not apply to reporting for casual installment sales of personal property and installment sales of real property occurring in a taxable year ending after October 19, 1980.

[T.D. 7768, 46 FR 10709, Feb. 4, 1981; 46 FR 43036, Aug. 26, 1981]

### § 15a.453–1 Installment method reporting for sales of real property and casual sales of personal property.

(a) *In general.* Unless the taxpayer otherwise elects in the manner prescribed in paragraph (d)(3) of this section, income from a sale of real property or a casual sale of personal property, where any payment is to be received in a taxable year after the year of sale, is to be reported on the installment method.

(b) *Installment sale defined*—(1) *In general.* The term ''installment sale'' means a disposition of property (except as provided in paragraph (b)(4) of this section) where at least one payment is to be received after the close of the taxable year in which the disposition occurs. The term ''installment sale'' includes dispositions from which payment is to be received in a lump sum in a taxable year subsequent to the year of sale. For purposes of this paragraph, the taxable year in which payments are to be received is to be determined without regard to section 453(e) (relating to related party sales), section (f)(3) (relating to the definition of a ''payment'') and section (g) (relating to sales of depreciable property to a spouse or 80-percent-owned entity).

(2) *Installment method defined*—(i) *In general.* Under the installment method, the amount of any payment which is income to the taxpayer is that portion of the installment payment received in that year which the gross profit realized or to be realized bears to the total contract price (the ''gross profit ratio''). See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.

(ii) *Selling price defined.* The term ''selling price'' means the gross selling price without reduction to reflect any existing mortgage or other encumbrance on the property (whether assumed or taken subject to by the buyer) and, for installment sales in taxable years ending after October 19, 1980, without reduction to reflect any selling expenses. Neither interest, whether stated or unstated, nor original issue discount is considered to be a part of the selling price. See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.

(iii) *Contract price defined.* The term ''contract price'' means the total contract price equal to selling price reduced by that portion of any qualifying indebtedness (as defined in paragraph (b)(2)(iv) of this section), assumed or taken subject to by the buyer, which does not exceed the seller's basis in the property (adjusted, for installment sales in taxable years ending after October 19, 1980, to reflect commissions and other selling expenses as provided in paragraph (b)(2)(v) of this section). See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.

(iv) *Qualifying indebtedness.* The term ''qualifying indebtedness'' means a mortgage or other indebtedness encumbering the property and indebtedness, not secured by the property but incurred or assumed by the purchaser incident to the purchaser's acquisition, holding, or operation in the ordinary course of business or investment, of the property. The term ''qualifying indebtedness'' does not include an obligation of the taxpayer incurred incident to the disposition of the property (*e.g.*, legal fees relating to the taxpayer's sale of the property) or an obligation

functionally unrelated to the acquisition, holding, or operating of the property (*e.g.*, the taxpayer's medical bill). Any obligation created subsequent to the taxpayer's acquisition of the property and incurred or assumed by the taxpayer or placed as an encumbrance on the property in contemplation of disposition of the property is not qualifying indebtedness if the arrangement results in accelerating recovery of the taxpayer's basis in the installment sale.

(v) *Gross profit defined.* The term ''gross profit'' means the selling price less the adjusted basis as defined in section 1011 and the regulations thereunder. For sales in taxable years ending after October 19, 1980, in the case of sales of real property by a person other than a dealer and casual sales of personal property, commissions and other selling expenses shall be added to basis for purposes of determining the proportion of payments which is gross profit attributable to the disposition. Such additions to basis will not be deemed to affect the taxpayer's holding period in the transferred property.

(3) *Payment*—(i) *In general.* Except as provided in paragraph (e) of this section (relating to purchaser evidences of indebtedness payable on demand or readily tradable), the term ''payment'' does not include the receipt of evidences of indebtedness of the person acquiring the property (''installment obligation''), whether or not payment of such indebtedness is guaranteed by a third party (including a government agency). For special rules regarding the receipt of an evidence of indebtedness of a transferee of a qualified intermediary, see §§ 1.1031(b)–2(b) and 1.1031(k)–1(j)(2)(iii) of this chapter. A standby letter of credit (as defined in paragraph (b)(3)(iii) of this section) shall be treated as a third party guarantee. Payments include amounts actually or constructively received in the taxable year under an installment obligation. For a special rule regarding a transfer of property to a qualified intermediary followed by the sale of such property by the qualified intermediary, see § 1.1031(k)–1(j)(2)(ii) of this chapter. Receipt of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, will be treated as the receipt of payment. For a special rule regarding a transfer of property in exchange for an obligation that is secured by cash or a cash equivalent held in a qualified escrow account or a qualified trust, see § 1.1031(k)–1(j)(2)(i) of this chapter. Payment may be received in cash or other property, including foreign currency, marketable securities, and evidences or indebtedness which are payable on demand or readily tradable. However, for special rules relating to the receipt of certain property with respect to which gain is not recognized, see paragraph (f) of this section (relating to transactions described in sections 351, 356(a) and 1031). Except as provided in § 15a.453–2 of these regulations (relating to distributions of installment obligations in corporate liquidations described in section 337), payment includes receipt of an evidence of indebtedness of a person other than the person acquiring the property from the taxpayer. For purposes of determining the amount of payment received in the taxable year, the amount of qualifying indebtedness (as defined in paragraph (b)(2)(iv) of this section) assumed or taken subject to by the person acquiring the property shall be included only to the extent that it exceeds the basis of the property (determined after adjustment to reflect selling expenses). For purposes of the preceding sentence, an arrangement under which the taxpayer's liability on qualifying indebtedness is eliminated incident to the disposition (*e.g.*, a novation) shall be treated as an assumption of the qualifying indebtedness. If the taxpayer sells property to a creditor of the taxpayer and indebtedness of the taxpayer is cancelled in consideration of the sale, such cancellation shall be treated as payment. To the extent that cancellation is not in consideration of the sale, see §§ 1.61–12(b)(1) and 1.1001–2(a)(2) relating to discharges of indebtedness. If the taxpayer sells property which is encumbered by a mortgage or other indebtedness on which the taxpayer is not personally liable, and the person acquiring

the property is the obligee, the taxpayer shall be treated as having received payment in the amount of such indebtedness.

(ii) *Wrap-around mortgage.* This paragraph (b)(3)(ii) shall apply generally to any installment sale after March 4, 1981 unless the installment sale was completed before June 1, 1981 pursuant to a written obligation binding on the seller that was executed on or before March 4, 1981. A ''wrap-around mortgage'' means an agreement in which the buyer initially does not assume and purportedly does not take subject to part or all of the mortgage or other indebtedness encumbering the property (''wrapped indebtedness'') and, instead, the buyer issues to the seller an installment obligation the principal amount of which reflects such wrapped indebtedness. Ordinarily, the seller will use payments received on the installment obligation to service the wrapped indebtedness. The wrapped indebtedness shall be deemed to have been taken subject to even though title to the property has not passed in the year of sale and even though the seller remains liable for payments on the wrapped indebtedness. In the hands of the seller, the wrap-around installment obligation shall have a basis equal to the seller's basis in the property which was the subject of the installment sale, increased by the amount of gain recognized in the year of sale, and decreased by the amount of cash and the fair market value of other nonqualifying property received in the year of sale. For purposes of this paragraph (b)(3)(ii), the amount of any indebtedness assumed or taken subject to by the buyer (other than wrapped indebtedness) is to be treated as cash received by the seller in the year of sale. Therefore, except as otherwise required by section 483 or 1232, the gross profit ratio with respect to the wrap-around installment obligation is a fraction, the numerator of which is the face value of the obligation less the taxpayer's basis in the obligation and the denominator of which is the face value of the obligation.

(iii) *Standby letter of credit.* The term ''standby letter of credit'' means a non-negotiable, non-transferable (except together with the evidence of indebtedness which it secures) letter of credit, issued by a bank or other financial institution, which serves as a guarantee of the evidence of indebtedness which is secured by the letter of credit. Whether or not the letter of credit explicitly states it is non-negotiable and nontransferable, it will be treated as non-negotiable and nontransferable if applicable local law so provides. The mere right of the secured party (under applicable local law) to transfer the proceeds of a letter of credit shall be disregarded in determining whether the instrument qualifies as a standby letter of credit. A letter of credit is not a standby letter of credit if it may be drawn upon in the absence of default in payment of the underlying evidence of indebtedness.

(4) *Exceptions.* The term ''installment sale'' does not include, and the provisions of section 453 do not apply to, dispositions of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan, or to dispositions of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year. See section 453A and the regulations thereunder for rules relating to installment sales by dealers in personal property. A dealer in real property or a farmer who is not required under his method of accounting to maintain inventories may report the gain on the installment method under section 453.

(5) *Examples.* The following examples illustrate installment method reporting under this section:

*Example (1).* In 1980, A, a calendar year taxpayer, sells Blackacre, an unencumbered capital asset in A's hands, to B for $100,000: $10,000 down and the remainder payable in equal annual installments over the next 9 years, together with adequate stated interest. A's basis in Blackacre, exclusive of selling expenses, is $38,000. Selling expenses paid by A are $2,000. Therefore, the gross profit is $60,000 ($100,000 selling price − $40,000 basis inclusive of selling expenses). The gross profit ratio is ⅗ (gross profit of $60,000 divided by $100,000 contract price). Accordingly, $6,000 ⅗ of $10,000) of each $10,000 payment received is gain attributable to the sale and $4,000 ($10,000 − $6,000) is recovery of basis. The interest received in addition to principal is ordinary income to A.

*Example (2).* C sells Whiteacre to D for a selling price of $160,000. Whiteacre is encumbered by a longstanding mortgage in the principal amount of $60,000. D will assume or take subject to the $60,000 mortgage and pay the remaining $100,000 in 10 equal annual installments together with adequate stated interest. C's basis in Whiteacre is $90,000. There are no selling expenses. The contract price is $100,000, the $160,000 selling price reduced by the mortgage of $60,000 assumed or taken subject to. Gross profit is $70,000 ($160,000 selling price less C's basis of $90,000). C's gross profit ratio is 7/10 (gross profit of $70,000 divided by $100,000 contract price). Thus, $7,000 (7/10 of $10,000) of each $10,000 annual payment is gain attributable to the sale, and $3,000 ($10,000 − $7,000) is recovery of basis.

*Example (3).* The facts are the same as in example (2), except that C's basis in the land is $40,000. In the year of the sale C is deemed to have received payment of $20,000 ($60,000 − $40,000, the amount by which the mortgage D assumed or took subject to exceeds C's basis). Since basis is fully recovered in the year of sale, the gross profit ratio is 1 ($120,000/$120,000) and C will report 100% of the $20,000 deemed payment in the year of sale and each $10,000 annual payment as gain attributable to the sale.

*Example (4).* E sells Blackacre, an unencumbered capital gain property in E's hands, to F on January 2, 1981. F makes a cash down payment of $500,000 and issues a note to E obliging F to pay an additional $500,000 on the fifth anniversary date. The note does not require a payment of interest. In determining selling price, section 483 will apply to recharacterize as interest a portion of the $500,000 future payment. Assume that under section 483 and the applicable regulations $193,045 is treated as total unstated interest, and the selling price is $806,955 ($1 million less unstated interest). Assuming E's basis (including selling expenses) in Blackacre is $200,000) gross profit is $606,955 ($806,955 − $200,000) and the gross profit ratio is 75.21547%. Accordingly, of the $500,000 cash down payment received by E in 1981, $376,077 (75.21547% of $500,000) is gain attributable to the sale and $123,923 is recovery of basis ($500,000 − $376,077).

*Example (5).* In 1982, G sells to H Blackacre, which is encumbered by a first mortgage with a principal amount of $500,000 and a second mortgage with a principal amount of $400,000, for a selling price of $2 million. G's basis in Blackacre is $700,000. Under the agreement between G and H, passage of title is deferred and H does not assume and purportedly does not take subject to either mortgage in the year of sale. H pays G $200,000 in cash and issues a wrap-around mortgage note with a principal amount of $1,800,000 bearing adequate stated interest. H is deemed to have acquired Blackacre subject to the first and second mortgages (wrapped indebtedness) totalling $900,000. The contract price is $1,300,000 (selling price of $2 million less $700,000 mortgages within the seller's basis assumed or taken subject to). Gross profit is also $1,300,000 (selling price of $2 million less $700,000 basis). Accordingly in the year of sale, the gross profit ratio is 1 ($1,300,000/$1,300,000). Payment in the year of sale is $400,000 ($200,000 cash received plus $200,000 mortgage in excess of basis ($900,000 − $700,000)). Therefore, G recognizes $400,000 gain in the year of sale ($400,000×1). In the hands of G the wrap-around installment obligation has a basis of $900,000, equal to G's basis in Blackacre ($700,000) increased by the gain recognized by G in the year of sale ($400,000) reduced by the cash received by G in the year of sale ($200,000). G's gross profit with respect to the note is $900,000 ($1,800,000 face amount less $900,000 basis in the note) and G's contract price with respect to the note is its face amount of $1,800,000. Therefore, the gross profit ratio with respect to the note is ½ ($900,000/$1,800,000).

*Example (6).* The facts are the same as example (5) except that under the terms of the agreement H assumes the $500,000 first mortgage on Blackacre. H does not assume and purportedly does not take subject to the $400,000 second mortgage on Blackacre. The wrap-around installment obligation issued by H to G has a face amount of $1,300,000. The tax results in the year of sale to G are the same as example (5) ($400,000 payment received and gain recognized). In the hands of G, basis in the wrap-around installment obligation is $400,000 ($700,000 basis in Blackacre plus $400,000 gain recognized in the year of sale minus $700,000 ($200,000 cash received and $500,000 treated as cash received as a result of H's assumption of the first mortgage)). G's gross profit with respect to the note is $900,000 ($1,300,000 face amount of the wrap-around installment obligation less $400,000 basis in that note) and G's contract price with respect to the note is its face value of $1,300,000. Therefore, the gross profit ratio with respect to the note is 9/13 ($900,000/ $1,300,000).

*Example (7).* A sells the stock of X corporation to B for a $1 million installment obligation payable in equal annual installments over the next 10 years with adequate stated interest. The installment obligation is secured by a standby letter of credit (within the meaning of paragraph (b)(3)(iii) of this section) issued by M bank. Under the agreement between B and M bank, B is required to maintain a compensating balance in an account B maintains with M bank and is required by the M bank to post additional collateral, which may include cash or a cash equivalent, with M bank. Under neither the standby letter of credit nor any other agreement or arrangement is A granted a direct

lien upon or other security interest in such cash or cash equivalent collateral. Receipt of B's installment obligation secured by the standby letter of credit will not be treated as the receipt of payment by A.

*Example (8).* The facts are the same as in example (7) except that the standby letter of credit is in the drawable sum of $600,000. To secure fully its $1 million note issued to A, B deposits in escrow $400,000 in cash and Treasury bills. Under the escrow agreement, upon default in payment of the note A may look directly to the escrowed collateral. Receipt of B's installment obligation will be treated as the receipt payment by A in the sum of $400,000.

(c) *Contingent payment sales*—(1) *In general.* Unless the taxpayer otherwise elects in the manner prescribed in paragraph (d)(3) of this section, contingent payment sales are to be reported on the installment method. As used in this section, the term ''contingent payment sale'' means a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs.

The term ''contingent payment sale'' does not include transactions with respect to which the installment obligation represents, under applicable principles of tax law, a retained interest in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions, regardless of the existence of a stated maximum selling price or a fixed payment term. See paragraph (c)(8) of this section, describing the extent to which the regulations under section 385 apply to the determination of whether an installment obligation represents an equity interest in a corporation.

This paragraph prescribes the rules to be applied in allocating the taxpayer's basis (including selling expenses except for selling expenses of dealers in real estate) to payments received and to be received in a contingent payment sale. The rules are designed appropriately to distinguish contingent payment sales for which a maximum selling price is determinable, sales for which a maximum selling price is not determinable but the time over which payments will be received is determinable, and sales for which neither a maximum selling price nor a definite payment term is determinable. In addition, rules are prescribed under which, in appropriate circumstances, the taxpayer will be permitted to recover basis under an income forecast computation.

(2) *Stated maximum selling price*—(i) *In general.* (A) contingent payment sale will be treated as having a stated maximum selling price if, under the terms of the agreement, the maximum amount of sale proceeds that may be received by the taxpayer can be determined as of the end of the taxable year in which the sale or other disposition occurs. The stated maximum selling price shall be determined by assuming that all of the contingencies contemplated by the agreement are met or otherwise resolved in a manner that will maximize the selling price and accelerate payments to the earliest date or dates permitted under the agreement. Except as provided in paragraph (c)(2)(ii) and (7) of this section (relating to certain payment recomputations), the taxpayer's basis shall be allocated to payments received and to be received under a stated maximum selling price agreement by treating the stated maximum selling price as the selling price for purposes of paragraph (b) of this section. The stated maximum selling price, as initially determined, shall thereafter be treated as the selling price unless and until that maximum amount is reduced, whether pursuant to the terms of the original agreement, by subsequent amendment, by application of the payment recharacterization rule (discribed in paragraph (c)(2)(ii) of this section), or by a subsequent supervening event such as bankruptcy of the obligor. When the maximum amount is subsequently reduced, the gross profit ratio will be recomputed with respect to payments received in or after the taxable year in which an event requiring reduction occurs. If, however, application of the foregoing rules in a particular case would substantially and inappropriately accelerate or defer recovery of the taxpayer's basis, a special rule will apply. See paragraph (c)(7) of this section.

(B) The following examples illustrate the provisions of paragraph (e)(2)(i) of

this section. In each example, it is assumed that application of the rules illustrated will not substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

*Example (1).* A sells all of the stock of X corporation to B for $100,000 payable at closing plus an amount equal to 5% of the net profits of X for each of the next nine years, the contingent payments to be made annually together with adequate stated interest. The agreement provides that the maximum amount A may receive, inclusive of the $100,000 down payment but exclusive of interest, shall be $2,000,000. A's basis in the stock of X inclusive of selling expenses, is $200,000. Selling price and contract price are considered to be $2,000,000. Gross profit is $1,800,000, and the gross profit ratio is 9/10 ($1,800,000/$2,000,000). Accordingly, of the $100,000 received by A in the year of sale, $90,000 is reportable as gain attributable to the sale and $10,000 is recovery of basis.

*Example (2).* C owns Blackacre which is encumbered by a long-standing mortgage of $100,000. On January 15, 1981, C sells Blackacre to D under the following payment arrangement: $100,000 in cash on closing; nine equal annual installment payments of $100,000 commencing January 15, 1982; and nine annual payments (the first to be made on March 30, 1982) equal to 5% of the gross annual rental receipts from Blackacre generated during the preceding calendar year. The agreement provides that each deferred payment shall be accompanied by a payment of interest calculated at the rate of 12% per annum and that the maximum amount payable to C under the agreement (exclusive of interest) shall be $2,100,000. The agreement also specifies that D will assume the long-standing mortgage. C's basis (inclusive of selling expenses) in Blackacre is $300,000. Accordingly, selling price is $2,100,000 and contract price is $2,000,000 (selling price of $2,100,000 less the $100,000 mortgage). The gross profit ratio is 9/10 (gross profit of $1,800,000 divided by $2,000,000 contract price). Of the $100,000 cash payment received by C in 1981, $90,000 is gain attributable to the sale of Blackacre and $10,000 is recovery of basis.

(ii) *Certain interest recomputations.* When interest is stated in the contingent price sale agreement at a rate equal to or greater than the applicable prescribed test rate referred to in § 1.483–1(d)(1)(ii) and such stated interest is payable in addition to the amounts otherwise payable under the agreement, such stated interest is not considered a part of the selling price. In other circumstances (*i.e.*, section 483 is applicable because no interest is stated or interest is stated below the applicable test rate, or interest is stated under a payment recharacterization provision of the sale agreement), the special rule set forth in this (ii) shall be applied in the initial computation and subsequent recomputations of selling price, contract price, and gross profit ratio. The special rule is referred to in this section as the ''price-interest recomputation rule.'' As used in this section, the term ''payment recharacterization'' refers to a contractual arrangement under which a computed amount otherwise payable as part of the selling price is denominated an interest payment. The amount of unstated interest determined under section 483 or (if section 483 is inapplicable in the particular case) the amount of interest determined under a payment recharacterization arrangement is collectively referred to in this section as ''internal interest'' amounts. The price-interest recomputation rule is applicable to any stated maximum selling price agreement which contemplates receipt of internal interest by the taxpayer. Under the rule, stated maximum selling price will be determined as of the end of the taxpayer's taxable year in which the sale or other disposition occurs, taking into account all events which have occurred and are subject to prompt subsequent calculation and verification and assuming that all amounts that may become payable under the agreement will be paid on the earliest date or dates permitted under the agreement. With respect to the year of sale, the amount (if any) of internal interest then shall be determined taking account of the respective components of that calculation. The maximum amount initially calculated, minus the internal interest so determined, is the initial stated maximum selling price under the price-interest recomputation rule. For each subsequent taxable year, stated maximum selling price (and thus selling price, contract price, and gross profit ratio) shall be recomputed, taking into account all events which have occurred and are subject to prompt subsequent calculation and verification and assuming that all amounts that may become payable under the agreement will be paid on the earliest date or dates

permitted under the agreement. The redetermined gross profit ratio, adjusted to reflect payments received and gain recognized in prior taxable years, shall be applied to payments received in that taxable year.

(iii) *Examples.* The following examples illustrate installment method reporting of a contingent payment sale under which there is a stated maximum selling price. In each example, it is assumed that application of the rules described will not substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

*Example (1).* A owns all of the stock of X corporation with a basis to A of $20 million. On July 1, 1981, A sells the stock of X to B under an agreement calling for fifteen annual payments respectively equal to 5% of the net profits of X earned in the immediately preceding fiscal year beginning with the fiscal year ending March 31, 1982. Each payment is to be made on the following June 15th, commencing June 15, 1982, together with adequate stated interest. The agreement specifies that the maximum amount (exclusive of interest) payable to A shall not exceed $60 million. Since stated interest is payable as an addition to the selling price and the specified rate is not below the section 483 test rate, there is no internal interest under the agreement. The stated maximum selling price is $60 million. The gross profit ratio is ⅔ (gross profit of $40 million divided by $60 million contract price). Thus, if on June 15, 1982, A receives a payment of $3 million (exclusive of interest) under the agreement, in that year A will report $2 million ($3 million × ⅔) as gain attributable to the sale, and $1 million as recovery of basis.

*Example (2).* (i) The facts are the same as in example (1) except that the agreement does not call for the payment of any stated interest but does provide for an initial cash payment of $3 million on July 1, 1981. The maximum amount payable, including the $3 million initial payment, remains $60 million. Since section 483 will apply to each payment received by A more than one year following the date of sale (section 483 is inapplicable to the contingent payment that will be received on June 15, 1982 since that date is within one year following the July 1, 1981 sale date), the agreement contemplates internal interest and the price-interest recomputation rule is applicable. Under the rule, an initial determination must be made for A's taxable year 1981. On December 31, 1981, the last day of the taxable year, no events with regard to the first fiscal year have occurred which are subject to prompt subsequent calculation and verification because that fiscal year will end March 31, 1982. Under the price-interest recomputation rule, on December 31, 1981 A is required to assume that the maximum amount subsequently payable under the agreement ($57 million, equal to $60 million less the $3 million initial cash payment received by A in 1981) will be paid on the earliest date permissible under the agreement, *i.e.,* on June 15, 1982. Since no part of a payment received on that date would be treated as interest under section 483, the initial stated maximum selling price, applicable to A's 1981 tax calculations, is deemed to be $60 million. Thus, the 1981 gross profit ratio is ⅔ and for the taxable year 1981 A will report $2 million as gain attributable to the sale.

(ii) The net profits of X for its fiscal year ending March 31, 1982 are $120 million. On June 15, 1982 A receives a payment from B equal to 5% of that amount, or $6 million. On December 31, 1982, A knows that the maximum amount he may subsequently receive under the agreement is $51 million, and A is required to assume that this amount will be paid to him on the earliest permissible date, June 15, 1983. Section 483 does not treat as interest any part of the $6 million received by A on June 15, 1982, but section 483 will treat as unstated interest a computed part of the $51 million it is assumed A will receive on June 15, 1983. Assuming that under the tables in the regulations under section 483, it is determined that the principal component of a payment received more than 21 months but less than 27 months after the date of sale is considered to be .82270, $41,957,700 of the presumed $51 million payment will be treated as principal. The balance of $9,042,300 is interest. Accordingly, in A's 1982 tax calculations stated maximum selling price will be $50,957,700, which amount is equal to the stated maximum selling price that was determined in the 1981 tax calculations ($60 million) reduced by the section 483 interest component of the $6 million payment received by A in 1982 ($0) and further reduced by the section 483 interest component of the $51 million presumed payment to be received by A on June 15, 1983 ($9,042,300). Similarly, in determining gross profit for 1982 tax calculations, the gross profit of $40 million determined in the 1981 tax calculations must be reduced by the same section 483 interest amounts, yielding a recomputed gross profit of $30,957,700 ($40,000,000–$9,042,300). Further, since prior to 1982 A received payment under the agreement (1981 payment of $3 million of which $2 million was profit), the appropriate amounts must be subtracted in the 1982 tax calculation. The total previously received selling price payment of $3 million is subtracted from the recomputed maximum selling price of $50,957,700, yielding an adjusted selling price of $47,957,700. The total previously recognized gain of $2 million is subtracted from the recomputed maximum gross profit of $30,957,700, yielding an adjusted gross profit of $28,957,700. The gross

profit percentage applicable to 1982 tax calculations thus is determined to be 60.38175%, equal to the quotient of dividing the adjusted gross profit of $28,957,700 by the adjusted selling price of $47,957,700. Accordingly, of the $6 million received by A in 1982, no part of which is unstated interest under section 483, A will report $3,622,905 (60.38175% of $6 million) as gain attributable to the sale and $2,377,095 ($6,000,000–$3,622,905) as recovery of basis.

(iii) The net profits of X for its fiscal year ending March 31, 1983 are $200 million. On June 15, 1983 A receives a payment from B equal to $10 million. On December 31, 1983, A knows that the maximum amount he may subsequently receive under the agreement is $41 million, and A is required to assume that this amount will be paid to him on the earliest permissible date, June 15, 1984. Assuming that under the tables in the regulations under section 483 it is determined that the principal component of a payment received more than 33 months but less than 39 months after the date of sale is .74622, $30,595,020 of the presumed $41 million ($51 million–$10 million) payment will be treated as principal and $10,404,980 is interest. Based upon the assumed factor for 21 months but less than 27 months (.82270) $8,227,000 of the $10 million payment is principal and $1,773,000 is interest. Accordingly, in A's 1983 tax calculations stated maximum selling price will be $47,822,020, which amount is equal to the stated maximum selling price determined in the 1981 calculation ($60 million) reduced by the section 483 interest component of the $6 million 1982 payment ($0), the section 483 interest component of the 1983 payment ($1,773,000) and by the section 483 interest component of the presumed $41 million payment to be received in 1984 ($10,404,980). The recomputed gross profit is $27,822,020 ($40 million–$10,404,980–$1,773,000). The previously reported payments must be deducted for the 1983 calculation. Selling price is reduced to $38,822,020 by subtracting the $3 million 1981 payment and the $6 million 1982 payment ($47,822,020–$9 million) and gross profit is reduced to $22,199,115 by subtracting the 1981 profit of $2 million and the 1982 profit of $3,622,905 ($27,822,020–$5,622,905), yielding a gross profit percentage of 57.18176% ($22,199,115/$38,822,020). Accordingly, of the $10 million received in 1983, A will report $1,773,000 as interest under section 483, and of the remaining principal component of $8,227,000, $4,704,343 as gain attributable to the sale ($8,227,000×57.18176%) and $3,522,657 ($8,227,000–$4,704,343) as recovery of basis.

*Example (3).* The facts are the same as in example (2) except that X is a collapsible corporation as defined in section 341(b)(1) and no limitation or exception under section 341 (d), (e), or (f) is applicable. Under section 341(a), all of A's gain on the sale will be ordinary income. Accordingly, section 483 will not apply to treat as interest any part of the payments to be received by A under his agreement with B. See section 483(f)(3). Therefore, the price-interest recomputation rule is inapplicable and the tax results to A in each year in which payment is received will be determined in a manner consistent with example (1).

*Example (4).* The facts are the same as in example (2) (maximum amount payable under the agreement $60 million) except that the agreement between A and B contains the following ''payment recharacterization'' provision:

''Any payment made more than one year after the (July 1, 1981) date of sale shall be composed of an interest element and a principal element, the interest element being computed on the principal element at an interest rate of 9% per annum computed from the date of sale to the date of payment.''

The results reached in example (2), with respect to the $3 million initial cash payment received by A in 1981 remain the same because, under the payment recharacterization formula, no amount received or assumed to be received prior to July 1, 1982 is treated as interest. The 1982 tax computation method described in example (2) is equally applicable to the $6 million payment received in 1982. However, the adjusted gross profit ratio determined in this example (4) will differ from the ratio determined in example (2). The difference is attributable to the difference between a 9% stated interest rate calculation (in this example (4)) and the compound rate of unstated interest required under section 483 and used in calculating the results in example (2).

*Example (5).* The facts are the same as in example (1). In 1992 X is adjudged a bankrupt and it is determined that, in and after 1992, B will not be required to make any further payments under the agreement, *i.e.*, B's contingent payment obligation held by A now has become worthless. Assume that A previously received aggregate payments (exclusive of interest) of $45 million and out of those payments recovered $15 million of A's total $20 million basis. For 1992 A will report a loss of $5 million attributable to the sale, taken at the time determined to be appropriate under the rules generally applicable to worthless debts.

*Example (6).* (i) C owns all of the stock of Z corporation, a calendar year taxpayer. On July 1, 1981, C sells the stock of Z to D under an agreement calling for payment, each year for the next ten years, of an amount equal to 10% of the net profits of Z earned in the immediately preceding calendar year beginning with the year ending December 31, 1981. Each payment is to be made on the following April 1st, commencing April 1, 1982. In addition, C

is to receive a payment of $5 million on closing. The agreement specifies that the maximum amount payable to C, including the $5 million cash payment at closing, is $24 million. The agreement does not call for the payment of any stated interest. Since section 483 will apply to each payment received by C more than one year following the date of sale (section 483 is inapplicable to the payment that will be received on April 1, 1982, since that date is within one year following the July 1, 1981 sale date), the agreement contemplates internal interest and the price interest recomputation rule is applicable. Under that rule, C must make an initial determination for his taxable year 1981.

(ii) On December 31, 1981, the exact amount of Z's 1981 net profit is not known, since it normally takes a number of weeks to compile the relevant information. However, the events which will determine the amount of the payment C will receive on April 1, 1982 have already occurred, and the information (Z's 1981 financial statement) will be promptly calculated and verified and will be available prior to the time C's 1981 tax return is timely filed. On March 15, 1982, Z reports net income of $14 million, and on April 1, 1982 D pays C $1.4 million.

(iii) Under the price-interest recomputation rule, C is required to determine the gross profit ratio for the 1981 $5 million payment on the basis of the events which occurred by the close of that taxable year and which are verifiable before the due date of the 1981 return. Because at the end of C's 1981 taxable year all events which will determine the amount of the April 1, 1982 payment have occurred and because the actual facts are known prior to the due date of C's return, C will take those facts into account when calculating the gross profit ratio. Thus, because C knows that the 1982 payment is $1.4 million, C knows that the remaining amount to be recovered under the contract is $17.6 million ($24 million − ($5 million + $1.4 million)). For purposes of this paragraph C must assume that the entire $17.6 million will be paid on the earliest possible date, April 1, 1983. Because section 483 will apply to that payment, and assuming that under the tables in the regulations under section 483 the principal component of a payment received 21 months after the date of sale is considered to be .86384, $15,203,584 of the $17.6 million would be principal and $2,396,416 ($17,600,000 − $15,203,584) would be interest. Therefore, C must assume, for purposes of reporting the $5 million payment received in 1981, that the selling price is $21,603,584 calculated as follows:

| | |
|---|---|
| Total selling price | $24,000,000 |
| Interest component of the $17,600,000 payment which C must assume will be made April 1, 1983 | −2,396,416 |
| Adjusted selling price to be used when reporting the 1981 payment | 21,603,584 |

(iv) Assume that on March 15, 1982, Z reports net income of $15 million for 1982 and that on April 1, 1983 D pays C $1.5 million. Because section 483 will apply to that payment, and assuming that under the tables in the regulations under section 483 the principal component of a payment received 21 months after the date of sale is considered to be .86384, $1,295,760 of the $1,500,000 payment will be principal and $204,240 ($1,500,000 − $1,295,760) will be interest. Because C knows the amount of the 1983 payment when filing the 1982 tax return, C must assume that the remaining amount to be received under the contract, $16.1 million ($24 million − ($5 million + $1.4 million + $1.5 million)), will be received as a lump sum on April 1, 1984. Because section 483 will again apply, and assuming that the principal component of a payment made 34 months after the date of the sale is .74622, $12,014,142 of the $16.1 million would be principal, and $4,085,858 ($16,100,000 − $12,014,142) would be interest. Therefore, C must assume, for purpose of reporting the $1.4 million payment made April 1, 1982, that the adjusted selling price (within the meaning of example (2)) is $14,709,902, calculated as follows:

| | |
|---|---|
| Total selling price | $24,000,000 |
| Interest component of the $1,500,000 payment made April 1, 1983 | −204,240 |
| Interest component of the $16,100,000 payment which C must assume will be made April 1, 1984 | −4,085,858 |
| Payment made in 1981 | −5,000,000 |
| Adjusted selling price for calculations for reporting the 1982 payment | 14,709,902 |

(3) *Fixed period*—(i) *In general.* When a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer's basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments. In making the allocation it is not relevant whether the buyer is required to pay adequate stated interest. However, if the terms of the agreement incorporate an arithmetic component that is not identical for all taxable years, basis shall be allocated among the taxable years to accord with that component unless, taking into account all of the payment terms of the agreement, it is inappropriate to presume that payments under the contract are likely to

accord with the variable component. If in any taxable year no payment is received or the amount of payment received (exclusive of interest) is less than the basis allocated to that taxable year, no loss shall be allowed unless the taxable year is the final payment year under the agreement or unless it is otherwise determined in accordance with the rules generally applicable to worthless debts that the future payment obligation under the agreement has become worthless. When no loss is allowed, the unrecovered portion of basis allocated to the taxable year shall be carried forward to the next succeeding taxable year. If application of the foregoing rules to a particular case would substantially and inappropriately defer or accelerate recovery of the taxpayer's basis, a special rule will apply. See paragraph (c)(7) of this section.

(ii) *Examples.* The following examples illustrate the rules for recovery of basis in a contingent payment sale in which stated maximum selling price cannot be determined but the period over which payments are to be received under the agreement is fixed. In each case, it is assumed that application of the described rules will not substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

*Example (1).* A sells Blackacre to B for 10 percent of Blackacre's gross yield for each of the next 5 years. A's basis in Blackacre is $5 million. Since the sales price is indefinite and the maximum selling price is not ascertainable from the terms of the contract, basis is recovered ratably over the period during which payment may be received under the contract. Thus, assuming A receives the payments (exclusive of interest) listed in the following table, A will report the following:

| Year | Payment | Basis recovered | Gain attributable to the sale |
|---|---|---|---|
| 1 ..... | $1,300,000 | $1,000,000 | $300,000 |
| 2 ..... | 1,500,000 | 1,000,000 | 500,000 |
| 3 ..... | 1,400,000 | 1,000,000 | 400,000 |
| 4 ..... | 1,800,000 | 1,000,000 | 800,000 |
| 5 ..... | 2,100,000 | 1,000,000 | 1,100,000 |

*Example (2).* The facts are the same as in example (1), except that the payment in year 1 is only $900,000. Since the installment payment is less than the amount of basis allocated to that year, the unrecovered basis, $100,000, is carried forward to year 2.

| Year | Payment | Basis recovered | Gain attributable to the sale |
|---|---|---|---|
| 1 ..... | $900,000 | $900,000 | ..... |
| 2 ..... | 1,500,000 | 1,100,000 | $400,000 |
| 3 ..... | 1,400,000 | 1,000,000 | 400,000 |
| 4 ..... | 1,800,000 | 1,000,000 | 800,000 |
| 5 ..... | 2,100,000 | 1,000,000 | 1,100,000 |

*Example (3).* C owns all of the stock of X corporation with a basis of $100,000 (inclusive of selling expenses). D purchases the X stock from C and agrees to make four payments computed in accordance with the following formula: 40% of the net profits of X in year 1, 30% in year 2, 20% in year 3, and 10% in year 4. Accordingly, C's basis is allocated as follows: $40,000 to year 1, $30,000 to year 2, $20,000 to year 3, and $10,000 to year 4.

*Example (4).* The facts are the same as in example (3), but the agreement also requires that D make fixed installment payments in accordance with the following schedule: no payment in year 1, $100,000 in year 2, $200,000 in year 3, $300,000 in year 4, and $400,000 in year 5. Thus, while it is reasonable to project that the contingent component of the payments will decrease each year, the fixed component of the payments will increase each year. Accordingly, C is required to allocate $20,000 of basis to each of the taxable years 1 through 5.

(4) *Neither stated maximum selling price nor fixed period.* If the agreement neither specifies a maximum selling price nor limits payments to a fixed period, a question arises whether a sale realistically has occurred or whether, in economic effect, payments received under the agreement are in the nature of rent or royalty income. Arrangements of this sort will be closely scrutinized. If, taking into account all of the pertinent facts, including the nature of the property, the arrangement is determined to qualify as a sale, the taxpayer's basis (including selling expenses) shall be recovered in equal annual increments over a period of 15 years commencing with the date of sale. However, if in any taxable year no payment is received or the amount of payment received (exclusive of interest) is less than basis allocated to the year, no loss shall be allowed unless it is otherwise determined in accordance with the timing rules generally applicable to worthless debts that the future payment obligation under the

agreement has become worthless; instead the excess basis shall be reallocated in level amounts over the balance of the 15 year term. Any basis not recovered at the end of the 15th year shall be carried forward to the next succeeding year, and to the extent unrecovered thereafter shall be carried forward from year to year until all basis has been recovered or the future payment obligation is determined to be worthless. The general rule requiring initial level allocation of basis over 15 years shall not apply if the taxpayer can establish to the satisfaction of the Internal Revenue Service that application of the general rule would substantially and inappropriately defer recovery of the taxpayer's basis. See paragraph (c)(7) of this section. If the Service determines that initially allocating basis in level amounts over the first 15 years will substantially and inappropriately accelerate recovery of the taxpayer's basis in early years of that 15-year term, the Service may require that basis be reallocated within the 15-year term but the Service will not require that basis initially be allocated over more than 15 years. See paragraph (c)(7) of this section.

(5) *Foreign currency and other fungible payment units*—(i) *In general.* An installment sale may call for payment in foreign currency. For federal income tax purposes, foreign currency is property. Because the value of foreign currency will vary over time in relation to the United States dollar, an installment sale requiring payment in foreign currency is a contingent payment sale. However, when the consideration payable under an installment sale agreement is specified in foreign currency, the taxpayer's basis (including selling expenses) shall be recovered in the same manner as basis would have been recovered had the agreement called for payment in United States dollars. This rule is equally applicable to any installment sale in which the agreement specifies that payment shall be made in identified, fungible units of property the value of which will or may vary over time in relation to the dollar (*e.g.*, bushels of wheat or ounces of gold).

(ii) *Example.* The following example illustrates the provisions of this subparagraph:

*Example.* A sells Blackacre to B for 4 million Swiss francs payable 1 million in year 2 and 3 million in year 3, together with adequate stated interest. A's basis (including selling expenses) in Blackacre is $100,000. Twenty five thousand dollars of A's basis (¼ of total basis) is allocable to the year 2 payment of 1 million Swiss francs and $75,000 of A's basis is allocable to the year 3 payment of 3 million Swiss francs.

(6) *Income forecast method for basis recovery*—(i) *In general.* The rules for ratable recovery of basis set forth in paragraph (c) (2) through (4) of this section focus on the payment terms of the contingent selling price agreement. Except to the extent contemplated by paragraph(c)(7) of this section (relating to a special rule to prevent substantial distortion of basis recovery), the nature and productivity of the property sold is not independently relevant to the basis to be recovered in any payment year. The special rule for an income forecast method of basis recovery set forth in paragraph (c)(6) of this section recognizes that there are cases in which failure to take account of the nature or productivity of the property sold may be expected to result in distortion of the taxpayer's income over time. Specifically, when the property sold is depreciable property of a type normally eligible for depreciation on the income forecast method, or is depletable property of a type normally eligible for cost depletion in which total future production must be estimated, and payments under the contingent selling price agreement are based upon receipts or units produced by or from the property, the taxpayer's basis may appropriately be recovered by using an income forecast method.

(ii) *Availability of method.* In lieu of applying the rules set forth in paragraph (c) (2) through (4) of this section, in an appropriate case the taxpayer may elect (on its tax return timely filed for the first year under the contingent payment agreement in which a payment is received) to recover basis using the income forecast method of basis recovery. No special form of election is prescribed. An appropriate case is one meeting the criteria set forth in paragraph (c)(6)(i) of this section in which the property sold is a mineral property, a motion picture film, a television film, or a taped television show.

The Internal Revenue Service may from time to time specify other properties of a similar character which, in appropriate circumstances, will be eligible for recovery of basis on the income forecast method. In addition, a taxpayer may seek a ruling from the Service as to whether a specific property qualifies as property of a similar character eligible, in appropriate circumstances, for income forecast recovery of basis.

(iii) *Required calculations.* The income forecast method requires application of a fraction, the numerator of which is the payment (exclusive of interest) received in the taxable year under a contingent payment agreement, and the denominator of which is the forecast or estimated total payments (exclusive of interest) to be received under the agreement. This fraction is multiplied by the taxpayer's basis in the property sold to determine the basis recovered with respect to the payment received in the taxable year. If in a subsequent year it is found that the income forecast was substantially overestimated or underestimated by reason of circumstances occurring in such subsequent year, an adjustment of the income forecast of such subsequent year shall be made. In such case, the formula for computing recovery of basis would be as follows: payment received in the taxable year (exclusive of interest) divided by the revised estimated total payments (exclusive of interest) then and thereafter to be made under the agreement (the current year's payment and total estimated future payments), multiplied by the taxpayer's unrecovered basis remaining as of the beginning of the taxable year. If the agreement contemplates internal interest (as defined in paragraph (c)(2)(ii) of this section), in making the initial income forecast computation and in making any required subsequent recomputation the amount of internal interest (which shall not be treated as payment under the agreement) shall be calculated by assuming that each future contingent selling price payment will be made in the amount and at the time forecast. The total forecast of estimated payments to be received under the agreement shall be based on the conditions known to exist at the end of the taxable year for which the return is filed. If a subsequent upward or downward revision of this estimate is required, the revision shall be made at the end of the subsequent taxable year based on additional information which became available after the last prior estimate. No loss shall be allowed unless the taxable year is the final payment year under the agreement or unless it is otherwise determined in accordance with the rules generally applicable to the time a debt becomes worthless that the future payment obligation under the agreement has become worthless.

(iv) *Examples.* The following examples illustrate the income forecast method of basis recovery:

*Example (1).* A sells a television film to B for 5% of annual gross receipts from the exploitation of the film. The film is an ordinary income asset in the hands of A. A reasonably forecasts that total payments to be received under the contingent selling price agreement will be $1,200,000, and that A will be paid $600,000 in year 1, $150,000 in year 2, $300,000 in year 3, $100,000 in year 4, and $50,000 in year 5. A reasonably anticipates no or only insignificant receipts thereafter. A's basis in the film is $100,000. Under the income forecast method, A's basis initially is allocated to the five taxable years of forecasted payment as follows:

| Year | Percentage | Basis |
|---|---|---|
| 1 | 50.00 | $50,000 |
| 2 | 12.50 | 12,500 |
| 3 | 25.00 | 25,000 |
| 4 | 8.33 | 8,333 |
| 5 | 4.17 | 4,167 |

Payments are received and A reports the sale under the installment method as follows:

| Year | Payment received | Basis recovered | Gain on sale |
|---|---|---|---|
| 1 | $600,000 | $50,000 | $550,000 |
| 2 | 150,000 | 12,500 | 137,500 |
| 3 | 300,000 | 25,000 | 275,000 |
| 4 | 100,000 | 8,333 | 91,667 |
| 5 | 50,000 | 4,167 | 45,833 |

*Example (2).* The facts are the same as in example (1), except that in year 2 A receives no payment. In year 3 A receives a payment of $300,000 and reasonably estimates that in subsequent years he will receive total additional payments of only $100,000. In year 2 A will be allowed no loss. At the beginning of year 3 A's unrecovered basis is $50,000. In year 3 A must recompute the applicable basis recovery fraction based upon facts known and forecast as at the end of year 3: year 3

payment of $300,000 divided by estimated current and future payments of $400,000, equaling 75%. Thus, in year 3 A recovers $37,500 (75% of $50,000) of A's previously unrecovered basis.

(7) *Special rule to avoid substantial distortion*—(i) *In general.* The normal basis recovery rules set forth in paragraph (c) (2) through (4) of this section may, with respect to a particular contingent payment sale, substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

(ii) *Substantial and inappropriate deferral.* The taxpayer may use an alternative method of basis recovery if the taxpayer is able to demonstrate prior to the due date of the return including extensions for the taxable year in which the first payment is received, that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis. To demonstrate that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis, the taxpayer must show (A) that the alternative method is a reasonable method of ratably recovering basis and, (B) that, under that method, it is reasonable to conclude that over time the taxpayer likely will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule. The taxpayer must receive a ruling from the Internal Revenue Service before using an alternative method of basis recovery described in paragraph (c)(7)(ii) of this section.

The request for a ruling shall be made in accordance with all applicable procedural rules set forth in the Statement of Procedural Rules (26 CFR part 601) and any applicable revenue procedures relating to submission of ruling requests. The request shall be submitted to the Commissioner of Internal Revenue, Attention: Assistant Commissioner (Technical), Washington, DC 20224. The taxpayer must file a request for a ruling prior to the due date for the return including extensions. In demonstrating that application of the normal basis recovery rule would substantially and inappropriately defer recovery of the taxpayer's basis, the taxpayer in appropriate circumstances may rely upon contemporaneous or immediate past relevant sales, profit, or other factual data that are subject to verification. The taxpayer ordinarily is not permitted to rely upon projections of future productivity, receipts, profits, or the like. However, in special circumstances a reasonable projection may be acceptable if the projection is based upon a specific event that already has occurred (*e.g.,* corporate stock has been sold for future payments contingent on profits and an inadequately insured major plant facility of the corporation has been destroyed).

(iii) *Substantial and inappropriate acceleration.* Notwithstanding the other provisions of this paragraph, the Internal Revenue Service may find that the normal basis recovery rule will substantially and inappropriately accelerate recovery of basis. In such a case, the Service may require an alternate method of basis recovery, unless the taxpayer is able to demonstrate either (A) that the method of basis recovery required by the Service is not a reasonable method of ratable recovery, or (B) that it is not reasonable to conclude that the taxpayer over time is likely to recover basis at a rate twice as fast under the normally applicable basis recovery rule as the rate at which basis would be recovered under the method proposed by the Service. In making such demonstrations the taxpayer may rely in appropriate circumstances upon contemporaneous or immediate past relevant sales, profit, or other factual data subject to verification. In special circumstances a reasonable projection may be acceptable, but only with the consent of the Service, if the projection is based upon a specific event that has already occurred.

(iv) *Subsequent recomputation.* A contingent payment sale may initially and properly have been reported under the normally applicable basis recovery rule and, during the term of the agreement, circumstances may show that continued reporting on the original method will substantially and inappropriately defer or accelerate recovery of the unrecovered balance of the taxpayer's basis. In this event, the special rule provided in this paragraph is applicable.

(v) *Examples.* The following examples illustrate the application of the special rule of this paragraph. In examples (1) and (2) it is assumed that rulings consistent with paragraph (c)(7)(ii) of this section have been requested.

*Example (1).* A owns all of the stock of X corporation with a basis of $100,000. A sells the stock of X to B for a cash down payment of $1,800,000 and B's agreement to pay A an amount equal to 1% of the net profits of X in each of the next 10 years (together with adequate stated interest). The agreement further specifies that the maximum amount that may be paid to A (exclusive of interest) shall not exceed $10 million. A is able to demonstrate that current and recent profits of X have approximated $2 million annually, and that there is no reason to anticipate a major increase in the annual profits of X during the next 10 years. One percent of $2 million annual profits is $20,000, a total of $200,000 over 10 years. Under the basis recovery rule normally applicable to a maximum contingent selling price agreement, in the year of sale A would recover $18,000 of A's total $100,000 basis, and would not recover more than a minor part of the balance until the final year under the agreement. On a $2 million selling price ($200,000 plus $1,800,000 down payment), A would recover $90,000 of A's total $100,000 basis in the year of sale and 5% of each payment ($100,000/$2,000,000) received up to a maximum of $10,000 over the next ten years. Since the rate of basis recovery under the demonstrated method is more than twice the rate under the normal rule, A will be permitted to recover $90,000 basis in the year of sale.

*Example (2).* The facts are the same as in example (1) except that no maximum contingent selling price is stated in the agreement. Under the basis recovery rule normally applicable when no maximum amount is stated but the payment term is fixed, in the year of sale and in each subsequent year A would recover approximately $9,100 (1/11 of $100,000) of A's total basis. A will be permitted to recover $90,000 of A's total basis in the year of sale.

*Example (3).* The facts are the same as in example (1) except that A sells the X stock to B on the following terms: 1% of the annual net profits of X in each of the next 10 years and a cash payment of $1,800,000 in the eleventh year, all payments to be made together with adequate stated interest. No maximum contingent selling price is stated. Under the normally applicable basis recovery rule, A would recover 1/11 of A's total $100,000 basis in each of the 11 payment years under the agreement. On the facts (see example (1)), A cannot demonstrate that application of the normal rule would not substantially and inappropriately accelerate recovery of A's basis. Accordingly, A will be allowed to recover only $1,000 of A's total basis in each of the 10 contingent payment years under the agreement, and will recover the $90,000 balance of A's basis in the final year in which the large fixed cash payment will be made.

(8) *Coordination with regulations under section 385.* (i) *In general.* The regulations under section 385 do not apply to an instrument (as defined in § 1.385–3(c)) providing for a contingent payment of principal (with or without stated interest) issued in connection with a sale or other disposition of property to a corporation if § 1.385–6 (relating to proportionality) does not apply to such instrument (or to a class of instruments which includes such instrument). Thus, such instrument will be treated as stock or indebtedness under applicable principles of law without reference to the regulations under section 385.

(ii) *Examples.* The following examples illustrate the application of this paragraph:

*Example (1).* On January 1, 1982, corporation X buys a factory from Y, an independent creditor (within the meaning of § 1.385–6(b)). In exchange for the factory, Y receives $200,000 in cash on January 1, 1982. In addition, on January 1, 1984, Y will receive a payment in the range of $100,000 to $300,000, plus adequate stated interest, depending on the factory's output. Based on these facts, § 1.385–6 does not apply to X's obligation to Y (see § 1.385–6(a)(3)(ii)) and the regulations under section 385 doe not apply to X's obligation to Y.

*Example (2).* The facts are the same as in example (1), except that the contingent payment due on January 1, 1984 will be in the range of $50,000 to $250,000. In addition, on January 1, 1982, Y receives a $50,000 non-interest-bearing note due absolutely and unconditionally on January 1, 1984. Based on these facts, the $50,000 note is treated as stock or indebtedness under the regulations under section 385.

(d) *Election not to report an installment sale on the installment method*—(1) *In general.* An installment sale is to be reported on the installment method unless the taxpayer elects otherwise in accordance with the rules set forth in paragraph (d)(3) of this section.

(2) *Treatment of an installment sale when a taxpayer elects not to report on the installment method*—(i) *In general.* A taxpayer who elects not to report an installment sale on the installment

method must recognize gain on the sale in accordance with the taxpayer's method of accounting. The fair market value of an installment obligation shall be determined in accordance with paragraph (d)(2) (ii) and (iii) of this section. In making such determination, any provision of contract or local law restricting the transferability of the installment obligation shall be disregarded. Receipt of an installment obligation shall be treated as a receipt of property, in an amount equal to the fair market value of the installment obligation, whether or not such obligation is the equivalent of cash. An installment obligation is considered to be property and is subject to valuation, as provided in paragraph (d)(2) (ii) and (iii) of this section, without regard to whether the obligation is embodied in a note, an executory contract, or any other instrument, or is an oral promise enforceable under local law.

(ii) *Fixed amount obligations.* (A) A fixed amount obligation means an installment obligation the amount payable under which is fixed. Solely for the purpose of determining whether the amount payable under an installment obligation is fixed, the provisions of section 483 and any ''payment recharacterization'' arrangement (as defined in paragraph (c)(2)(ii) of this section) shall be disregarded. If the fixed amount payable is stated in identified, fungible units of property the value of which will or may vary over time in relation to the United States dollar (*e.g.*, foreign currency, ounces of gold, or bushels of wheat), such units shall be converted to United States dollars at the rate of exchange or dollar value on the date the installment sale is made. A taxpayer using the cash receipts and disbursements methods of accounting shall treat as an amount realized in the year of sale the fair market value of the installment obligation. In no event will the fair market value of the installment obligation be considered to be less than the fair market value of the property sold (minus any other consideration received by the taxpayer on the sale). A taxpayer using the accrual method of accounting shall treat as an amount realized in the year of sale the total amount payable under the installment obligation. For this purpose, neither interest (whether stated or unstated) nor original issue discount is considered to be part of the amount payable. If the amount payable is otherwise fixed, but because the time over which payments may be made is contingent, a portion of the fixed amount will or may be treated as internal interest (as defined in paragraph (c)(2)(ii) of this section), the amount payable shall be determined by applying the price interest recomputation rule (described in paragraph (c)(2)(ii) of this section). Under no circumstances will an installment sale for a fixed amount obligation be considered an ''open'' transaction. For purposes of this (ii), remote or incidential contingencies are not to be taken into account.

(B) The following examples illustrate the provisions of paragraph (d)(2) of this section.

*Example (1).* A, an accrual method taxpayer, owns all of the stock of X corporation with a basis of $20 million. On July 1, 1981, A sells the stock of X corporation to B for $60 million payable on June 15, 1992. The agreement also provides that against this fixed amount, B shall make annual prepayments (on June 15) equal to 5% of the net profits of X earned in the immediately preceding fiscal year beginning with the fiscal year ending March 31, 1982. Thus the first prepayment will be made on June 15, 1982. No stated interest is payable under the agreement and thus the unstated interest provisions of section 483 are applicable. Under section 483, no part of any payment made on June 15, 1982 (which is within one year following the July 1, 1981 sale date), will be treated as unstated interest. Under the price interest recomputation rule, it is presumed that the entire $60 million fixed amount will be paid on June 15, 1982. Accordingly, if A elects not to report the transaction on the installment method, in 1981 A must report $60 million as the amount realized on the sale and must report $40 million as gain on the sale in that year.

*Example (2).* The facts are the same as in example (1) except that A uses the cash receipts and disbursements method of accounting. In 1981 A must report as an amount realized on the sale the fair market value of the installment obligation and must report as gain on the sale in 1981 the excess of that amount realized over A's basis of $20 million. In no event will the fair market value of the installment obligation be considered to be less than the fair market value of the stock of X. In determining the fair market value of the installment obligation, any contractual or legal restrictions on the transferability of

the installment obligation, and any remote or incidental contingencies otherwise affecting the amount payable or time of payments under the installment obligation, shall be disregarded.

(iii) *Contingent payment obligations.* Any installment obligation which is not a fixed amount obligation (as defined in paragraph (d)(2)(ii) of this section) is a contingent payment obligation. If an installment obligation contains both a fixed amount component and a contingent payment component, the fixed amount component shall be treated under the rules of paragraph (d)(2)(ii) of this section and the contingent amount component shall be treated under the rules of this (iii). The fair market value of a contingent payment obligation shall be determined by disregarding any restrictions on transfer imposed by agreement or under local law. The fair market value of a contingent payment obligation may be ascertained from, and in no event shall be considered to be less than, the fair market value of the property sold (less the amount of any other consideration received in the sale). Only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation (determinable under the preceding sentences) cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is ''open.'' Any such transaction will be carefully scrutinized to determine whether a sale in fact has taken place. A taxpayer using the cash receipts and disbursements method of accounting must report as an amount realized in the year of sale the fair market value of the contingent payment obligation. A taxpayer using the accrual method of accounting must report an amount realized in the year of sale determined in accordance with that method of accounting, but in no event less than the fair market value of the contingent payment obligation.

(3) *Time and manner for making election*—(i) *In general.* An election under paragraph (d)(1) of this section must be made on or before the due date prescribed by law (including extensions) for filing the taxpayer's return for the taxable year in which the installment sale occurs. The election must be made in the manner prescribed by the appropriate forms for the taxpayer's return for the taxable year of the sale. A taxpayer who reports an amount realized equal to the selling price including the full face amount of any installment obligation on the tax return filed for the taxable year in which the installment sale occurs will be considered to have made an effective election under paragraph (d)(1) of this section. A cash method taxpayer receiving an obligation the fair market value of which is less than the face value must make the election in the manner prescribed by appropriate instructions for the return filed for the taxable year of the sale.

(ii) *Election made after the due date.* Elections after the time specified in paragraph (d)(3)(i) of this section will be permitted only in those rare circumstances when the Internal Revenue Service concludes that the taxpayer had good cause for failing to make a timely election. A recharacterization of a transaction as a sale in a taxable year subsequent to the taxable year in which the transaction occurred (*e.g.,* a transaction initially reported as a lease later is determined to have been an installment sale) will not justify a late election. No conditional elections will be permitted. For a special transitional rule relating to certain taxable years for which a return is filed prior to February 19, 1981, see paragraph (d)(5) of this section.

(4) *Revoking an election.* Generally, an election made under paragraph (d)(1) is irrevocable. An election may be revoked only with the consent of the Internal Revenue Service. A revocation is retroactive. A revocation will not be permitted when one of its purposes is the avoidance of Federal income taxes, or when the taxable year in which any payment was received has closed. For a special transitional rule relating to certain taxable years for which a return is filed prior to February 19, 1981, see paragraph (d)(5) of this section.

(5) *Transitional rules.* The following transitional rules shall apply with respect to any contingent payment sale made after October 19, 1980 in a taxable year, ending after that date, for which the taxpayer has filed a federal income tax return prior to February 19, 1981. If in such tax return the taxpayer has

treated the contingent payment sale under the installment method, consent of the Internal Revenue Service to a late election by the taxpayer not to report the transaction on the installment method will generally be granted if the request for election out of installment method treatment is filed by May 5, 1981. If in such tax return the taxpayer has elected not to report the contingent payment sale under the installment method, consent of the Service to revocation of the election by the taxpayer will generally be granted if the request for revocation is filed by May 5, 1981.

(e) *Purchaser evidences of indebtedness payable on demand or readily tradable*—(1) *Treatment as payment*—(i) *In general.* A bond or other evidence of indebtedness (hereinafter in this section referred to as an obligation) issued by any person and payable on demand shall be treated as a payment in the year received, not as installment obligations payable in future years. In addition, an obligation issued by a corporation or a government or political subdivision thereof—

(A) With interest coupons attached (whether or not the obligation is readily tradable in an established securities market),

(B) In registered form (other than an obligation issued in registered form which the taxpayer establishes will not be readily tradable in an established securities market), or

(C) In any other form designed to render such obligation readily tradable in an established securities market,

shall be treated as a payment in the year received, not as an installment obligation payable in future years. For purposes of this paragraph, an obligation is to be considered in registered form if it is registered as to principal, interest, or both and if its transfer must be effected by the surrender of the old instrument and either the reissuance by the corporation of the old instrument to the new holder or the issuance by the corporation of a new instrument to the new holder.

(ii) *Examples.* The rules stated in this paragraph may be illustrated by the following examples:

*Example (1).* On July 1, 1981, A, an individual on the cash method of accounting reporting on a calendar year basis, transferred all of his stock in corporation X (traded on an established securities market and having a fair market value of $1,000,000) to corporation Y in exchange for 250 of Y's registered bonds (which are traded in an over-the-counter-market) each with a principal amount and fair market value of $1,000 (with interest payable at the rate of 12 percent per year), and Y's unsecured promissory note with a principal amount of $750,000. At the time of such exchange A's basis in the X stock is $900,000. The promissory note is payable at the rate of $75,000 annually, due on July 1 of each year following 1981 until the principal balance is paid. The note provides for the payment of interest at the rate of 12 percent per year also payable on July 1 of each year. Under the rule stated in paragraph (e)(1)(i) of this section, the 250 registered bonds of Y are treated as a payment in 1981 in the amount of the value of the bonds, $250,000.

*Example (2).* Assume the same facts as in example (1). Assume further that on July 1, 1982, Y makes its first installment payment to A under the terms of the unsecured promissory note with 75 more of its $1,000 registered bonds. A must include $7,500 (*i.e.,* 10 percent gross profit percentage times $75,000) A's gross income for calendar year 1982. In addition, A includes the interest payment made by Y on July 1 in A's gross income for 1982.

(2) *Amounts treated as payment.* If under paragraph (e)(1) of this section an obligation is treated as a payment in the year received, the amount realized by reason of such payment shall be determined in accordance with the taxpayer's method of accounting. If the taxpayer uses the cash receipts and disbursements method of accounting, the amount realized on such payment is the fair market value of the obligation. If the taxpayer uses the accrual method of accounting, the amount realized on receipt of an obligation payable on demand is the face amount of the obligation, and the amount realized on receipt of an obligation with coupons attached or a readily tradable obligation is the stated redemption price at maturity less any original issue discount (as defined in section 1232(b)(1)) or, if there is no original issue discount, the amount realized is the stated redemption price at maturity appropriately discounted to reflect total unstated interest (as defined in section 483(b)), if any.

(3) *Payable on demand.* An obligation shall be treated as payable on demand

only if the obligation is treated as payable on demand under applicable state or local law.

(4) *Designed to be readily tradable in an established securities market*—(i) *In general.* Obligations issued by a corporation or government or political subdivision thereof will be deemed to be in a form designed to render such obligations readily tradable in an established securities market if—

(A) Steps necessary to create a market for them are taken at the time of issuance (or later, if taken pursuant to an expressed or implied agreement or understanding which existed at the time of issuance),

(B) If they are treated as readily tradable in an established securities market under paragraph (e)(4)(ii) of this section, or

(C) If they are convertible obligations to which paragraph (e)(5) of this section applies.

(ii) *Readily tradable in an established securities market.* An obligation will be treated as readily tradable in an established securities market if—

(A) The obligation is part of an issue or series of issues which are readily tradable in an established securities market, or

(B) The corporation issuing the obligation has other obligations of a comparable character which are described in paragraph (e)(4)(ii)(A) of this section. For purposes of paragraph (e)(4)(ii)(B) of this section, the determination as to whether there exist obligations of a comparable character depends upon the particular facts and circumstances. Factors to be considered in making such determination include, but are not limited to, substantial similarity with respect to the presence and nature of security for the obligation, the number of obligations issued (or to be issued), the number of holders of such obligation, the principal amount of the obligation, and other relevant factors.

(iii) *Readily tradable.* For purposes of paragraph (e)(4)(ii)(A) of this section, an obligation shall be treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such obligation or is part of an issue a portion of which is in fact traded in an established securities market.

(iv) *Established securities market.* For purposes of this paragraph, the term ''established securities market'' includes (A) a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f), (B) an exchange which is exempted from registration under section 5 of the Securities Exchange Act of 1934 (15 U.S.C. 78e) because of the limited volume of transactions, and (c) any over-the-counter market. For purposes of this (iv), an over-the-counter market is reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of obligations by identified brokers or dealers, other than a quotation sheet prepared and distributed by a broker or dealer in the regular course of business and containing only quotations of such broker or dealer.

(v) *Examples.* The rules stated in this paragraph may be illustrated by the following examples:

*Example (1).* On June 1, 1982, 25 individuals owning equal interests in a tract of land with a fair market value of $1 million sell the land to corporation Y. The $1 million sales price is represented by 25 bonds issued by Y, each having a face value of $40,000. The bonds are not in registered form and do not have interest coupons attached, and, in addition, are payable in 120 equal installments, each due on the first business day of each month. In addition, the bonds are negotiable and may be assigned by the holder to any other person. However, the bonds are not quoted by any brokers or dealers who deal in corporate bonds, and, furthermore, there are no comparable obligations of Y (determined with reference to the characteristics set forth in paragraph (e)(2) of this section) which are so quoted. Therefore, the bonds are not treated as readily tradable in an established securities market. In addition, under the particular facts and circumstances stated, the bonds will not be considered to be in a form designed to render them readily tradable in an established securities market. The receipt of such bonds by the holder is not treated as a payment for purposes of section 453(f)(4), notwithstanding that they are freely assignable.

*Example (2).* On April 1, 1981, corporation M purchases in a casual sale of personal property a fleet of trucks from corporation N in exchange for M's negotiable notes, not in

registered form and without coupons attached. The M notes are comparable to earlier notes issued by M, which notes are quoted in the Eastern Bond section of the National Daily Quotation Sheet, which is an interdealer quotation system. Both issues of notes are unsecured, held by more than 100 holders, have a maturity date of more than 5 years, and were issued for a comparable principal amount. On the basis of these similar characteristics it appears that the latest notes will also be readily tradable. Since an interdealer system reflects an over-the-counter market, the earlier notes are treated as readily tradable in an established securities market. Since the later notes are obligations comparable to the earlier ones, which are treated as readily tradable in an established securities market, the later notes are also treated as readily tradable in an established securities market (whether or not such notes are actually traded).

(5) *Special rule for convertible securities*—(i) *General rule.* If an obligation contains a right whereby the holder of such obligation may convert it directly or indirectly into another obligation which would be treated as a payment under paragraph (e)(1) of this section or may convert it directly or indirectly into stock which would be treated as readily tradable or designed to be readily tradable in an established securities market under paragraph (e)(4) of this section, the convertible obligation shall be considered to be in a form designed to render such obligation readily tradable in an established securities market unless such obligation is convertible only at a substantial discount. In determining whether the stock or obligation into which an obligation is convertible is readily tradable or designed to be readily tradable in an established securities market, the rules stated in paragraph (e)(4) of this section shall apply, and for purposes of such paragraph (e)(4) if such obligation is convertible into stock then the term ''stock'' shall be substituted for the term ''obligation'' wherever it appears in such paragraph (e)(4).

(ii) *Substantial discount rule.* Whether an obligation is convertible at a substantial discount depends upon the particular facts and circumstances. A substantial discount shall be considered to exist if at the time the convertible obligation is issued, the fair market value of the stock or obligation into which the obligation is convertible is less than 80 percent of the fair market value of the obligation (determined by taking into account all relevant factors, including proper discount to reflect the fact that the convertible obligation is not readily tradable in an established securities market and any additional consideration required to be paid by the taxpayer). Also, if a privilege to convert an obligation into stock or an obligation which is readily tradable in an established securities market may not be exercised within a period of one year from the date the obligation is issued, a substantial discount shall be considered to exist.

(6) *Effective date.* The provisions of this paragraph (e) shall apply to sales or other dispositions occurring after May 27, 1969, which are not made pursuant to a binding written contract entered into on or before such date. No inference shall be drawn from this section as to any questions of law concerning the application of section 453 to sales or other dispositions occurring on or before May 27, 1969.

[T.D. 7768, 46 FR 10709, Feb. 4, 1981; 46 FR 13688, Feb. 24, 1981; 46 FR 43036, Aug. 26, 1981, as amended by T.D. 7788, 46 FR 48920, Oct. 5, 1981; T.D. 8535, 59 FR 18751, Apr. 20, 1994]

### § 15a.453–2 Installment obligations received as liquidating distribution. [Reserved]

## PART 16—TEMPORARY REGULATIONS UNDER THE REVENUE ACT OF 1962

AUTHORITY: Sec. 7805, 68 Stat. 917; 26 U.S.C. 7805.

### § 16.3–1 Returns as to the creation of or transfers to certain foreign trusts.

(a) *Requirement of return.* Every United States person who, on or after October 16, 1962, either creates a foreign trust or transfers money or property to a foreign trust, directly or indirectly, shall file an information return on Form 3520, except as provided in subparagraph (4) of paragraph (d) of this section. The return must be filed by the grantor or the transferor, or the fiduciary of the estate in the case of a testamentary trust. The return must be filed whether or not any beneficiary

is a United States person and whether or not the grantor or any other person may be treated as the substantial owner of any portion of the trust under sections 671–678.

(b) *Meaning of terms.* For purposes of this section the following terms shall have the meaning assigned to them in this paragraph:

(1) *Foreign trust.* See section 7701(a)(31) of the Code for the definition of foreign trust.

(2) *United States person.* See section 7701(a)(30) of the Code for the definition of United States person.

(3) *Grantor.* The term ''grantor'' refers to any United States person who by an inter vivos declaration or agreement creates a foreign trust.

(4) *Transferor.* The term ''transferor'' refers to any United States person, other than a person who is the grantor or the fiduciary (as defined in subparagraph (5) of this paragraph), who transfers money or property to or for the benefit of a foreign trust. It does not refer to a person who transfers money or property to a foreign trust pursuant to a sale or an exchange which is made for full and adequate consideration.

(5) *Fiduciary of an estate.* In the case of a testamentary trust expressed in the will of a decedent the term ''fiduciary of an estate'' refers to the executor or administrator who is responsible for establishing a foreign trust on behalf of the decedent.

(c) *Information required.* The return required by section 6048 and this section shall be made on Form 3520 and shall set forth the following information:

(1) The name, address, and identifying number of the person (or persons) filing the return, a statement identifying each person named as either a grantor, fiduciary of an estate, or transferor, and the date of the transaction for which the return is being filed;

(2) In the case of a fiduciary of an estate, the name and identifying number of the decedent;

(3) The name of the trust and the name of the country under whose laws the foreign trust was created;

(4) The date the foreign trust was created and the name and address of the person (or persons) who created it;

(5) The date on which the trust is to terminate or a statement describing the conditions which will cause the trust to terminate;

(6) The name and business address of the foreign trustee (or trustees);

(7) A statement either that the trustee is required to distribute all of the trust's income currently (in which case the information required in subparagraph (c)(9) of this paragraph need not be furnished) or a statement that the trust may accumulate some or all of its income;

(8) The name, address, and identifying number, if any, of each beneficiary who is either named in the instrument or whose identity is definitely ascertainable at the time the return required by this section is filed, and the date of birth for each beneficiary who is a United States person and whose rights under the trust are determined, in whole or in part, by reference to the beneficiary's age;

(9) Except as provided in subparagraph (c)(7) of this paragraph, a statement with respect to each beneficiary setting forth his right to receive income or corpus, or both, from the trust, his proportionate interest, if any, in the income or corpus, or both, of the trust, and any condition governing the time when a distribution to him may be made, such as a specific date or age (or in lieu of such statement a copy of the trust instrument which must be attached to the return);

(10) A detailed list of the property transferred to the foreign trust in the transaction for which the return is being filed, containing a complete description of each item transferred, its adjusted basis and its fair market value on the date transferred, and the consideration, if any, paid by the foreign trust for such transfer; and

(11) The name and address of the person (or persons) having custody of the books of account and records of the foreign trust, and the location of such books and records if different from such address.

(d) *Special provisions*—(1) *Separate return for each foreign trust and each transfer.* If a United States person creates more than one foreign trust or transfers money or property to more than one foreign trust, then separate

returns must be filed with respect to each foreign trust where returns are required under section 6048 and this section. If a United States person transfers money or property to the same foreign trust at different times, then separate returns must be filed with respect to each transfer where returns are required under section 6048 and this section. However, where more than one transfer to the same foreign trust is made by a United States person during any 90-day period, such person may, at his election, file a single return, so long as the return includes the information required with respect to each transfer and is filed on or before the 90th day after the earliest transfer in any such period.

(2) *Joint returns.* Where returns are required under section 6048 and this section by two or more persons who either jointly create a foreign trust or jointly transfer money or property to a foreign trust, they may jointly execute and file one return in lieu of filing several returns.

(3) *Actual ownership of money or property transferred.* If any person referred to in this section is not the real party in interest as to the money or property transferred but is merely acting for a United States person, the information required under this section shall be furnished in the name of and by the actual owner of such money or property, except that a fiduciary of an estate shall file information relating to the decedent.

(4) *Payments to an employees' trust, etc.* In the case of contributions made to a foreign trust under a plan which provides pension, profit-sharing, stock bonus, sickness, accident, unemployment, welfare, or similar benefits or a combination of such benefits for employees, neither employers nor employees shall be required to file a return as set forth in this section.

(e) *Time and place for filing return*—(1) *Time for filing.* Any return required by section 6048 and this section shall be filed on or before the 90th day after either the creation of any foreign trust by a United States person or the transfer of any money or property to a foreign trust by a United States person. The Director of International Operations is authorized to grant reasonable extensions of time to file returns under section 6048 and this section in accordance with the applicable provisions of section 6081(a) and §1.6081–1.

(2) *Place for filing.* Returns required by section 6048 and this section shall be filed with the Director of International Operations, Internal Revenue Service, Washington D.C. 20225.

(f) *Penalties*—(1) *Criminal.* For criminal penalties for failure to file a return see section 7203. For criminal penalties for filing a false or fraudulent return, see sections 7206 and 7207.

(2) *Civil.* For civil penalty for failure to file a return or failure to show the information required on a return under this section, see section 6677.

[T.D. 6632, 28 FR 277, Jan. 10, 1963]

## PART 16A—TEMPORARY INCOME TAX REGULATIONS RELATING TO THE PARTIAL EXCLUSION FOR CERTAIN CONSERVATION COST-SHARING PAYMENTS

Sec.
16A.126–0 Effective dates.
16A.126–1 Certain cost-sharing payments—in general.
16A.126–2 Section 126 elections.
16A.1255–1 General rule for treatment of gain from disposition of section 126 property.
16A.1255–2 Special rules.

AUTHORITY: Secs. 126 and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2888, 26 U.S.C. 126; 68A Stat. 917, 26 U.S.C. 7805).

SOURCE: T.D. 7778, 46 FR 27637, May 21, 1981, unless otherwise noted.

### §16A.126–0 Effective dates.

These temporary regulations shall apply to any payments received under a contract signed by the taxpayer and the appropriate agency after September 30, 1979.

### §16A.126–1 Certain cost-sharing payments—in general.

(a) *Introduction.* In general, section 126 provides that recipients of payments made after September 30, 1979 under certain conservation, reclamation and restoration programs may exclude all or a portion of those payments from income if the payments do not substantially increase the annual income derived by the taxpayer from

the affected property. For purposes of this section, the term ''payment'' as used in section 126 means payment of the economic benefit, if any, conferred upon the taxpayer upon receipt of the improvement. An increase in annual income is substantial if it exceeds the greater of 10 percent of the average annual income derived from the affected property prior to receipt of the improvement or an amount equal to $2.50 times the number of affected acres. The amount of gross income which a taxpayer realizes upon the receipt of a section 126 payment is the value of the section 126 improvement, reduced by the sum of the excludable portion and the taxpayer's share of the cost of the improvement (if any).

(b) *Definitions.* For purposes of this section, the term:

(1) ''Cost of the improvement'' means the sum of amounts paid by a government and the taxpayer, whether or not with borrowed funds, for the improvement.

(2) ''Section 126 cost'' means the cost of the improvement less the sum of

(i) Any government payments under a program which is not listed in section 126(a),

(ii) Any portion of a government payment under a program which is listed in section 126(a) which the Secretary of Agriculture has not certified is primarily for purposes of conservation,

(iii) Any government payment to the taxpayer which is in the nature of rent or compensation for services.

(3) ''Value of the section 126 improvement'' means the fair market value of the improvement multiplied by a fraction, the numerator of which is the section 126 cost and the denominator of which is the cost of the improvement.

(4) ''Affected acreage'' means the acres affected by the improvement.

(5) ''Excludable portion'' means the present fair market value of the right to receive annual income from the affected acreage of the greater of 10 percent of the prior average annual income from the affected acreage or $2.50 times the number of affected acres.

(6) ''Prior average annual income'' means the average of the gross receipts from the affected acreage for the last three taxable years preceding the taxable year in which installation of the improvement is commenced.

(7) ''Section 126 improvement'' means the portion of the improvement equal to the percentage which government payments made to the taxpayer, which the Secretary of Agriculture has certified were made primarily for the purpose of conservation, bear to the cost of the improvement.

(c) *Income realized upon receipt of a section 126 improvement*—(1) *Section 126 exclusion applied.* Unless a taxpayer elects not to have section 126 apply, the amount of gross income realized on receipt of the section 126 improvement is the value of the section 126 improvement less the sum of the taxpayer's share of the cost of the improvement and the excludable portion.

(2) *Section 126 exclusion not applied.* If a taxpayer elects under section 126(c) not to have section 126 apply in whole or in part, the amount realized on the receipt of the section 126 improvement is the value of the section 126 improvement less the sum of the taxpayer's share of the cost of the improvement and the excludable portion that applies, if any.

(d) *Payments under watershed programs*—(1) *Programs within section 126(a)(9).* Section 126(a)(9) covers certain programs affecting small watersheds.

These programs must be administered by the Secretary of Agriculture and be determined by the Commissioner to be substantially similar to the type of program described in section 126(a) (1) through (8). The Commissioner has determined that section 126 improvements made in connection with small watersheds are within the scope of section 126(a)(9) if they are made under one of the following programs:

(A) The Watershed Protection and Flood Prevention Act, Pub. L. 566, 68 Stat. 666, as amended (16 U.S.C. 1001, *et seq.*), as funded by the Act of November 9, 1979, Pub. L. 96–108, 93 Stat. 834.

(B) Flood Prevention Projects, Pub. L. 86–468, sec. 1, 74 Stat. 131, as amended (16 U.S.C. 1006a); Pub. L. 78–534, sec. 2, 58 Stat. 889 (33 U.S.C. 701a–1); Pub. L. 78–534, sec. 13, 58 Stat. 905;

(C) Emergency Watershed Protection, Pub. L. 81–516, sec. 216, 64 Stat. 184 (33 U.S.C. 701b–1), and

(D) Colorado River Basin Salinity Control Act, Pub. L. 93–320, 88 Stat. 266:

*(1)* Title 1—Programs downstream from Imperial Dam, and

*(2)* Title 2—Measures upstream from Imperial Dam.

(2) *Other programs.* The Commissioner may announce further determinations under section 126(a)(9) from time to time in the Internal Revenue Bulletin.

(3) *Small watershed defined.* A watershed is a ''small watershed'' under this paragraph and section 126(a)(9) if the watershed or subwatershed does not exceed 250,000 acres and does not include any single structure providing more than 12,500 acre-feet of floodwater detention capacity, nor more than 25,000 acre-feet of total capacity.

(e) *Basis of property not increased by reason of excludable amounts.* Notwithstanding any provision of section 1016 (relating to adjustments to basis) to the contrary, basis of any property does not include any amount which is excludable from gross income under section 126.

(f) *Cross reference.* For rules relating to the recapture as ordinary income of the gain from the disposition (within 20 years of the date of receipt) of property for which an exclusion is claimed for a section 126 improvement, see section 1255 and the regulations thereunder.

(g) *Examples.* The provisions of this section are illustrated by the following examples:

*Example (1).* In 1981, 100 acres of the taxpayer's land is reclaimed under a Rural Abandoned Mine Program contract with the Soil Conservation Service of the U.S. Department of Agriculture. The total cost of the improvement is $700,000. USDA pays $690,000, the taxpayer $10,000. The Secretary of Agriculture certifies that 95% of the $690,000 USDA payment was primarily for the purpose of conservation. Therefore, $34,500 ($690,000×.05) is a nonsection 126 payment. $150,000 of USDA's payment is compensation for the taxpayer's service in the reclamation project and is includable in gross income as compensation for services. The taxpayer has $20,000 of allowable deductions in 1981, $15,500 of which are properly attributable to the USDA payment. Based on all the facts and circumstances, the value of the improvement is $21,000. The taxpayer elects not to have section 126 apply. The taxpayer computes the amount which is included in gross income as a result of receipt of the improvement as follows:

(1)

| | |
|---|---|
| Cost of improvement | $700,000 |
| Nonsection 126 payment | (34,500) |
| Compensation for services | (150,000) |
| Current deductions | (15,500) |
| Section 126 cost | 500,000 |

(2)

| | |
|---|---|
| Value of improvement | 21,000 |
| Multiplied by section 126 cost | ×500,000 |
| Cost of improvement | 700,000 |
| Value of section 126 improvement | 15,000 |

(3)

| | |
|---|---|
| Value of section 126 improvement | 15,000 |
| (Taxpayer's contribution) | 10,000 |
| Amount included in gross income | 5,000 |

*Example (2).* The facts are the same as example (1) except that section 126 applies. Based on all the facts and circumstances, the present fair market value of the right to receive annual income from the property of 10 percent of the prior average annual income of the affected acreage prior to the receipt of the improvement is $1,380 and the present fair market value of the right to receive $250 ($2.50×100 acres) is $1,550. The excludable portion is, therefore, $1,550. The taxpayer computes the amount included in gross income as follows:

| | |
|---|---|
| Value of section 126 improvement | $15,000 |
| (Taxpayer's contribution) | (10,000) |
| (Excludable portion) | (1,550) |
| Amount included in income | 3,450 |

*Example (3).* The facts are the same as example (2) except that the present value of 10 percent of the prior average annual income is $5,600. The taxpayer realizes no income as a result of receipt of the section 126 project.

(1)

| | |
|---|---|
| Value of section 126 improvement | $15,000 |
| (Taxpayer's contribution) | (10,000) |
| (Excludable portion) | (5,600) |
| Amount included in income | 0 |

*Example (4).* In 1983, the taxpayer signs a contract under the water bank program under which he will maintain 20 acres of undisturbed wetlands as a wildfowl preserve. In return he will receive $90 an acre as rent from the government. Although the payment is made under a program listed in section 126(a) and the Secretary of Agriculture has certified that the entire amount of payment was made primarily for the purpose of conservation, there is no income eligible for section 126 exclusion because the full payment is rent. The rent is included in full in gross income.

*Example (5).* In 1980, the taxpayer reforests 200 acres of nonindustrial private forest land by planting tree seedlings. The taxpayer pays the full cost of the reforestation,

$15,000. Under the cost-sharing provisions of the forestry incentives program, the taxpayer receives a reimbursement from USDA of $12,000. The Secretary of Agriculture certifies that 100% of the USDA payment is primarily for the purpose of conservation. Assume that the excludable portion is $3,500 and that based on all the facts and circumstances, the value of the improvement is $15,000. The amount which is includable in income is the value of the section 126 improvement, reduced by the excludable portion and the taxpayer's share of the cost of the improvement. Therefore the taxpayer includes $8,500 in gross income as a result of the USDA payment, computed as follows:

| | |
|---|---|
| Value of the section 126 improvement | $15,000 |
| (Excludable portion) | (3,500) |
| (Taxpayer's contribution) | (3,000) |
| Amount included in gross income | 8,500 |

[T.D. 7748, 46 FR 27637, May 21, 1981; 46 FR 41043, Aug. 14, 1981]

### § 16A.126–2 Section 126 elections.

(a) *Election for section 126 not to apply in whole or in part.* A taxpayer may elect under section 126(c) not to have section 126 apply to all or any part of an improvement described in section 126.

(b) *Application of the section 126 exclusion.* To the extent the section 126 exclusion applies, the taxpayer should so indicate on an attachment to the tax return (or amended return) for the taxable year in which the taxpayer received the last payment made by a government for the improvement. The attachment should state the dollar amount of the section 126 cost funded by a government payment, the value of the section 126 improvement, and the amount that the taxpayer is excluding under section 126.

### § 16A.1255–1 General rule for treatment of gain from disposition of section 126 property.

(a) *Ordinary income*—(1) *General rule.* Except as otherwise provided in this section and § 16A.1255–2, if section 126 property is disposed of after September 30, 1979, then under section 1255(a)(1) there shall be recognized as ordinary income the lesser of—

(i) The ''excludable portion'' under section 126, or

(ii)(A) The excess of the amount realized (in the case of a sale, exchange, or involuntary conversion), or the fair market value of the section 126 property (in the case of any other disposition), over the adjusted basis of the property, less

(B) The amount recognized as ordinary income under the other provisions of Chapter I, Subchapter P, Part IV of the Code.

(2) *Application of section.* Any gain treated as ordinary income under section 1255(a)(1) shall be recognized as ordinary income notwithstanding any other provision of subtitle A of the Code except that section 1255 does not apply to the extent the gain is recognized as ordinary income under the other provisions of Subchapter P, Part IV of the Code. For special rules with respect to the application of section 1255, see § 16A.1255–2. For the relation of section 1255 to other provisions, see paragraph (c) of this section.

(3) *Meaning of terms.* For purposes of section 1255 and these regulations—

(i) The term ''section 126 property'' means any property acquired, improved, or otherwise modified as a result of a payment listed in section 126(a) which has been certified by the Secretary of Agriculture as primarily for the purpose of conservation;

(ii) The term ''excludable portion'' is defined in § 16A.126–1(b)(5);

(iii) The term ''disposition'' has the same meaning as in § 1.1245–1(a)(3);

(iv) The term ''date of receipt of the section 126 payment'' means the last date the government made a payment for the improvements.

(4) *Applicable percentage.* If section 126 property is disposed of less than 10 years after the date of receipt of the last payment which has been certified by the Secretary of Agriculture as primarily for the purpose of conservation, the ''applicable percentage'' is 100 percent; if section 126 property is disposed of more than 10 years after that date, the applicable percentage is 100 percent reduced (but not below zero) by 10 percent for each year or part thereof in excess of 10 years such property was held after the date of the section 126 payment.

(5) *Portion of parcel.* The amount of gain to be recognized as ordinary income under section 1255(a)(1) shall be determined separately for each parcel of section 126 property in a manner

consistent with the principles of § 1245–1(a) (4) and (5) relating to gain from disposition of certain depreciable property. If (i) only a portion of a parcel of section 126 property is disposed of in a transaction, or if two or more portions of a single parcel are disposed of in one transaction, and (ii) the aggregate of ''excludable portions'' with respect to any such portion cannot be established to the satisfaction of the Commissioner, then the aggregate of the ''excludable portions'' in respect of the entire parcel shall be allocated to each portion in proportion to the fair market value of each at the time of the disposition.

(b) *Instances of nonapplication*—(1) *In general.* Section 1255 does not apply if a taxpayer disposes of section 126 property more than 20 years after receipt of the last section 126 payment with respect to the property.

(2) *Losses.* Section 1255(a)(1) does not apply to losses. Thus, section 1255(a)(1) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of property, all of which is section 126 property, nor does the section apply to a disposition of the property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of the property is not greater than its adjusted basis.

(c) *Relation of section 1255 to other provisions*—(1) *General.* The provisions of section 1255 apply notwithstanding any other provisions of Subtitle A of the Code except that they do not apply to the extent gain is recognized as ordinary income under the other provisions of Subchapter P, Part IV of the Code. Thus, unless an exception or limitation under § 16A.1255–2 applies, gain under section 1255(a)(1) is recognized notwithstanding any contrary nonrecognition provision or income characterizing provision. For example, since section 1255 overrides section 1231 (relating to property used in the trade or business), the gain recognized under section 1255 upon a disposition of section 126 property will be treated as ordinary income and only the remaining gain, if any, from the disposition may be considered as gain from the sale or exchange of property to which section 1231 applies. See example (1) of paragraph (d) of this section.

(2) *Nonrecognition sections overridden.* The nonrecognition of gain provisions of Subtitle A of the Code which section 1255 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337, and 512(b)(5). See § 16A.1255–2 for the extent to which section 1255(a)(1) overrides sections 332, 351, 361, 371(a), 374(a), 721, 731, 1031, and 1033.

(3) *Installment method.* Gain from a disposition to which section 1255(a)(1) applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such a case, the portion of the installment payment that is gain is treated as follows: first as ordinary gain under other sections of Chapter I Subchapter P, Part IV of the Code until all that gain has been reported; next as ordinary gain to which section 1255 applies until all that gain is reported; and finally as gain under other sections of Chapter I, Subchapter D, Part IV of the Code. For treatment of amounts as interest on certain deferred payments, see section 483.

(4) *Exempt income.* With regard to exempt income, the principles of § 1.1245–6(e) shall be applicable.

(5) *Treatment of gain not recognized under section 1255(a)(1).* For treatment of gain not recognized under this section, the principles of § 1.1245–6(f) shall be applicable.

(d) *Example.* The provisions of this section may be illustrated by the following example:

*Example.* Individual A uses the calendar year as his taxable year. On April 10, 1995, A sells for $75,000 section 126 property with an adjusted basis of $52,500 for a realized gain of $22,500. The excludable portion under section 126 was $18,000. A received the section 126 payment on January 5, 1990. No gain is recognized as ordinary gain under sections 1231 through 1254. Because the applicable percentage, 100 percent, of the aggregate of the section 126 improvements ($18,000), $18,000, is lower than the gain realized, $22,500, the amount of gain recognized as ordinary income under section 1255(a)(1) is $18,000. The remaining $4,500 of the gain may be treated as gain from the sale or exchange of property described in section 1231.

## § 16A.1255–2 Special rules.

(a) *Exception for gifts*—(1) *General rule.* In general, no gain shall be recognized under section 1255(a)(1) upon a disposition of section 126 property by gift. For purposes of section 1255 and this paragraph, the term ''gift'' shall have the same meaning as in § 1.1245–4(a) and, with respect to the application of this paragraph, principles illustrated by the examples of § 1.1245–4(a)(2) shall apply.

(2) *Disposition in part a sale or exchange and in part a gift.* Where a disposition of section 126 property is in part a sale or exchange and in part a gift, the amount of gain which shall be recognized as ordinary income under section 1255(a)(1) shall be computed under § 16A.1255–1(a)(1), applied by treating the gain realized (for purposes of § 16A.1255–1(a)(1)(ii)), as the excess of the amount realized over the adjusted basis of the section 126 property.

(3) *Treatment of section 126 property in hands of transferee.* See paragraph (d) of this section for treatment of the transferee in the case of a disposition to which this paragraph applies.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

*Example (1).* On March 2, 1986, A makes a gift to B of a parcel of land having an adjusted basis of $40,000 and fair market value of $65,000. On the date of that gift, the aggregate of excludable portions under section 126 was $24,000. The section 126 payments were all received on January 15, 1981. Upon making the gift, A recognizes no gain under section 1255(a)(1). See paragraph (a)(1) of this section. For treatment of the property in the hands of B, see example (1) of paragraph (d)(3) of this section.

*Example (2).* (i) Assume the same facts as in example (1), except that A transfers the land to B for $50,000. Assume further that no gain is recognized as ordinary income under any other provision of Chapter I, Subchapter P, Part IV of the Code. Thus, the gain realized is $10,000 (amount realized, $50,000, minus adjusted basis, $40,000), and A has made a gift of $15,000 (fair market value, $65,000, minus amount realized, $50,000).

(ii) Upon the transfer of the land to B, A recognizes $10,000 as ordinary income under section 1255(a)(1), computed under paragraph (a)(2) of this section as follows:

| | |
|---|---|
| (1) Aggregate of excludable portions under section 126 | $24,000 |
| (2) Multiply: Applicable percentage for land disposed if within sixth year after section 126 payments were received | 100 |
| (3) Amount in § 16A.1255–1(a)(1)(i) | $24,000 |
| (4) Gain realized (see (i) of this example) | 10,000 |
| (5) Amount in § 16A.1255–1(a)(1)(ii) applied in accordance with paragraph (a)(2) of this section | 10,000 |
| (6) Lower of line (3) or line (5) | 10,000 |

Thus, the entire gain realized on the transfer, $10,000, is recognized as ordinary income.

For treatment of the farm land in the hands of B, see example (2) of paragraph (d)(3) of this section.

(b) *Exception for transfer at death*—(1) *In general.* Except as provided in section 691 (relating to income in respect of a decedent), no gain shall be recognized under section 1255(a)(1) upon a transfer at death. For purposes of section 1255 and this paragraph, the term ''transfer at death'' shall have the same meaning as in § 1.1245–4(b) and, with respect to the application of this paragraph, principles illustrated by the examples of § 1.1245–4(b)(2) shall apply.

(2) *Treatment of section 126 property in hands of transferee.* If, as of the date a person acquires section 126 property from a decedent, the person's basis is determined by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death, or on the applicable date provided in section 2032 (relating to alternative valuation date), then on that date the aggregate of excludable portions under section 126 in the hands of such transferee is zero.

(c) *Limitation for certain tax-free transactions*—(1) *Limitation on amount of gain.* Upon a transfer of section 126 property described in paragraph (c)(2) of this section, the amount of gain recognized as ordinary income under section 1255(a)(1) shall not exceed an amount equal to the excess (if any) of (i) the amount of gain recognized to the transferor on the transfer (determined without regard to section 1255) over (ii) the amount (if any) of gain recognized as ordinary income under the other provisions of Chapter I, Subchapter P, Part IV of the Code. For purposes of paragraph (c)(1) of this section, the principles of § 1.1245–4(c)(1) shall apply. Thus, in the case of a transfer of section 126 property and other property in one transaction, the amount realized from the disposition of the section 126 property (as determined

in a manner consistent with the principles of § 1.1245–1(a)(5)) shall consist of that portion of the fair market value of each property acquired which bears the same ratio to the fair market value of the acquired property as the amount realized from the disposition of the section 126 property bears to the total amount realized. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard to section 1255) which is eligible to be recognized as ordinary income under section 1255(a)(1). The provisions of this paragraph do not apply to a disposition of property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by Chapter I of the Code.

(2) *Transfers covered.* The transfers referred to in paragraph (c)(1) of this section are transfers of section 126 property in which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(i) Section 332 (relating to distributions in complete liquidation of an 80-percent-or-more controlled subsidiary corporation). For application of paragraph (c)(1) of this section to such a complete liquidation, the principles of § 1.1245–4(c)(3) shall apply. Thus, for example, the provisions of paragraph (c)(1) of this section do not apply to a liquidating distribution of section 126 property by an 80-percent-or-more controlled subsidiary to its parent if the parent's basis for the property is determined, under section 334(b)(2), by reference to its basis for the stock of the subsidiary.

(ii) Section 351 (relating to transfer to a corporation controlled by the transferor).

(iii) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(iv) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(v) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(vi) Section 721 (relating to transfers to a partnership in exchange for a partnership interest). See paragraph (e) of this section.

(vii) Section 731 (relating to distributions by a partnership to a partner). For special carryover of basis rule, see paragraph (e) of this section.

(viii) Section 1031 (relating to like kind exchanges).

(ix) Section 1034 (relating to rollover of gain on the sale of a principal residence).

(3) *Treatment of section 126 property in the hands of transferee.* See paragraph (d) of this section for treatment of the transferee in the case of a disposition to which this paragraph applies.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

*Example (1).* On January 4, 1986, A holds a parcel of property that is section 126 property having an adjusted basis of $15,000 and a fair market value of $40,000. On that date he transfers the parcel to corporation M in exchange for stock in the corporation worth $40,000 in a transaction qualifying under section 351. On the date of the transfer, the aggregate of excludable portions under section 126 with respect to the transferred property is $18,000 and all of such amount was received on March 25, 1981. With regard to section 1255, A would recognize no gain under section 351 upon the transfer and M's basis for the land would be determined under section 362(a) by reference to its basis in the hands of A. Thus, as a result of the disposition, no gain is recognized as ordinary income under section 1255 by A since the amount of gain recognized under that section is limited to the amount of gain which is recognized under section 351 (determined without regard to section 1255). See paragraph (c)(1) of this section. For treatment of the section 126 property in the hands of B, see paragraph (d)(1) of this section.

*Example (2).* Assume the same facts in example (1), except that A transferred the property to M for stock in the corporation worth $32,000 and $8,000 cash. The gain realized is $25,000 (amount realized, $40,000, minus adjusted basis, $15,000). Without regard to section 1255, A would recognize $8,000 of gain under section 351(b). Assume further that no gain is recognized as ordinary income under the other provisions of Chapter I, Subchapter P, Part IV of the Code. Therefore, since the applicable percentage, 100 percent of the aggregate excludable portions under section 126, $18,000, is lower than the gain realized, $25,000, the amount of gain to be recognized as ordinary income under section 1255(a)(1) would be $18,000 if the provisions of paragraph (c)(1) of this section do not apply. Since under section 351(b) gain in

the amount of $8,000 would be recognized to the transferor without regard to section 1255, the limitation provided in paragraph (c)(1) of this section limits the gain taken into account by A under section 1255(a)(1) to $8,000.

*Example (3).* Assume the same facts as in example (2), except that $5,000 of gain is recognized as ordinary income under section 1251(c)(1). The amount of gain recognized as ordinary income under section 1255(a)(1) is $3,000 computed as follows:

| | |
|---|---|
| (1) Amount of gain under section 1255(a)(1) (determined without regard to paragraph (c)(1) of this section): | |
| (a) Aggregate of excludable portions under section 126 | $18,000 |
| (b) Multiply: Applicable percentage for property disposed of within the fifth year after section 126 payments were received (percent) | 100 |
| (c) Amount in § 16A.1255–1(a)(1)(i) | $18,000 |
| (d) Gain realized (amount realized $40,000 less adjusted basis, $15,000) | $25,000 |
| (e) Lower of line (c) or line (d) | $18,000 |
| (2) Limitation in paragraph (c)(1) of this section: | |
| (a) Gain recognized (determined without regard to section 1255) | $8,000 |
| (b) Minus: Gain recognized as ordinary income under section 1251(c)(1) | $5,000 |
| (c) Difference | $3,000 |
| (3) Lower of line (1)(e) or line (2)(c) | $3,000 |

Thus, the entire gain recognized under section 351(b) (determined without regard to sections 1251 and 1255), $8,000, is recognized as ordinary income since that amount is equal to the sum of the gain recognized as ordinary income under section 1251(c)(1), $5,000, and under section 1255(a)(1), $3,000.

(d) *Treatment of section 126 property received by a transferee in a disposition by gift and certain tax-free transactions*—(1) *General rule.* If section 126 property is disposed of in a transaction which is either a gift to which paragraph (a)(1) of this section applies, or a completely tax-free transfer to which paragraph (c)(1) of this section applies, then for purposes of section 1255—

(i) The aggregate of the excludable portions under section 126 in respect of the land in the hands of the transferee immediately after the disposition shall be an amount equal to the amount of such aggregate in the hands of the transferor immediately before the disposition, and

(ii) For purposes of applying section 1255 upon a subsequent disposition by the transferee (including a computation of the applicable percentage), the dates of receipt of section 126 payments shall not be affected by the dispositions.

(2) *Certain partially tax-free transfers.* If section 126 property is disposed of in a transaction which either is in part a sale or exchange and in part a gift to which paragraph (a)(2) of this section applies, or is a partially tax-free transfer to which paragraph (c)(1) of this section applies, then for purposes of section 1255 the amount determined under paragraph (d)(1) of this section shall be reduced by the amount of gain taken into account under section 1255 by the transferor upon the disposition. Upon a subsequent disposition by the transferee, the dates of receipt of section 126 payments remain the same in the hands of the transferee as they were in the hands of the transferor. With respect to the 175 and 182 deductions taken by the transferee, the holding period shall not include the holding period of the transferor.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

*Example (1).* Assume the same facts as in example (1) of paragraph (a)(4) of this section. Therefore, on the date B receives the land in the gift transaction, under paragraph (d)(1) of this section the aggregate of excludable portions under section 126 in respect of the land in the hands of B is the amount in the hands of A, $24,000, and for purposes of applying section 1255 upon a subsequent disposition by B (including a computation of the applicable percentage) the date the section 126 payments were received is the same as it was when the property was in A's hands (January 15, 1981).

*Example (2).* Assume the same facts as in example (2) of paragraph (a)(4) of this section. Under paragraph (d)(2) of this section, the aggregate of excludable portions under section 126 which pass over to B for purposes of section 1255 is $14,000 ($24,000 excluded under section 126 minus $10,000 gain recognized under section 1255(d)(1) in accordance with example (2) of paragraph (a)(4) of this section). The date the section 126 payments were received is the same as when the property was in B's hands (January 15, 1981).

(e) *Disposition of section 126 property not specifically covered.* If section 126 property is disposed of in a transaction not specifically covered under § 16A.1255–1, and this section, then the principles of section 1245 shall apply.

# PART 17—TEMPORARY INCOME TAX REGULATIONS UNDER 26 U.S.C. 103(c)

AUTHORITY: Sec. 7805 of the Internal Revenue Code of 1954; 68A Stat. 917 (26 U.S.C. 7805).

## § 17.1 Industrial development bonds used to provide solid waste disposal facilities; temporary rules.

(a) *In general.* Section 103(c)(4)(E) provides that section 103(c)(1) shall not apply to obligations issued by a State or local governmental unit which are part of an issue substantially all the proceeds of which are used to provide solid waste disposal facilities. Section 1.103–8(f) of this chapter provides general rules with respect to such facilities and defines such facilities. In the case of property which has both a solid waste disposal function and a function other than the disposal of solid waste, only the portion of the cost of the property allocable to the function of solid waste disposal (as determined under paragraph (b) of this section) is taken into account as an expenditure to provide solid waste disposal facilities. A facility which otherwise qualifies as a solid waste disposal facility will not be treated as having a function other than solid waste disposal merely because material or heat which has utility or value is recovered or results from the disposal process. Where materials or heat are recovered, the waste disposal function includes the processing of such materials or heat which occurs in order to put them into the form in which the materials or heat are in fact sold or used, but does not include further processing which converts the materials or heat into other products.

(b) *Allocation.* The portion of the cost of property allocable to solid waste disposal is determined by allocating the cost of such property between the property's solid waste disposal function and any other functions by any method which, with reference to all the facts and circumstances with respect to such property, reasonably reflects a separation of costs for each function of the property.

(c) *Example.* The principles of this paragraph may be illustrated by the following example:

*Example.* Company A intends to construct a new facility to process solid waste which City X will deliver to the facility. City X will pay a disposal fee for each ton of solid waste that City X dumps at the facility. The waste will be processed by A in a manner which separates metals, glass, and similar materials. As separated, some of such items are commercially saleable; but A does not intend to sell the metals and glass until the metals are further separated, sorted, sized, and cleaned and the glass is pulverized. The metals and pulverized glass will then be sold to commercial users. The waste disposal function includes such processing of the metals and glass, but no further processing is included.

The remaining waste will be burned in an incinerator. Gases generated by the incinerator will be cleaned by use of an electrostatic precipitator. To reduce the size and cost of the electrostatic precipitator, the incinerator exhaust gases will be cooled and reduced in volume by means of a heat exchange process using boilers. The precipitator is functionally related and subordinate to disposal of the waste residue and is therefore property used in solid waste disposal. The heat can be used by A to produce steam. Company B operates an adjacent electric generating facility and B can use steam to power its turbine-generator. B needs steam with certain physical characteristics and as a result A's boilers, heat exchanger and related equipment are somewhat more costly than might be required to produce steam for some other uses. The disposal function includes the equipment actually used to put the heat into the form in which it is sold.

Company A intends to construct pipes to carry the steam from A's boiler to B's facility. When converted to such steam the heat is in the form in which sold, and therefore the disposal function does not include subsequent transporting of the steam by pipes. Similarly, if A installed generating equipment and used the steam to generate electricity, the disposal function would not include the generating equipment, since such equipment transforms the commercially saleable steam into another form of energy.

[T.D. 7362, 40 FR 26028, June 20, 1975]

# PART 18—TEMPORARY INCOME TAX REGULATIONS UNDER THE SUBCHAPTER S REVISION ACT OF 1982

Sec.
18.0 Effective date of temporary regulations under the Subchapter S Revision Act of 1982.
18.1371–1 Election to treat distributions as dividends during certain post-termination transition periods.
18.1378–1 Taxable year of S corporation.
18.1379–1 Transitional rules on enactment.
18.1379–2 Special rules for all elections, consents, and refusals.

AUTHORITY: 26 U.S.C. 7805.

SOURCE: T.D. 7872, 48 FR 3590, Jan. 26, 1983, unless otherwise noted.

## § 18.0 Effective date of temporary regulations under the Subchapter S Revision Act of 1982.

The temporary regulations provided under § 18.1377–1, 18.1379–1, and 18.1379–2 are effective with respect to taxable years beginning after 1982, and the temporary regulations provided under § 18.1378–1 are effective with respect to elections made after October 19, 1982.

[T.D. 8600, 60 FR 37588, July 21, 1995]

## § 18.1371–1 Election to treat distributions as dividends during certain post-termination transition periods.

A corporation may make an election under section 1371(e) (as amended by section 721(o) of the Act) to treat all distributions of money made during the post-termination transition period described in section 1377(b)(1)(A) as coming out of the corporation's earnings and profits (after earnings and profits have been eliminated, the distributions are applied against and reduce the adjusted basis of the stock). The election may be made only with the consent of each shareholder to whom the corporation makes a distribution (whether or not it is a cash distribution) during such post-termination transition period. Any such election shall be made by the corporation by attaching to its income tax return for the C year in which such post-termination transition period ends a statement which clearly indicates that the corporation elects to have section 1371(e)(1) not apply to all distributions made during such post-termination transition period. The election shall not be effective unless such statement is signed by a person authorized to sign the return required to be filed under section 6012 and by each shareholder required to consent to the election.

[T.D. 7976, 49 FR 35493, Sept. 10, 1984]

## § 18.1378–1 Taxable year of S corporation.

(a) *In general.* No corporation may make an election be an S corporation for any taxable year unless the taxable year is a permitted year. In addition, an S corporation shall not change its taxable year to any taxable year other than a permitted year. A permitted year is a taxable year ending on December 31 or is any other taxable year for which the corporation establishes a business purpose (within the meaning of § 1.442–1(b)(1)) to the satisfaction of the Commissioner.

(b) *Corporations qualifying for automatic change of taxable year to a taxable year ending December 31 and corporations adopting a taxable year ending December 31*—(1) *Qualification for automatic change.* Notwithstanding section 442 (relating to change of taxable year) and the regulations thereunder, a corporation may automatically change its taxable year to a taxable year ending on December 31 to comply with the permitted year requirement if all of its principal shareholders have taxable years ending on December 31, or if all of its principal shareholders concurrently change to such taxable year. A shareholder may not change his or her taxable year without securing prior approval from the Commissioner. See section 442 and the regulations thereunder. For purposes of this paragraph, a principal shareholder is a shareholder having 5% or more of the issued and outstanding stock of the corporation. See paragraph (d) of this section in the case where a corporation does not qualify under this subparagraph for an automatic change of its taxable year to a taxable year ending on December 31.

(2) *Effect of filing an election*—(i) *General rule.* The filing of an election to be an S corporation by a corporation that has, prior to making the election, adopted a taxable year ending other than on December 31, and that qualifies

under paragraph (b)(1) of this section for an automatic change of its taxable year to a taxable year ending on December 31, shall constitute such automatic change for the first taxable year for which the election is effective. The filing of an election to be an S corporation by a corporation that has not, prior to making the election, adopted a taxable year shall constitute the adoption of a taxable year (or, if the corporation qualifies under paragraph (b)(1) of this section for the automatic change, the change to a taxable year) ending on December 31 for the first taxable year for which the election is effective. Where the taxable year has been changed pursuant to this subdivision and paragraph (b)(1) of this section, the first taxable year for which the election shall be effective shall commence on the first day of the first taxable year for which the election would have been effective if the taxable year had not been changed and shall end on December 31 of that taxable year. See § 1.1362–6(b)(2)(ii) of this chapter for the time within which to make an election to be an S corporation.

(ii) *Request to retain (or adopt) a taxable year ending other than December 31.* A request to retain (or adopt) a taxable year ending other than on December 31 by a corporation subject to paragraph (b)(2)(i) of this section shall (except as provided in paragraph (b)(3)(ii) of this paragraph and in paragraph (c) of this section) be made on Form 2553 when the election to be an S corporation is filed. See § 1.1362–6(b)(2)(i) of this chapter for the manner of making an election to be an S corporation. If such corporation receives permission to retain (or adopt) a taxable year ending other than on December 31, the election shall be effective and the provisions of paragraph (b)(2)(i) of this section shall be inapplicable. Denial of the request shall render the election ineffective unless—

(A) The request is accompanied by another request in which the corporation states that, in the event the request to retain (or adopt) a taxable year ending other than on December 31 is denied, it chooses to be governed by the provisions of paragraph (b)(2)(i) of this section, or

(B) The Commissioner waives the requirement to file the additional request described in paragraph (b)(2)(ii)(A) of this section and permits the corporation to be governed by the provisions of paragraph (b)(2)(i) of this section.

(c) [Reserved]

(d) *Elections by corporations not qualifying for automatic change.* An election to be an S corporation made after October 19, 1982, by a corporation that has a taxable year ending other than on December 31, and that does not qualify under paragraph (b)(1) of this section for an automatic change of its taxable year to a taxable year ending on December 31, shall be ineffective unless the corporation has first secured a permitted year. At the request of a corporation wishing to secure a permitted year, the Commissioner shall make a determination that—

(1) The corporation's taxable year is a permitted year, or

(2) The corporation may, under § 1.442–1(b)(1), change its taxable year to a taxable year ending on December 31, or

(3) The corporation may, under §1.442–1(b)(1), change its taxable year to a taxable year ending other than on December 31, which taxable year shall be a permitted year.

[T.D. 7872, 48 FR 3590, Jan. 26, 1983; 48 FR 33481, July 22, 1983, as amended by T.D. 8123, 52 FR 3623, Feb. 5, 1987; T.D. 8600, 60 FR 37589, July 21, 1995]

### § 18.1379–1 Transitional rules on enactment.

(a) *Prior elections.* Any election that was made under section 1372(a) (as in effect before the enactment of the Subchapter S Revision Act of 1982), and that is still in effect as of the first day of a taxable year beginning in 1983, shall be treated as being an election made under section 1362(a). In addition, any election that was made under section 1371(g)(2) (as in effect before the enactment of that Act), and that is still in effect as of the first day of a taxable year beginning in 1983, shall be treated as being an election made under section 1362(d)(2).

(b) *Prior terminations.* For purposes of section 1362(g), any termination under section 1372(e) (as in effect before the

enactment of the Subchapter S Revision Act of 1982) shall not be taken into account.

(c) *Time and manner of making an election under section 6(c)(3)(B) of the Subchapter S Revision Act of 1982.* In the case of a qualified oil corporation (as defined in section 6(c)(3)(B) of the Subchapter S Revision Act of 1982), the corporation may elect under that section of the Act to have the amendments made by the Act not apply and to have Subchapter S (as in effect on July 1, 1982), Chapter I of the Internal Revenue Code of 1954 apply. The election shall be made by the corporation by filing a statement that—

(1) Contains the name, address, and taxpayer identification number of the corporation and of each shareholder,

(2) Identifies the election as an election under section 6(c)(3)(B) of the Subchapter S Revision Act of 1982, and

(3) Provides all information necessary in the judgment of the district director to show that the corporation meets the requirements (other than the requirement of making this election) of a qualified oil corporation.

The statement shall be signed by any person authorized to sign the return required to be filed under section 6037 and by each person who is or was a shareholder in the corporation at any time during the taxable year beginning in 1983 and shall be filed with the return for that taxable year.

### § 18.1379–2 Special rules for all elections, consents, and refusals.

(a) *Additional information required.* If later regulations issued under the section of the Code or of the Subchapter S Revision Act of 1982 under which the election, consent, or refusal was made require the furnishing of information in addition to that which was furnished with the statement of election, consent, or refusal as provided by part 18 of this title, and if an office of the Internal Revenue Service requests the taxpayer to provide the additional information, the taxpayer shall furnish the additional information in a statement filed with that office of the Internal Revenue Service within 60 days after the date on which the request is made. This statement shall also—

(1) Contain the name, address, and taxpayer identification number of each party identified in connection with the election, consent, or refusal,

(2) Identify the election, consent, or refusal by reference to the section of the Code or Act under which the election, consent, or refusal was made, and

(3) Specify the scope of the election, consent, or refusal.

If the additional information is not provided within 60 days after the date on which the request is made, the election, consent, or refusal may, at the discretion of the Commissioner, be held invalid.

(b) *State law incorporator.* For purposes of any election, consent, or refusal provided in part 18 of this title, any person who is considered to be a shareholder for state law purposes solely by virtue of his or her status as an incorporator shall not be treated as a shareholder.

## PART 19—TEMPORARY REGULATIONS UNDER THE REVENUE ACT OF 1964

AUTHORITY: 26 U.S.C. 7805.

### § 19.3–1 Interest on certain deferred payments; interest rate for use in determining whether there is total unstated interest under a contract.

(a) *In general.* Section 224(a) of the Revenue Act of 1964 adds a new section 483 to the Internal Revenue Code of 1954. Section 483(a) provides, generally, that in the case of any contract for the sale or exchange of property (which is a capital asset or section 1231 property) there shall be treated as interest that part of a payment to which section 483 applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which such section applies which are due under the contract. Section 483(b) defines the term ''total unstated interest'', with respect to a contract for the sale or exchange of property, as an amount equal to the excess of—

(1) The sum of the payments to which section 483 applies which are due under the contract, over

(2) The sum of the present values of such payments and the present values of any interest payments due under the contract.

Section 483(b) further provides that, for purposes of section 483(b)(2), the present value of a payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary or his delegate, and that such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment. Section 483(c) provides that, except as provided in section 483(f) (relating to exceptions and limitations), section 483 shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract under which some or all of the payments are due more than one year after the date of such sale or exchange, and under which, using a rate provided by regulations (for purposes of section 483(c)(1)(B)), there is total unstated interest. Section 483(c) further provides that any rate prescribed for determining whether there is total unstated interest for purposes of section 483(c)(1)(B) shall be at least one percentage point lower than the rate prescribed for purposes of section 483(b)(2).

(b) *Rate of interest and table of present values for purposes of section 483(c)(1)(B).* For purposes of determining under section 483(c)(1)(B) whether there is total unstated interest under a contract (other than a contract of sale or exchange under which the purchaser is the United States, a State, or any other purchaser described in section 103) which provides for the payment of some interest, a rate of 4 percent per annum simple interest shall be used. As an illustration of the meaning of simple interest, if a contract provides for payments of $6,000 in 3 equal installments of $2,000 plus 4 percent per annum simple interest, such installments of principal and interest being due 1, 2, and 3 years, respectively, from the date of the sale, the amount of interest due with the first installment is $80 ($2,000×0.04×1), the amount of interest due with the second installment is $160 ($2,000×0.04×2), and the amount of interest due with the third installment is $240 ($2,000×0.04×3). Section 483 shall not apply if the interest payments specified in a contract are at a rate of at least 4 percent per annum, whether simple or compounded. In all other cases, for purposes of determining, under section 483(c)(1)(B), whether there is total unstated interest, under a contract (not involving a purchaser described in section 103), the following table, which provides for discounting payments at a 4 percent per annum simple interest rate, shall be used for computing the present value of a payment to which section 483 applies which is due under the contract, and the present value of any interest payment due under the contract:

PRESENT VALUE OF DEFERRED PAYMENT (4 PERCENT PER ANNUM SIMPLE INTEREST)

| Number of months deferred | | Present value of $1 at 4% simple interest |
|---|---|---|
| At least | But less than | |
| 0 | 6 | 1.00000 |
| 6 | 9 | .98039 |
| 9 | 15 | .96154 |
| 15 | 21 | .94340 |
| 21 | 27 | .92593 |
| 27 | 33 | .90909 |
| 33 | 39 | .89286 |
| 39 | 45 | .87719 |
| 45 | 51 | .86207 |
| 51 | 57 | .84746 |
| 57 | 63 | .83333 |
| 63 | 69 | .81967 |
| 69 | 75 | .80645 |
| 75 | 81 | .79365 |
| 81 | 87 | .78125 |
| 87 | 93 | .76923 |
| 93 | 99 | .75758 |
| 99 | 105 | .74627 |
| 105 | 111 | .73529 |
| 111 | 117 | .72464 |
| 117 | 123 | .71429 |
| 123 | 129 | .70423 |
| 129 | 135 | .69444 |
| 135 | 141 | .68493 |
| 141 | 147 | .67568 |
| 147 | 153 | .66667 |
| 153 | 159 | .65789 |
| 159 | 165 | .64935 |
| 165 | 171 | .64103 |
| 171 | 177 | .63291 |
| 177 | 183 | .62500 |

PRESENT VALUE OF DEFERRED PAYMENT (4 PERCENT PER ANNUM SIMPLE INTEREST)—Continued

| Number of months deferred | | Present value of $1 at 4% simple interest |
|---|---|---|
| At least | But less than | |
| 183 | 189 | .61728 |
| 189 | 195 | .60976 |
| 195 | 201 | .60241 |
| 201 | 207 | .59524 |
| 207 | 213 | .58824 |
| 213 | 219 | .58140 |
| 219 | 225 | .57471 |
| 225 | 231 | .56818 |
| 231 | 237 | .56180 |
| 237 | 243 | .55556 |
| 243 | 249 | .54945 |
| 249 | 255 | .54348 |
| 255 | 261 | .53763 |
| 261 | 267 | .53191 |
| 267 | 273 | .52632 |
| 273 | 279 | .52083 |
| 279 | 285 | .51546 |
| 285 | 291 | .51020 |
| 291 | 297 | .50505 |
| 297 | 303 | .50000 |
| 303 | 309 | .49505 |
| 309 | 315 | .49020 |
| 315 | 321 | .48544 |
| 321 | 327 | .48077 |
| 327 | 333 | .47619 |
| 333 | 339 | .47170 |
| 339 | 345 | .46729 |
| 345 | 351 | .46296 |
| 351 | 357 | .45872 |
| 357 | 363 | .45455 |
| 363 | 369 | .45045 |
| 369 | 375 | .44643 |
| 375 | 381 | .44248 |
| 381 | 387 | .43860 |
| 387 | 393 | .43478 |
| 393 | 399 | .43103 |
| 399 | 405 | .42735 |
| 405 | 411 | .42373 |
| 411 | 417 | .42017 |
| 417 | 423 | .41667 |
| 423 | 429 | .41322 |
| 429 | 435 | .40984 |
| 435 | 441 | .40650 |
| 441 | 447 | .40323 |
| 447 | 453 | .40000 |
| 453 | 459 | .39683 |
| 459 | 465 | .39370 |
| 465 | 471 | .39063 |
| 471 | 477 | .38760 |
| 477 | 483 | .38462 |
| 483 | 489 | .38168 |
| 489 | 495 | .37879 |
| 495 | 501 | .37594 |
| 501 | 507 | .37313 |
| 507 | 513 | .37037 |
| 513 | 519 | .36765 |
| 519 | 525 | .36496 |
| 525 | 531 | .36232 |

PRESENT VALUE OF DEFERRED PAYMENT (4 PERCENT PER ANNUM SIMPLE INTEREST)—Continued

| Number of months deferred | | Present value of $1 at 4% simple interest |
|---|---|---|
| At least | But less than | |
| 531 | 537 | .35971 |
| 537 | 543 | .35714 |
| 543 | 549 | .35461 |
| 549 | 555 | .35211 |
| 555 | 561 | .34965 |
| 561 | 567 | .34722 |
| 567 | 573 | .34483 |
| 573 | 579 | .34247 |
| 579 | 585 | .34014 |
| 585 | 591 | .33784 |
| 591 | 597 | .33557 |
| 597 | 603 | .33333 |
| 603 | 609 | .33113 |
| 609 | 615 | .32895 |
| 615 | 621 | .32680 |
| 621 | 627 | .32468 |
| 627 | 633 | .32258 |
| 633 | 639 | .32051 |
| 639 | 645 | .31847 |
| 645 | 651 | .31646 |
| 651 | 657 | .31447 |
| 657 | 663 | .31250 |
| 663 | 669 | .31056 |
| 669 | 675 | .30864 |
| 675 | 681 | .30675 |
| 681 | 687 | .30488 |
| 687 | 693 | .30303 |
| 693 | 699 | .30120 |
| 699 | 705 | .29940 |
| 705 | 711 | .29762 |
| 711 | 717 | .29586 |
| 717 | 723 | .29412 |

To compute the present value of a payment, multiply the amount of the payment by the factor contained in the present value column for the appropriate number of months the payment is deferred. For example, the present value of an installment payment of $5,000 due 2 years (24 months) from the date of the sale would be $4,629.65 ($5,000×0.92593).

(c) *Effective date.* The provisions of section 483 and these temporary regulations shall apply to payments made after December 31, 1963, on account of sales or exchanges of property occurring after June 30, 1963, other than any sale or exchange made pursuant to a binding written contract (including an irrevocable written option) entered into before July 1, 1963.

[T.D. 6720, 29 FR 4882, Apr. 7, 1964]

# SUBCHAPTER B—ESTATE AND GIFT TAXES

## PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

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AUTHORITY: 26 U.S.C. 7805.

Section 20.2031–7 also issued under 26 U.S.C. 7520(c)(2).

Section 20.2031–7A also issued under 26 U.S.C. 7520(c)(2).

Section 20.7520–1 also issued under 26 U.S.C. 7520(c)(2).

Section 20.7520–2 also issued under 26 U.S.C. 7520(c)(2).

Section 20.7520–3 also issued under 26 U.S.C. 7520(c)(2).

Section 20.7520–4 also issued under 26 U.S.C. 7520(c)(2).

SOURCE: T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, unless otherwise noted.

INTRODUCTION

## § 20.0–1 Introduction.

(a) *In general.* (1) The regulations in this part (part 20, subchapter B, chapter I, title 26, Code of Federal Regulations) are designated ''Estate Tax Regulations.'' These regulations pertain to (i) the Federal estate tax imposed by chapter 11 of subtitle B of the Internal Revenue Code on the transfer of estates of decedents dying after August 16,

1954, and (ii) certain related administrative provisions of subtitle F of the Code. It should be noted that the application of many of the provisions of these regulations may be affected by the provisions of an applicable death tax convention with a foreign country. Unless otherwise indicated, references in the regulations to the ''Internal Revenue Code'' or the ''Code'' are references to the Internal Revenue Code of 1954, as amended, and references to a section or other provision of law are references to a section or other provision of the Internal Revenue Code of 1954, as amended. Unless otherwise provided, the Estate Tax Regulations are applicable to the estates of decedents dying after August 16, 1954, and supersede the regulations contained in part 81, subchapter B, chapter I, title 26, *Code of Federal Regulations* (1939) (Regulations 105, Estate Tax), as prescribed and made applicable to the Internal Revenue Code of 1954 by Treasury Decision 6091, signed August 16, 1954 (19 FR 5167, Aug. 17, 1954). The regulations in this part do not reflect the amendments made by the Foreign Investors Tax Act of 1966 (80 Stat. 1539).

(2) Section 2208 makes the provisions of chapter 11 of the Code apply to the transfer of the estates of certain decedents dying after September 2, 1958, who were citizens of the United States and residents of a possession thereof at the time of death. Section 2209 makes the provisions of chapter 11 apply to the transfer of the estates of certain other decedents dying after September 14, 1960, who were citizens of the United States and residents of a possession thereof at the time of death. See §§ 20.2208–1 and 20.2209–1. Except as otherwise provided in §§ 20.2208–1 and 20.2209–1, the provisions of these regulations do not apply to the estates of such decedents.

(b) *Scope of regulations*—(1) *Estates of citizens or residents.* Subchapter A of Chapter 11 of the Code pertains to the taxation of the estate of a person who was a citizen or a resident of the United States at the time of his death. A ''resident'' decedent is a decedent who, at the time of his death, had his domicile in the United States. The term ''United States'', as used in the estate tax regulations, includes only the States and the District of Columbia. The term also includes the Territories of Alaska and Hawaii prior to their admission as States. See section 7701(a)(9). A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal. For the meaning of the term ''citizen of the United States'' as applied in a case where the decedent was a resident of a possession of the United States, see § 20.2208–1. The regulations pursuant to subchapter A are set forth in §§ 20.2001–1 to 20.2056(d)–1.

(2) *Estates of nonresidents not citizens.* Subchapter B of Chapter 11 of the Code pertains to the taxation of the estate of a person who was a nonresident not a citizen of the United States at the time of his death. A ''nonresident'' decedent is a decedent who, at the time of his death, had his domicile outside the United States under the principles set forth in subparagraph (1) of this paragraph. (See, however, section 2202 with respect to missionaries in foreign service.) The regulations pursuant to subchapter B are set forth in §§ 20.2101–1 to 20.2107–1.

(3) *Miscellaneous substantive provisions.* Subchapter C of Chapter 11 of the Code contains a number of miscellaneous substantive provisions. The regulations pursuant to subchapter C are set forth in §§ 20.2201–1 to 20.2209–1.

(4) *Procedure and administration provisions.* Subtitle F of the Internal Revenue Code contains some sections which are applicable to the Federal estate tax. The regulations pursuant to those sections are set forth in §§ 20.6001–1 to 20.7101–1. Such regulations do not purport to be all the regulations on procedure and administration which are pertinent to estate tax matters. For the remainder of the regulations on procedure and administration which are pertinent to estate tax matters, see part 301 (Regulations on Procedure and Administration) of this chapter.

(c) *Arrangement and numbering.* Each section of the regulations in this part (other than this section and § 20.0–2) is designated by a number composed of the part number followed by a decimal point (20.); the section of the Internal Revenue Code which it interprets; a hyphen (-); and a number identifying the section. By use of these designations one can ascertain the sections of the regulations relating to a provision of the Code. For example, the regulations pertaining to section 2012 of the Code are designated § 20.2012–1.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6526, 26 FR 414, Jan. 19, 1961; T.D. 7238, 37 FR 28717, Dec. 29, 1972; T.D. 7296, 38 FR 34191, Dec. 12, 1973; T.D. 7665, 45 FR 6089, Jan. 25, 1980; T.D. 8522, 59 FR 9646, Mar. 1, 1994]

### § 20.0–2 General description of tax.

(a) *Nature of tax.* The Federal estate tax is neither a property tax nor an inheritance tax. It is a tax imposed upon the transfer of the entire taxable estate and not upon any particular legacy, devise, or distributive share. Escheat of a decedent's property to the State for lack of heirs is a transfer which causes the property to be included in the decedent's gross estate.

(b) *Method of determining tax; estate of citizen or resident*—(1) *In general.* Subparagraphs (2) to (5) of this paragraph contain a general description of the method to be used in determining the Federal estate tax imposed upon the transfer of the estate of a decedent who was a citizen or resident of the United States at the time of his death.

(2) *Gross estate.* The first step in determining the tax is to ascertain the total value of the decedent's gross estate. The value of the gross estate includes the value of all property to the extent of the interest therein of the decedent at the time of his death. (For certain exceptions in the case of real property situated outside the United States, see paragraphs (a) and (c) of § 20.2031–1.) In addition, the gross estate may include property in which the decedent did not have an interest at the time of his death. A decedent's gross estate for Federal estate tax purposes may therefore be very different from the same decedent's estate for local probate purposes. Examples of items which may be included in a decedent's gross estate and not in his probate estate are the following: certain property transferred by the decedent during his lifetime without adequate consideration; property held jointly by the decedent and others; property over which the decedent had a general power of appointment; proceeds of certain policies of insurance on the decedent's life; annuities; and dower or curtesy of a surviving spouse or a statutory estate in lieu thereof. For a detailed explanation of the method of ascertaining the value of the gross estate, see sections 2031 through 2044, and the regulations thereunder.

(3) *Taxable estate.* The second step in determining the tax is to ascertain the value of the decedent's taxable estate. The value of the taxable estate is determined by subtracting from the value of the gross estate the authorized exemption and deductions. Under various conditions and limitations, deductions are allowable for expenses, indebtedness, taxes, losses, charitable transfers, and transfers to a surviving spouse. For a detailed explanation of the method of ascertaining the value of the taxable estate, see sections 2051 through 2056, and the regulations thereunder.

(4) *Gross estate tax.* The third step is the determination of the gross estate tax. This is accomplished by the application of certain rates to the value of the decedent's taxable estate. In this connection, see section 2001 and the regulations thereunder.

(5) *Net estate tax payable.* The final step is the determination of the net estate tax payable. This is done by subtracting from the gross estate tax the authorized credits against tax. Under certain conditions and limitations, credits are allowable for the following (computed in the order stated below):

(i) State death taxes paid in connection with the decedent's estate (section 2011);

(ii) Gift taxes paid on inter-vivos transfers by the decedent of property included in his gross estate (section 2012);

(iii) Foreign death taxes paid in connection with the decedent's estate (section 2014); and

(iv) Federal estate taxes paid on transfers of property to the decedent (section 2013).

Sections 25.2701–5 and 25.2702–6 of this chapter contain rules that provide additional adjustments to mitigate double taxation in cases where the amount of the decedent's gift was previously determined under the special valuation provisions of sections 2701 and 2702. For a detailed explanation of the credits against tax, see sections 2011 through 2016 and the regulations thereunder.

(c) *Method of determining tax; estate of nonresident not a citizen.* In general, the method to be used in determining the Federal estate tax imposed upon the transfer of an estate of a decedent who was a nonresident not a citizen of the United States is similar to that described in paragraph (b) of this section with respect to the estate of a citizen or resident. Briefly stated, the steps are as follows: First, ascertain the sum of the value of that part of the decedent's ''entire gross estate'' which at the time of his death was situated in the United States (see §§ 20.2103–1 and 20.2014–1) and, in the case of an estate of an expatriate to which section 2107 applies, any amounts includible in his gross estate under section 2107(b) (see paragraph (b) of § 20.2107–1); second, determine the value of the taxable estate by subtracting from the amount determined under the first step the amount of the allowable deductions (see § 20.2106–1); third, compute the gross estate tax on the taxable estate (see § 20.2106–1); and fourth, subtract from the gross estate tax the total amount of any allowable credits in order to arrive at the net estate tax payable (see § 20.2102–1 and paragraph (c) of § 20.2107–1).

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6684, 28 FR 11408, Oct. 24, 1963; T.D. 7296, 38 FR 34191, Dec. 12, 1973; T.D. 8395, 57 FR 4254, Feb. 4, 1992]

ESTATES OF CITIZENS OR RESIDENTS

TAX IMPOSED

### § 20.2001–1 Rate of tax.

(a) The gross estate tax is computed by the application of progressively graduated rates to the value of the decedent's taxable estate in accordance with the following table:

TABLE FOR COMPUTATION OF GROSS ESTATE TAX

| (A)—Taxable estate equal to or more than— | (B)—Taxable estate less than— | (C)—Tax on amount in column (A) | (D)—Rate of tax on excess over amount in column (A) (percent) |
|---|---|---|---|
| | $5,000 | ..... | 3 |
| $5,000 | 10,000 | $150 | 7 |
| 10,000 | 20,000 | 500 | 11 |
| 20,000 | 30,000 | 1,600 | 14 |
| 30,000 | 40,000 | 3,000 | 18 |
| 40,000 | 50,000 | 4,800 | 22 |
| 50,000 | 60,000 | 7,000 | 25 |
| 60,000 | 100,000 | 9,500 | 28 |
| 100,000 | 250,000 | 20,700 | 30 |
| 250,000 | 500,000 | 65,700 | 32 |
| 500,000 | 750,000 | 145,700 | 35 |
| 750,000 | 1,000,000 | 233,200 | 37 |
| 1,000,000 | 1,250,000 | 325,700 | 39 |
| 1,250,000 | 1,500,000 | 423,200 | 42 |
| 1,500,000 | 2,000,000 | 528,200 | 45 |
| 2,000,000 | 2,500,000 | 753,200 | 49 |
| 2,500,000 | 3,000,000 | 998,200 | 53 |
| 3,000,000 | 3,500,000 | 1,263,200 | 56 |
| 3,500,000 | 4,000,000 | 1,543,200 | 59 |
| 4,000,000 | 5,000,000 | 1,838,200 | 63 |
| 5,000,000 | 6,000,000 | 2,468,200 | 67 |
| 6,000,000 | 7,000,000 | 3,138,200 | 70 |
| 7,000,000 | 8,000,000 | 3,838,200 | 73 |
| 8,000,000 | 10,000,000 | 4,568,200 | 76 |
| 10,000,000 | ..... | 6,088,200 | 77 |

(b) The application of the table may be illustrated by the following example:

*Example.* The decedent died January 1, 1955, having a gross estate of $600,000. The exemption and authorized deductions amount to $75,000, thus leaving a taxable estate of $525,000. Reference to the table discloses that the specified amount in column (A) nearest to and less than the value of the decedent's taxable estate is $500,000. The tax upon this amount as indicated in column (C), is $145,700. The amount by which the taxable estate exceeds the same specified amount is $25,000. The tax upon this amount, computed at the rate of 35 percent indicated in column (D), is $8,750. Thus the total gross estate tax upon a taxable estate of $525,000 is $154,450. From this amount, the credits authorized by sections 2011 through 2014 are subtracted in order to determine the net estate tax payable.

### § 20.2002–1 Liability for payment of tax.

The Federal estate tax imposed both with respect to the estates of citizens or residents and with respect to estates of nonresidents not citizens is payable by the executor or administrator of the

decedent's estate. This duty applies to the entire tax, regardless of the fact that the gross estate consists in part of property which does not come within the possession of the executor or administrator. If there is no executor or administrator appointed, qualified and acting in the United States, any person in actual or constructive possession of any property of the decedent is required to pay the entire tax to the extent of the value of the property in his possession. See section 2203, defining the term ''executor''. The personal liability of the executor or such other person is described in section 3467 of the Revised Statutes (31 U.S.C. 192) as follows:

> Every executor, administrator, or assignee, or other person, who pays, in whole or in part, any debt due by the person or estate for whom or for which he acts before he satisfies and pays the debts due to the United States from such person or estate, shall become answerable in his own person and estate to the extent of such payments for the debts so due to the United States, or for so much thereof as may remain due and unpaid.

As used in said section, the word ''debt'' includes a beneficiary's distributive share of an estate. Thus, if the executor pays a debt due by the decedent's estate or distributes any portion of the estate before all the estate tax is paid, he is personally liable, to the extent of the payment or distribution, for so much of the estate tax as remains due and unpaid. In addition, section 6324(a)(2) provides that if the estate tax is not paid when due, then the spouse, transferee, trustee (except the trustee of an employee's trust which meets the requirements of section 401(a)), surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under section 2034 through 2042, is personally liable for the tax to the extent of the value, at the time of the decedent's death, of such property. See also the following related sections of the Internal Revenue Code: Section 2204, discharge of executor from personal liability; section 2205, reimbursement out of estate; sections 2206 and 2207, liability of life insurance beneficiaries and recipients of property over which decedent had power of appointment; sections 6321 through 6325, concerning liens for taxes; and section 6901(a)(1), concerning the liabilities of transferees and fiduciaries.

## CREDITS AGAINST TAX

### § 20.2011–1 Credit for State death taxes.

(a) *In general.* A credit is allowed under section 2011 against the Federal estate tax for estate, inheritance, legacy or succession taxes actually paid to any State, Territory, or the District of Columbia, or, in the case of decedents dying before September 3, 1958, any possession of the United States (hereinafter referred to as ''State death taxes''). The credit, however, is allowed only for State death taxes paid (1) with respect to property included in the decedent's gross estate, and (2) with respect to the decedent's estate. The amount of the credit is subject to the limitation described in paragraph (b) of this section. It is subject to further limitations described in § 20.2011–2 if a deduction is allowed under section 2053(d) for State death taxes paid with respect to a charitable gift. See paragraph (a) of § 20.2014–1 as to the allowance of a credit for death taxes paid to a possession of the United States in a case where the decedent died after September 2, 1958.

(b) *Amount of credit.* (1) If the decedent's taxable estate does not exceed $40,000, the credit for State death taxes is zero. If the decedent's taxable estate does exceed $40,000, the credit for State death taxes is limited to an amount computed in accordance with the following table:

TABLE FOR COMPUTATION OF MAXIMUM CREDIT FOR STATE DEATH TAXES

| (A)—Taxable estate equal to or more than— | (B)—Taxable estate less than— | (C)—Credit on amount in column (A) | (D)—Rates of credit on excess over amount in column (A) (percent) |
|---|---|---|---|
| $40,000 | $90,000 | ..... | 0.8 |
| 90,000 | 140,000 | $400 | 1.6 |
| 140,000 | 240,000 | 1,200 | 2.4 |
| 240,000 | 440,000 | 3,600 | 3.2 |
| 440,000 | 640,000 | 10,000 | 4.0 |
| 640,000 | 840,000 | 18,000 | 4.8 |
| 840,000 | 1,040,000 | 27,600 | 5.6 |

TABLE FOR COMPUTATION OF MAXIMUM CREDIT FOR STATE DEATH TAXES—Continued

| (A)—Taxable estate equal to or more than— | (B)—Taxable estate less than— | (C)—Credit on amount in column (A) | (D)—Rates of credit on excess over amount in column (A) (percent) |
|---|---|---|---|
| 1,040,000 | 1,540,000 | 38,800 | 6.4 |
| 1,540,000 | 2,040,000 | 70,800 | 7.2 |
| 2,040,000 | 2,540,000 | 106,800 | 8.0 |
| 2,540,000 | 3,040,000 | 146,800 | 8.8 |
| 3,040,000 | 3,540,000 | 190,800 | 9.6 |
| 3,540,000 | 4,040,000 | 238,800 | 10.4 |
| 4,040,000 | 5,040,000 | 290,800 | 11.2 |
| 5,040,000 | 6,040,000 | 402,800 | 12.0 |
| 6,040,000 | 7,040,000 | 522,800 | 12.8 |
| 7,040,000 | 8,040,000 | 650,800 | 13.6 |
| 8,040,000 | 9,040,000 | 786,800 | 14.4 |
| 9,040,000 | 10,040,000 | 930,800 | 15.2 |
| 10,040,000 | ..... | 1,082,800 | 16.0 |

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

*Example.* (i) The decedent died January 1, 1955, leaving a taxable estate of $150,000. On January 1, 1956, inheritance taxes totaling $2,500 were actually paid to a State with respect to property included in the decedent's gross estate. Reference to the table discloses that the specified amount in column (A) nearest to but less than the value of the decedent's taxable estate is $140,000. The maximum credit in respect of this amount, as indicated in column (C), is $1,200. The amount by which the taxable estate exceeds the same specified amount is $10,000. The maximum credit in respect of this amount, computed at the rate of 2.4 percent indicated in column (D), is $240. Thus, the maximum credit in respect of the decedent's taxable estate of $150,000 is $1,440, even though $2,500 in inheritance taxes was actually paid to the State.

(ii) If, in subdivision (i) of this example, the amount actually paid to the State was $950, the credit for State death taxes would be limited to $950. If, in subdivision (i) of this example, the decedent's taxable estate was $35,000, no credit for State death taxes would be allowed.

(c) *Miscellaneous limitations and conditions to credit*—(1) *Period of limitations.* The credit for State death taxes is limited under section 2011(c) to those taxes which were actually paid and for which a credit was claimed within four years after the filing of the estate tax return for the decedent's estate. If, however, a petition has been filed with the Tax Court of the United States for the redetermination of a deficiency within the time prescribed in section 6213(a), the credit is limited to those taxes which were actually paid and for which a credit was claimed within four years after the filing of the return or within 60 days after the decision of the Tax Court becomes final, whichever period is the last to expire. Similarly, if an extension of time has been granted under section 6161 for payment of the tax shown on the return, or of a deficiency, the credit is limited to those taxes which were actually paid and for which a credit was claimed within four years after the filing of the return, or before the date of the expiration of the period of the extension, whichever period is last to expire. If a claim for refund or credit of an overpayment of the Federal estate tax is filed within the time prescribed in section 6511, the credit for State death taxes is limited to such taxes as were actually paid and credit therefor claimed within four years after the filing of the return or before the expiration of 60 days from the date of mailing by certified or registered mail by the district director to the taxpayer of a notice of disallowance of any part of the claim, or before the expiration of 60 days after a decision by any court of competent jurisdiction becomes final with respect to a timely suit instituted upon the claim, whichever period is the last to expire. See section 2015 for the applicable period of limitations for credit for State death taxes on reversionary or remainder interests if an election is made under section 6163(a) to postpone payment of the estate tax attributable to reversionary or remainder interests. If a claim for refund based on the credit for State death taxes is filed within the applicable period described in this subparagraph, a refund may be made despite the general limitation provisions of sections 6511 and 6512. Any refund based on the credit described in this section shall be made without interest.

(2) *Submission of evidence.* Before the credit for State death taxes is allowed, evidence that such taxes have been paid must be submitted to the district director. The district director may require the submission of a certificate from the proper officer of the taxing State, Territory, or possession of the United States, or the District of Columbia, showing: (i) The total amount of tax imposed (before adding interest

and penalties and before allowing discount); (ii) the amount of any discount allowed; (iii) the amount of any penalties and interest imposed or charged; (iv) the total amount actually paid in cash; and (v) the date or dates of payment. If the amount of these taxes has been redetermined, the amount finally determined should be stated. The required evidence should be filed with the return, but if that is not convenient or possible, then it should be submitted as soon thereafter as practicable. The district director may require the submission of such additional proof as is deemed necessary to establish the right to the credit. For example, he may require the submission of a certificate of the proper officer of the taxing jurisdiction showing (vi) whether a claim for refund of any part of the State death tax is pending and (vii) whether a refund of any part thereof has been authorized, and if a refund has been made, its date and amount, and a description of the property or interest in respect of which the refund was made. The district director may also require an itemized list of the property in respect of which State death taxes were imposed certified by the officer having custody of the records pertaining to those taxes. In addition, he may require the executor to submit a written statement (containing a declaration that it is made under penalties of perjury) stating whether, to his knowledge, any person has instituted litigation or taken an appeal (or contemplates doing so), the final determination of which may affect the amount of those taxes. See section 2016 concerning the redetermination of the estate tax if State death taxes claimed as credit are refunded.

(d) *Definition of ''basic estate tax''.* Section 2011(d) provides definitions of the terms ''basic estate tax'' and ''additional estate tax'', used in the Internal Revenue Code of 1939, and ''estate tax imposed by the Revenue Act of 1926'', for the purpose of supplying a means of computing State death taxes under local statutes using those terms, and for use in determining the exemption provided for in section 2201 for estates of certain members of the Armed Forces. See section 2011(e)(3) for a modification of these definitions if a deduction is allowed under section 2053(d) for State death taxes paid with respect to a charitable gift.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6526, 26 FR 414, Jan. 19, 1961]

### § 20.2011–2 Limitation on credit if a deduction for State death taxes is allowed under section 2053(d).

If a deduction is allowed under section 2053(d) for State death taxes paid with respect to a charitable gift, the credit for State death taxes is subject to special limitations. Under these limitations, the credit cannot exceed the least of the following:

(a) The amount of State death taxes paid other than those for which a deduction is allowed under section 2053(d);

(b) The amount indicated in section 2011(b) to be the maximum credit allowable with respect to the decedent's taxable estate; or

(c) An amount, A, which bears the same ratio to B (the amount which would be the maximum credit allowable under section 2011(b) if the deduction under section 2053(d) for State death taxes were not allowed in computing the decedent's taxable estate) as C (the amount of State death taxes paid other than those for which a deduction is allowed under section 2053(d)) bears to D (the total amount of State death taxes paid). For the purpose of this computation, in determining what the decedent's taxable estate would be if the deduction for State death taxes under section 2053(d) were not allowed, adjustment must be made for the decrease in the deduction for charitable gifts under section 2055 or 2106(a)(2) (for estates of nonresidents not citizens) by reason of any increase in Federal estate tax which would be charged against the charitable gifts.

The application of this section may be illustrated by the following example:

*Example.* The decedent died January 1, 1955, leaving a gross estate of $925,000. Expenses, indebtedness, etc., amounted to $25,000. The decedent bequeathed $400,000 to his son with the direction that the son bear the State death taxes on the bequest. The residuary estate was left to a charitable organization. Except as noted above, all Federal and State death taxes were payable out of the residuary estate. The State imposed death taxes of $60,000 on the son's bequest and death

taxes of $75,000 on the bequest to charity. No death taxes were imposed by a foreign country with respect to any property in the gross estate. The decedent's taxable estate (determined without regard to the limitation imposed by section 2011(e)(2)(B) is computed as follows:

| | | | | |
|---|---|---|---|---|
| Gross estate | | | | $925,000.00 |
| Expenses, indebtedness, etc. | | | $25,000.00 | |
| Exemption | | | 60,000.00 | |
| Deduction under section 2053(d) | | | 75,000.00 | |
| Charitable deduction: | | | | |
| Gross estate | | $925,000.00 | | |
| Expenses, etc | $25,000.00 | | | |
| Bequest to son | 400,000.00 | | | |
| State death tax paid from residue | 75,000.00 | | | |
| Federal estate tax paid from residue | 122,916.67 | 622,916.67 | 302,083.33 | 462,083.33 |
| Taxable estate | | | | 462,916.67 |

If the deduction under section 2053(d) were not allowed, the decedent's taxable estate would be computed as follows:

| | | | | |
|---|---|---|---|---|
| Gross estate | | | | $925,000.00 |
| Expenses, indebtedness, etc. | | | $25,000.00 | |
| Exemption | | | 60,000.00 | |
| Charitable deduction: | | | | |
| Gross estate | | $925,000.00 | | |
| Expenses, etc | $25,000.00 | | | |
| Bequest to son | 400,000.00 | | | |
| State death tax paid from residue | 75,000.00 | | | |
| Federal estate tax paid from residue | 155,000.00 | 655,000.00 | 270,000.00 | 355,000.00 |
| Taxable estate | | | | 570,000.00 |

On a taxable estate of $570,000, the maximum credit allowable under section 2011(b) would be $15,200. Under these facts, the credit for State death taxes is determined as follows:

| | |
|---|---|
| (1) Amount of State death taxes paid other than those for which a deduction is allowed under section 2053(d) ($135,000 – $75,000) | $60,000.00 |
| (2) Amount indicated in section 2011(b) to be the maximum credit allowable with respect to the decedent's taxable estate of $462,916.67 | 10,916.67 |
| (3) Amount determined by use of the ratio described in paragraph (c) above [($60,000÷$135,000)×$15,200] | 6,755.56 |
| (4) Credit for State death taxes (least of subparagraphs (1) through (3) above) | 6,755.56 |

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6600, 27 FR 4983, May 29, 1962]

## § 20.2012–1 Credit for gift tax.

(a) *In general.* With respect to gifts made before 1977, a credit is allowed under section 2012 against the Federal estate tax for gift tax paid under chapter 12 of the Internal Revenue Code, or corresponding provisions of prior law, on a gift by the decedent of property subsequently included in the decedent's gross estate. The credit is allowable even though the gift tax is paid after the decedent's death and the amount of the gift tax is deductible from the gross estate as a debt of the decedent.

(b) *Limitations on credit.* The credit for gift tax is limited to the smaller of the following amounts:

(1) The amount of gift tax paid on the gift computed as set forth in paragraph (c) of this section, or

(2) The amount of the estate tax attributable to the inclusion of the gift in the gross estate, computed as set forth in paragraph (d) of this section.

When more than one gift is included in the gross estate, a separate computation of the two limitations on the credit is to be made for each gift.

(c) *''First limitation''.* The amount of the gift tax paid on the gift is the ''first limitation''. Thus, if only one gift was made during a certain calendar quarter, or calendar year if the gift was made before January 1, 1971, and the gift is wholly included in the decedent's gross estate for the purpose of the estate tax, the credit with respect to the gift is limited to the amount of the gift tax paid for that calendar quarter or calendar year. On the other hand, if more than one gift

was made during a certain calendar quarter or calendar year, the credit with respect to any such gift which is included in the decedent's gross estate is limited under section 2012(d) to an amount, A, which bears the same ratio to B (the total gift tax paid for that calendar quarter or calendar year) as C (the ''amount of the gift,'' computed as described below) bears to D (the total taxable gifts for the calendar quarter or the calendar year, computed without deduction of the gift tax specific exemption). Stated algebraically, the ''first limitation'' (A) equals:

''Amount of the gift'' (C) ÷ Total taxable gifts, plus specific exemption allowed (D) × Total gift tax paid (B).

For purposes of the ratio stated above, the ''amount of the gift'' referred to as factor ''C'' is the value of the gift reduced by any portion excluded or deducted under sections 2503(b) (annual exclusion), 2522 (charitable deduction), or 2523 (marital deduction) of the Internal Revenue Code or corresponding provisions of prior law. In making the computations described in this paragraph, the values to be used are those finally determined for the purpose of the gift tax, irrespective of the values determined for the purpose of the estate tax. A similar computation is made in case only a portion of any gift is included in the decedent's gross estate. The application of this paragraph may be illustrated by the following example:

*Example.* The donor made gifts during the calendar year 1955 on which a gift tax was determined as shown below:

| | | |
|---|---|---|
| Gift of property to son on February 1 | | $13,000 |
| Gift of property to wife on May 1 | | 86,000 |
| Gift of property to charitable organization on May 15 | | 10,000 |
| Total gifts | | 109,000 |
| Less exclusions ($3,000 for each gift) | | 9,000 |
| Total included amount of gifts | | 100,000 |
| Marital deduction (for gift to wife) | $43,000 | |
| Charitable deduction | 7,000 | |
| Specific exemption ($30,000 less $20,000 used in prior years) | 10,000 | |
| Total deductions | | 60,000 |
| Taxable gifts | | 40,000 |
| Total gift tax paid for calendar year 1955 | | 3,600 |

The donor's gift to his wife was made in contemplation of death and was thereafter included in his gross estate. Under the ''first limitation'', the credit with respect to that gift cannot exceed:

[$86,000 − $3,000 − $43,000 (gift to wife, less annual exclusion and marital deduction)] ÷ [$40,000 + $10,000 (taxable gifts, plus specific exemption allowed)] × $3,600 (total gift tax paid) = $2,880.

(d) *''Second limitation''.* (1) The amount of the estate tax attributable to the inclusion of the gift in the gross estate is the ''second limitation''. Thus, the credit with respect to any gift of property included in the gross estate is limited to an amount, E, which bears the same ratio to F (the gross estate tax, reduced by any credit for State death taxes under section 2011) as G (the ''value of the gift'', computed as described in subparagraph (2) of this paragraph) bears to H (the value of entire gross estate, reduced by the total deductions allowed under sections 2055 or 2106(a)(2) (charitable deduction) and 2056 (marital deduction)). Stated algebraically, the ''second limitation'' (E) equals:

''Value of the gift'' (G) ÷ Value of gross estate, less marital and charitable deductions (H) × Gross estate tax, less credit for State death taxes (F).

(2) For purposes of the ratio stated in subparagraph (1) of this paragraph, the ''value of the gift'' referred to as factor ''G'' is the value of the property transferred by gift and included in the gross estate, as determined for the purpose of the gift tax or for the purpose of the estate tax, whichever is lower, and adjusted as follows:

(i) The appropriate value is reduced by all or a portion of any annual exclusion allowed for gift tax purposes under section 2503(b) of the Internal Revenue Code or corresponding provisions of prior law. If the gift tax value is lower than the estate tax value, it is reduced by the entire amount of the exclusion. If the estate tax value is lower than the gift tax value, it is reduced by an amount which bears the same ratio to the estate tax value as the annual exclusion bears to the total value of the property as determined for gift tax purposes. To illustrate: In 1955, a donor, in contemplation of death, transferred certain property to his five children which was valued at $300,000, for the purpose of the gift tax. Thereafter, the same property was included in his

gross estate at a value of $270,000. In computing his gift tax, the donor was allowed annual exclusions totalling $15,000. The reduction provided for in this subdivision is:

$15,000 (annual exclusions allowed) ÷ $300,000 (value of transferred property for the purpose of the gift tax) × $270,000 (value of transferred property for the purpose of the estate tax) = $13,500.

(ii) The appropriate value is further reduced if any portion of the value of the property is allowed as a marital deduction under section 2056 or as a charitable deduction under section 2055 or section 2106(a)(2) (for estates of nonresidents not citizens). The amount of the reduction is an amount which bears the same ratio to the value determined under subdivision (i) of this subparagraph as the portion of the property allowed as a marital deduction or as a charitable deduction bears to the total value of the property as determined for the purpose of the estate tax. Thus, if a gift is made solely to the decedent's surviving spouse and is subsequently included in the decedent's gross estate as having been made in contemplation of death, but a marital deduction is allowed under section 2056 for the full value of the gift, no credit for gift tax on the gift will be allowed since the reduction under this subdivision together with the reduction under subdivision (i) of this subparagraph will have the effect of reducing the factor ''G'' of the ratio in subparagraph (1) of this paragraph to zero.

(e) *Credit for ''split gifts''.* If a decedent made a gift of property which is thereafter included in his gross estate, and, under the provisions of section 2513 of the Internal Revenue Code of 1954 or section 1000(f) of the Internal Revenue Code of 1939, the gift was considered as made one-half by the decedent and one-half by his spouse, credit against the estate tax is allowed for the gift tax paid with respect to both halves of the gift. The ''first limitation'' is to be separately computed with respect to each half of the gift in accordance with the principles stated in paragraph (c) of this section. The ''second limitation'' is to be computed with respect to the entire gift in accordance with the principles stated in paragraph (d) of this section. To illustrate: A donor, in contemplation of death, transferred property valued at $106,000 to his son on January 1, 1955, and he and his wife consented that the gift should be considered as made one-half by him and one-half by her. The property was thereafter included in the donor's gross estate. Under the ''first limitation'', the amount of the gift tax of the donor paid with respect to the one-half of the gift considered as made by him is determined to be $11,250, and the amount of the gift tax of his wife paid with respect to the one-half of the gift considered as made by her is determined to be $1,200. Under the ''second limitation'', the amount of the estate tax attributable to the property is determined to be $28,914. Therefore, the credit for gift tax allowed is $12,450 ($11,250 plus $1,200).

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 7238, 37 FR 28718, Dec. 29, 1972; T.D. 8522, 59 FR 9646, Mar. 1, 1994]

### § 20.2013–1 Credit for tax on prior transfers.

(a) *In general.* A credit is allowed under section 2013 against the Federal estate tax imposed on the present decedent's estate for Federal estate tax paid on the transfer of property to the present decedent from a transferor who died within ten years before, or within two years after, the present decedent's death. See § 20.2013–5 for definition of the terms ''property'' and ''transfer''. There is no requirement that the transferred property be identified in the estate of the present decedent or that the property be in existence at the time of the decedent's death. It is sufficient that the transfer of the property was subjected to Federal estate tax in the estate of the transferor and that the transferor died within the prescribed period of time. The executor must submit such proof as may be requested by the district director in order to establish the right of the estate to the credit.

(b) *Limitations on credit.* The credit for tax on prior transfers is limited to the smaller of the following amounts:

(1) The amount of the Federal estate tax attributable to the transferred property in the transferor's estate, computed as set forth in § 20.2013–2; or

(2) The amount of the Federal estate tax attributable to the transferred property in the decedent's estate, computed as set forth in § 20.2013–3.

Rules for valuing property for purposes of the credit are contained in § 20.2013–4.

(c) *Percentage reduction.* If the transferor died within the two years before, or within the two years after, the present decedent's death, the credit is the smaller of the two limitations described in paragraph (b) of this section. If the transferor predeceased the present decedent by more than two years, the credit is a certain percentage of the smaller of the two limitations described in paragraph (b) of this section, determined as follows:

(1) 80 percent, if the transferor died within the third or fourth years preceding the present decedent's death;

(2) 40 percent, if the transferor died within the fifth or sixth years preceding the present decedent's death;

(3) 40 percent, if the transferor died within the seventh or eighth years preceding the present decedent's death; and

(4) 20 percent, if the transferor died within the ninth or tenth years preceding the present decedent's death.

The word ''within'' as used in this paragraph means ''during''. Therefore, if a death occurs on the second anniversary of another death, the first death is considered to have occurred within the two years before the second death. If the credit for tax on prior transfers relates to property received from two or more transferors, the provisions of this paragraph are to be applied separately with respect to the property received from each transferor. See paragraph (d) of example (2) in § 20.2013–6.

(d) *Examples.* For illustrations of the application of this section, see examples (1) and (2) set forth in § 20.2013–6.

### § 20.2013–2 "First limitation".

(a) The amount of the Federal estate tax attributable to the transferred property in the transferor's estate is the ''first limitation.'' Thus, the credit is limited to an amount, A, which bears the same ratio to B (the ''transferor's adjusted Federal estate tax'', computed as described in paragraph (b) of this section) as C (the value of the property transferred (see § 20.2013–4)) bears to D (the ''transferor's adjusted taxable estate'', computed as described in paragraph (c) of this section). Stated algebraically, the ''first limitation'' (A) equals:

Value of transferred property (C) ÷ ''Transferor's adjusted taxable estate'' (D) × ''Transferor's adjusted Federal estate tax'' (B).

(b) For purposes of the ratio stated in paragraph (a) of this section, the ''transferor's adjusted Federal estate tax'' referred to as factor ''B'' is the amount of the Federal estate tax paid with respect to the transferor's estate plus:

(1) Any credit allowed the transferor's estate for gift tax under section 2012, or the corresponding provisions of prior law; and

(2) Any credit allowed the transferor's estate, under section 2013, for tax on prior transfers, but only if the transferor acquired property from a person who died within 10 years before the death of the present decedent.

(c)(1) For purposes of the ratio stated in paragraph (a) of this section, the ''transferor's adjusted taxable estate'' referred to as factor ''D'' is the amount of the transferor's taxable estate (or net estate) decreased by the amount of any ''death taxes'' paid with respect to his gross estate and increased by the amount of the exemption allowed in computing his taxable estate (or net estate). The amount of the transferor's taxable estate (or net estate) is determined in accordance with the provisions of § 20.2051–1 in the case of a citizen or resident of the United States or of § 20.2106–1 in the case of a nonresident not a citizen of the United States (or the corresponding provisions of prior regulations). The term ''death taxes'' means the Federal estate tax plus all other estate, inheritance, legacy, succession, or similar death taxes imposed by, and paid to, any taxing authority, whether within or without the United States. However, only the net amount of such taxes paid is taken into consideration.

(2) The amount of the exemption depends upon the citizenship and residence of the transferor at the time of his death. Except in the case of a decedent described in section 2209 (relating to certain residents of possessions of

the United States who are considered nonresidents not citizens), if the decedent was a citizen or resident of the United States, the exemption is the $60,000 authorized by section 2052 (or the corresponding provisions of prior law). If the decedent was a nonresident not a citizen of the United States, or is considered under section 2209 to have been such a nonresident, the exemption is the $30,000 or $2,000, as the case may be, authorized by section 2106(a)(3) (or the corresponding provisions of prior law), or such larger amount as is authorized by section 2106(a)(3)(B) or may have been allowed as an exemption pursuant to the prorated exemption provisions of an applicable death tax convention. See § 20.2052–1 and paragraph (a)(3) of § 20.2106–1.

(d) If the credit for tax on prior transfers relates to property received from two or more transferors, the provisions of this section are to be applied separately with respect to the property received from each transferor. See paragraph (b) of example (2) in § 20.2013–6.

(e) For illustrations of the application of this section, see examples (1) and (2) set forth in § 20.2013–6.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7296, 38 FR 34191, Dec. 12, 1973]

### § 20.2013–3 "Second limitation".

(a) The amount of the Federal estate tax attributable to the transferred property in the present decedent's estate is the ''second limitation''. Thus, the credit is limited to the difference between—

(1) The net estate tax payable (see paragraph (b)(5) or (c), as the case may be, of § 20.0–2) with respect to the present decedent's estate, determined without regard to any credit for tax on prior transfers under section 2013 or any credit for foreign death taxes claimed under the provisions of a death tax convention, and

(2) The net estate tax determined as provided in subparagraph (1) of this paragraph but computed by subtracting from the present decedent's gross estate the value of the property transferred (see § 20.2013–4), and by making only the adjustment indicated in paragraph (b) of this section if a charitable deduction is allowable to the estate of the present decedent.

(b) If a charitable deduction is allowable to the estate of the present decedent under the provisions of section 2055 or section 2106 (a)(2) (for estates of nonresidents not citizens), for purposes of determining the tax described in paragraph (a)(2) of this section, the charitable deduction otherwise allowable is reduced by an amount, E, which bears the same ratio to F (the charitable deduction otherwise allowable) as G (the value of the transferred property (see § 20.2013–4)) bears to H (the value of the present decedent's gross estate reduced by the amount of the deductions for expenses, indebtedness, taxes, losses, etc., allowed under the provisions of sections 2053 and 2054 or section 2106(a)(1) (for estates of nonresidents not citizens)). See paragraph (c)(2) of example (1) and paragraph (c)(2) of example (2) in § 20.2013–6.

(c) If the credit for tax on prior transfers relates to property received from two or more transferors, the property received from all transferors is aggregated in determining the limitation on credit under this section (the ''second limitation''). However, the limitation so determined is apportioned to the property received from each transferor in the ratio that the property received from each transferor bears to the total property received from all transferors. See paragraph (c) of example (2) in § 20.2013–6.

(d) For illustrations of the application of this section, see examples (1) and (2) set forth in § 20.2013–6.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7296, 38 FR 34191, Dec. 12, 1973]

### § 20.2013–4 Valuation of property transferred.

(a) For purposes of section 2013 and §§ 20.2013–1 to 20.2013–6, the value of the property transferred to the decedent is the value at which the property was included in the transferor's gross estate for the purpose of the Federal estate tax (see sections 2031, 2032, 2103, and 2107, and the regulations thereunder) reduced as indicated in paragraph (b) of this section. If the decedent received a

life estate or a remainder or other limited interest in property that was included in a transferor decedent's gross estate, the value of the interest is determined as of the date of the transferor's death on the basis of recognized valuation principles (see §§ 20.2031–7 (or, for certain prior periods, § 20.2031–7A) and 20.7520–1 through 20.7520–4). The application of this paragraph may be illustrated by the following examples:

*Example (1).* A died on January 1, 1953, leaving Blackacre to B. The property was included in A's gross estate at a value of $100,000. On January 1, 1955, B sold Blackacre to C for $150,000. B died on February 1, 1955. For purposes of computing the credit against the tax imposed on B's estate, the value of the property transferred to B is $100,000.

*Example (2).* A died on January 1, 1953, leaving Blackacre to B for life and, upon B's death, remainder to C. At the time of A's death, B was 56 years of age. The property was included in A's gross estate at a value of $100,000. The part of that value attributable to the life estate is $44,688 and the part of that value attributable to the remainder is $55,312 (see § 20.2031–7A(b)). B died on January 1, 1955, and C died on January 1, 1956. For purposes of computing the credit against the tax imposed on B's estate, the value of the property transferred to B is $44,688. For purposes of computing the credit against the tax imposed on C's estate, the value of the property transferred to C is $55,312.

(b) In arriving at the value of the property transferred to the decedent, the value at which the property was included in the transferor's gross estate (see paragraph (a) of this section) is reduced as follows:

(1) By the amount of the Federal estate tax and any other estate, inheritance, legacy, or succession taxes which were payable out of the property transferred to the decedent or which were payable by the decedent in connection with the property transferred to him. For example, if under the transferor's will or local law all death taxes are to be paid out of other property with the result that the decedent receives a bequest free and clear of all death taxes, no reduction is to be made under this subparagraph;

(2) By the amount of any marital deduction allowed the transferor's estate under section 2056 (or under section 812(e) of the Internal Revenue Code of 1939) if the decedent was the spouse of the transferor at the time of the transferor's death; and

(3)(i) By the amount of any encumbrance on the property or by the amount of any obligation imposed by the transferor and incurred by the decedent with respect to the property, to the extent such charges would be taken into account if the amount of a gift to the decedent of such property were being determined.

(ii) For purposes of this subparagraph, an obligation imposed by the transferor and incurred by the decedent with respect to the property includes a bequest, etc., in lieu of the interest of the surviving spouse under community property laws, unless the interest was, immediately prior to the transferor's death, a mere expectancy. However, an obligation imposed by the transferor and incurred by the decedent with respect to the property does not include a bequest, devise, or other transfer in lieu of dower, curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the transferor's property or estate.

(iii) The application of this subparagraph may be illustrated by the following examples:

*Example (1).* The transferor devised to the decedent real estate subject to a mortgage. The value of the property transferred to the decedent does not include the amount of the mortgage. If, however, the transferor by his will directs the executor to pay off the mortgage, such payment constitutes an additional amount transferred to the decedent.

*Example (2).* The transferor bequeathed certain property to the decedent with a direction that the decedent pay $1,000 to X. The value of the property transferred to the decedent is the value of the property reduced by $1,000.

*Example (3).* The transferor bequeathed certain property to his wife, the decedent, in lieu of her interest in property held by them as community property under the law of the State of their residence. The wife elected to relinquish her community property interest and to take the bequest. The value of the property transferred to the decedent is the value of the property reduced by the value of the community property interest relinquished by the wife.

*Example (4).* The transferor bequeathed to the decedent his entire residuary estate, out of which certain claims were to be satisfied.

The entire distributable income of the transferor's estate (during the period of its administration) was applied toward the satisfaction of these claims and the remaining portion of the claims was satisfied by the decedent out of his own funds. Thus, the decedent received a larger sum upon settlement of the transferor's estate than he was actually bequeathed. The value of the property transferred to the decedent is the value at which such property was included in the transferor's gross estate, reduced by the amount of the estate income and the decedent's own funds paid out in satisfaction of the claims.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 7077, 35 FR 18461, Dec. 4, 1970; T.D. 7296, 38 FR 34191, Dec. 12, 1973; T.D. 8522, 59 FR 9646, Mar. 1, 1994; T.D. 8540, 59 FR 30151, June 10, 1994]

### § 20.2013–5 "Property" and "transfer" defined.

(a) For purposes of section 2013 and §§ 20.2013–1 to 20.2013–6, the term ''property'' means any beneficial interest in property, including a general power of appointment (as defined in section 2041) over property. Thus, the term does not include an interest in property consisting merely of a bare legal title, such as that of a trustee. Nor does the term include a power of appointment over property which is not a general power of appointment (as defined in section 2041). Examples of property, as described in this paragraph, are annuities, life estates, estates for terms of years, vested or contingent remainders and other future interests.

(b) In order to obtain the credit for tax on prior transfers, there must be a transfer of property described in paragraph (a) of this section by or from the transferor to the decedent. The term ''transfer'' of property by or from a transferor means any passing of property or an interest in property under circumstances which were such that the property or interest was included in the gross estate of the transferor. In this connection, if the decedent receives property as a result of the exercise or nonexercise of a power of appointment, the donee of the power (and not the creator) is deemed to be the transferor of the property if the property subject to the power is includible in the donee's gross estate under section 2041 (relating to powers of appointment). Thus, notwithstanding the designation by local law of the capacity in which the decedent takes, property received from the transferor includes interests in property held by or devolving upon the decedent: (1) As spouse under dower or curtesy laws or laws creating an estate in lieu of dower or curtesy; (2) as surviving tenant of a tenancy by the entirety or joint tenancy with survivorship rights; (3) as beneficiary of the proceeds of life insurance; (4) as survivor under an annuity contract; (5) as donee (possessor) of a general power of appointment (as defined in section 2041); (6) as appointee under the exercise of a general power of appointment (as defined in section 2041); or (7) as remainderman under the release or nonexercise of a power of appointment by reason of which the property is included in the gross estate of the donee of the power under section 2041.

(c) The application of this section may be illustrated by the following example:

*Example:* A devises Blackacre to B, as trustee, with directions to pay the income therefore to C, his son, for life. Upon C's death. Blackacre is to be sold. C is given a general testamentary power, to appoint one-third of the proceeds, and a testamentary power, which is not a general power, to appoint the remaining two-thirds of the proceeds, to such of the issue of his sister D as he should choose. D has a daughter, E, and a son, F. Upon his death, C exercised his general power by appointing one-third of the proceeds to D and his special power by appointing two-thirds of the proceeds to E. Since B's interest in Blackacre as a trustee is not a beneficial interest, no part of it is ''property'' for purpose of the credit in B's estate. On the other hand, C's life estate and his testamentary power over the one-third interest in the remainder constitute ''property'' received from A for purpose of the credit in C's estate. Likewise, D's one-third interest in the remainder received through the exercise of C's general power of appointment is ''property'' received from C for purpose of the credit in D's estate. No credit is allowed E's estate for the property which passed to her from C since the property was not included in C's gross estate. On the other hand, no credit is allowed in E's estate for property passing to her from A since her interest was not susceptible of valuation at the time of A's death (see § 20.2013–4).

### § 20.2013–6 Examples.

The application of §§ 20.2013–1 to 20.2013–5 may be further illustrated by the following examples:

*Example (1).* (a) A died December 1, 1953, leaving a gross estate of $1,000,000. Expenses, indebtedness, etc., amounted to $90,000. A bequeathed $200,000 to B, his wife, $100,000 of which qualified for the marital deduction. B died November 1, 1954, leaving a gross estate of $500,000. Expenses, indebtedness, etc., amounted to $40,000. B bequeathed $150,000 to charity. A and B were both citizens of the United States. The estates of A and B both paid State death taxes equal to the maximum credit allowable for State death taxes. Death taxes were not a charge on the bequest to B.

(b) ''First limitation'' on credit for B's estate (§ 20.2013–2):

| | | |
|---|---|---|
| A's gross estate | | $1,000,000.00 |
| Expenses, indebtedness, etc. | | 90,000.00 |
| A's adjusted gross estate | | 910,000.00 |
| Marital deduction | $100,000.00 | |
| Exemption | 60,000.00 | |
| | | 160,000.00 |
| A's taxable estate | | 750,000.00 |
| A's gross estate tax | | 233,200.00 |
| Credit for State death taxes | | 23,280.00 |
| A's net estate tax payable | | 209,920.00 |
| ''First limitation'' = $209,920.00 (§ 20.2013–2(b)) × [($200,000.00 − $100,000.00) (§ 20.2013–4) ÷ ($750,000.00 − $209,920.00 − $23,280.00 + $60,000.00) (§ 20.2013–2(c))] | | $36,393.90 |

(c) ''Second limitation'' on credit for B's estate (§ 20.2013–3):

(1) B's net estate tax payable as described in § 20.2013–3(a)(1) (previously taxed transfer included):

| | | |
|---|---|---|
| B's gross estate | $500,000.00 | |
| Expenses, indebtedness, etc. | $40,000.00 | |
| Charitable deduction | 150,000.00 | |
| Exemption | 60,000.00 | |
| | | 250,000.00 |
| B's taxable estate | | 250,000.00 |
| B's gross estate tax | | $65,700.00 |
| Credit for State death taxes | | 3,920.00 |
| B's net estate tax payable | | 61,780.00 |

(2) B's net estate tax payable as described in § 20.2013–3(a)(2) (previously taxed transfer excluded):

| | | |
|---|---|---|
| B's gross estate | | $400,000.00 |
| Expenses, indebtedness, etc | $40,000.00 | |
| Charitable deduction (§ 20.2013–3(b))=$150,000.00 − [$150,000.00 × ($200,000.00 − $100,000.00 ÷ $500,000.00 − $40,000.00)] | 117,391.30 | |
| Exemption | 60,000.00 | |
| | | 217,391.30 |
| B's taxable estate | | 182,608.70 |
| B's gross estate tax | | 45,482.61 |
| Credit for State death taxes | | 2,221.61 |
| B's net estate tax payable | | 43,260.00 |

(3) ''Second limitation'':

| | | |
|---|---|---|
| Subparagraph (1) | $61,780.00 | |
| Less: Subparagraph (2) | 43,260.00 | |
| | | $18,520.00 |

(d) Credit of B's estate for tax on prior transfers (§ 20.2013–1(c)):

| | | |
|---|---|---|
| Credit for tax on prior transfers=$18,520.00 (lower of paragraphs (b) and (c))×100 percent (percentage to be taken into account under § 20.2013–1(c)) | | $18,520.00 |

*Example (2).* (a) The facts are the same as those contained in example (1) of this paragraph with the following additions. C died December 1, 1950, leaving a gross estate of $250,000. Expenses, indebtedness, etc., amounted to $50,000. C bequeathed $50,000 to B. C was a citizen of the United States. His estate paid State death taxes equal to the maximum credit allowable for State death taxes. Death taxes were not a charge on the bequest to B.

(b) ''First limitation'' on credit for B's estate (§ 20.2013–2(d)) −

(1) With respect to the property received from A:

''First limitation''=$36,393.90 (this computation is identical with the one contained in paragraph (b) of example (1) of this section).

(2) With respect to the property received from C:

| | | |
|---|---|---|
| C's gross estate | | $250,000.00 |
| Expenses, indebtedness, etc. | $50,000.00 | |
| Exemption | $60,000.00 | |
| | | $110,000.00 |
| C's taxable estate | | 140,000.00 |
| C's gross estate tax | | 32,700.00 |
| Credit for State death taxes | | 1,200.00 |
| C's net estate tax payable | | 31,500.00 |
| ''First limitation'' = $31,500.00 (§ 20.2013–2(b)) × [$50,000.00 (§ 20.2013–4) ÷ ($140,000.00 − $31,500.00 − $1,200.00 + $60,000.00) (§ 20.2013–2(c))] | | $9,414.23 |

(c) ''Second limitation'' on credit for B's estate (§ 20.2013–3(c)):

(1) B's net estate tax payable as described in § 20.2013–3(a)(1) (previously taxed transfers included)=$61,780.00 (this computation is identical with the one contained in paragraph (c)(1) of example (1) of this section).

(2) B's net estate tax payable as described in § 20.2013–3(a)(2) (previously taxed transfers excluded):

| | | |
|---|---|---|
| B's gross estate | | $350,000.00 |
| Expenses, indebtedness, etc | $40,000.00 | |
| Charitable deduction (§ 20.2013–3(b)) = $150,000.00 − [$150,000.00 × ($200,000.00 − $100,000.00 + $50,000.00) ÷ ($500,000.00 − $40,000.00)] | 101,086.96 | |
| Exemption | 60,000.00 | |
| | | 201,086.96 |
| B's taxable estate | | 148,913.04 |
| B's gross estate tax | | 35,373.91 |
| Credit for State death taxes | | 1,413.91 |
| B's net estate tax payable | | 33,960.00 |

(3) ''Second limitation'':

| | | |
|---|---|---|
| Subparagraph (1) | $61,780.00 | |
| Less: Subparagraph (2) | 33,960.00 | |
| | | $27,820.00 |

(4) Apportionment of ''second limitation'' on credit:

| | |
|---|---|
| Transfer from A (§ 20.2013–4) | $100,000.00 |
| Transfer from C (§ 20.2013–4) | 50,000.00 |
| Total | 150,000.00 |
| Portion of ''second limitation'' attributable to transfer from A (100/150 of $27,820.00) | 18,546.67 |
| Portion of ''second limitation'' attributable to transfer from C (50/150 of $27,820.00) | 9,273.33 |

(d) Credit of B's estate for tax on prior transfers (§ 20.2013–1(c)):

| | |
|---|---|
| Credit for tax on transfer from A= $18,546.67 (lower of ''first limitation'' computed in paragraph (b)(1) and ''second limitation'' apportioned to A's transfer in paragraph (c)(4)) × 100 percent (percentage to be taken into account under § 20.2013–1(c)) | $18,546.67 |
| Credit for tax on transfer from C= $9,273.33 (lower of ''first limitation'' computed in paragraph (b)(2) and ''second limitation'' apportioned to B's transfer in paragraph (c)(4)) × 80 percent (percentage to be taken into account under § 20.2013–1(c)) | 7,418.66 |
| Total credit for tax on prior transfers | 25,965.33 |

## § 20.2014–1 Credit for foreign death taxes.

(a) *In general.* (1) A credit is allowed under section 2014 against the Federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any foreign country (hereinafter referred to as ''foreign death taxes''). The credit is allowed only for foreign death taxes paid (i) with respect to property situated within the country to which the tax is paid, (ii) with respect to property included in the decedent's gross estate, and (iii) with respect to the decedent's estate. The credit is allowable to the estate of a decedent who was a citizen of the United States at the time of his death. The credit is also allowable, as provided in paragraph (c) of this section, to the estate of a decedent who was a resident but not a citizen of the United States at the time of his death. The credit is not allowable to the estate of a decedent who was neither a citizen nor a resident of the United States at the time of his death. See paragraph (b)(1) of § 20.0–1 for the meaning of the term ''resident'' as applied to a decedent. The credit is allowable not only for death taxes paid to foreign countries which are states in the international sense, but also for death taxes paid to possessions or political subdivisions of foreign states. With respect to the estate of a decedent dying after September 2, 1958, the term ''foreign country'', as used in this section and §§ 20.2014–2 to 20.2014–6, includes a possession of the United States. See §§ 20.2011–1 and 20.2011–2 for the allowance of a credit for death taxes paid to a possession of the United States in the case of a decedent dying before September 3, 1958. No credit is allowable for interest or penalties paid in connection with foreign death taxes.

(2) In addition to the credit for foreign death taxes under section 2014, similar credits are allowed under death tax conventions with certain foreign countries. If credits against the Federal estate tax are allowable under section 2014, or under section 2014 and one or more death tax conventions, for death taxes paid to more than one country, the credits are combined and the aggregate amount is credited against the Federal estate tax, subject to the limitation provided for in paragraph (c) of § 20.2014–4. For application of the credit in cases involving a death tax convention, see § 20.2014–4.

(3) No credit is allowable under section 2014 in connection with property situated outside of the foreign country imposing the tax for which credit is claimed. However, such a credit may be allowable under certain death tax conventions. In the case of a tax imposed by a political subdivision of a foreign

country, credit for the tax shall be allowed with respect to property having a situs in that foreign country, even though, under the principles described in this subparagraph, the property has a situs in a political subdivision different from the one imposing the tax. Whether or not particular property of a decedent is situated in the foreign country imposing the tax is determined in accordance with the same principles that would be applied in determining whether or not similar property of a nonresident decedent not a citizen of the United States is situated within the United States for Federal estate tax purposes. See §§ 20.2104–1 and 20.2105–1. For example, under § 20.2104–1 shares of stock are deemed to be situated in the United States only if issued by a domestic corporation. Thus, a share of corporate stock is regarded as situated in the foreign country imposing the tax only if the issuing corporation is incorporated in that country. Further, under § 20.2105–1 amounts receivable as insurance on the life of a nonresident not a citizen of the United States at the time of his death are not deemed situated in the United States. Therefore, in determining the credit under section 2014 in the case of a decedent who was a citizen or resident of the United States, amounts receivable as insurance on the life of the decedent and payable under a policy issued by a corporation incorporated in a foreign country are not deemed situated in such foreign country. In addition, under § 20.2105–1 in the case of an estate of a nonresident not a citizen of the United States who died on or after November 14, 1966, a debt obligation of a domestic corporation is not considered to be situated in the United States if any interest thereon would be treated under section 862(a)(1) as income from sources without the United States by reason of section 861(a)(1)(B) (relating to interest received from a domestic corporation less than 20 percent of whose gross income for a 3-year period was derived from sources within the United States). Accordingly, a debt obligation the primary obligor on which is a corporation incorporated in the foreign country imposing the tax is not considered to be situated in that country if, under circumstances corresponding to those described in § 20.2105–1 less than 20 percent of the gross income of the corporation for the 3-year period was derived from sources within that country. Further, under § 20.2104–1 in the case of an estate of a nonresident not a citizen of the United States who died before November 14, 1966, a bond for the payment of money is not situated within the United States unless it is physically located in the United States. Accordingly, in the case of the estate of a decedent dying before November 14, 1966, a bond is deemed situated in the foreign country imposing the tax only if it is physically located in that country. Finally, under § 20.2105–1 moneys deposited in the United States with any person carrying on the banking business by or for a nonresident not a citizen of the United States who died before November 14, 1966, and who was not engaged in business in the United States at the time of death are not deemed situated in the United States. Therefore, an account with a foreign bank in the foreign country imposing the tax is not considered to be situated in that country under corresponding circumstances.

(4) Where a deduction is allowed under section 2053(d) for foreign death taxes paid with respect to a charitable gift, the credit for foreign death taxes is subject to further limitations as explained in § 20.2014–7.

(b) *Limitations on credit.* The credit for foreign death taxes is limited to the smaller of the following amounts:

(1) The amount of a particular foreign death tax attributable to property situated in the country imposing the tax and included in the decedent's gross estate for Federal estate tax purposes, computed as set forth in § 20.2014–2; or

(2) The amount of the Federal estate tax attributable to particular property situated in a foreign country, subjected to foreign death tax in that country, and included in the decedent's gross estate for Federal estate tax purposes, computed as set forth in § 20.2014–3.

(c) *Credit allowable to estate of resident not a citizen.* (1) In the case of an estate of a decedent dying before November 14, 1966, who was a resident but not a citizen of the United States, a credit is allowed to the estate under section 2014

only if the foreign country of which the decedent was a citizen or subject, in imposing foreign death taxes, allows a similar credit to the estates of citizens of the United States who were resident in that foreign country at the time of death.

(2) In the case of an estate of a decedent dying on or after November 14, 1966, who was a resident but not a citizen of the United States, a credit is allowed to the estate under section 2014 without regard to the similar credit requirement of subparagraph (1) of this paragraph unless the decedent was a citizen or subject of a foreign country with respect to which there is in effect at the time of the decedent's death a Presidential proclamation, as authorized by section 2014(h), reinstating the similar credit requirement. In the case of an estate of a decedent who was a resident of the United States and a citizen or subject of a foreign country with respect to which such a proclamation has been made, and who dies while the proclamation is in effect, a credit is allowed under section 2014 only if that foreign country, in imposing foreign death taxes, allows a similar credit to the estates of citizens of the United States who were resident in that foreign country at the time of death. The proclamation authorized by section 2014(h) for the reinstatement of the similar credit requirement with respect to the estates of citizens or subjects of a specific foreign country may be made by the President whenever he finds that—

(i) The foreign country, in imposing foreign death taxes, does not allow a similar credit to the estates of citizens of the United States who were resident in the foreign country at the time of death,

(ii) The foreign country, after having been requested to do so, has not acted to provide a similar credit to the estates of such citizens, and

(iii) It is in the public interest to allow the credit under section 2014 to the estates of citizens or subjects of the foreign country only if the foreign country allows a similar credit to the estates of citizens of the United States who were resident in the foreign country at the time of death.

The proclamation for the reinstatement of the similar credit requirement with respect to the estates of citizens or subjects of a specific foreign country may be revoked by the President. In that case, a credit is allowed under section 2014, to the estate of a decedent who was a citizen or subject of that foreign country and a resident of the United States at the time of death, without regard to the similar credit requirement if the decedent dies after the proclamation reinstating the similar credit requirement has been revoked.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6526, 26 FR 415, Jan. 19, 1961; T.D. 6600, 27 FR 4983, May 29, 1962; T.D. 7296, 38 FR 34192, Dec. 12, 1973]

### § 20.2014–2 "First limitation".

(a) The amount of a particular foreign death tax attributable to property situated in the country imposing the tax and included in the decedent's gross estate for Federal estate tax purposes is the ''first limitation.'' Thus, the credit for any foreign death tax is limited to an amount, A, which bears the same ratio to B (the amount of the foreign death tax without allowance of credit, if any, for Federal estate tax), as C (the value of the property situated in the country imposing the foreign death tax, subjected to the foreign death tax, included in the gross estate and for which a deduction is not allowed under section 2053(d)) bears to D (the value of all property subjected to the foreign death tax). Stated algebraically, the ''first limitation'' (A) equals—

Value of property in foreign country subjected to foreign death tax, included in gross estate and for which a deduction is not allowed under section 2053(d)(C) ÷ Value of all property subjected to foreign death tax (D) × Amount of foreign death tax (B)

The values used in this proportion are the values determined for the purpose of the foreign death tax. The amount of the foreign death tax for which credit is allowable must be converted into United States money. The application of this paragraph may be illustrated by the following example:

*Example.* At the time of his death on June 1, 1966, the decedent, a citizen of the United

States, owned stock in X Corporation (a corporation organized under the laws of Country Y) valued at $80,000. In addition, he owned bonds issued by Country Y valued at $80,000. The stock and bond certificates were in the United States. Decedent left by will $20,000 of the stock and $50,000 of the Country Y bonds to his surviving spouse. He left the rest of the stock and bonds to his son. Under the situs rules referred to in paragraph (a)(3) of § 20.2014–1 the stock is deemed situated in Country Y while the bonds are deemed to have their situs in the United States. (The bonds would be deemed to have their situs in Country Y if the decedent had died on or after November 14, 1966.) There is not death tax convention in existence between the United States and Country Y. The laws of Country Y provide for inheritance taxes computed as follows:

| | |
|---|---|
| Inheritance tax of surviving spouse: | |
| Value of stock | $20,000 |
| Value of bonds | 50,000 |
| Total value | 70,000 |
| Tax (16 percent rate) | 11,200 |
| Inheritance tax of son: | |
| Value of stock | 60,000 |
| Value of bonds | $30,000 |
| Total value | 90,000 |
| Tax (16 percent rate) | 14,400 |

The ''first limitation'' on the credit for foreign death taxes is:

$20,000 + $60,000 (factor C of the ratio stated at § 20.2014 − 2(a)) ÷ $70,000+ $90,000 (factor D of the ratio stated at § 20.2014 − 2(a)) × ($11,200+$14,400) (factor B of the ratio stated at § 20.2014–2(a)) = $12,800

(b) If a foreign country imposes more than one kind of death tax or imposes taxes at different rates upon the several shares of an estate, or if a foreign country and a political subdivision or possession thereof each imposes a death tax, a ''first limitation'' is to be computed separately for each tax or rate and the results added in order to determine the total ''first limitation.'' The application of this paragraph may be illustrated by the following example:

*Example.* The facts are the same as those contained in the example set forth in paragraph (a) of this section, except that the tax of the surviving spouse was computed at a 10 percent rate and amounted to $7,000, and the tax of the son was computed at a 20 percent rate and amounted to $18,000. In this case, the ''first limitation'' on the credit for foreign death taxes is computed as follows:

| | |
|---|---|
| ''First limitation'' with respect to inheritance tax of surviving spouse: | |
| [$20,000 (factor C of the ratio stated at § 20.2014–2(a)) ÷ $70,000 (factor D of the ratio stated at § 20.2014–2(a))] × $7,000 (factor B of the ratio stated at § 20.2014–2(a))= | $2,000. |
| ''First limitation'' with respect to inheritance tax of son: | |
| [$60,000 (factor C of the ratio stated at § 20.2014–2(a)) ÷ $90,000 (factor D of the ratio stated at § 20.2014–2(a))] × $18,000 (factor B of the ratio stated at § 20.2014–2(a))= | 12,000. |
| Total ''first limitation'' on the credit for foreign death taxes | 14,000 |

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6600, 27 FR 4984, May 29, 1962; T.D. 6684, 28 FR 11408, Oct. 24, 1963; T.D. 7296, 38 FR 34193, Dec. 12, 1973; 39 FR 2090, Jan. 17, 1974]

## § 20.2014–3 "Second limitation".

(a) The amount of the Federal estate tax attributable to particular property situated in a foreign country, subjected to foreign death tax in that country, and included in the decedent's gross estate for Federal estate tax purposes is the ''second limitation.'' Thus, the credit is limited to an amount, E, which bears the same ratio to F (the gross Federal estate tax, reduced by any credit for State death taxes under section 2011 and by any credit for gift tax under section 2012) as G (the ''adjusted value of the property situated in the foreign country, subjected to foreign death tax, and included in the gross estate'', computed as described in paragraph (b) of this section) bears to H (the value of the entire gross estate, reduced by the total amount of the deductions allowed under sections 2055 (charitable deduction) and 2056 (marital deduction)). Stated algebraically, the ''second limitation'' (E) equals:

''Adjusted value of the property situated in the foreign country, subjected to foreign death taxes, and included in the gross estate'' (G) ÷ Value of entire gross estate, less charitable and marital deductions (H) × Gross Federal estate tax, less credits for State death taxes and gift tax (F)

The values used in this proportion are the values determined for the purpose of the Federal estate tax.

(b) Adjustment is required to factor ''G'' of the ratio stated in paragraph (a) of this section if a deduction for foreign death taxes under section 2053(d), a charitable deduction under section

2055, or a marital deduction under section 2056 is allowed with respect to the foreign property. If a deduction for foreign death taxes is allowed, the value of the property situated in the foreign country, subjected to foreign death tax, and included in the gross estate does not include the value of any property in respect of which the deduction for foreign death taxes is allowed. See § 20.2014–7. If a charitable deduction or a marital deduction is allowed, the value of such foreign property (after exclusion of the value of any property in respect of which the deduction for foreign death taxes is allowed) is reduced as follows:

(1) If a charitable deduction or a marital deduction is allowed to a decedent's estate with respect to any part of the foreign property, except foreign property in respect of which a deduction for foreign death taxes is allowed, specifically bequeathed, devised, or otherwise specifically passing to a charitable organization or to the decedent's spouse, the value of the foreign property is reduced by the amount of the charitable deduction or marital deduction allowed with respect to such specific transfer. See example (1) of paragraph (c) of this section.

(2) If a charitable deduction or a marital deduction is allowed to a decedent's estate with respect to a bequest, devise or other transfer of an interest in a group of assets including both the foreign property and other property, the value of the foreign property is reduced by an amount, I, which bears the same ratio to J (the amount of the charitable deduction or marital deduction allowed with respect to such transfer of an interest in a group of assets) as K (the value of the foreign property, except foreign property in respect of which a deduction for foreign death taxes is allowed, included in the group of assets) bears to L (the value of the entire group of assets). As used in this subparagraph, the term ''group of assets'' has reference to those assets which, under applicable law, are chargeable with the charitable or marital transfer. See example (2) of paragraph (c) of this section.

Any reduction described in paragraph (b)(1) or (b)(2) of this section on account of the marital deduction must proportionately take into account, if applicable, the limitation on the aggregate amount of the marital deduction contained in § 20.2056(a)–1(c). See § 20.2014–3(c), *Example 3.*

(c) The application of paragraphs (a) and (b) of this section may be illustrated by the following examples. In each case, the computations relate to the amount of credit under section 2014 without regard to the amount of credit which may be allowable under an applicable death tax convention.

*Example (1).* (i) Decedent, a citizen and resident of the United States at the time of his death on February 1, 1967, left a gross estate of $1,000,000 which includes the following: shares of stock issued by a domestic corporation, valued at $750,000; bonds issued in 1960 by the United States and physically located in foreign Country X, valued at $50,000; and shares of stock issued by a Country X corporation, valued at $200,000, with respect to which death taxes were paid to Country X. Expenses, indebtedness, etc., amounted to $60,000. Decedent specifically bequeathed $40,000 of the stock issued by the Country X corporation to a U.S. charity and left the residue of his estate, in equal shares, to his son and daughter. The gross Federal estate tax is $266,500, and the credit for State death taxes is $27,600. Under the situs rules referred to in paragraph (a)(3) of § 20.2014–1, the shares of stock issued by the Country X corporation comprise the only property deemed to be situated in Country X. (The bonds also would be deemed to have their situs in Country X if the decedent had died before November 14, 1966.)

(ii) The ''second limitation'' on the credit for foreign death taxes is:

[($200,000 − $40,000 (factor G of the ratio stated at § 20.2014–3(a); see also § 20.2014–3(b)(1))) ÷ ($1,000,000 − $40,000 (factor H of the ratio stated at § 20.2014–3(a)))] × ($266,500 − $27,600) (factor F of the ratio stated at § 20.2014–3(a)) = $39,816.67.

The lesser of this amount and the amount of the ''first limitation'' (computed under § 20.2014–2) is the credit for foreign death taxes.

*Example (2).* (i) Decedent, a citizen and resident of the United States at the time of his death, left a gross estate of $1,000,000 which includes: shares of stock issued by a United States corporation, valued at $650,000; shares of stock issued by a Country X corporation, valued at $200,000; and life insurance, in the amount of $150,000, payable to a son. Expenses, indebtedness, etc., amounted to $40,000. The decedent made a specific bequest of $25,000 of the Country X corporation stock to Charity A and a general bequest of $100,000

to Charity B. The residue of his estate was left to his daughter. The gross Federal estate tax is $242,450 and the credit for State death taxes is $24,480. Under these facts and applicable law, neither the stock of the Country X corporation specifically bequeathed to Charity A nor the insurance payable to the son could be charged with satisfying the bequest to Charity B. Therefore, the ''group of assets'' which could be so charged is limited to stock of the Country X corporation valued at $175,000 and stock of the United States corporation valued at $650,000.

(ii) Factor ''G'' of the ratio which is used in determining the ''second limitation'' is computed as follows:

| | | |
|---|---|---|
| Value of property situated in Country X ..... | | $200,000.00 |
| Less: | | |
| Reduction described in § 20.2014–3(b)(1) ..... | $25,000.00 | |
| Reduction described in § 20.2014–3(b)(2) = [$175,000 (factor K of the ratio stated at § 20.2014–3 (b)(2)) ÷ ($175,000 + $650,000 (factor L of the ratio stated at § 20.2014–3 (b)(2)))] × $100,000 (factor J of the ratio stated at § 20.2014–3(b)(2)) = ..... | 21,212.12 | |
| | | 46,212.12 |
| Factor ''G'' of the ratio ..... | ..... | 153,787.88 |

(iii) In this case, the ''second limitation'' on the credit for foreign death taxes is:

[$153,787.88 (factor G of the ratio stated at § 20.2014–3(a); see also subdivision (ii) above) ÷ ($1,000,000 − $125,000 (factor H of the ratio stated at § 20.2014–3(a)))] × ($242,450 − $24,480) (factor F of the ratio stated at § 20.2014–3(a)) = $38,309.88.

*Example (3).* (i) Decedent, a citizen and resident of the United States at the time of his death, left a gross estate of $850,000 which includes: shares of stock issued by United States corporations, valued at $440,000; real estate located in the United States, valued at $110,000; and shares of stock issued by Country X corporations, valued at $300,000. Expenses, indebtedness, etc., amounted to $50,000. Decedent devised $40,000 in real estate to a United States charity. In addition, he bequeathed to his wife $200,000 in United States stocks and $300,000 in Country X stocks. The residue of his estate passed to his children. The gross Federal estate tax is $81,700 and the credit for State death taxes is $5,520.

(ii) Decedent's adjusted gross estate is $800,000 (i.e., the $850,000, gross estate less $50,000, expenses, indebtedness, etc.). Assume that the limitation imposed by section 2056(c), as in effect before 1982, is applicable so that the aggregate allowable marital deduction is limited to one-half the adjusted gross estate, or $400,000 (which is 50 percent of $800,000). Factor ''G'' of the ratio which is used in determining the ''second limitation'' is computed as follows:

| | | |
|---|---|---|
| Value of property situated in Country X. ..... | | $300,000 |
| Less: Reduction described in § 20.2014–3 (b)(1) determined as follows (see also end of § 20.2014–3(b))— | | |
| Total amount of bequests which qualify for the marital deduction: | | |
| Specific bequest of Country X stock ..... | $300,000 | |
| Specific bequest of United States stock .... | 200,000 | |
| | 500,000 | |
| Limitation on aggregate marital deduction under section 2056(c) ..... | 400,000 | |
| Part of specific bequest of Country X stock with respect to which the marital deduction is allowed—($400,000 ÷ $500,000 × $300,000) | | 240,000 |
| Factor ''G'' of the ratio ..... | | 60,000 |

(iii) Thus, the ''second limitation'' on the credit for foreign death taxes is:

[$60,000 (factor G of the ratio stated at § 20.2014–3(a); see also subdivision (ii) above) ÷ ($850,000 − $40,000 − $400,000 (factor H of the ratio stated at § 20.2014–3(a)))] × ($81,700 − $5,520) (factor F of the ratio stated at § 20.2014–3(a)) = $11,148.29.

(d) If the foreign country imposes more than one kind of death tax or imposes taxes at different rates upon the several shares of an estate, or if the foreign country and a political subdivision or possession thereof each imposes a death tax, the ''second limitation'' is still computed by applying the ratio set forth in paragraph (a) of this section. Factor ''G'' of the ratio is determined by taking into consideration the combined value of the foreign property which is subjected to each different tax or different rate. The combined value, however, cannot exceed the value at which such property was included in the gross estate for Federal estate tax purposes. Thus, if Country X imposes a tax on the inheritance of a surviving spouse at a 10-percent rate and on the inheritance of a son at a 20-percent rate, the combined value of their inheritances is taken into consideration in determining factor ''G'' of the ratio, which is then used in computing the ''second limitation.'' However, the ''first limitation'' is computed as provided in paragraph (b) of § 20.2014–2. The lesser of the ''first limitation'' and the

''second limitation'' is the credit for foreign death taxes.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6600, 27 FR 4984, May 29, 1962; T.D. 7296, 38 FR 34193, Dec. 12, 1973; T.D. 8522, 59 FR 9646, Mar. 1, 1994]

## § 20.2014–4 Application of credit in cases involving a death tax convention.

(a) *In general.* (1) If credit for a particular foreign death tax is authorized by a death tax convention, there is allowed either the credit provided for by the convention or the credit provided for by section 2014, whichever is the more beneficial to the estate. For cases where credit may be taken under both the death tax convention and section 2014, see paragraph (b) of this section. The application of this paragraph may be illustrated by the following example:

*Example.* (i) Decedent, a citizen of the United States and a domiciliary of foreign Country X at the time of his death on December 1, 1966, left a gross estate of $1 million which includes the following: Shares of stock issued by a Country X corporation, valued at $400,000; bonds issued in 1962 by the United States and physically located in Country X, valued at $350,000; and real estate located in the United States, valued at $250,000. Expenses, indebtedness, etc., amounted to $50,000. Decedent left his entire estate to his son. There is in effect a death tax convention between the United States and Country X which provides for the allowance of credit by the United States for succession duties imposed by the national government of Country X. The gross Federal estate tax is $307,200, and the credit for State death taxes is $33,760. Country X imposed a net succession duty on the stocks and bonds of $180,000. Under the situs rules referred to in paragraph (a)(3) of § 20.2014–1, the shares of stock comprise the only property deemed to be situated in Country X. (If the decedent has died before November 14, 1966, the bonds also would be deemed to have their situs in Country X.) Under the convention, both the stocks and the bonds are deemed to be situated in Country X. In this example all figures are rounded to the nearest dollar.

(ii)(*a*) The credit authorized by the convention for death taxes imposed by Country X is computed as follows:

| | |
|---|---|
| *(1)* Country X tax attributable to property situated in Country X and subjected to tax by both countries ($750,000÷$750,000×$180,000) | $180,000 |
| *(2)* Federal estate tax attributable to property situated in Country X and subjected to tax by both countries—($750,000 ÷ $1,000,000 × $273,440) | 205,080 |
| *(3)* Credit (subdivision *(1)* or *(2)*, whichever is less) | 180,000 |

*(b)* The credit authorized by section 2014 for death taxes imposed by Country X is computed as follows:

| | |
|---|---|
| *(1)* ''First limitation'' computed under § 20.2014–2 ($400,000÷$750,000×$180,000) | $96,000 |
| *(2)* ''Second limitation'' computed under § 20.2014–3 ($400,000÷$1,000,000×$273,440) | 109,376 |
| *(3)* Credit (subdivision *(1)* or *(2)*, whichever is less) | 96,000 |

(iii) On the basis of the facts contained in this example, the credit of $180,000 authorized by the convention is the more beneficial to the estate.

(2) It should be noted that the greater of the treaty credit and the statutory credit is not necessarily the more beneficial to the estate. Such is the situation, for example, in those cases which involve both a foreign death tax credit and a credit under section 2013 for tax on prior transfers. The reason is that the amount of the credit for tax on prior transfers may differ depending upon whether the credit for foreign death tax is taken under the treaty or under the statute. Therefore, under certain circumstances, the advantage of taking the greater of the treaty credit and the statutory credit may be more than offset by a resultant smaller credit for tax on prior transfers. The solution is to compute the net estate tax payable first on the assumption that the treaty credit will be taken and then on the assumption that the statutory credit will be taken. Such computations will indicate whether the treaty credit or the statutory credit is in fact the more beneficial to the estate.

(b) *Taxes imposed by both a foreign country and a political subdivision thereof.* If death taxes are imposed by both a foreign country with which the United States has entered into a death tax convention and one or more of its possessions or political subdivisions, there is allowed, against the tax imposed by section 2001—

(1) A credit for the combined death taxes paid to the foreign country and its political subdivisions or possessions as provided for by the convention, or

(2) A credit for the combined death taxes paid to the foreign country and its political subdivisions or possessions as determined under section 2014, or

(3)(i) A credit for that amount of the combined death taxes paid to the foreign country and its political subdivisions or possessions as is allowable under the convention, and

(ii) A credit under section 2014 for the death taxes paid to each political subdivision or possession, but only to the extent such death taxes are not directly or indirectly creditable under the convention.

whichever is the most beneficial to the estate. The application of this paragraph may be illustrated by the following example:

*Example.* (1) Decedent, a citizen of the United States and a domiciliary of Province Y of foreign Country X at the time of his death on February 1, 1966, left a gross estate of $250,000 which includes the following: Bonds issued by Country X physically located in Province Y, valued at $75,000; bonds issued by Province Z of Country X and physically located in the United States, valued at $50,000; and shares of stock issued by a domestic corporation, valued at $125,000. Decedent left his entire estate to his son. Expenses, indebtedness etc., amounted to $26,000. The Federal estate tax after allowance of the credit for State death taxes is $38,124. Province Y imposed a death tax of 8 percent on the Country X bonds located therein which amounted to $6,000. No death tax was imposed by Province Z. Country X imposed a death tax of 15 percent on the Country X bonds and the Province Z bonds which amounted to $18,750 before allowance of any credit for the death tax of Province Y. Country X allows against its death taxes a credit for death taxes paid to any of its provinces on property which it also taxes, but only to the extent of one-half of the Country X death tax attributable to the property, or the amount of death taxes paid to its province, whichever is less. Country X, therefore, allowed a credit of $5,625 for the death taxes paid to Province Y. There is in effect a death tax convention between the United States and Country X which provides for allowance of credit by the United States for death taxes imposed by the national government of Country X. The death tax convention provides that in computing the ''first limitation'' for the credit under the convention, the tax of Country X is not to be reduced by the amount of the credit allowed for provincial taxes. Under the situs rules described in paragraph (a)(3) of § 20.2014–1, only the Country X bonds located in Province Y are deemed situated in Country X. (The bonds issued by Province Z also would be deemed to have their situs in Country X if the decedent had died on or after November 14, 1966.) Under the convention, both the Country X bonds and the Province Z bonds are deemed to be situated in Country X. In this example all figures are rounded to the nearest dollar.

(2)(i) The credit authorized by section 2014 for death taxes imposed by Country X (which includes death taxes imposed by Province Y according to § 20.2014–1(a)(1)) is computed as follows:

| | |
|---|---|
| *(a)* ''First limitation'' with respect to tax imposed by national government of Country X (computed under paragraph (b) of § 20.2014–2) | |
| *(1)* Gross Country X death tax attributable to Country X bonds (before allowance of provincial death taxes) (75,000÷$125,000×$18,750) | $11,250 |
| *(2)* Less credit for Province Y death taxes on such bonds | 5,625 |
| *(3)* Net Country X death tax attributable to such bonds | 5,625 |
| *(b)* ''First limitation'' with respect to tax imposed by Province Y (computed under paragraph (b) of § 20.2014–2) ($75,000÷$75,000×$6,000) | 6,000 |
| *(c)* Total ''first limitation'' | 11,625 |
| *(d)* ''Second limitation'' (computed under paragraph (d) of § 20.2014–3) ($75,000÷$250,000×$38,124) | 11,437 |
| *(e)* Credit (subdivision *(c)* or *(d)*, whichever is less) | 11,437 |

(ii) The credit authorized under the death tax convention between the United States and Country X is computed as follows:

| | |
|---|---|
| *(a)* Country X tax attributable to property situated in Country X and subject to tax by both countries ($125,000÷$125,000×$18,750) | $18,750 |
| *(b)* Federal estate tax attributable to property situated in Country X and subjected to tax by both countries ($125,000÷$250,000×$38,124) | 19,062 |
| *(c)* Credit (subdivision *(a) or (b),* whichever is less) | 18,750 |

(3) If the estate takes a credit for death taxes under the convention, it would receive a credit of $18,750 which would include an indirect credit of $5,625 for death taxes paid to Province Y. The death tax of Province Y which was not directly or indirectly creditable under the convention is $375 ($6,000 − $5,625). A credit for this tax would also be allowed under section 2014 but only to the extent of $187, as the amount of credit for the combined foreign death taxes is limited to the amount of Federal estate tax attributable to the property, determined in accordance with the rules prescribed for computing the ''second limitation'' under section 2014. In this case, the ''second limitation'' under section 2014 on the taxes attributable to the Country X bonds is $11,437 (see computation set forth in (2)(i) *(d)* of this example). The amount of credit under the convention for taxes attributable to Country X bonds is $11,250 − ($75,000÷$125,000× $18,750). Inasmuch as the ''second limitation'' under section 2014 in respect of the Country X bonds ($11,437) exceeds the amount of the credit allowed under the convention in respect of the Country X bonds ($11,250) by $187, the additional credit allowable under section 2014 for the death taxes paid to Province Y not directly

or indirectly creditable under the convention is limited to $187.

(c) *Taxes imposed by two foreign countries with respect to the same property.* It is stated as a general rule in paragraph (a)(2) of § 20.2014–1 that if credits against the Federal estate tax are allowable under section 2014, or under section 2014 and one or more death tax conventions, for death taxes paid to more than one country, the credits are combined and the aggregate amount is credited against the Federal estate tax. This rule may result in credit being allowed for taxes imposed by two different countries upon the same item of property. If such is the case, the total amount of the credits with respect to such property is limited to the amount of the Federal estate tax attributable to the property, determined in accordance with the rules prescribed for computing the ''second limitation'' set forth in § 20.2014–3. The application of this section may be illustrated by the following example:

*Example.* The decedent, a citizen of the United States and a domiciliary of Country X at the time of his death on May 1, 1967, left a taxable estate which included bonds issued by Country Z and physically located in Country X. Each of the three countries involved imposed death taxes on the Country Z bonds. Assume that under the provisions of a treaty between the United States and Country X the estate is entitled to a credit against the Federal estate tax for death taxes imposed by Country X on the bonds in the maximum amount of $20,000. Assume, also, that since the decedent died after November 13, 1966, so that under the situs rules referred to in paragraph (a)(3) of § 20.2014–1 the bonds are deemed to have their situs in Country Z, the estate is entitled to a credit against the Federal estate tax for death taxes imposed by Country Z on the bonds in the maximum amount of $10,000. Finally, assume that the Federal estate tax attributable to the bonds is $25,000. Under these circumstances, the credit allowed the estate with respect to the bonds would be limited to $25,000.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6742, 29 FR 7928, June 23, 1964; T.D. 7296, 38 FR 34193, Dec. 12, 1973]

### § 20.2014–5 Proof of credit.

(a) If the foreign death tax has not been determined and paid by the time the Federal estate tax return required by section 6018 is filed, credit may be claimed on the return in an estimated amount. However, before credit for the foreign death tax is finally allowed, satisfactory evidence, such as a statement by an authorized official of each country, possession or political subdivision thereof imposing the tax, must be submitted on Form 706CE certifying:

(1) The full amount of the tax (exclusive of any interest or penalties), as computed before allowance of any credit, remission, or relief;

(2) The amount of any credit, allowance, remission, or relief, and other pertinent information, including the nature of the allowance and a description of the property to which it pertains;

(3) The net foreign death tax payable after any such allowance;

(4) The date on which the death tax was paid, or if not all paid at one time, the date and amount of each partial payment; and

(5) A list of the property situated in the foreign country and subjected to its tax, showing a description and the value of the property.

Satisfactory evidence must also be submitted showing that no refund of the death tax is pending and none is authorized or, if any refund is pending or has been authorized, its amount and other pertinent information. See also section 2016 and § 20.2016–1 for requirements if foreign death taxes claimed as a credit are subsequently recovered.

(b) The following information must also be submitted whenever applicable:

(1) If any of the property subjected to the foreign death tax was situated outside of the country imposing the tax, the description of each item of such property and its value.

(2) If more than one inheritance or succession is involved with respect to which credit is claimed, or if the foreign country, possession or political subdivision thereof imposes more than one kind of death tax, or if both the foreign country and a possession or political subdivision thereof each imposes a death tax, a separate computation with respect to each inheritance or succession tax.

(c) In addition to the information required under paragraphs (a) and (b) of this section, the district director may require the submission of any further

proof deemed necessary to establish the right to the credit.

### § 20.2014–6 Period of limitations on credit.

The credit for foreign death taxes under section 2014 is limited to those taxes which were actually paid and for which a credit was claimed within four years after the filing of the estate tax return for the decedent's estate. If, however, a petition has been filed with the Tax Court of the United States for the redetermination of a deficiency within the time prescribed in section 6213(a), the credit is limited to those taxes which were actually paid and for which a credit was claimed within four years after the filing of the return, or before the expiration of 60 days after the decision of the Tax Court becomes final, whichever period is the last to expire. Similarly, if an extension of time has been granted under section 6161 for payment of the tax shown on the return, or of a deficiency, the credit is limited to those taxes which were actually paid and for which a credit was claimed within four years after the filing of the return, or before the date of the expiration of the period of the extension, whichever period is the last to expire. See section 2015 for the applicable period of limitations for credit for foreign death taxes on reversionary or remainder interests if an election is made under section 6163(a) to postpone payment of the estate tax attributable to reversionary or remainder interests. If a claim for refund based on the credit for foreign death taxes is filed within the applicable period described in this section, a refund may be made despite the general limitation provisions of sections 6511 and 6512. Any refund based on the credit for foreign death taxes shall be made without interest.

### § 20.2014–7 Limitation on credit if a deduction for foreign death taxes is allowed under section 2053(d).

If a deduction is allowed under section 2053(d) for foreign death taxes paid with respect to a charitable gift, the credit for foreign death taxes is subject to special limitations. In such a case the property described in subparagraphs (A), (B), and (C) of paragraphs (1) and (2) of section 2014(b) shall not include any property with respect to which a deduction is allowed under section 2053(d). The application of this section may be illustrated by the following example:

*Example.* The decedent, a citizen of the United States, died July 1, 1955, leaving a gross estate of $1,200,000 consisting of: Shares of stock issued by United States corporations, valued at $600,000; bonds issued by the United States Government physically located in the United States, valued at $300,000; and shares of stock issued by a Country X corporation, valued at $300,000. Expenses, indebtedness, etc., amounted to $40,000. The decedent made specific bequests of $400,000 of the United States corporation stock to a niece and $100,000 of the Country X corporation stock to a nephew. The residue of his estate was left to charity. There is no death tax convention in existence between the United States and Country X. The Country X tax imposed was at a 50-percent rate on all beneficiaries. A State inheritance tax of $20,000 was imposed on the niece and nephew. The decedent did not provide in his will for the payment of the death taxes, and under local law the Federal estate tax is payable from the general estate, the same as administration expenses.

DISTRIBUTION OF THE ESTATE

| | | |
|---|---|---|
| Gross estate | | $1,200,000.00 |
| Debts and charges | $40,000.00 | |
| Bequest of U.S. corporation stock to niece | 400,000.00 | |
| Bequest of country X corporation stock to nephew | 100,000.00 | |
| Net Federal estate tax | 136,917.88 | |
| | | 676,917.88 |
| Residue before country X tax | | 523,082.12 |
| Country X succession tax on charity | | 100,000.00 |
| Charitable deduction | | 423,082.12 |

TAXABLE ESTATE AND FEDERAL ESTATE TAX

| | | |
|---|---|---|
| Gross estate | | 1,200,000.00 |
| Debts and charges | 40,000.00 | |
| Deduction of foreign death tax under section 2053(d) | 100,000.00 | |
| Charitable deduction | 423,082.12 | |
| Exemption | 60,000.00 | |
| | | 623,082.12 |
| Taxable estate | | 576,917.88 |
| Gross estate tax | | 172,621.26 |
| Credit for State death taxes | | 15,476.72 |
| Gross estate tax less credit for State death taxes | | 157,144.54 |
| Credit for foreign death taxes | | 20,226.66 |
| Net Federal estate tax | | 136,917.88 |

CREDIT FOR FOREIGN DEATH TAXES

COUNTRY X TAX

| | | |
|---|---|---|
| Succession tax on nephew: | | |
| Value of stock of country X corporation | | 100,000 |
| Tax (50% rate) | | $50,000 |

DISTRIBUTION OF THE ESTATE

| | | |
|---|---|---|
| Succession tax on charity: | | |
| Value of stock of country X corporation | ..... | 200,000 |
| Tax (50% rate) | ..... | 100,000 |

COMPUTATION OF EXCLUSION UNDER SECTION 2014(B)

| | | |
|---|---|---|
| Value of situated in country X | ..... | 300,000 |
| Value of property in respect of which a deduction is allowed under section 2053(d) | ..... | 200,000 |
| Value of property situated within country X, subjected to tax, and included in gross estate as limited by section 2014(f) | ..... | 100,000 |

FIRST LIMITATION, § 28.2014–2(A)

$100,000 (factor C of the ratio stated at § 20.2014–2(a)) ÷ $100,000 + $200,000 (factor D of the ratio stated at § 20.2014 2(a) × $50,000 + $100,000) (factor B of the ratio stated at § 20.2014–2(a)) = $50,000.00

SECOND LIMITATION, § 28.2014–3(A)

$100,000 (factor G of the ratio stated at § 20.2014–3(a)) (as limited by section 2014(f)) ÷ $1,200,000 − $423,082.12 (factor H of the ratio stated at § 20.2014 3(a) × $172,621.26 − $15,476.72) (factor F of the ratio stated at § 20.2014–3(a)) = $20,226.66Z

[T.D. 6600, 27 FR 4984, May 27, 1962]

## § 20.2015–1 Credit for death taxes on remainders.

(a) If the executor of an estate elects under section 6163(a) to postpone the time for payment of any portion of the Federal estate tax attributable to a reversionary or remainder interest in property, credit is allowed under sections 2011 and 2014 against that portion of the Federal estate tax for State death taxes and foreign death taxes attributable to the reversionary or remainder interest if the State death taxes or foreign death taxes are paid and if credit therefor is claimed either—

(1) Within the time provided for in sections 2011 and 2014, or

(2) Within the time for payment of the tax imposed by section 2001 or 2101 as postponed under section 6163(a) and as extended under section 6163(b) (on account of undue hardship) or, if the precedent interest terminated before July 5, 1958, within 60 days after the termination of the preceding interest or interests in the property.

The allowance of credit, however, is subject to the other limitations contained in sections 2011 and 2014 and, in the case of the estate of a decedent who was a nonresident not a citizen of the United States, in section 2102(b).

(b) In applying the rule stated in paragraph (a) of this section, credit for State death taxes or foreign death taxes paid within the time provided in sections 2011 and 2014 is applied first to the portion of the Federal estate tax payment of which is not postponed, and any excess is applied to the balance of the Federal estate tax. However, credit for State death taxes or foreign death taxes not paid within the time provided in section 2011 and 2014 is allowable only against the portion of the Federal estate tax attributable to the reversionary or remainder interest, and only for State or foreign death taxes attributable to that interest. If a State death tax or a foreign death tax is imposed upon both a reversionary or remainder interest and upon other property, without a definite apportionment of the tax, the amount of the tax deemed attributable to the reversionary or remainder interest is an amount which bears the same ratio to the total tax as the value of the reversionary or remainder interest bears to the value of the entire property with respect to which the tax was imposed. In applying this ratio, adjustments consistent with those required under paragraph (c) of § 20.6163–1 must be made.

(c) The application of this section may be illustrated by the following examples:

*Example (1).* One-third of the Federal estate tax was attributable to a remainder interest in real property located in State Y, and two-thirds of the Federal estate tax was attributable to other property located in State X. The payment of the tax attributable to the remainder interest was postponed under the provisions of section 6163(a). The maximum credit allowable for State death taxes under the provisions of section 2011 is $12,000. Therefore, of the maximum credit allowable, $4,000 is attributable to the remainder interest and $8,000 is attributable to the other property. Within the 4-year period provided for in section 2011, inheritance tax in the amount of $9,000 was paid to State X in connection with the other property. With respect to this $9,000, $8,000 (the maximum amount allowable) is allowed as a credit against the Federal estate tax attributable to the other property, and $1,000 is allowed as a credit against the postponed tax. The life

estate or other precedent interest expired after July 4, 1958. After the expiration of the 4-year period but before the expiration of the period of postponment elected under section 6163(a) and of the period of extension granted under section 6163(b) for payment of the tax, inheritance tax in the amount of $5,000 was paid to State Y in connection with the remainder interest. As the maximum credit allowable with respect to the remainder interest is $4,000 and $1,000 has already been allowed as a credit, an additional $3,000 will be credited against the Federal estate tax attributable to the remainder interest. It should be noted that if the life estate or other precedent interest had expired after the expiration of the 4-year period but before July 5, 1958, the same result would be reached only if the inheritance tax had been paid to State Y before the expiration of 60 days after the termination of the life estate or other precedent interest.

*Example (2).* The facts are the same as in example (1), except that within the 4-year period inheritance tax in the amount of $2,500 was paid to State Y with respect to the remainder interest and inheritance tax in the amount of $7,500 was paid to State X with respect to the other property. The amount of $8,000 is allowed as a credit against the Federal estate tax attributable to the other property and the amount of $2,000 is allowed as a credit against the postponed tax. The life estate or other precedent interest expired after July 4, 1958. After the expiration of the 4-year period but before the expiration of the period of postponement elected under section 6163(a) and of the period of extension granted under section 6163(b) for payment of the tax, inheritance tax in the amount of $5,000 was paid to State Y in connection with the remainder interest. As the maximum credit allowable with respect to the remainder interest is $4,000 and $2,000 already has been allowed as a credit, an additional $2,000 will be credited against the Federal estate tax attributable to the remainder interest. It should be noted that if the life estate or other precedent interest had expired after the expiration of the 4-year period but before July 5, 1958, the same result would be reached only if the inheritance tax had been paid to State Y before the expiration of 60 days after the termination of the life estate or other precedent interest.

*Example (3).* The facts are the same as in example (2), except that no payment was made to State Y within the 4-year period. The amount of $7,500 is allowed as a credit against the Federal estate tax attributable to the other property. After termination of the life interest additional credit will be allowed in the amount of $4,000 against the Federal estate tax attributable to the remainder interest. Since the payment of $5,000 was made to State Y following the expiration of the 4-year period, no part of the payment may be allowed as a credit against the Federal estate tax attributable to the other property.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6526, 26 FR 415, Jan. 19, 1961; T.D. 7296, 38 FR 34194, Dec. 12, 1973]

### § 20.2016–1 Recovery of death taxes claimed as credit.

In accordance with the provisions of section 2016, the executor (or any other person) receiving a refund of any State death taxes or foreign death taxes claimed as a credit under section 2011 or section 2014 shall notify the district director of the refund within 30 days of its receipt. The notice shall contain the following information:

(a) The name of the decedent;

(b) The date of the decedent's death;

(c) The property with respect to which the refund was made;

(d) The amount of the refund, exclusive of interest;

(e) The date of the refund; and

(f) The name and address of the person receiving the refund.

If the refund was in connection with foreign death taxes claimed as a credit under section 2014, the notice shall also contain a statement showing the amount of interest, if any, paid by the foreign country on the refund. Finally, the person filing the notice shall furnish the district director such additional information as he may request. Any Federal estate tax found to be due by reason of the refund is payable by the person or persons receiving it, upon notice and demand, even though the refund is received after the expiration of the period of limitations set forth in section 6501 (see section 6501(c)(5)). If the tax found to be due results from a refund of foreign death tax claimed as a credit under section 2014, such tax shall not bear interest for any period before the receipt of the refund, except to the extent that interest was paid by the foreign country on the refund.

## GROSS ESTATE

### § 20.2031–0 Table of contents.

This section lists the section headings and undesignated center headings that appear in the regulations under section 2031.

*§ 2031–1 Definition of gross estate; valuation of property.*

*§ 20.2031–2 Valuation of stocks and bonds.*

*§ 20.2031–3 Valuation of interests in businesses.*

*§ 20.2031–4 Valuation of notes.*

*§ 20.2031–5 Valuation of cash on hand or on deposit.*

*§ 20.2031–6 Valuation of household and personal effects.*

*§ 20.2031–7 Valuation of annuities, interests for life or term of years, and remainder or reversionary interests for estates of decedents for which the valuation date of the gross estate is after April 30, 1989.*

*§ 20.2031–8 Valuation of certain life insurance and annuity contracts; valuation of shares in an open-end investment company.*

*§ 20.2031–9 Valuation of other property.*

ACTUARIAL TABLES APPLICABLE BEFORE MAY 1, 1989

*§ 20.2031–7A Valuation of annuities, interests for life or term of years, and remainder or reversionary interests for estates of decedents for which the valuation date of the gross estate is before May 1, 1989.*

[T.D. 8540, 59 FR 30151, June 10, 1994]

## § 20.2031–1 Definition of gross estate; valuation of property.

(a) *Definition of gross estate.* Except as otherwise provided in this paragraph the value of the gross estate of a decedent who was a citizen or resident of the United States at the time of his death is the total value of the interests described in sections 2033 through 2044. The gross estate of a decedent who died before October 17, 1962, does not include real property situated outside the United States (as defined in paragraph (b)(1) of § 20.0–1). Except as provided in paragraph (c) of this section (relating to the estates of decedents dying after October 16, 1962, and before July 1, 1964), in the case of a decedent dying after October 16, 1962, real property situated outside the United States which comes within the scope of sections 2033 through 2044 is included in the gross estate to the same extent as any other property coming within the scope of those sections. In arriving at the value of the gross estate the interests described in sections 2033 through 2044 are valued as described in this section, §§ 20.2031–2 through 20.2031–9 and § 20.2032–1. The contents of sections 2033 through 2044 are, in general, as follows:

(1) Sections 2033 and 2034 are concerned mainly with interests in property passing through the decedent's probate estate. Section 2033 includes in the decedent's gross estate any interest that the decedent had in property at the time of his death. Section 2034 provides that any interest of the decedent's surviving spouse in the decedent's property, such as dower or curtesy, does not prevent the inclusion of such property in the decedent's gross estate.

(2) Sections 2035 through 2038 deal with interests in property transferred by the decedent during his life under such circumstances as to bring the interests within the decedent's gross estate. Section 2035 includes in the decedent's gross estate property transferred in contemplation of death, even though the decedent had not interest in, or control over, the property at the time of his death. Section 2036 provides for the inclusion of transferred property with respect to which the decedent retained the income or the power to designate who shall enjoy the income. Section 2037 includes in the decedent's gross estate certain transfers under which the beneficial enjoyment of the property could be obtained only by surviving the decedent. Section 2038 provides for the inclusion of transferred property if the decedent had at the time of his death the power to change the beneficial enjoyment of the property. It should be noted that there is considerable overlap in the application of sections 2036 through 2038 with respect to reserved powers, so that transferred property may be includible in the decedent's gross estate in varying degrees under more than one of those sections.

(3) Sections 2039 through 2042 deal with special kinds of property and powers. Sections 2039 and 2040 concern annuities and jointly held property respectively. Section 2041 deals with powers held by the decedent over the beneficial enjoyment of property not originating with the decedent. Section 2042 concerns insurance under policies on the life of the decedent.

(4) Section 2043 concerns the sufficiency of consideration for transfers made by the decedent during his life. This has a bearing on the amount to be included in the decedent's gross estate under sections 2035 through 2038, and 2041. Section 2044 deals with retroactivity.

(b) *Valuation of property in general.* The value of every item of property includible in a decedent's gross estate under sections 2031 through 2044 is its fair market value at the time of the decedent's death, except that if the executor elects the alternate valuation method under section 2032, it is the fair market value thereof at the date, and with the adjustments, prescribed in that section. The fair market value is 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. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the fair market value of an automobile (an article generally obtained by the public in the retail market) includible in the decedent's gross estate is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the decedent would be purchased by a dealer in used automobiles. Examples of items of property which are generally sold to the public at retail may be found in §§ 20.2031–6 and 20.2031–8. The value is generally to be determined by ascertaining as a basis the fair market value as of the applicable valuation date of each unit of property. For example, in the case of shares of stock or bonds, such unit of property is generally a share of stock or a bond. Livestock, farm machinery, harvested and growing crops must generally be itemized and the value of each item separately returned. Property shall not be returned 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. All relevant facts and elements of value as of the applicable valuation date shall be considered in every case. The value of items of property which were held by the decedent for sale in the course of a business generally should be reflected in the value of the business. For valuation of interests in businesses, see § 20.2031–3. See § 20.2031–2 and §§ 20.2031–4 through 20.2031–8 for further information concerning the valuation of other particular kinds of property. For certain circumstances under which the sale of an item of property at a price below its fair market value may result in a deduction for the estate, see paragraph (d)(2) of § 20.2053–3.

(c) *Real property situated outside the United States; gross estate of decedent dying after October 16, 1962, and before July 1, 1964*—(1) *In general.* In the case of decedent dying after October 16, 1962, and before July 1, 1964, the value of real property situated outside the United States (as defined in paragraph (b)(1) of § 20.0–1) is not included in the gross estate of the decedent—

(i) Under section 2033, 2034, 2035(a), 2036(a), 2037(a), or 2038(a) to the extent the real property, or the decedent's interest in it, was acquired by the decedent before February 1, 1962;

(ii) Under section 2040 to the extent such property or interest was acquired by the decedent before February 1, 1962, or was held by the decedent and the survivor in a joint tenancy or tenancy by the entirety before February 1, 1962; or

(iii) Under section 2041(a) to the extent that before February 1, 1962, such property or interest was subject to a general power of appointment (as defined in section 2041) possessed by the decedent.

(2) *Certain property treated as acquired before February 1, 1962.* For purposes of this paragraph real property situated outside the United States (including property held by the decedent and the survivor in a joint tenancy or tenancy by the entirety), or an interest in such property or a general power of appointment in respect of such property, which was acquired by the decedent after January 31, 1962, is treated as acquired by the decedent before February 1, 1962, if

(i) Such property, interest, or power was acquired by the decedent by gift within the meaning of section 2511, or from a prior decedent by devise or inheritance, or by reason of death, form of ownership, or other conditions (including the exercise or nonexercise of a power of appointment); and

(ii) Before February 1, 1962, the donor or prior decedent had acquired the property or his interest therein or had possessed a power of appointment in respect thereof.

(3) *Certain property treated as acquired after January 31, 1962.* For purposes of this paragraph that portion of capital additions or improvements made after January 31, 1962, to real property situated outside the United States is, to the extent that it materially increases the value of the property, treated as real property acquired after January 31, 1962. Accordingly, the gross estate may include the value of improvements on unimproved real property, such as office buildings, factories, houses, fences, drainage ditches, and other capital items, and the value of capital additions and improvements to existing improvements, placed on real property after January 31, 1962, whether or not the value of such real property or existing improvements is included in the gross estate.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6684, 28 FR 11408, Oct. 24, 1963; T.D. 6826, 30 FR 7708, June 15, 1965]

### § 20.2031–2 Valuation of stocks and bonds.

(a) *In general.* The value of stocks and bonds is the fair market value per share or bond on the applicable valuation date.

(b) *Based on selling prices.* (1) In general, 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. 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 available in a generally available listing or publication of general circulation, the records of such combined exchanges should be employed. In valuing listed securities, the executor should be careful to consult accurate records to obtain values as of the applicable valuation date. If quotations of unlisted securities are obtained from brokers, or evidence as to their sale is obtained from officers of the issuing companies, copies of the letters furnishing such quotations or evidence of sale should be attached to the return.

(2) 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. 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 date. 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. In valuing listed securities, the executor should be careful to consult accurate records to obtain values as of the applicable valuation date.

(3) The application of this paragraph may be illustrated by the following examples:

*Example (1).* Assume that sales of X Company common stock nearest the valuation date (Friday, June 15) occurred two trading days before (Wednesday, June 13) and three trading days after (Wednesday, June 20) and on these days the mean sale prices per share were $10 and $15, respectively. The price of $12 is taken as representing the fair market value of a share of X Company common stock as of the valuation date

$$\left[(3\times 10)+(2\times 15)\right]/5.$$

*Example (2).* Assume the same facts as in example (1) except that the mean sale prices per share on June 13, and June 20 were $15 and $10, respectively. The price of $13 is taken as representing the fair market value of a share of X Company common stock as of the valuation date

$$\left[(3\times 5)+(2\times 10)\right]/5.$$

*Example (3).* Assume the decedent died on Sunday, October 7, and that Saturday and Sunday were not trading days. If sales of X Company common stock occurred on Friday, October 5, at mean sale prices per share of $20 and on Monday, October 8, at mean sale prices per share of $23, the price of $21.50 is taken as representing the fair market value of a share of X Company common stock as of the valuation date

$$\left[(1\times 20)+(23\times 1)\right]/2.$$

*Example (4).* Assume that on the valuation date (Tuesday, April 3, 1973) the closing selling price of a listed bond was $25 per bond and that the highest and lowest selling prices are not available in a generally available listing or publication of general circulation for that date. Assume further, that the closing selling price of the same listed bond was $21 per bond on the day before the valuation date (Monday, April 2, 1973). Thus, under paragraph (b)(2) of this section the price of $23 is taken as representing the fair market value per bond as of the valuation date

$$(25+21)/2.$$

*Example (5).* Assume the same facts as in example (4) except that there were no sales on the day before the valuation date. Assume further, that there were sales on Thursday, March 29, 1973, and that the closing selling price on that day was $23. The price of $24.50 is taken as representing the fair market value per bond as of the valuation date

$$\left[(1\times 23)+(3\times 25)\right]/4.$$

*Example (6).* Assume that no bonds were traded on the valuation date (Friday, April 20). Assume further, that sales of bonds nearest the valuation date occurred two trading days before (Wednesday, April 18) and three trading days after (Wednesday, April 25) the valuation date and that on these two days the closing selling prices per bond were $29 and $22, respectively. The highest and lowest selling prices are not available for these dates in a generally available listing or publication of general circulation. Thus, under paragraph (b)(2) of this section, the price of $26.20 is taken as representing the fair market value of a bond as of the valuation date

$$\left[(3\times 29)+(2\times 22)\right]/5.$$

(c) *Based on bid and asked prices.* If the provisions of paragraph (b) of this section 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 in paragraph (b) of this section.

(d) *Based on incomplete selling prices or bid and asked prices.* If the provisions of paragraphs (b) and (c) of this section 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.

(e) *Where selling prices or bid and asked prices do not reflect fair market value.* 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 under paragraphs (b), (c), and (d) of this section 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. Where sales at or near the date of death 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 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. Complete data in support of any allowance claimed due to the size of the block of stock being valued shall be submitted with the return. On the other hand, if the block of stock to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to its true value.

(f) *Where selling prices or bid and asked prices are unavailable.* If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because 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 subparagraphs (1) and (2) of this paragraph are: 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. In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including 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. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of any examinations of the company

made by accountants, engineers, or any technical experts as of or near the applicable valuation date.

(g) *Pledged securities.* 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 in accordance with the provisions of § 20.2053–1 or § 20.2106–1 (for estates of nonresidents not citizens).

(h) *Securities subject to an option or contract to purchase.* 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. See section 2703 and the regulations at § 25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990.

(i) *Stock sold ''ex-dividend.''* In any case where a dividend is declared on a share of stock before the decedent's death but payable to stock holders 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.

(j) *Application of chapter 14.* See section 2701 and the regulations at § 25.2701 of this chapter for special rules for valuing the transfer of an interest in a corporation and for the treatment of unpaid qualified payments at the death of the transferor or an applicable family member. See section 2704(b) and the regulations at § 25.2704–2 of this chapter for special valuation rules involving certain restrictions on liquidation rights created after October 8, 1990.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7312, 39 FR 14948, Apr. 29, 1974; T.D. 7327, 39 FR 35354, Oct. 1, 1974; T.D. 7432, 41 FR 38769, Sept. 13, 1976; T.D. 8395, 57 FR 4254, Feb. 4, 1992]

### § 20.2031–3 Valuation of interests in businesses.

The fair market value of any interest of a decedent in a business, whether a partnership 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 relevant facts. The net value is determined on the basis of all relevant factors including—

(a) A fair appraisal as of the applicable valuation date of all the assets of the business, tangible and intangible, including good will;

(b) The demonstrated earning capacity of the business; and

(c) The other factors set forth in paragraphs (f) and (h) of § 20.2031–2 relating to the valuation of corporate stock, to the extent applicable.

Special attention should be given to determining an adequate value of the good will of the business in all cases in which the decedent has not agreed, for

an adequate and full consideration in money or money's worth, that his interest passes at his death to, for example, his surviving partner or partners. 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. See section 2701 and the regulations at § 25.2701 of this chapter for special rules for valuing the transfer of an interest in a partnership and for the treatment of unpaid qualified payments at the death of the transferor or an applicable family member. See section 2703 and the regulations at § 25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990. See section 2704(b) and the regulations at § 25.2704–2 of this chapter for special valuation rules involving certain restrictions on liquidation rights created after October 8, 1990.

[T.D. 8395, 57 FR 4254, Feb. 4, 1992]

### § 20.2031–4 Valuation of notes.

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, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. 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.

### § 20.2031–5 Valuation of cash on hand or on deposit.

The amount of cash belonging to the decedent at the date of his death, whether in his possession or in the possession of another, or deposited with a bank, is included in the decedent's gross estate. If bank checks outstanding at the time of the decedent's death and given in discharge of bona fide legal obligations of the decedent incurred for an adequate and full consideration in money or money's worth are subsequently honored by the bank and charged to the decedent's account, the balance remaining in the account may be returned, but only if the obligations are not claimed as deductions from the gross estate.

### § 20.2031–6 Valuation of household and personal effects.

(a) *General rule.* The fair market value of the decedent's household and personal effects is the price which a willing buyer would pay to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. A room by room itemization of household and personal effects is desirable. All the articles should be named specifically, except that a number of articles contained in the same room, none of which has a value in excess of $100, may be grouped. A separate value should be given for each article named. In lieu of an itemized list, the executor may furnish a written statement, containing a declaration that it is made under penalties of perjury, setting forth the aggregate value as appraised by a competent appraiser or appraisers of recognized standing and ability, or by a dealer or dealers in the class of personalty involved.

(b) *Special rule in cases involving a substantial amount of valuable articles.* Notwithstanding the provisions of paragraph (a) of this section, if there are included among the household and personal effects articles having marked artistic or intrinsic value of a total value in excess of $3,000 (e.g., jewelry, furs, silverware, paintings, etchings, engravings, antiques, books, statuary, vases, oriental rugs, coin or stamp collections), the appraisal of an expert or experts, under oath, shall be filed with the return. The appraisal shall be accompanied by a written statement of the executor containing a declaration that it is made under the penalties of perjury as to the completeness of the itemized list of such property and as to the disinterested character and the

qualifications of the appraiser or appraisers.

(c) *Disposition of household effects prior to investigation.* If it is desired to effect distribution or sale of any portion of the household or personal effects of the decedent in advance of an investigation by an officer of the Internal Revenue Service, information to that effect shall be given to the district director. The statement to the district director shall be accompanied by an appraisal of such property, under oath, and by a written statement of the executor, containing a declaration that it is made under the penalties of perjury, regarding the completeness of the list of such property and the qualifications of the appraiser, as heretofore described. If a personal inspection by an officer of the Internal Revenue Service is not deemed necessary, the executor will be so advised. This procedure is designed to facilitate disposition of such property and to obviate future expense and inconvenience to the estate by affording the district director an opportunity to make an investigation should one be deemed necessary prior to sale or distribution.

(d) *Additional rules if an appraisal involved.* If, pursuant to paragraphs (a), (b), and (c) of this section, expert appraisers are employed, care should be taken to see that they are reputable and of recognized competency to appraise the particular class of property involved. In the appraisal, books in sets by standard authors should be listed in separate groups. In listing paintings having artistic value, the size, subject, and artist's name should be stated. In the case of oriental rugs, the size, make, and general condition should be given. Sets of silverware should be listed in separate groups. Groups or individuals pieces of silverware should be weighed and the weights given in troy ounces. In arriving at the value of silverware, the appraisers should take into consideration its antiquity, utility, desirability, condition, and obsolescence.

## § 20.2031–7 Valuation of annuities, interests for life or term of years, and remainder or reversionary interests for estates of decedents for which the valuation date of the gross estate is after April 30, 1989.

(a) *In general.* Except as otherwise provided in paragraph (b) of this section and § 20.7520–3(b) (pertaining to certain limitations on the use of prescribed tables), the fair market value of annuities, life estates, terms of years, remainders, and reversionary interests for estates of decedents is the present value of such interests, determined under paragraph (d) of this section. The regulations in this and in related sections provide tables with standard actuarial factors and examples that illustrate how to use the tables to compute the present value of ordinary annuity, life, and remainder interests in property. These sections also refer to standard and special actuarial factors that may be necessary to compute the present value of similar interests in more unusual fact situations.

(b) *Commercial annuities and insurance contracts.* The value of annuities issued by companies regularly engaged in their sale, and of insurance policies on the lives of persons other than the decedent, is determined under § 20.2031–8. See § 20.2042–1 with respect to insurance policies on the decedent's life.

(c) *Actuarial valuations before May 1, 1989.* The present value of annuities, life estates, terms of years, remainders, and reversions for estates of decedents for which the valuation date of the gross estate is before May 1, 1989, is determined under the following sections:

| Valuation date | | Applicable section |
|---|---|---|
| After | Before | |
| | 01–01–52 | 20.2031–7A(a) |
| 12–31–51 | 01–01–71 | 20.2031–7A(b) |
| 12–31–70 | 12–01–83 | 20.2031–7A(c) |
| 11–30–83 | 05–01–89 | 20.2031–7A(d) |

(d) *Actuarial valuations after April 30, 1989*—(1) *In general.* Except as otherwise provided in paragraph (b) of this section and § 20.7520–3(b) (pertaining to

certain limitations on the use of prescribed tables), if the valuation date for the gross estate of the decedent is after April 30, 1989, the fair market value of annuities, life estates, terms of years, remainders, and reversionary interests is their present value determined by use of standard or special section 7520 actuarial factors. These factors are derived by using the appropriate section 7520 interest rate and, if applicable, the mortality component for the valuation date of the interest that is being valued. See §§ 20.7520–1 through 20.7520–4.

(2) *Specific Interests*—(i) *Charitable Remainder Trusts.* The fair market value of a remainder interest in a pooled income fund, as defined in § 1.642(c)–5 of this chapter, is its value determined under § 1.642(c)–6(e) of this chapter. The fair market value of a remainder interest in a charitable remainder annuity trust, as defined in § 1.664–2(a) of this chapter, is its present value determined under § 1.664–2(c) of this chapter. The fair market value of a remainder interest in a charitable remainder unitrust, as defined in § 1.664–3 of this chapter, is its present value determined under § 1.664–4(e) of this chapter. The fair market value of a life interest or term of years in a charitable remainder unitrust is the fair market value of the property as of the date of valuation less the fair market value of the remainder interest on that date determined under § 1.664–4(e) of this chapter.

(ii) *Ordinary remainder and reversionary interests.* If the interest to be valued is to take effect after a definite number of years or after the death of one individual, the present value of the interest is computed by multiplying the value of the property by the appropriate remainder interest actuarial factor (that corresponds to the applicable section 7520 interest rate and remainder interest period) in Table B (for a term certain) or Table S (for one measuring life), as the case may be. Tables B and S are included in paragraph (d)(6) of this section and in Internal Revenue Service Publication 1457. For information about obtaining actuarial factors for other types of remainder interests, see paragraph (d)(4) of this section.

(iii) *Ordinary term-of-years and life interests.* If the interest to be valued is the right of a person to receive the income of certain property, or to use certain nonincome-producing property, for a term of years or for the life of one individual, the present value of the interest is computed by multiplying the value of the property by the appropriate term-of-years or life interest actuarial factor (that corresponds to the applicable section 7520 interest rate and term-of-years or life interest period). Internal Revenue Service Publication 1457 includes actuarial factors for an interest for a term of years in Table B and for the life of one individual in Table S. However, term-of-years and life interest actuarial factors are not included in Table B or Table S in § 20.2031–7(d)(6) of this chapter. If Internal Revenue Service Publication 1457 (or any other reliable source of term-of-years and life interest actuarial factors) is not conveniently available, an actuarial factor for the interest may be derived mathematically. This actuarial factor may be derived by subtracting the correlative remainder factor (that corresponds to the applicable section 7520 interest rate and the term of years or the life) in Table B (for a term of years) or in Table S (for the life of one individual) in § 20.2031–7(d)(6), as the case may be, from 1.000000. For information about obtaining actuarial factors for other types of term-of-years and life interests, see paragraph (d)(4) of this section.

(iv) *Annuities.* (A) If the interest to be valued is the right of a person to receive an annuity that is payable at the end of each year for a term of years or for the life of one individual, the present value of the interest is computed by multiplying the aggregate amount payable annually by the appropriate annuity actuarial factor (that corresponds to the applicable section 7520 interest rate and annuity period). Internal Revenue Publication 1457 includes actuarial factors in Table B (for an annuity payable for a term of years) and in Table S (for an annuity payable for the life of one individual). However, annuity actuarial factors are not included in Table B or Table S in paragraph (d)(6) of this section. If Internal Revenue Service Publication 1457 (or

any other reliable source of annuity actuarial factors) is not conveniently available, a required annuity factor for a term of years or for one life may be mathematically derived. This annuity factor may be derived by subtracting the applicable remainder factor (that corresponds to the applicable section 7520 interest rate and annuity period) in Table B (in the case of a term-of-years annuity) or in Table S (in the case of a one-life annuity) in paragraph (d)(6) of this section, as the case may be, from 1.000000 and then dividing the result by the applicable section 7520 interest rate expressed as a decimal number.

(B) If the annuity is payable at the end of semiannual, quarterly, monthly, or weekly periods, the product obtained by multiplying the annuity factor by the aggregate amount payable annually is then multiplied by the applicable adjustment factor set forth in Table K for payments made at the end of the specified periods. The provisions of this paragraph (d)(2)(iv)(B) are illustrated by the following example:

*Example.* At the time of the decedent's death in January 1990, the annuitant, age 72, is entitled to receive an annuity of $15,000 a year for life payable in equal monthly installments at the end of each period. The section 7520 rate for January 1990 is 9.6 percent. Under Table S, the remainder factor at 9.6 percent for an individual aged 72 is .40138. By converting the remainder factor to an annuity factor, as described above, the annuity factor at 9.6 percent for an individual aged 72 is 6.2356 (1.00000 minus .40138, divided by .096). Under Table K, the adjustment factor under the column for payments made at the end of each monthly period at the rate of 9.6 percent is 1.0433. The aggregate annual amount, $15,000, is multiplied by the factor 6.2356 and the product multiplied by 1.0433. The present value of the annuity at the date of the decedent's death is, therefore, $97,584.02 ($15,000×6.2356×1.0433).

(C) If an annuity is payable at the beginning of annual, semiannual, quarterly, monthly, or weekly periods for a term of years, the value of the annuity is computed by multiplying the aggregate amount payable annually by the annuity factor described in paragraph (d)(2)(iv)(A) of this section; and the product so obtained is then multiplied by the adjustment factor in Table J at the appropriate interest rate component for payments made at the beginning of specified periods. If an annuity is payable at the beginning of annual, semiannual, quarterly, monthly, or weekly periods for one or more lives, the value of the annuity is the sum of the first payment plus the present value of a similar annuity, the first payment of which is not to be made until the end of the payment period, determined as provided in this paragraph (d)(2)(iv).

(v) *Annuity and unitrust interests for a term of years or until the prior death of an individual.* See § 25.2512–5(d)(2)(v) of this chapter for examples explaining how to compute the present value of an annuity or unitrust interest that is payable until the earlier of the lapse of a specific number of years or the death of an individual.

(3) *Transitional rule.* (i) If the valuation date is after April 30, 1989, and before June 10, 1994, a taxpayer can rely on Notice 89–24, 1989–1 C.B. 660, or Notice 89–60, 1989–1 C.B. 700 (See § 601.601(d)(2)(ii)(*b*) of this chapter).

(ii) If a decedent dies after April 30, 1989, and if on May 1, 1989, the decedent was mentally incompetent so that the disposition of the decedent's property could not be changed, and the decedent dies without having regained competency to dispose of the decedent's property or dies within 90 days of the date on which the decedent first regains competency, the fair market value of annuities, life estates, terms for years, remainders, and reversions included in the gross estate of the decedent is their present value determined either under this section or under the corresponding section applicable at the time the decedent became mentally incompetent, at the option of the decedent's executor. For example, see § 20.2031–7A(d).

(4) *Publications and actuarial computations by the Internal Revenue Service.* Many standard actuarial factors not included in paragraph (d)(6) of this section are included in Internal Revenue Service Publication 1457, ''Actuarial Values, Alpha Volume,'' (8–89). Publication 1457 also includes examples that illustrate how to compute many special factors for more unusual situations. A copy of this publication may be purchased from the Superintendent of Documents, United States Government

Printing Office, Washington, DC 20402. If a special factor is required in the case of an actual decedent, the Service may furnish the factor to the executor upon a request for a ruling. The request for a ruling must be accompanied by a recitation of the facts including a statement of the date of birth for each measuring life, the date of the decedent's death, any other applicable dates, and a copy of the will, trust, or other relevant documents. A request for a ruling must comply with the instructions for requesting a ruling published periodically in the Internal Revenue Bulletin (see §§ 601.201 and 601.601(d)(2)(ii)(*b*) of this chapter) and include payment of the required user fee.

(5) *Examples.* The provisions of this section are illustrated by the following examples:

*Example 1. Remainder payable at an individual's death.* The decedent, or the decedent's estate, was entitled to receive certain property worth $50,000 upon the death of the decedent's elder sister, to whom the income was bequeathed for life. The decedent died in February 1990. At the time of the decedent's death, the elder sister was 47 years 5 months old. In February 1990, the section 7520 rate was 9.8 percent. Under Table S in paragraph (d)(6) of this section, the remainder factor at 9.8 percent for determining the present value of the remainder interest due at the death of a person aged 47, the number of years nearest the elder sister's actual age at the decedent's death, is .11352. The present value of the remainder interest at the date of the decedent's death is, therefore, $5,676.00 ($50,000×.11352).

*Example 2. Income payable for an individual's life.* A's parent bequeathed an income interest in property to A for life, with the remainder interest passing to B at A's death. At the time of the parent's death in October 1989, the value of the property was $50,000 and A was 30 years 10 months old. The section 7520 rate in October 1989 was 10.2 percent. Under Table S in paragraph (d)(6) of this section, the remainder factor at 10.2 percent for determining the present value of the remainder interest due at the death of a person aged 31, the number of years closest to A's age at the decedent's death, is .03753. Converting this remainder factor to an income factor, as described in paragraph (d)(2)(iii) of this section, the factor for determining the present value of an income interest for the life of a person aged 31 is .96247. The present value of A's interest at the time of the parent's death is, therefore, $48,123.50 ($50,000×.96247).

*Example 3. Annuity payable for an individual's life.* A purchased an annuity for the benefit of both A and B. Under the terms of the annuity contract, at A's death, a survivor annuity of $10,000 a year payable in equal semiannual installments made at the end of each interval is payable to B for life. A died in September 1989. For September 1989, the section 7520 rate was 9.6 percent. At A's death, B was 45 years 7 months old. Under Table S in paragraph (d)(6) of this section, the factor at 9.6 percent for determining the present value of the remainder interest at the death of a person age 46 (the number of years nearest B's actual age) is .11013. By converting the factor to an annuity factor, as described in paragraph (d)(2)(iv) of this section, the factor for the present value of an annuity payable until the death of a person age 46 is 9.2695 (1.00000 minus .11013, divided by .096). The adjustment factor from Table K in paragraph (d)(6) of this section at an interest rate of 9.6 percent for semiannual annuity payments made at the end of the period is 1.0235. The present value of the annuity at the date of A's death is, therefore, $94,873.33 ($10,000×9.2695×1.0235).

*Example 4. Annuity payable for a term of years.* The decedent, or the decedent's estate, was entitled to receive an annuity of $10,000 a year payable in equal quarterly installments at the end of each quarter throughout a term certain. The decedent died in February 1990. For February 1990, the section 7520 rate was 9.8 percent. A quarterly payment had just been made prior to the decedent's death and payments were to continue for 5 more years. Under Table B in paragraph (d)(6) of this section for the interest rate of 9.8 percent, the factor for the present value of a remainder interest due after a term of 5 years is .626597. Converting the factor to an annuity factor, as described in paragraph (d)(2)(iv) of this section, the factor for the present value of an annuity for a term of 5 years is 3.8102. The adjustment factor from Table K in paragraph (d)(6) of this section at an interest rate of 9.8 percent for quarterly annuity payments made at the end of the period is 1.0360. The present value of the annuity is, therefore, $39,473.67 ($10,000×3.8102×1.0360).

(6) *Actuarial Tables.* Except as provided in § 20.7520–3(b) (pertaining to certain limitations on the use of prescribed tables), the following tables must be used in the application of the provisions of this section when the section 7520 interest rate component is between 4.2 and 14 percent.

TABLE B.—TERM CERTAIN REMAINDER FACTORS APPLICABLE AFTER APRIL 30, 1989

| Years | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 4.2% | 4.4% | 4.6% | 4.8% | 5.0% | 5.2% | 5.4% | 5.6% | 5.8% | 6.0% |
| 1 | .959693 | .957854 | .956023 | .954198 | .952381 | .950570 | .948767 | .946970 | .945180 | .943396 |
| 2 | .921010 | .917485 | .913980 | .910495 | .907029 | .903584 | .900158 | .896752 | .893364 | .889996 |
| 3 | .883887 | .878817 | .873786 | .868793 | .863838 | .858920 | .854040 | .849197 | .844390 | .839619 |
| 4 | .848260 | .841779 | .835359 | .829001 | .822702 | .816464 | .810285 | .804163 | .798100 | .792094 |
| 5 | .814069 | .806302 | .798623 | .791031 | .783526 | .776106 | .768771 | .761518 | .754348 | .747258 |
| 6 | .781257 | .772320 | .763501 | .754801 | .746215 | .737744 | .729384 | .721135 | .712994 | .704961 |
| 7 | .749766 | .739770 | .729925 | .720230 | .710681 | .701277 | .692015 | .682893 | .673908 | .665057 |
| 8 | .719545 | .708592 | .697825 | .687242 | .676839 | .666613 | .656561 | .646679 | .636964 | .627412 |
| 9 | .690543 | .678728 | .667137 | .655765 | .644609 | .633663 | .622923 | .612385 | .602045 | .591898 |
| 10 | .662709 | .650122 | .637798 | .625730 | .613913 | .602341 | .591009 | .579910 | .569041 | .558395 |
| 11 | .635997 | .622722 | .609750 | .597071 | .584679 | .572568 | .560729 | .549157 | .537846 | .526788 |
| 12 | .610362 | .596477 | .582935 | .569724 | .556837 | .544266 | .532001 | .520035 | .508361 | .496969 |
| 13 | .585760 | .571339 | .557299 | .543630 | .530321 | .517363 | .504745 | .492458 | .480492 | .468839 |
| 14 | .562150 | .547259 | .532790 | .518731 | .505068 | .491790 | .478885 | .466343 | .454151 | .442301 |
| 15 | .539491 | .524195 | .509360 | .494972 | .481017 | .467481 | .454350 | .441612 | .429255 | .417265 |
| 16 | .517746 | .502102 | .486960 | .472302 | .458112 | .444374 | .431072 | .418194 | .405723 | .393646 |
| 17 | .496877 | .480941 | .465545 | .450670 | .436297 | .422408 | .408987 | .396017 | .383481 | .371364 |
| 18 | .476849 | .460671 | .445071 | .430028 | .415521 | .401529 | .388033 | .375016 | .362458 | .350344 |
| 19 | .457629 | .441256 | .425498 | .410332 | .395734 | .381681 | .368153 | .355129 | .342588 | .330513 |
| 20 | .439183 | .422659 | .406786 | .391538 | .376889 | .362815 | .349291 | .336296 | .323807 | .311805 |
| 21 | .421481 | .404846 | .388897 | .373605 | .358942 | .344881 | .331396 | .318462 | .306056 | .294155 |
| 22 | .404492 | .387783 | .371794 | .356494 | .341850 | .327834 | .314417 | .301574 | .289278 | .277505 |
| 23 | .388188 | .371440 | .355444 | .340166 | .325571 | .311629 | .298309 | .285581 | .273420 | .261797 |
| 24 | .372542 | .355785 | .339813 | .324586 | .310068 | .296225 | .283025 | .270437 | .258431 | .246979 |
| 25 | .357526 | .340791 | .324869 | .309719 | .295303 | .281583 | .268525 | .256096 | .244263 | .232999 |
| 26 | .343115 | .326428 | .310582 | .295533 | .281241 | .267664 | .254768 | .242515 | .230873 | .219810 |
| 27 | .329285 | .312670 | .296923 | .281998 | .267848 | .254434 | .241715 | .229654 | .218216 | .207368 |
| 28 | .316012 | .299493 | .283866 | .269082 | .255094 | .241857 | .229331 | .217475 | .206253 | .195630 |
| 29 | .303275 | .286870 | .271382 | .256757 | .242946 | .229902 | .217582 | .205943 | .194947 | .184557 |
| 30 | .291051 | .274780 | .259447 | .244997 | .231377 | .218538 | .206434 | .195021 | .184260 | .174110 |
| 31 | .279319 | .263199 | .248038 | .233776 | .220359 | .207736 | .195858 | .184679 | .174158 | .164255 |
| 32 | .268061 | .252106 | .237130 | .223069 | .209866 | .197468 | .185823 | .174886 | .164611 | .154957 |
| 33 | .257256 | .241481 | .226702 | .212852 | .199873 | .187707 | .176303 | .165612 | .155587 | .146186 |
| 34 | .246887 | .231304 | .216732 | .203103 | .190355 | .178429 | .167270 | .156829 | .147058 | .137912 |
| 35 | .236935 | .221556 | .207201 | .193801 | .181290 | .169609 | .158701 | .148512 | .138996 | .130105 |
| 36 | .227385 | .212218 | .198089 | .184924 | .172657 | .161225 | .150570 | .140637 | .131376 | .122741 |
| 37 | .218220 | .203274 | .189377 | .176454 | .164436 | .153256 | .142856 | .133179 | .124174 | .115793 |
| 38 | .209424 | .194707 | .181049 | .168373 | .156605 | .145681 | .135537 | .126116 | .117367 | .109239 |
| 39 | .200983 | .186501 | .173087 | .160661 | .149148 | .138480 | .128593 | .119428 | .110933 | .103056 |
| 40 | .192882 | .178641 | .165475 | .153302 | .142046 | .131635 | .122004 | .113095 | .104851 | .097222 |
| 41 | .185107 | .171112 | .158198 | .146281 | .135282 | .125128 | .115754 | .107098 | .099103 | .091719 |
| 42 | .177646 | .163900 | .151241 | .139581 | .128840 | .118943 | .109823 | .101418 | .093670 | .086527 |
| 43 | .170486 | .156992 | .144590 | .133188 | .122704 | .113064 | .104197 | .096040 | .088535 | .081630 |
| 44 | .163614 | .150376 | .138231 | .127088 | .116861 | .107475 | .098858 | .090947 | .083682 | .077009 |
| 45 | .157019 | .144038 | .132152 | .121267 | .111297 | .102163 | .093793 | .086124 | .079094 | .072650 |
| 46 | .150690 | .137968 | .126340 | .115713 | .105997 | .097113 | .088988 | .081557 | .074758 | .068538 |
| 47 | .144616 | .132153 | .120784 | .110413 | .100949 | .092312 | .084429 | .077232 | .070660 | .064658 |
| 48 | .138787 | .126583 | .115473 | .105356 | .096142 | .087749 | .080103 | .073136 | .066786 | .060998 |
| 49 | .133193 | .121248 | .110395 | .100530 | .091564 | .083412 | .075999 | .069258 | .063125 | .057546 |
| 50 | .127824 | .116138 | .105540 | .095926 | .087204 | .079289 | .072106 | .065585 | .059665 | .054288 |
| 51 | .122672 | .111243 | .100898 | .091532 | .083051 | .075370 | .068411 | .062107 | .056394 | .051215 |
| 52 | .117728 | .106555 | .096461 | .087340 | .079096 | .071644 | .064907 | .058813 | .053302 | .048316 |
| 53 | .112982 | .102064 | .092219 | .083340 | .075330 | .068103 | .061581 | .055695 | .050380 | .045582 |
| 54 | .108428 | .097763 | .088164 | .079523 | .071743 | .064737 | .058426 | .052741 | .047618 | .043001 |
| 55 | .104058 | .093642 | .084286 | .075880 | .068326 | .061537 | .055433 | .049944 | .045008 | .040567 |
| 56 | .099864 | .089696 | .080580 | .072405 | .065073 | .058495 | .052593 | .047296 | .042541 | .038271 |
| 57 | .095839 | .085916 | .077036 | .069089 | .061974 | .055604 | .049898 | .044787 | .040208 | .036105 |
| 58 | .091976 | .082295 | .073648 | .065924 | .059023 | .052855 | .047342 | .042412 | .038004 | .034061 |
| 59 | .088268 | .078826 | .070409 | .062905 | .056212 | .050243 | .044916 | .040163 | .035921 | .032133 |
| 60 | .084710 | .075504 | .067313 | .060024 | .053536 | .047759 | .042615 | .038033 | .033952 | .030314 |

TABLE B.—TERM CERTAIN REMAINDER FACTORS APPLICABLE AFTER APRIL 30, 1989

| Years | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 6.2% | 6.4% | 6.6% | 6.8% | 7.0% | 7.2% | 7.4% | 7.6% | 7.8% | 8.0% |
| 1 | .941620 | .939850 | .938086 | .936330 | .934579 | .932836 | .931099 | .929368 | .927644 | .925926 |
| 2 | .886647 | .883317 | .880006 | .876713 | .873439 | .870183 | .866945 | .863725 | .860523 | .857339 |
| 3 | .834885 | .830185 | .825521 | .820892 | .816298 | .811738 | .807211 | .802718 | .798259 | .793832 |

TABLE B.—TERM CERTAIN REMAINDER FACTORS APPLICABLE AFTER APRIL 30, 1989—Continued

| Years | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 6.2% | 6.4% | 6.6% | 6.8% | 7.0% | 7.2% | 7.4% | 7.6% | 7.8% | 8.0% |
| 4 | .786144 | .780249 | .774410 | .768626 | .762895 | .757218 | .751593 | .746021 | .740500 | .735030 |
| 5 | .740248 | .733317 | .726464 | .719687 | .712986 | .706360 | .699808 | .693328 | .686920 | .680583 |
| 6 | .697032 | .689208 | .681486 | .673864 | .666342 | .658918 | .651590 | .644357 | .637217 | .630170 |
| 7 | .656339 | .647752 | .639292 | .630959 | .622750 | .614662 | .606694 | .598845 | .591111 | .583490 |
| 8 | .618022 | .608789 | .599711 | .590786 | .582009 | .573379 | .564892 | .556547 | .548340 | .540269 |
| 9 | .581942 | .572170 | .562581 | .553170 | .543934 | .534868 | .525971 | .517237 | .508664 | .500249 |
| 10 | .547968 | .537754 | .527750 | .517950 | .508349 | .498944 | .489731 | .480704 | .471859 | .463193 |
| 11 | .515977 | .505408 | .495075 | .484972 | .475093 | .465433 | .455987 | .446750 | .437717 | .428883 |
| 12 | .485854 | .475007 | .464423 | .454093 | .444012 | .434173 | .424569 | .415196 | .406046 | .397114 |
| 13 | .457490 | .446436 | .435669 | .425181 | .414964 | .405012 | .395316 | .385870 | .376666 | .367698 |
| 14 | .430781 | .419582 | .408695 | .398109 | .387817 | .377810 | .368078 | .358615 | .349412 | .340461 |
| 15 | .405632 | .394344 | .383391 | .372762 | .362446 | .352434 | .342717 | .333285 | .324130 | .315242 |
| 16 | .381951 | .370624 | .359654 | .349028 | .338735 | .328763 | .319103 | .309745 | .300677 | .291890 |
| 17 | .359653 | .348331 | .337386 | .326805 | .316574 | .306682 | .297117 | .287867 | .278921 | .270269 |
| 18 | .338656 | .327379 | .316498 | .305997 | .295864 | .286084 | .276645 | .267534 | .258739 | .250249 |
| 19 | .318885 | .307687 | .296902 | .286514 | .276508 | .266870 | .257584 | .248638 | .240018 | .231712 |
| 20 | .300268 | .289179 | .278520 | .268272 | .258419 | .248946 | .239836 | .231076 | .222651 | .214548 |
| 21 | .282739 | .271785 | .261276 | .251191 | .241513 | .232225 | .223311 | .214755 | .206541 | .198656 |
| 22 | .266232 | .255437 | .245099 | .235197 | .225713 | .216628 | .207925 | .199586 | .191596 | .183941 |
| 23 | .250689 | .240073 | .229924 | .220222 | .210947 | .202078 | .193598 | .185489 | .177733 | .170315 |
| 24 | .236054 | .225632 | .215689 | .206201 | .197147 | .188506 | .180259 | .172387 | .164873 | .157699 |
| 25 | .222273 | .212060 | .202334 | .193072 | .184249 | .175845 | .167839 | .160211 | .152943 | .146018 |
| 26 | .209297 | .199305 | .189807 | .180779 | .172195 | .164035 | .156275 | .148895 | .141877 | .135202 |
| 27 | .197078 | .187317 | .178056 | .169269 | .160930 | .153017 | .145507 | .138379 | .131611 | .125187 |
| 28 | .185572 | .176049 | .167031 | .158491 | .150402 | .142740 | .135482 | .128605 | .122088 | .115914 |
| 29 | .174739 | .165460 | .156690 | .148400 | .140563 | .133153 | .126147 | .119521 | .113255 | .107328 |
| 30 | .164537 | .155507 | .146989 | .138951 | .131367 | .124210 | .117455 | .111079 | .105060 | .099377 |
| 31 | .154932 | .146154 | .137888 | .130104 | .122773 | .115868 | .109362 | .103233 | .097458 | .092016 |
| 32 | .145887 | .137362 | .129351 | .121820 | .114741 | .108085 | .101827 | .095942 | .090406 | .085200 |
| 33 | .137370 | .129100 | .121342 | .114064 | .107235 | .100826 | .094811 | .089165 | .083865 | .078889 |
| 34 | .129350 | .121335 | .113830 | .106802 | .100219 | .094054 | .088278 | .082867 | .077797 | .073045 |
| 35 | .121798 | .114036 | .106782 | .100001 | .093663 | .087737 | .082196 | .077014 | .072168 | .067635 |
| 36 | .114688 | .107177 | .100171 | .093634 | .087535 | .081844 | .076532 | .071574 | .066946 | .062625 |
| 37 | .107992 | .100730 | .093969 | .087673 | .081809 | .076347 | .071259 | .066519 | .062102 | .057986 |
| 38 | .101688 | .094671 | .088151 | .082090 | .076457 | .071219 | .066349 | .061821 | .057609 | .053690 |
| 39 | .095751 | .088977 | .082693 | .076864 | .071455 | .066436 | .061778 | .057454 | .053440 | .049713 |
| 40 | .090161 | .083625 | .077573 | .071970 | .066780 | .061974 | .057521 | .053396 | .049573 | .046031 |
| 41 | .084897 | .078595 | .072770 | .067387 | .062412 | .057811 | .053558 | .049625 | .045987 | .042621 |
| 42 | .079941 | .073867 | .068265 | .063097 | .058329 | .053929 | .049868 | .046120 | .042659 | .039464 |
| 43 | .075274 | .069424 | .064038 | .059079 | .054513 | .050307 | .046432 | .042862 | .039572 | .036541 |
| 44 | .070880 | .065248 | .060074 | .055318 | .050946 | .046928 | .043233 | .039835 | .036709 | .033834 |
| 45 | .066742 | .061323 | .056354 | .051796 | .047613 | .043776 | .040254 | .037021 | .034053 | .031328 |
| 46 | .062845 | .057635 | .052865 | .048498 | .044499 | .040836 | .037480 | .034406 | .031589 | .029007 |
| 47 | .059176 | .054168 | .049592 | .045410 | .041587 | .038093 | .034898 | .031976 | .029303 | .026859 |
| 48 | .055722 | .050910 | .046522 | .042519 | .038867 | .035535 | .032493 | .029717 | .027183 | .024869 |
| 49 | .052469 | .047848 | .043641 | .039812 | .036324 | .033148 | .030255 | .027618 | .025216 | .023027 |
| 50 | .049405 | .044970 | .040939 | .037277 | .033948 | .030922 | .028170 | .025668 | .023392 | .021321 |
| 51 | .046521 | .042265 | .038405 | .034903 | .031727 | .028845 | .026229 | .023855 | .021699 | .019742 |
| 52 | .043805 | .039722 | .036027 | .032681 | .029651 | .026907 | .024422 | .022170 | .020129 | .018280 |
| 53 | .041248 | .037333 | .033796 | .030600 | .027711 | .025100 | .022739 | .020604 | .018673 | .016925 |
| 54 | .038840 | .035087 | .031704 | .028652 | .025899 | .023414 | .021172 | .019149 | .017322 | .015672 |
| 55 | .036572 | .032977 | .029741 | .026828 | .024204 | .021842 | .019714 | .017796 | .016068 | .014511 |
| 56 | .034437 | .030993 | .027900 | .025119 | .022621 | .020375 | .018355 | .016539 | .014906 | .013436 |
| 57 | .032427 | .029129 | .026172 | .023520 | .021141 | .019006 | .017091 | .015371 | .013827 | .012441 |
| 58 | .030534 | .027377 | .024552 | .022023 | .019758 | .017730 | .015913 | .014285 | .012827 | .011519 |
| 59 | .028751 | .025730 | .023032 | .020620 | .018465 | .016539 | .014817 | .013276 | .011899 | .010666 |
| 60 | .027073 | .024183 | .021606 | .019307 | .017257 | .015428 | .013796 | .012339 | .011038 | .009876 |

TABLE B.—TERM CERTAIN REMAINDER FACTORS APPLICABLE AFTER APRIL 30, 1989

| Years | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 8.2% | 8.4% | 8.6% | 8.8% | 9.0% | 9.2% | 9.4% | 9.6% | 9.8% | 10.0% |
| 1 | .924214 | .922509 | .920810 | .919118 | .917431 | .915751 | .914077 | .912409 | .910747 | .909091 |
| 2 | .854172 | .851023 | .847892 | .844777 | .841680 | .838600 | .835536 | .832490 | .829460 | .826446 |
| 3 | .789438 | .785077 | .780747 | .776450 | .772183 | .767948 | .763744 | .759571 | .755428 | .751315 |
| 4 | .729610 | .724241 | .718920 | .713649 | .708425 | .703250 | .698121 | .693039 | .688003 | .683013 |
| 5 | .674316 | .668119 | .661989 | .655927 | .649931 | .644001 | .638136 | .632335 | .626597 | .620921 |
| 6 | .623213 | .616346 | .609566 | .602874 | .596267 | .589745 | .583305 | .576948 | .570671 | .564474 |

TABLE B.—TERM CERTAIN REMAINDER FACTORS APPLICABLE AFTER APRIL 30, 1989—Continued

| Years | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 8.2% | 8.4% | 8.6% | 8.8% | 9.0% | 9.2% | 9.4% | 9.6% | 9.8% | 10.0% |
| 7 | .575982 | .568585 | .561295 | .554112 | .547034 | .540059 | .533186 | .526412 | .519737 | .513158 |
| 8 | .532331 | .524524 | .516846 | .509294 | .501866 | .494560 | .487373 | .480303 | .473349 | .466507 |
| 9 | .491988 | .483879 | .475917 | .468101 | .460428 | .452894 | .445496 | .438233 | .431101 | .424098 |
| 10 | .454703 | .446383 | .438230 | .430240 | .422411 | .414738 | .407218 | .399848 | .392624 | .385543 |
| 11 | .420243 | .411792 | .403526 | .395441 | .387533 | .379797 | .372228 | .364824 | .357581 | .350494 |
| 12 | .388394 | .379882 | .371571 | .363457 | .355535 | .347799 | .340245 | .332869 | .325666 | .318631 |
| 13 | .358960 | .350445 | .342147 | .334060 | .326179 | .318497 | .311010 | .303713 | .296599 | .289664 |
| 14 | .331756 | .323288 | .315052 | .307040 | .299246 | .291664 | .284287 | .277110 | .270127 | .263331 |
| 15 | .306613 | .298236 | .290103 | .282206 | .274538 | .267092 | .259860 | .252838 | .246017 | .239392 |
| 16 | .283376 | .275126 | .267130 | .259381 | .251870 | .244589 | .237532 | .230691 | .224059 | .217629 |
| 17 | .261901 | .253806 | .245976 | .238401 | .231073 | .223983 | .217123 | .210485 | .204061 | .197845 |
| 18 | .242052 | .234139 | .226497 | .219119 | .211994 | .205113 | .198467 | .192048 | .185848 | .179859 |
| 19 | .223708 | .215995 | .208561 | .201396 | .194490 | .187832 | .181414 | .175226 | .169260 | .163508 |
| 20 | .206754 | .199257 | .192045 | .185107 | .178431 | .172007 | .165826 | .159878 | .154153 | .148644 |
| 21 | .191085 | .183817 | .176837 | .170135 | .163698 | .157516 | .151578 | .145874 | .140395 | .135131 |
| 22 | .176604 | .169573 | .162834 | .156374 | .150182 | .144245 | .138554 | .133097 | .127864 | .122846 |
| 23 | .163220 | .156432 | .149939 | .143726 | .137781 | .132093 | .126649 | .121439 | .116452 | .111678 |
| 24 | .150850 | .144310 | .138065 | .132101 | .126405 | .120964 | .115767 | .110802 | .106058 | .101526 |
| 25 | .139418 | .133128 | .127132 | .121416 | .115968 | .110773 | .105820 | .101097 | .096592 | .092296 |
| 26 | .128852 | .122811 | .117064 | .111596 | .106393 | .101441 | .096727 | .092241 | .087971 | .083905 |
| 27 | .119087 | .113295 | .107794 | .102570 | .097608 | .092894 | .088416 | .084162 | .080119 | .076278 |
| 28 | .110062 | .104515 | .099258 | .094274 | .089548 | .085068 | .080819 | .076790 | .072968 | .069343 |
| 29 | .101721 | .096416 | .091398 | .086649 | .082155 | .077901 | .073875 | .070064 | .066456 | .063039 |
| 30 | .094012 | .088945 | .084160 | .079640 | .075371 | .071338 | .067527 | .063927 | .060524 | .057309 |
| 31 | .086887 | .082053 | .077495 | .073199 | .069148 | .065328 | .061725 | .058327 | .055122 | .052099 |
| 32 | .080302 | .075694 | .071358 | .067278 | .063438 | .059824 | .056422 | .053218 | .050202 | .047362 |
| 33 | .074216 | .069829 | .065708 | .061837 | .058200 | .054784 | .051574 | .048557 | .045722 | .043057 |
| 34 | .068592 | .064418 | .060504 | .056835 | .053395 | .050168 | .047142 | .044304 | .041641 | .039143 |
| 35 | .063394 | .059426 | .055713 | .052238 | .048986 | .045942 | .043092 | .040423 | .037924 | .035584 |
| 36 | .058589 | .054821 | .051301 | .048013 | .044941 | .042071 | .039389 | .036882 | .034539 | .032349 |
| 37 | .054149 | .050573 | .047239 | .044130 | .041231 | .038527 | .036005 | .033652 | .031457 | .029408 |
| 38 | .050045 | .046654 | .043498 | .040560 | .037826 | .035281 | .032911 | .030704 | .028649 | .026735 |
| 39 | .046253 | .043039 | .040053 | .037280 | .034703 | .032309 | .030083 | .028015 | .026092 | .024304 |
| 40 | .042747 | .039703 | .036881 | .034264 | .031838 | .029587 | .027498 | .025561 | .023763 | .022095 |
| 41 | .039508 | .036627 | .033961 | .031493 | .029209 | .027094 | .025136 | .023322 | .021642 | .020086 |
| 42 | .036514 | .033789 | .031271 | .028946 | .026797 | .024811 | .022976 | .021279 | .019711 | .018260 |
| 43 | .033746 | .031170 | .028795 | .026605 | .024584 | .022721 | .021002 | .019415 | .017951 | .016600 |
| 44 | .031189 | .028755 | .026515 | .024453 | .022555 | .020807 | .019197 | .017715 | .016349 | .015091 |
| 45 | .028825 | .026527 | .024415 | .022475 | .020692 | .019054 | .017548 | .016163 | .014890 | .013719 |
| 46 | .026641 | .024471 | .022482 | .020657 | .018984 | .017449 | .016040 | .014747 | .013561 | .012472 |
| 47 | .024622 | .022575 | .020701 | .018986 | .017416 | .015978 | .014662 | .013456 | .012351 | .011338 |
| 48 | .022756 | .020825 | .019062 | .017451 | .015978 | .014632 | .013402 | .012277 | .011248 | .010307 |
| 49 | .021031 | .019212 | .017552 | .016039 | .014659 | .013400 | .012250 | .011202 | .010244 | .009370 |
| 50 | .019437 | .017723 | .016163 | .014742 | .013449 | .012271 | .011198 | .010221 | .009330 | .008519 |
| 51 | .017964 | .016350 | .014883 | .013550 | .012338 | .011237 | .010236 | .009325 | .008497 | .007744 |
| 52 | .016603 | .015083 | .013704 | .012454 | .011319 | .010290 | .009356 | .008508 | .007739 | .007040 |
| 53 | .015345 | .013914 | .012619 | .011446 | .010385 | .009423 | .008552 | .007763 | .007048 | .006400 |
| 54 | .014182 | .012836 | .011620 | .010521 | .009527 | .008629 | .007817 | .007083 | .006419 | .005818 |
| 55 | .013107 | .011841 | .010699 | .009670 | .008741 | .007902 | .007146 | .006463 | .005846 | .005289 |
| 56 | .012114 | .010923 | .009852 | .008888 | .008019 | .007237 | .006532 | .005897 | .005324 | .004809 |
| 57 | .011196 | .010077 | .009072 | .008169 | .007357 | .006627 | .005971 | .005380 | .004849 | .004371 |
| 58 | .010347 | .009296 | .008354 | .007508 | .006749 | .006069 | .005458 | .004909 | .004416 | .003974 |
| 59 | .009563 | .008576 | .007692 | .006901 | .006192 | .005557 | .004989 | .004479 | .004022 | .003613 |
| 60 | .008838 | .007911 | .007083 | .006343 | .005681 | .005089 | .004560 | .004087 | .003663 | .003284 |

TABLE B.—TERM CERTAIN REMAINDER FACTORS APPLICABLE AFTER APRIL 30, 1989

| Years | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 10.2% | 10.4% | 10.6% | 10.8% | 11.0% | 11.2% | 11.4% | 11.6% | 11.8% | 12.0% |
| 1 | .907441 | .905797 | .904159 | .902527 | .900901 | .899281 | .897666 | .896057 | .894454 | .892857 |
| 2 | .823449 | .820468 | .817504 | .814555 | .811622 | .808706 | .805804 | .802919 | .800049 | .797194 |
| 3 | .747232 | .743178 | .739153 | .735158 | .731191 | .727253 | .723343 | .719461 | .715607 | .711780 |
| 4 | .678069 | .673168 | .668312 | .663500 | .658731 | .654005 | .649321 | .644679 | .640078 | .635518 |
| 5 | .615307 | .609754 | .604261 | .598827 | .593451 | .588134 | .582873 | .577669 | .572520 | .567427 |
| 6 | .558355 | .552313 | .546348 | .540457 | .534641 | .528897 | .523225 | .517625 | .512093 | .506631 |
| 7 | .506674 | .500284 | .493985 | .487777 | .481658 | .475627 | .469682 | .463821 | .458044 | .452349 |
| 8 | .459777 | .453156 | .446641 | .440232 | .433926 | .427722 | .421617 | .415610 | .409700 | .403883 |
| 9 | .417221 | .410467 | .403835 | .397322 | .390925 | .384642 | .378472 | .372411 | .366458 | .360610 |

TABLE B.—TERM CERTAIN REMAINDER FACTORS APPLICABLE AFTER APRIL 30, 1989—Continued

| Years | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 10.2% | 10.4% | 10.6% | 10.8% | 11.0% | 11.2% | 11.4% | 11.6% | 11.8% | 12.0% |
| 10 | .378603 | .371800 | .365131 | .358593 | .352184 | .345901 | .339741 | .333701 | .327780 | .321973 |
| 11 | .343560 | .336775 | .330137 | .323640 | .317283 | .311062 | .304974 | .299016 | .293184 | .287476 |
| 12 | .311760 | .305050 | .298496 | .292094 | .285841 | .279732 | .273765 | .267935 | .262240 | .256675 |
| 13 | .282904 | .276313 | .269888 | .263623 | .257514 | .251558 | .245749 | .240085 | .234561 | .229174 |
| 14 | .256719 | .250284 | .244022 | .237927 | .231995 | .226221 | .220601 | .215130 | .209804 | .204620 |
| 15 | .232957 | .226706 | .220634 | .214735 | .209004 | .203436 | .198026 | .192769 | .187661 | .182696 |
| 16 | .211395 | .205350 | .199489 | .193804 | .188292 | .182946 | .177761 | .172732 | .167854 | .163122 |
| 17 | .191828 | .186005 | .180369 | .174914 | .169633 | .164520 | .159570 | .154778 | .150138 | .145644 |
| 18 | .174073 | .168483 | .163083 | .157864 | .152822 | .147950 | .143241 | .138690 | .134291 | .130040 |
| 19 | .157961 | .152612 | .147453 | .142477 | .137678 | .133048 | .128582 | .124274 | .120117 | .116107 |
| 20 | .143340 | .138235 | .133321 | .128589 | .124034 | .119648 | .115424 | .111357 | .107439 | .103667 |
| 21 | .130073 | .125213 | .120543 | .116055 | .111742 | .107597 | .103612 | .099782 | .096100 | .092560 |
| 22 | .118033 | .113418 | .108990 | .104743 | .100669 | .096760 | .093009 | .089410 | .085957 | .082643 |
| 23 | .107108 | .102733 | .098544 | .094533 | .090693 | .087014 | .083491 | .080117 | .076884 | .073788 |
| 24 | .097195 | .093056 | .089100 | .085319 | .081705 | .078250 | .074947 | .071789 | .068770 | .065882 |
| 25 | .088198 | .084289 | .080560 | .077003 | .073608 | .070369 | .067278 | .064327 | .061511 | .058823 |
| 26 | .080035 | .076349 | .072839 | .069497 | .066314 | .063281 | .060393 | .057641 | .055019 | .052521 |
| 27 | .072627 | .069157 | .065858 | .062723 | .059742 | .056908 | .054213 | .051650 | .049212 | .046894 |
| 28 | .065905 | .062642 | .059547 | .056609 | .053822 | .051176 | .048665 | .046281 | .044018 | .041869 |
| 29 | .059804 | .056741 | .053840 | .051091 | .048488 | .046022 | .043685 | .041470 | .039372 | .037383 |
| 30 | .054269 | .051396 | .048680 | .046111 | .043683 | .041386 | .039214 | .037160 | .035216 | .033378 |
| 31 | .049246 | .046554 | .044014 | .041617 | .039354 | .037218 | .035201 | .033297 | .031500 | .029802 |
| 32 | .044688 | .042169 | .039796 | .037560 | .035454 | .033469 | .031599 | .029836 | .028175 | .026609 |
| 33 | .040552 | .038196 | .035982 | .033899 | .031940 | .030098 | .028365 | .026735 | .025201 | .023758 |
| 34 | .036798 | .034598 | .032533 | .030595 | .028775 | .027067 | .025463 | .023956 | .022541 | .021212 |
| 35 | .033392 | .031339 | .029415 | .027613 | .025924 | .024341 | .022857 | .021466 | .020162 | .018940 |
| 36 | .030301 | .028387 | .026596 | .024921 | .023355 | .021889 | .020518 | .019235 | .018034 | .016910 |
| 37 | .027497 | .025712 | .024047 | .022492 | .021040 | .019684 | .018418 | .017236 | .016131 | .015098 |
| 38 | .024952 | .023290 | .021742 | .020300 | .018955 | .017702 | .016533 | .015444 | .014428 | .013481 |
| 39 | .022642 | .021096 | .019658 | .018321 | .017077 | .015919 | .014841 | .013839 | .012905 | .012036 |
| 40 | .020546 | .019109 | .017774 | .016535 | .015384 | .014316 | .013323 | .012400 | .011543 | .010747 |
| 41 | .018645 | .017309 | .016071 | .014923 | .013860 | .012874 | .011959 | .011111 | .010325 | .009595 |
| 42 | .016919 | .015678 | .014531 | .013469 | .012486 | .011577 | .010735 | .009956 | .009235 | .008567 |
| 43 | .015353 | .014201 | .013138 | .012156 | .011249 | .010411 | .009637 | .008922 | .008260 | .007649 |
| 44 | .013932 | .012864 | .011879 | .010971 | .010134 | .009362 | .008651 | .007994 | .007389 | .006830 |
| 45 | .012642 | .011652 | .010740 | .009902 | .009130 | .008419 | .007765 | .007163 | .006609 | .006098 |
| 46 | .011472 | .010554 | .009711 | .008937 | .008225 | .007571 | .006971 | .006419 | .005911 | .005445 |
| 47 | .010410 | .009560 | .008780 | .008065 | .007410 | .006809 | .006257 | .005752 | .005287 | .004861 |
| 48 | .009447 | .008659 | .007939 | .007279 | .006676 | .006123 | .005617 | .005154 | .004729 | .004340 |
| 49 | .008572 | .007844 | .007178 | .006570 | .006014 | .005506 | .005042 | .004618 | .004230 | .003875 |
| 50 | .007779 | .007105 | .006490 | .005929 | .005418 | .004952 | .004526 | .004138 | .003784 | .003460 |
| 51 | .007059 | .006435 | .005868 | .005351 | .004881 | .004453 | .004063 | .003708 | .003384 | .003089 |
| 52 | .006406 | .005829 | .005306 | .004830 | .004397 | .004005 | .003647 | .003322 | .003027 | .002758 |
| 53 | .005813 | .005280 | .004797 | .004359 | .003962 | .003601 | .003274 | .002977 | .002708 | .002463 |
| 54 | .005275 | .004783 | .004337 | .003934 | .003569 | .003238 | .002939 | .002668 | .002422 | .002199 |
| 55 | .004786 | .004332 | .003922 | .003551 | .003215 | .002912 | .002638 | .002390 | .002166 | .001963 |
| 56 | .004343 | .003924 | .003546 | .003205 | .002897 | .002619 | .002368 | .002142 | .001938 | .001753 |
| 57 | .003941 | .003554 | .003206 | .002892 | .002610 | .002355 | .002126 | .001919 | .001733 | .001565 |
| 58 | .003577 | .003220 | .002899 | .002610 | .002351 | .002118 | .001908 | .001720 | .001550 | .001398 |
| 59 | .003246 | .002916 | .002621 | .002356 | .002118 | .001905 | .001713 | .001541 | .001387 | .001248 |
| 60 | .002945 | .002642 | .002370 | .002126 | .001908 | .001713 | .001538 | .001381 | .001240 | .001114 |

TABLE B.—TERM CERTAIN REMAINDER FACTORS APPLICABLE AFTER APRIL 30, 1989

| Years | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 12.2% | 12.4% | 12.6% | 12.8% | 13.0% | 13.2% | 13.4% | 13.6% | 13.8% | 14.0% |
| 1 | .891266 | .889680 | .888099 | .886525 | .884956 | .883392 | .881834 | .880282 | .878735 | .877193 |
| 2 | .794354 | .791530 | .788721 | .785926 | .783147 | .780382 | .777632 | .774896 | .772175 | .769468 |
| 3 | .707981 | .704208 | .700462 | .696743 | .693050 | .689383 | .685742 | .682127 | .678536 | .674972 |
| 4 | .630999 | .626520 | .622080 | .617680 | .613319 | .608996 | .604711 | .600464 | .596254 | .592080 |
| 5 | .562388 | .557402 | .552469 | .547589 | .542760 | .537982 | .533255 | .528577 | .523949 | .519369 |
| 6 | .501237 | .495909 | .490648 | .485451 | .480319 | .475249 | .470242 | .465297 | .460412 | .455587 |
| 7 | .446735 | .441200 | .435744 | .430364 | .425061 | .419831 | .414676 | .409592 | .404580 | .399637 |
| 8 | .398160 | .392527 | .386984 | .381529 | .376160 | .370876 | .365675 | .360557 | .355518 | .350559 |
| 9 | .354866 | .349223 | .343680 | .338235 | .332885 | .327629 | .322465 | .317391 | .312406 | .307508 |
| 10 | .316280 | .310697 | .305222 | .299853 | .294588 | .289425 | .284361 | .279394 | .274522 | .269744 |
| 11 | .281889 | .276421 | .271068 | .265827 | .260698 | .255676 | .250759 | .245945 | .241232 | .236617 |
| 12 | .251238 | .245926 | .240735 | .235663 | .230706 | .225862 | .221128 | .216501 | .211979 | .207559 |

TABLE B.—TERM CERTAIN REMAINDER FACTORS APPLICABLE AFTER APRIL 30, 1989—Continued

| Years | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 12.2% | 12.4% | 12.6% | 12.8% | 13.0% | 13.2% | 13.4% | 13.6% | 13.8% | 14.0% |
| 13 | .223920 | .218795 | .213797 | .208921 | .204165 | .199525 | .194998 | .190582 | .186273 | .182069 |
| 14 | .199572 | .194658 | .189873 | .185213 | .180677 | .176258 | .171956 | .167766 | .163685 | .159710 |
| 15 | .177872 | .173183 | .168626 | .164196 | .159891 | .155705 | .151637 | .147681 | .143835 | .140096 |
| 16 | .158531 | .154077 | .149757 | .145564 | .141496 | .137549 | .133718 | .130001 | .126393 | .122892 |
| 17 | .141293 | .137080 | .132999 | .129046 | .125218 | .121510 | .117917 | .114438 | .111066 | .107800 |
| 18 | .125930 | .121957 | .118116 | .114403 | .110812 | .107341 | .103984 | .100737 | .097598 | .094561 |
| 19 | .112237 | .108503 | .104899 | .101421 | .098064 | .094824 | .091696 | .088677 | .085762 | .082948 |
| 20 | .100033 | .096533 | .093161 | .089912 | .086782 | .083767 | .080861 | .078061 | .075362 | .072762 |
| 21 | .089156 | .085883 | .082736 | .079709 | .076798 | .073999 | .071306 | .068716 | .066224 | .063826 |
| 22 | .079462 | .076408 | .073478 | .070664 | .067963 | .065370 | .062880 | .060489 | .058193 | .055988 |
| 23 | .070821 | .067979 | .065255 | .062646 | .060144 | .057747 | .055450 | .053247 | .051136 | .049112 |
| 24 | .063121 | .060480 | .057953 | .055537 | .053225 | .051014 | .048898 | .046873 | .044935 | .043081 |
| 25 | .056257 | .053807 | .051468 | .049235 | .047102 | .045065 | .043119 | .041261 | .039486 | .037790 |
| 26 | .050140 | .047871 | .045709 | .043648 | .041683 | .039810 | .038024 | .036321 | .034698 | .033149 |
| 27 | .044688 | .042590 | .040594 | .038695 | .036888 | .035168 | .033531 | .031973 | .030490 | .029078 |
| 28 | .039829 | .037892 | .036052 | .034304 | .032644 | .031067 | .029569 | .028145 | .026793 | .025507 |
| 29 | .035498 | .033711 | .032017 | .030411 | .028889 | .027444 | .026075 | .024776 | .023544 | .022375 |
| 30 | .031638 | .029992 | .028435 | .026960 | .025565 | .024244 | .022994 | .021810 | .020689 | .019627 |
| 31 | .028198 | .026684 | .025253 | .023901 | .022624 | .021417 | .020277 | .019199 | .018180 | .017217 |
| 32 | .025132 | .023740 | .022427 | .021189 | .020021 | .018920 | .017881 | .016900 | .015975 | .015102 |
| 33 | .022399 | .021121 | .019917 | .018785 | .017718 | .016714 | .015768 | .014877 | .014038 | .013248 |
| 34 | .019964 | .018791 | .017689 | .016653 | .015680 | .014765 | .013905 | .013096 | .012336 | .011621 |
| 35 | .017793 | .016718 | .015709 | .014763 | .013876 | .013043 | .012261 | .011528 | .010840 | .010194 |
| 36 | .015858 | .014873 | .013951 | .013088 | .012279 | .011522 | .010813 | .010148 | .009525 | .008942 |
| 37 | .014134 | .013233 | .012390 | .011603 | .010867 | .010178 | .009535 | .008933 | .008370 | .007844 |
| 38 | .012597 | .011773 | .011004 | .010286 | .009617 | .008992 | .008408 | .007864 | .007355 | .006880 |
| 39 | .011227 | .010474 | .009772 | .009119 | .008510 | .007943 | .007415 | .006922 | .006463 | .006035 |
| 40 | .010007 | .009319 | .008679 | .008084 | .007531 | .007017 | .006538 | .006093 | .005679 | .005294 |
| 41 | .008919 | .008291 | .007708 | .007167 | .006665 | .006199 | .005766 | .005364 | .004991 | .004644 |
| 42 | .007949 | .007376 | .006845 | .006354 | .005898 | .005476 | .005085 | .004722 | .004386 | .004074 |
| 43 | .007084 | .006562 | .006079 | .005633 | .005219 | .004837 | .004484 | .004157 | .003854 | .003573 |
| 44 | .006314 | .005838 | .005399 | .004993 | .004619 | .004273 | .003954 | .003659 | .003386 | .003135 |
| 45 | .005628 | .005194 | .004795 | .004427 | .004088 | .003775 | .003487 | .003221 | .002976 | .002750 |
| 46 | .005016 | .004621 | .004258 | .003924 | .003617 | .003335 | .003075 | .002835 | .002615 | .002412 |
| 47 | .004470 | .004111 | .003782 | .003479 | .003201 | .002946 | .002711 | .002496 | .002298 | .002116 |
| 48 | .003984 | .003658 | .003359 | .003084 | .002833 | .002602 | .002391 | .002197 | .002019 | .001856 |
| 49 | .003551 | .003254 | .002983 | .002734 | .002507 | .002299 | .002108 | .001934 | .001774 | .001628 |
| 50 | .003165 | .002895 | .002649 | .002424 | .002219 | .002031 | .001859 | .001702 | .001559 | .001428 |
| 51 | .002821 | .002576 | .002353 | .002149 | .001963 | .001794 | .001640 | .001499 | .001370 | .001253 |
| 52 | .002514 | .002292 | .002089 | .001905 | .001737 | .001585 | .001446 | .001319 | .001204 | .001099 |
| 53 | .002241 | .002039 | .001856 | .001689 | .001538 | .001400 | .001275 | .001161 | .001058 | .000964 |
| 54 | .001997 | .001814 | .001648 | .001497 | .001361 | .001237 | .001124 | .001022 | .000930 | .000846 |
| 55 | .001780 | .001614 | .001463 | .001327 | .001204 | .001093 | .000991 | .000900 | .000817 | .000742 |
| 56 | .001586 | .001436 | .001300 | .001177 | .001066 | .000965 | .000874 | .000792 | .000718 | .000651 |
| 57 | .001414 | .001277 | .001154 | .001043 | .000943 | .000853 | .000771 | .000697 | .000631 | .000571 |
| 58 | .001260 | .001136 | .001025 | .000925 | .000835 | .000753 | .000680 | .000614 | .000554 | .000501 |
| 59 | .001123 | .001011 | .000910 | .000820 | .000739 | .000665 | .000600 | .000540 | .000487 | .000439 |
| 60 | .001001 | .000900 | .000809 | .000727 | .000654 | .000588 | .000529 | .000476 | .000428 | .000385 |

TABLE J.—ADJUSTMENT FACTORS FOR TERM CERTAIN ANNUITIES PAYABLE AT THE BEGINNING OF EACH INTERVAL APPLICABLE AFTER APRIL 30, 1989

[Frequency of payments]

| Interest rate | Annually | Semi annually | Quarterly | Monthly | Weekly |
|---|---|---|---|---|---|
| 4.2 | 1.0420 | 1.0314 | 1.0261 | 1.0226 | 1.0213 |
| 4.4 | 1.0440 | 1.0329 | 1.0274 | 1.0237 | 1.0223 |
| 4.6 | 1.0460 | 1.0344 | 1.0286 | 1.0247 | 1.0233 |
| 4.8 | 1.0480 | 1.0359 | 1.0298 | 1.0258 | 1.0243 |
| 5.0 | 1.0500 | 1.0373 | 1.0311 | 1.0269 | 1.0253 |
| 5.2 | 1.0520 | 1.0388 | 1.0323 | 1.0279 | 1.0263 |
| 5.4 | 1.0540 | 1.0403 | 1.0335 | 1.0290 | 1.0273 |
| 5.6 | 1.0560 | 1.0418 | 1.0348 | 1.0301 | 1.0283 |
| 5.8 | 1.0580 | 1.0433 | 1.0360 | 1.0311 | 1.0293 |
| 6.0 | 1.0600 | 1.0448 | 1.0372 | 1.0322 | 1.0303 |
| 6.2 | 1.0620 | 1.0463 | 1.0385 | 1.0333 | 1.0313 |
| 6.4 | 1.0640 | 1.0478 | 1.0397 | 1.0343 | 1.0323 |
| 6.6 | 1.0660 | 1.0492 | 1.0409 | 1.0354 | 1.0333 |

TABLE J.—ADJUSTMENT FACTORS FOR TERM CERTAIN ANNUITIES PAYABLE AT THE BEGINNING OF EACH INTERVAL APPLICABLE AFTER APRIL 30, 1989—Continued

[Frequency of payments]

| Interest rate | Annually | Semi annually | Quarterly | Monthly | Weekly |
|---|---|---|---|---|---|
| 6.8 | 1.0680 | 1.0507 | 1.0422 | 1.0365 | 1.0343 |
| 7.0 | 1.0700 | 1.0522 | 1.0434 | 1.0375 | 1.0353 |
| 7.2 | 1.0720 | 1.0537 | 1.0446 | 1.0386 | 1.0363 |
| 7.4 | 1.0740 | 1.0552 | 1.0458 | 1.0396 | 1.0373 |
| 7.6 | 1.0760 | 1.0567 | 1.0471 | 1.0407 | 1.0383 |
| 7.8 | 1.0780 | 1.0581 | 1.0483 | 1.0418 | 1.0393 |
| 8.0 | 1.0800 | 1.0596 | 1.0495 | 1.0428 | 1.0403 |
| 8.2 | 1.0820 | 1.0611 | 1.0507 | 1.0439 | 1.0413 |
| 8.4 | 1.0840 | 1.0626 | 1.0520 | 1.0449 | 1.0422 |
| 8.6 | 1.0860 | 1.0641 | 1.0532 | 1.0460 | 1.0432 |
| 8.8 | 1.0880 | 1.0655 | 1.0544 | 1.0471 | 1.0442 |
| 9.0 | 1.0900 | 1.0670 | 1.0556 | 1.0481 | 1.0452 |
| 9.2 | 1.0920 | 1.0685 | 1.0569 | 1.0492 | 1.0462 |
| 9.4 | 1.0940 | 1.0700 | 1.0581 | 1.0502 | 1.0472 |
| 9.6 | 1.0960 | 1.0715 | 1.0593 | 1.0513 | 1.0482 |
| 9.8 | 1.0980 | 1.0729 | 1.0605 | 1.0523 | 1.0492 |
| 10.0 | 1.1000 | 1.0744 | 1.0618 | 1.0534 | 1.0502 |
| 10.2 | 1.1020 | 1.0759 | 1.0630 | 1.0544 | 1.0512 |
| 10.4 | 1.1040 | 1.0774 | 1.0642 | 1.0555 | 1.0521 |
| 10.6 | 1.1060 | 1.0788 | 1.0654 | 1.0565 | 1.0531 |
| 10.8 | 1.1080 | 1.0803 | 1.0666 | 1.0576 | 1.0541 |
| 11.0 | 1.1100 | 1.0818 | 1.0679 | 1.0586 | 1.0551 |
| 11.2 | 1.1120 | 1.0833 | 1.0691 | 1.0597 | 1.0561 |
| 11.4 | 1.1140 | 1.0847 | 1.0703 | 1.0607 | 1.0571 |
| 11.6 | 1.1160 | 1.0862 | 1.0715 | 1.0618 | 1.0581 |
| 11.8 | 1.1180 | 1.0877 | 1.0727 | 1.0628 | 1.0590 |
| 12.0 | 1.1200 | 1.0892 | 1.0739 | 1.0639 | 1.0600 |
| 12.2 | 1.1220 | 1.0906 | 1.0752 | 1.0649 | 1.0610 |
| 12.4 | 1.1240 | 1.0921 | 1.0764 | 1.0660 | 1.0620 |
| 12.6 | 1.1260 | 1.0936 | 1.0776 | 1.0670 | 1.0630 |
| 12.8 | 1.1280 | 1.0950 | 1.0788 | 1.0681 | 1.0639 |
| 13.0 | 1.1300 | 1.0965 | 1.0800 | 1.0691 | 1.0649 |
| 13.2 | 1.1320 | 1.0980 | 1.0812 | 1.0701 | 1.0659 |
| 13.4 | 1.1340 | 1.0994 | 1.0824 | 1.0712 | 1.0669 |
| 13.6 | 1.1360 | 1.1009 | 1.0836 | 1.0722 | 1.0679 |
| 13.8 | 1.1380 | 1.1024 | 1.0849 | 1.0733 | 1.0688 |
| 14.0 | 1.1400 | 1.1039 | 1.0861 | 1.0743 | 1.0698 |

TABLE K.—ADJUSTMENT FACTORS FOR ANNUITIES PAYABLE AT THE END OF EACH INTERVAL APPLICABLE AFTER APRIL 30, 1989

[Frequency of Payments]

| Interest Rate | Annually | Semi annually | Quarterly | Monthly | Weekly |
|---|---|---|---|---|---|
| 4.2 | 1.0000 | 1.0104 | 1.0156 | 1.0191 | 1.0205 |
| 4.4 | 1.0000 | 1.0109 | 1.0164 | 1.0200 | 1.0214 |
| 4.6 | 1.0000 | 1.0114 | 1.0171 | 1.0209 | 1.0224 |
| 4.8 | 1.0000 | 1.0119 | 1.0178 | 1.0218 | 1.0234 |
| 5.0 | 1.0000 | 1.0123 | 1.0186 | 1.0227 | 1.0243 |
| 5.2 | 1.0000 | 1.0128 | 1.0193 | 1.0236 | 1.0253 |
| 5.4 | 1.0000 | 1.0133 | 1.0200 | 1.0245 | 1.0262 |
| 5.6 | 1.0000 | 1.0138 | 1.0208 | 1.0254 | 1.0272 |
| 5.8 | 1.0000 | 1.0143 | 1.0215 | 1.0263 | 1.0282 |
| 6.0 | 1.0000 | 1.0148 | 1.0222 | 1.0272 | 1.0291 |
| 6.2 | 1.0000 | 1.0153 | 1.0230 | 1.0281 | 1.0301 |
| 6.4 | 1.0000 | 1.0158 | 1.0237 | 1.0290 | 1.0311 |
| 6.6 | 1.0000 | 1.0162 | 1.0244 | 1.0299 | 1.0320 |
| 6.8 | 1.0000 | 1.0167 | 1.0252 | 1.0308 | 1.0330 |
| 7.0 | 1.0000 | 1.0172 | 1.0259 | 1.0317 | 1.0339 |
| 7.2 | 1.0000 | 1.0177 | 1.0266 | 1.0326 | 1.0349 |
| 7.4 | 1.0000 | 1.0182 | 1.0273 | 1.0335 | 1.0358 |
| 7.6 | 1.0000 | 1.0187 | 1.0281 | 1.0344 | 1.0368 |
| 7.8 | 1.0000 | 1.0191 | 1.0288 | 1.0353 | 1.0378 |
| 8.0 | 1.0000 | 1.0196 | 1.0295 | 1.0362 | 1.0387 |
| 8.2 | 1.0000 | 1.0201 | 1.0302 | 1.0370 | 1.0397 |
| 8.4 | 1.0000 | 1.0206 | 1.0310 | 1.0379 | 1.0406 |

TABLE K.—ADJUSTMENT FACTORS FOR ANNUITIES PAYABLE AT THE END OF EACH INTERVAL APPLICABLE AFTER APRIL 30, 1989—Continued

[Frequency of Payments]

| Interest Rate | Annually | Semi annually | Quarterly | Monthly | Weekly |
|---|---|---|---|---|---|
| 8.6 | 1.0000 | 1.0211 | 1.0317 | 1.0388 | 1.0416 |
| 8.8 | 1.0000 | 1.0215 | 1.0324 | 1.0397 | 1.0425 |
| 9.0 | 1.0000 | 1.0220 | 1.0331 | 1.0406 | 1.0435 |
| 9.2 | 1.0000 | 1.0225 | 1.0339 | 1.0415 | 1.0444 |
| 9.4 | 1.0000 | 1.0230 | 1.0346 | 1.0424 | 1.0454 |
| 9.6 | 1.0000 | 1.0235 | 1.0353 | 1.0433 | 1.0463 |
| 9.8 | 1.0000 | 1.0239 | 1.0360 | 1.0442 | 1.0473 |
| 10.0 | 1.0000 | 1.0244 | 1.0368 | 1.0450 | 1.0482 |
| 10.2 | 1.0000 | 1.0249 | 1.0375 | 1.0459 | 1.0492 |
| 10.4 | 1.0000 | 1.0254 | 1.0382 | 1.0468 | 1.0501 |
| 10.6 | 1.0000 | 1.0258 | 1.0389 | 1.0477 | 1.0511 |
| 10.8 | 1.0000 | 1.0263 | 1.0396 | 1.0486 | 1.0520 |
| 11.0 | 1.0000 | 1.0268 | 1.0404 | 1.0495 | 1.0530 |
| 11.2 | 1.0000 | 1.0273 | 1.0411 | 1.0503 | 1.0539 |
| 11.4 | 1.0000 | 1.0277 | 1.0418 | 1.0512 | 1.0549 |
| 11.6 | 1.0000 | 1.0282 | 1.0425 | 1.0521 | 1.0558 |
| 11.8 | 1.0000 | 1.0287 | 1.0432 | 1.0530 | 1.0568 |
| 12.0 | 1.0000 | 1.0292 | 1.0439 | 1.0539 | 1.0577 |
| 12.2 | 1.0000 | 1.0296 | 1.0447 | 1.0548 | 1.0587 |
| 12.4 | 1.0000 | 1.0301 | 1.0454 | 1.0556 | 1.0596 |
| 12.6 | 1.0000 | 1.0306 | 1.0461 | 1.0565 | 1.0605 |
| 12.8 | 1.0000 | 1.0310 | 1.0468 | 1.0574 | 1.0615 |
| 13.0 | 1.0000 | 1.0315 | 1.0475 | 1.0583 | 1.0624 |
| 13.2 | 1.0000 | 1.0320 | 1.0482 | 1.0591 | 1.0634 |
| 13.4 | 1.0000 | 1.0324 | 1.0489 | 1.0600 | 1.0643 |
| 13.6 | 1.0000 | 1.0329 | 1.0496 | 1.0609 | 1.0652 |
| 13.8 | 1.0000 | 1.0334 | 1.0504 | 1.0618 | 1.0662 |
| 14.0 | 1.0000 | 1.0339 | 1.0511 | 1.0626 | 1.0671 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 4.2% | 4.4% | 4.6% | 4.8% | 5.0% | 5.2% | 5.4% | 5.6% | 5.8% | 6.0% |
| 0 | .07389 | .06749 | .06188 | .05695 | .05261 | .04879 | .04541 | .04243 | .03978 | .03744 |
| 1 | .06494 | .05832 | .05250 | .04738 | .04287 | .03889 | .03537 | .03226 | .02950 | .02705 |
| 2 | .06678 | .05999 | .05401 | .04874 | .04410 | .03999 | .03636 | .03314 | .03028 | .02773 |
| 3 | .06897 | .06200 | .05587 | .05045 | .04567 | .04143 | .03768 | .03435 | .03139 | .02875 |
| 4 | .07139 | .06425 | .05796 | .05239 | .04746 | .04310 | .03922 | .03578 | .03271 | .02998 |
| 5 | .07401 | .06669 | .06023 | .05451 | .04944 | .04494 | .04094 | .03738 | .03421 | .03137 |
| 6 | .07677 | .06928 | .06265 | .05677 | .05156 | .04692 | .04279 | .03911 | .03583 | .03289 |
| 7 | .07968 | .07201 | .06521 | .05918 | .05381 | .04903 | .04477 | .04097 | .03757 | .03453 |
| 8 | .08274 | .07489 | .06792 | .06172 | .05621 | .05129 | .04689 | .04297 | .03945 | .03630 |
| 9 | .08597 | .07794 | .07079 | .06443 | .05876 | .05370 | .04917 | .04511 | .04148 | .03821 |
| 10 | .08936 | .08115 | .07383 | .06730 | .06147 | .05626 | .05159 | .04741 | .04365 | .04027 |
| 11 | .09293 | .08453 | .07704 | .07035 | .06436 | .05900 | .05419 | .04988 | .04599 | .04250 |
| 12 | .09666 | .08807 | .08040 | .07354 | .06739 | .06188 | .05693 | .05248 | .04847 | .04486 |
| 13 | .10049 | .09172 | .08387 | .07684 | .07053 | .06487 | .05977 | .05518 | .05104 | .04731 |
| 14 | .10437 | .09541 | .08738 | .08017 | .07370 | .06788 | .06263 | .05791 | .05364 | .04978 |
| 15 | .10827 | .09912 | .09090 | .08352 | .07688 | .07090 | .06551 | .06064 | .05623 | .05225 |
| 16 | .11220 | .10285 | .09445 | .08689 | .08008 | .07394 | .06839 | .06337 | .05883 | .05472 |
| 17 | .11615 | .10661 | .09802 | .09028 | .08330 | .07699 | .07129 | .06612 | .06144 | .05719 |
| 18 | .12017 | .11043 | .10165 | .09373 | .08656 | .08009 | .07422 | .06890 | .06408 | .05969 |
| 19 | .12428 | .11434 | .10537 | .09726 | .08992 | .08327 | .07724 | .07177 | .06679 | .06226 |
| 20 | .12850 | .11836 | .10919 | .10089 | .09337 | .08654 | .08035 | .07471 | .06959 | .06492 |
| 21 | .13282 | .12248 | .11311 | .10462 | .09692 | .08991 | .08355 | .07775 | .07247 | .06765 |
| 22 | .13728 | .12673 | .11717 | .10848 | .10059 | .09341 | .08686 | .08090 | .07546 | .07049 |
| 23 | .14188 | .13113 | .12136 | .11248 | .10440 | .09703 | .09032 | .08418 | .07858 | .07345 |
| 24 | .14667 | .13572 | .12575 | .11667 | .10839 | .10084 | .09395 | .08764 | .08187 | .07659 |
| 25 | .15167 | .14051 | .13034 | .12106 | .11259 | .10486 | .09778 | .09130 | .08536 | .07991 |
| 26 | .15690 | .14554 | .13517 | .12569 | .11703 | .10910 | .10184 | .09518 | .08907 | .08346 |
| 27 | .16237 | .15081 | .14024 | .13056 | .12171 | .11359 | .10614 | .09930 | .09302 | .08724 |
| 28 | .16808 | .15632 | .14555 | .13567 | .12662 | .11831 | .11068 | .10366 | .09720 | .09125 |
| 29 | .17404 | .16208 | .15110 | .14104 | .13179 | .12329 | .11547 | .10827 | .10163 | .09551 |
| 30 | .18025 | .16808 | .15692 | .14665 | .13721 | .12852 | .12051 | .11313 | .10631 | .10002 |
| 31 | .18672 | .17436 | .16300 | .15255 | .14291 | .13403 | .12584 | .11827 | .11127 | .10480 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 4.2% | 4.4% | 4.6% | 4.8% | 5.0% | 5.2% | 5.4% | 5.6% | 5.8% | 6.0% |
| 32 | .19344 | .18090 | .16935 | .15870 | .14888 | .13980 | .13142 | .12367 | .11650 | .10985 |
| 33 | .20044 | .18772 | .17598 | .16514 | .15513 | .14587 | .13730 | .12936 | .12201 | .11519 |
| 34 | .20770 | .19480 | .18287 | .17185 | .16165 | .15221 | .14345 | .13533 | .12780 | .12080 |
| 35 | .21522 | .20215 | .19005 | .17884 | .16846 | .15883 | .14989 | .14159 | .13388 | .12670 |
| 36 | .22299 | .20974 | .19747 | .18609 | .17552 | .16571 | .15660 | .14812 | .14022 | .13287 |
| 37 | .23101 | .21760 | .20516 | .19360 | .18286 | .17288 | .16358 | .15492 | .14685 | .13933 |
| 38 | .23928 | .22572 | .21311 | .20139 | .19048 | .18032 | .17085 | .16201 | .15377 | .14607 |
| 39 | .24780 | .23409 | .22133 | .20945 | .19837 | .18804 | .17840 | .16939 | .16097 | .15310 |
| 40 | .25658 | .24273 | .22982 | .21778 | .20654 | .19605 | .18624 | .17706 | .16847 | .16043 |
| 41 | .26560 | .25163 | .23858 | .22639 | .21499 | .20434 | .19436 | .18502 | .17627 | .16806 |
| 42 | .27486 | .26076 | .24758 | .23525 | .22370 | .21289 | .20276 | .19326 | .18434 | .17597 |
| 43 | .28435 | .27013 | .25683 | .24436 | .23268 | .22172 | .21143 | .20177 | .19270 | .18416 |
| 44 | .29407 | .27975 | .26633 | .25373 | .24191 | .23081 | .22038 | .21057 | .20134 | .19265 |
| 45 | .30402 | .28961 | .27608 | .26337 | .25142 | .24019 | .22962 | .21966 | .21028 | .20144 |
| 46 | .31420 | .29970 | .28608 | .27326 | .26120 | .24983 | .23913 | .22904 | .21951 | .21053 |
| 47 | .32460 | .31004 | .29632 | .28341 | .27123 | .25975 | .24892 | .23870 | .22904 | .21991 |
| 48 | .33521 | .32058 | .30679 | .29379 | .28151 | .26992 | .25897 | .24862 | .23883 | .22957 |
| 49 | .34599 | .33132 | .31746 | .30438 | .29201 | .28032 | .26926 | .25879 | .24888 | .23949 |
| 50 | .35695 | .34224 | .32833 | .31518 | .30273 | .29094 | .27978 | .26921 | .25918 | .24966 |
| 51 | .36809 | .35335 | .33940 | .32619 | .31367 | .30180 | .29055 | .27987 | .26973 | .26010 |
| 52 | .37944 | .36468 | .35070 | .33744 | .32486 | .31292 | .30158 | .29081 | .28057 | .27083 |
| 53 | .39098 | .37622 | .36222 | .34892 | .33629 | .32429 | .31288 | .30203 | .29170 | .28186 |
| 54 | .40269 | .38794 | .37393 | .36062 | .34795 | .33590 | .32442 | .31349 | .30308 | .29316 |
| 55 | .41457 | .39985 | .38585 | .37252 | .35983 | .34774 | .33621 | .32522 | .31474 | .30473 |
| 56 | .42662 | .41194 | .39796 | .38464 | .37193 | .35981 | .34824 | .33720 | .32666 | .31658 |
| 57 | .43884 | .42422 | .41028 | .39697 | .38426 | .37213 | .36053 | .34945 | .33885 | .32872 |
| 58 | .45123 | .43668 | .42279 | .40951 | .39682 | .38468 | .37307 | .36196 | .35132 | .34114 |
| 59 | .46377 | .44931 | .43547 | .42224 | .40958 | .39745 | .38584 | .37471 | .36405 | .35383 |
| 60 | .47643 | .46206 | .44830 | .43513 | .42250 | .41040 | .39880 | .38767 | .37699 | .36674 |
| 61 | .48916 | .47491 | .46124 | .44814 | .43556 | .42350 | .41192 | .40080 | .39012 | .37985 |
| 62 | .50196 | .48783 | .47427 | .46124 | .44874 | .43672 | .42518 | .41408 | .40340 | .39314 |
| 63 | .51480 | .50081 | .48736 | .47444 | .46201 | .45006 | .43856 | .42749 | .41684 | .40658 |
| 64 | .52770 | .51386 | .50054 | .48773 | .47540 | .46352 | .45208 | .44105 | .43043 | .42019 |
| 65 | .54069 | .52701 | .51384 | .50115 | .48892 | .47713 | .46577 | .45480 | .44422 | .43401 |
| 66 | .55378 | .54029 | .52727 | .51472 | .50262 | .49093 | .47965 | .46876 | .45824 | .44808 |
| 67 | .56697 | .55368 | .54084 | .52845 | .51648 | .50491 | .49373 | .48293 | .47248 | .46238 |
| 68 | .58026 | .56717 | .55453 | .54231 | .53049 | .51905 | .50800 | .49729 | .48694 | .47691 |
| 69 | .59358 | .58072 | .56828 | .55624 | .54459 | .53330 | .52238 | .51179 | .50154 | .49160 |
| 70 | .60689 | .59427 | .58205 | .57021 | .55874 | .54762 | .53683 | .52638 | .51624 | .50641 |
| 71 | .62014 | .60778 | .59578 | .58415 | .57287 | .56193 | .55131 | .54100 | .53099 | .52126 |
| 72 | .63334 | .62123 | .60948 | .59808 | .58700 | .57624 | .56579 | .55563 | .54577 | .53617 |
| 73 | .64648 | .63465 | .62315 | .61198 | .60112 | .59056 | .58029 | .57030 | .56059 | .55113 |
| 74 | .65961 | .64806 | .63682 | .62590 | .61527 | .60492 | .59485 | .58504 | .57550 | .56620 |
| 75 | .67274 | .66149 | .65054 | .63987 | .62948 | .61936 | .60950 | .59990 | .59053 | .58140 |
| 76 | .68589 | .67495 | .66429 | .65390 | .64377 | .63390 | .62427 | .61487 | .60570 | .59676 |
| 77 | .69903 | .68841 | .67806 | .66796 | .65811 | .64849 | .63910 | .62993 | .62097 | .61223 |
| 78 | .71209 | .70182 | .69179 | .68199 | .67242 | .66307 | .65393 | .64501 | .63628 | .62775 |
| 79 | .72500 | .71507 | .70537 | .69588 | .68660 | .67754 | .66867 | .65999 | .65151 | .64321 |
| 80 | .73768 | .72809 | .71872 | .70955 | .70058 | .69180 | .68320 | .67479 | .66655 | .65849 |
| 81 | .75001 | .74077 | .73173 | .72288 | .71422 | .70573 | .69741 | .68926 | .68128 | .67345 |
| 82 | .76195 | .75306 | .74435 | .73582 | .72746 | .71926 | .71123 | .70335 | .69562 | .68804 |
| 83 | .77346 | .76491 | .75654 | .74832 | .74026 | .73236 | .72460 | .71699 | .70952 | .70219 |
| 84 | .78456 | .77636 | .76831 | .76041 | .75265 | .74503 | .73756 | .73021 | .72300 | .71592 |
| 85 | .79530 | .78743 | .77971 | .77212 | .76466 | .75733 | .75014 | .74306 | .73611 | .72928 |
| 86 | .80560 | .79806 | .79065 | .78337 | .77621 | .76917 | .76225 | .75544 | .74875 | .74216 |
| 87 | .81535 | .80813 | .80103 | .79404 | .78717 | .78041 | .77375 | .76720 | .76076 | .75442 |
| 88 | .82462 | .81771 | .81090 | .80420 | .79760 | .79111 | .78472 | .77842 | .77223 | .76612 |
| 89 | .83356 | .82694 | .82043 | .81401 | .80769 | .80147 | .79533 | .78929 | .78334 | .77747 |
| 90 | .84225 | .83593 | .82971 | .82357 | .81753 | .81157 | .80570 | .79991 | .79420 | .78857 |
| 91 | .85058 | .84455 | .83861 | .83276 | .82698 | .82129 | .81567 | .81013 | .80466 | .79927 |
| 92 | .85838 | .85263 | .84696 | .84137 | .83585 | .83040 | .82503 | .81973 | .81449 | .80933 |
| 93 | .86557 | .86009 | .85467 | .84932 | .84405 | .83884 | .83370 | .82862 | .82360 | .81865 |
| 94 | .87212 | .86687 | .86169 | .85657 | .85152 | .84653 | .84160 | .83673 | .83192 | .82717 |
| 95 | .87801 | .87298 | .86801 | .86310 | .85825 | .85345 | .84872 | .84404 | .83941 | .83484 |
| 96 | .88322 | .87838 | .87360 | .86888 | .86420 | .85959 | .85502 | .85051 | .84605 | .84165 |
| 97 | .88795 | .88328 | .87867 | .87411 | .86961 | .86515 | .86074 | .85639 | .85208 | .84782 |
| 98 | .89220 | .88769 | .88323 | .87883 | .87447 | .87016 | .86589 | .86167 | .85750 | .85337 |
| 99 | .89612 | .89176 | .88745 | .88318 | .87895 | .87478 | .87064 | .86656 | .86251 | .85850 |
| 100 | .89977 | .89555 | .89136 | .88722 | .88313 | .87908 | .87506 | .87109 | .86716 | .86327 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 4.2% | 4.4% | 4.6% | 4.8% | 5.0% | 5.2% | 5.4% | 5.6% | 5.8% | 6.0% |
| 101 | .90326 | .89917 | .89511 | .89110 | .88712 | .88318 | .87929 | .87543 | .87161 | .86783 |
| 102 | .90690 | .90294 | .89901 | .89513 | .89128 | .88746 | .88369 | .87995 | .87624 | .87257 |
| 103 | .91076 | .90694 | .90315 | .89940 | .89569 | .89200 | .88835 | .88474 | .88116 | .87760 |
| 104 | .91504 | .91138 | .90775 | .90415 | .90058 | .89704 | .89354 | .89006 | .88661 | .88319 |
| 105 | .92027 | .91681 | .91337 | .90996 | .90658 | .90322 | .89989 | .89659 | .89331 | .89006 |
| 106 | .92763 | .92445 | .92130 | .91816 | .91506 | .91197 | .90890 | .90586 | .90284 | .89983 |
| 107 | .93799 | .93523 | .93249 | .92977 | .92707 | .92438 | .92170 | .91905 | .91641 | .91378 |
| 108 | .95429 | .95223 | .95018 | .94814 | .94611 | .94409 | .94208 | .94008 | .93809 | .93611 |
| 109 | .97985 | .97893 | .97801 | .97710 | .97619 | .97529 | .97438 | .97348 | .97259 | .97170 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 6.2% | 6.4% | 6.6% | 6.8% | 7.0% | 7.2% | 7.4% | 7.6% | 7.8% | 8.0% |
| 0 | .03535 | .03349 | .03183 | .03035 | .02902 | .02783 | .02676 | .02579 | .02492 | .02413 |
| 1 | .02486 | .02292 | .02119 | .01963 | .01824 | .01699 | .01587 | .01486 | .01395 | .01312 |
| 2 | .02547 | .02345 | .02164 | .02002 | .01857 | .01727 | .01609 | .01504 | .01408 | .01321 |
| 3 | .02640 | .02429 | .02241 | .02073 | .01921 | .01785 | .01662 | .01552 | .01451 | .01361 |
| 4 | .02753 | .02535 | .02339 | .02163 | .02005 | .01863 | .01735 | .01619 | .01514 | .01418 |
| 5 | .02883 | .02656 | .02453 | .02269 | .02105 | .01956 | .01822 | .01700 | .01590 | .01490 |
| 6 | .03026 | .02790 | .02578 | .02387 | .02215 | .02060 | .01919 | .01792 | .01677 | .01572 |
| 7 | .03180 | .02935 | .02714 | .02515 | .02336 | .02174 | .02027 | .01894 | .01773 | .01664 |
| 8 | .03347 | .03092 | .02863 | .02656 | .02469 | .02300 | .02146 | .02007 | .01881 | .01766 |
| 9 | .03528 | .03263 | .03025 | .02810 | .02615 | .02438 | .02278 | .02133 | .02000 | .01880 |
| 10 | .03723 | .03449 | .03201 | .02977 | .02774 | .02590 | .02423 | .02271 | .02133 | .02006 |
| 11 | .03935 | .03650 | .03393 | .03160 | .02949 | .02757 | .02583 | .02424 | .02279 | .02147 |
| 12 | .04160 | .03865 | .03598 | .03356 | .03136 | .02936 | .02755 | .02589 | .02438 | .02299 |
| 13 | .04394 | .04088 | .03811 | .03560 | .03331 | .03123 | .02934 | .02761 | .02603 | .02458 |
| 14 | .04629 | .04312 | .04025 | .03764 | .03527 | .03311 | .03113 | .02933 | .02768 | .02617 |
| 15 | .04864 | .04536 | .04238 | .03968 | .03721 | .03496 | .03290 | .03103 | .02930 | .02773 |
| 16 | .05099 | .04759 | .04451 | .04170 | .03913 | .03679 | .03466 | .03270 | .03090 | .02926 |
| 17 | .05333 | .04982 | .04662 | .04370 | .04104 | .03861 | .03638 | .03434 | .03247 | .03075 |
| 18 | .05570 | .05207 | .04875 | .04573 | .04296 | .04044 | .03812 | .03599 | .03404 | .03225 |
| 19 | .05814 | .05438 | .05095 | .04781 | .04494 | .04231 | .03990 | .03769 | .03565 | .03378 |
| 20 | .06065 | .05677 | .05321 | .04996 | .04698 | .04424 | .04173 | .03943 | .03731 | .03535 |
| 21 | .06325 | .05922 | .05554 | .05217 | .04907 | .04623 | .04362 | .04122 | .03901 | .03697 |
| 22 | .06594 | .06178 | .05797 | .05447 | .05126 | .04831 | .04559 | .04309 | .04078 | .03865 |
| 23 | .06876 | .06446 | .06051 | .05688 | .05355 | .05048 | .04766 | .04505 | .04265 | .04042 |
| 24 | .07174 | .06729 | .06321 | .05945 | .05599 | .05281 | .04987 | .04715 | .04465 | .04233 |
| 25 | .07491 | .07031 | .06609 | .06219 | .05861 | .05530 | .05224 | .04941 | .04680 | .04438 |
| 26 | .07830 | .07355 | .06918 | .06515 | .06142 | .05799 | .05481 | .05187 | .04915 | .04662 |
| 27 | .08192 | .07702 | .07250 | .06832 | .06446 | .06090 | .05759 | .05454 | .05170 | .04906 |
| 28 | .08577 | .08071 | .07603 | .07171 | .06772 | .06402 | .06059 | .05740 | .05445 | .05170 |
| 29 | .08986 | .08464 | .07981 | .07534 | .07120 | .06736 | .06380 | .06049 | .05742 | .05456 |
| 30 | .09420 | .08882 | .08383 | .07921 | .07492 | .07095 | .06725 | .06381 | .06061 | .05763 |
| 31 | .09881 | .09327 | .08812 | .08335 | .07891 | .07479 | .07095 | .06738 | .06405 | .06095 |
| 32 | .10369 | .09797 | .09267 | .08774 | .08315 | .07888 | .07491 | .07120 | .06774 | .06451 |
| 33 | .10885 | .10297 | .09750 | .09241 | .08767 | .08325 | .07913 | .07529 | .07170 | .06834 |
| 34 | .11430 | .10824 | .10261 | .09736 | .09246 | .08790 | .08363 | .07964 | .07592 | .07243 |
| 35 | .12002 | .11380 | .10800 | .10259 | .09754 | .09282 | .08841 | .08428 | .08041 | .07679 |
| 36 | .12602 | .11963 | .11366 | .10809 | .10288 | .09800 | .09344 | .08917 | .08516 | .08140 |
| 37 | .13230 | .12574 | .11961 | .11387 | .10850 | .10347 | .09876 | .09433 | .09018 | .08628 |
| 38 | .13887 | .13214 | .12584 | .11994 | .11441 | .10922 | .10436 | .09978 | .09549 | .09145 |
| 39 | .14573 | .13883 | .13237 | .12630 | .12061 | .11527 | .11025 | .10553 | .10109 | .09690 |
| 40 | .15290 | .14583 | .13920 | .13297 | .12712 | .12162 | .11644 | .11157 | .10698 | .10266 |
| 41 | .16036 | .15312 | .14633 | .13994 | .13393 | .12827 | .12294 | .11792 | .11318 | .10871 |
| 42 | .16810 | .16071 | .15375 | .14720 | .14103 | .13522 | .12973 | .12456 | .11967 | .11505 |
| 43 | .17614 | .16858 | .16146 | .15475 | .14842 | .14245 | .13682 | .13149 | .12645 | .12169 |
| 44 | .18447 | .17675 | .16948 | .16261 | .15613 | .15000 | .14421 | .13873 | .13355 | .12864 |
| 45 | .19310 | .18524 | .17780 | .17078 | .16414 | .15787 | .15192 | .14630 | .14096 | .13591 |
| 46 | .20204 | .19402 | .18644 | .17926 | .17247 | .16604 | .15995 | .15418 | .14870 | .14350 |
| 47 | .21128 | .20311 | .19538 | .18806 | .18112 | .17454 | .16830 | .16238 | .15676 | .15141 |
| 48 | .22080 | .21249 | .20462 | .19716 | .19007 | .18335 | .17696 | .17090 | .16513 | .15964 |
| 49 | .23059 | .22214 | .21413 | .20653 | .19930 | .19244 | .18591 | .17970 | .17379 | .16816 |
| 50 | .24063 | .23206 | .22391 | .21617 | .20881 | .20180 | .19514 | .18879 | .18274 | .17697 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 6.2% | 6.4% | 6.6% | 6.8% | 7.0% | 7.2% | 7.4% | 7.6% | 7.8% | 8.0% |
| 51 | .25095 | .24225 | .23398 | .22610 | .21861 | .21147 | .20466 | .19818 | .19199 | .18609 |
| 52 | .26157 | .25275 | .24436 | .23636 | .22874 | .22147 | .21453 | .20791 | .20159 | .19556 |
| 53 | .27249 | .26357 | .25505 | .24694 | .23919 | .23180 | .22474 | .21799 | .21154 | .20537 |
| 54 | .28369 | .27466 | .26604 | .25782 | .24995 | .24244 | .23526 | .22839 | .22181 | .21552 |
| 55 | .29518 | .28605 | .27734 | .26900 | .26103 | .25341 | .24611 | .23912 | .23243 | .22601 |
| 56 | .30695 | .29774 | .28893 | .28050 | .27242 | .26469 | .25728 | .25019 | .24338 | .23685 |
| 57 | .31902 | .30973 | .30084 | .29232 | .28415 | .27632 | .26881 | .26161 | .25469 | .24805 |
| 58 | .33138 | .32203 | .31306 | .30446 | .29621 | .28829 | .28069 | .27339 | .26637 | .25962 |
| 59 | .34402 | .33461 | .32558 | .31691 | .30859 | .30059 | .29290 | .28550 | .27839 | .27155 |
| 60 | .35690 | .34745 | .33836 | .32963 | .32124 | .31317 | .30540 | .29792 | .29073 | .28379 |
| 61 | .36999 | .36050 | .35137 | .34259 | .33414 | .32601 | .31817 | .31062 | .30334 | .29633 |
| 62 | .38325 | .37374 | .36458 | .35576 | .34726 | .33907 | .33117 | .32356 | .31621 | .30912 |
| 63 | .39669 | .38717 | .37799 | .36913 | .36060 | .35236 | .34441 | .33674 | .32933 | .32217 |
| 64 | .41031 | .40078 | .39159 | .38272 | .37415 | .36588 | .35789 | .35016 | .34270 | .33548 |
| 65 | .42416 | .41464 | .40545 | .39656 | .38798 | .37968 | .37166 | .36390 | .35639 | .34912 |
| 66 | .43825 | .42876 | .41958 | .41070 | .40211 | .39380 | .38576 | .37797 | .37043 | .36312 |
| 67 | .45260 | .44315 | .43399 | .42513 | .41655 | .40824 | .40019 | .39238 | .38482 | .37749 |
| 68 | .46720 | .45779 | .44868 | .43985 | .43129 | .42299 | .41494 | .40713 | .39956 | .39221 |
| 69 | .48197 | .47263 | .46357 | .45478 | .44625 | .43798 | .42995 | .42215 | .41458 | .40722 |
| 70 | .49686 | .48760 | .47861 | .46988 | .46140 | .45316 | .44516 | .43738 | .42983 | .42248 |
| 71 | .51182 | .50265 | .49374 | .48508 | .47666 | .46847 | .46051 | .45276 | .44523 | .43790 |
| 72 | .52685 | .51778 | .50896 | .50038 | .49203 | .48390 | .47599 | .46829 | .46079 | .45349 |
| 73 | .54194 | .53298 | .52426 | .51578 | .50751 | .49946 | .49161 | .48397 | .47652 | .46926 |
| 74 | .55714 | .54832 | .53972 | .53134 | .52317 | .51520 | .50744 | .49986 | .49247 | .48527 |
| 75 | .57250 | .56382 | .55536 | .54710 | .53904 | .53118 | .52351 | .51601 | .50870 | .50156 |
| 76 | .58803 | .57951 | .57120 | .56308 | .55515 | .54740 | .53984 | .53245 | .52522 | .51817 |
| 77 | .60369 | .59535 | .58720 | .57923 | .57144 | .56383 | .55639 | .54912 | .54200 | .53504 |
| 78 | .61942 | .61126 | .60329 | .59549 | .58787 | .58040 | .57310 | .56596 | .55896 | .55212 |
| 79 | .63508 | .62713 | .61935 | .61174 | .60428 | .59698 | .58983 | .58283 | .57597 | .56925 |
| 80 | .65059 | .64285 | .63527 | .62785 | .62058 | .61345 | .60646 | .59961 | .59290 | .58632 |
| 81 | .66579 | .65827 | .65090 | .64368 | .63659 | .62965 | .62283 | .61615 | .60959 | .60316 |
| 82 | .68061 | .67332 | .66616 | .65914 | .65226 | .64550 | .63886 | .63235 | .62595 | .61968 |
| 83 | .69499 | .68793 | .68099 | .67418 | .66749 | .66092 | .65447 | .64813 | .64191 | .63579 |
| 84 | .70896 | .70213 | .69541 | .68881 | .68233 | .67595 | .66969 | .66353 | .65748 | .65153 |
| 85 | .72256 | .71596 | .70947 | .70308 | .69681 | .69063 | .68456 | .67859 | .67271 | .66693 |
| 86 | .73569 | .72931 | .72305 | .71688 | .71081 | .70484 | .69896 | .69318 | .68748 | .68188 |
| 87 | .74818 | .74204 | .73599 | .73003 | .72417 | .71839 | .71271 | .70711 | .70159 | .69616 |
| 88 | .76011 | .75419 | .74836 | .74261 | .73695 | .73137 | .72588 | .72046 | .71512 | .70986 |
| 89 | .77169 | .76599 | .76037 | .75484 | .74938 | .74400 | .73870 | .73347 | .72831 | .72323 |
| 90 | .78302 | .77755 | .77215 | .76683 | .76158 | .75640 | .75129 | .74625 | .74128 | .73638 |
| 91 | .79395 | .78870 | .78352 | .77842 | .77337 | .76840 | .76349 | .75864 | .75385 | .74913 |
| 92 | .80423 | .79920 | .79423 | .78933 | .78449 | .77971 | .77499 | .77033 | .76572 | .76118 |
| 93 | .81377 | .80894 | .80417 | .79946 | .79481 | .79022 | .78568 | .78120 | .77677 | .77239 |
| 94 | .82247 | .81784 | .81325 | .80873 | .80425 | .79983 | .79547 | .79115 | .78688 | .78266 |
| 95 | .83033 | .82586 | .82145 | .81709 | .81278 | .80852 | .80431 | .80014 | .79602 | .79195 |
| 96 | .83729 | .83298 | .82872 | .82451 | .82034 | .81622 | .81215 | .80812 | .80414 | .80019 |
| 97 | .84361 | .83944 | .83532 | .83124 | .82721 | .82322 | .81927 | .81537 | .81151 | .80769 |
| 98 | .84929 | .84525 | .84126 | .83730 | .83339 | .82952 | .82569 | .82190 | .81815 | .81443 |
| 99 | .85454 | .85062 | .84674 | .84290 | .83910 | .83534 | .83161 | .82792 | .82427 | .82066 |
| 100 | .85942 | .85561 | .85184 | .84810 | .84440 | .84074 | .83711 | .83352 | .82997 | .82644 |
| 101 | .86408 | .86037 | .85670 | .85306 | .84946 | .84589 | .84236 | .83886 | .83539 | .83196 |
| 102 | .86894 | .86534 | .86177 | .85823 | .85473 | .85126 | .84782 | .84442 | .84104 | .83770 |
| 103 | .87408 | .87060 | .86714 | .86371 | .86032 | .85695 | .85362 | .85031 | .84703 | .84378 |
| 104 | .87980 | .87644 | .87311 | .86980 | .86653 | .86328 | .86005 | .85686 | .85369 | .85054 |
| 105 | .88684 | .88363 | .88046 | .87731 | .87418 | .87108 | .86800 | .86494 | .86191 | .85890 |
| 106 | .89685 | .89389 | .89095 | .88804 | .88514 | .88226 | .87940 | .87656 | .87374 | .87094 |
| 107 | .91117 | .90858 | .90600 | .90344 | .90089 | .89836 | .89584 | .89334 | .89085 | .88838 |
| 108 | .93414 | .93217 | .93022 | .92828 | .92634 | .92442 | .92250 | .92060 | .91870 | .91681 |
| 109 | .97081 | .96992 | .96904 | .96816 | .96729 | .96642 | .96555 | .96468 | .96382 | .96296 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 8.2% | 8.4% | 8.6% | 8.8% | 9.0% | 9.2% | 9.4% | 9.6% | 9.8% | 10.0% |
| 0 | .02341 | .02276 | .02217 | .02163 | .02114 | .02069 | .02027 | .01989 | .01954 | .01922 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 8.2% | 8.4% | 8.6% | 8.8% | 9.0% | 9.2% | 9.4% | 9.6% | 9.8% | 10.0% |
| 1 | .01237 | .01170 | .01108 | .01052 | .01000 | .00953 | .00910 | .00871 | .00834 | .00801 |
| 2 | .01243 | .01172 | .01107 | .01048 | .00994 | .00944 | .00899 | .00857 | .00819 | .00784 |
| 3 | .01278 | .01203 | .01135 | .01073 | .01016 | .00964 | .00916 | .00872 | .00832 | .00795 |
| 4 | .01332 | .01253 | .01182 | .01116 | .01056 | .01001 | .00951 | .00904 | .00862 | .00822 |
| 5 | .01400 | .01317 | .01241 | .01172 | .01109 | .01051 | .00998 | .00949 | .00904 | .00862 |
| 6 | .01477 | .01390 | .01310 | .01238 | .01171 | .01110 | .01054 | .01002 | .00954 | .00910 |
| 7 | .01563 | .01472 | .01389 | .01312 | .01242 | .01178 | .01118 | .01064 | .01013 | .00966 |
| 8 | .01660 | .01564 | .01477 | .01396 | .01322 | .01254 | .01192 | .01134 | .01081 | .01031 |
| 9 | .01770 | .01669 | .01577 | .01492 | .01414 | .01342 | .01276 | .01216 | .01159 | .01107 |
| 10 | .01891 | .01785 | .01688 | .01599 | .01517 | .01442 | .01372 | .01308 | .01249 | .01194 |
| 11 | .02026 | .01915 | .01814 | .01720 | .01634 | .01555 | .01481 | .01414 | .01351 | .01293 |
| 12 | .02173 | .02056 | .01950 | .01852 | .01761 | .01678 | .01601 | .01529 | .01463 | .01402 |
| 13 | .02326 | .02204 | .02092 | .01989 | .01895 | .01807 | .01726 | .01651 | .01582 | .01517 |
| 14 | .02478 | .02351 | .02234 | .02126 | .02027 | .01935 | .01850 | .01771 | .01698 | .01630 |
| 15 | .02628 | .02495 | .02372 | .02259 | .02155 | .02058 | .01969 | .01886 | .01810 | .01738 |
| 16 | .02774 | .02635 | .02507 | .02388 | .02279 | .02178 | .02084 | .01997 | .01917 | .01842 |
| 17 | .02917 | .02772 | .02637 | .02513 | .02399 | .02293 | .02194 | .02103 | .02018 | .01940 |
| 18 | .03059 | .02907 | .02767 | .02637 | .02517 | .02406 | .02302 | .02207 | .02118 | .02035 |
| 19 | .03205 | .03046 | .02899 | .02763 | .02637 | .02521 | .02412 | .02312 | .02218 | .02131 |
| 20 | .03355 | .03188 | .03035 | .02892 | .02760 | .02638 | .02524 | .02419 | .02320 | .02229 |
| 21 | .03509 | .03334 | .03173 | .03024 | .02886 | .02758 | .02638 | .02527 | .02424 | .02328 |
| 22 | .03669 | .03487 | .03318 | .03162 | .03017 | .02882 | .02757 | .02640 | .02532 | .02430 |
| 23 | .03837 | .03646 | .03470 | .03306 | .03154 | .03013 | .02881 | .02759 | .02644 | .02538 |
| 24 | .04018 | .03819 | .03634 | .03463 | .03303 | .03155 | .03016 | .02888 | .02767 | .02655 |
| 25 | .04214 | .04006 | .03812 | .03633 | .03465 | .03309 | .03164 | .03029 | .02902 | .02784 |
| 26 | .04428 | .04210 | .04008 | .03820 | .03644 | .03481 | .03328 | .03186 | .03052 | .02928 |
| 27 | .04662 | .04434 | .04223 | .04025 | .03841 | .03670 | .03509 | .03360 | .03219 | .03088 |
| 28 | .04915 | .04677 | .04456 | .04249 | .04056 | .03876 | .03708 | .03550 | .03403 | .03264 |
| 29 | .05189 | .04941 | .04709 | .04493 | .04291 | .04102 | .03925 | .03760 | .03604 | .03458 |
| 30 | .05485 | .05226 | .04984 | .04757 | .04546 | .04348 | .04162 | .03988 | .03825 | .03671 |
| 31 | .05805 | .05535 | .05282 | .05045 | .04824 | .04616 | .04421 | .04238 | .04067 | .03905 |
| 32 | .06149 | .05867 | .05603 | .05356 | .05124 | .04906 | .04702 | .04510 | .04329 | .04160 |
| 33 | .06520 | .06226 | .05950 | .05692 | .05449 | .05221 | .05007 | .04806 | .04616 | .04438 |
| 34 | .06916 | .06609 | .06322 | .06052 | .05799 | .05560 | .05336 | .05125 | .04926 | .04738 |
| 35 | .07339 | .07020 | .06720 | .06439 | .06174 | .05925 | .05690 | .05469 | .05260 | .05063 |
| 36 | .07787 | .07455 | .07143 | .06850 | .06573 | .06313 | .06068 | .05836 | .05617 | .05411 |
| 37 | .08262 | .07917 | .07593 | .07287 | .06999 | .06727 | .06470 | .06228 | .05999 | .05783 |
| 38 | .08765 | .08407 | .08069 | .07751 | .07451 | .07167 | .06899 | .06646 | .06407 | .06180 |
| 39 | .09296 | .08925 | .08574 | .08243 | .07931 | .07635 | .07356 | .07092 | .06841 | .06604 |
| 40 | .09858 | .09472 | .09109 | .08765 | .08440 | .08132 | .07841 | .07565 | .07303 | .07055 |
| 41 | .10449 | .10050 | .09673 | .09316 | .08978 | .08658 | .08355 | .08067 | .07794 | .07535 |
| 42 | .11069 | .10656 | .10265 | .09895 | .09544 | .09212 | .08896 | .08596 | .08312 | .08041 |
| 43 | .11718 | .11291 | .10887 | .10503 | .10140 | .09794 | .09466 | .09154 | .08858 | .08576 |
| 44 | .12399 | .11958 | .11540 | .11143 | .10766 | .10407 | .10067 | .09743 | .09434 | .09141 |
| 45 | .13111 | .12656 | .12224 | .11814 | .11423 | .11052 | .10699 | .10362 | .10042 | .09736 |
| 46 | .13856 | .13387 | .12941 | .12516 | .12113 | .11728 | .11362 | .11013 | .10680 | .10363 |
| 47 | .14633 | .14150 | .13690 | .13252 | .12835 | .12438 | .12059 | .11697 | .11352 | .11022 |
| 48 | .15442 | .14945 | .14471 | .14020 | .13589 | .13179 | .12787 | .12412 | .12055 | .11713 |
| 49 | .16280 | .15769 | .15281 | .14816 | .14373 | .13949 | .13544 | .13157 | .12787 | .12433 |
| 50 | .17147 | .16622 | .16121 | .15643 | .15186 | .14749 | .14331 | .13931 | .13548 | .13182 |
| 51 | .18045 | .17507 | .16993 | .16501 | .16030 | .15580 | .15150 | .14737 | .14342 | .13963 |
| 52 | .18979 | .18427 | .17899 | .17394 | .16911 | .16448 | .16004 | .15579 | .15172 | .14780 |
| 53 | .19947 | .19383 | .18842 | .18324 | .17828 | .17352 | .16896 | .16458 | .16038 | .15635 |
| 54 | .20950 | .20372 | .19819 | .19288 | .18779 | .18291 | .17822 | .17372 | .16940 | .16524 |
| 55 | .21986 | .21397 | .20831 | .20288 | .19767 | .19266 | .18785 | .18322 | .17878 | .17450 |
| 56 | .23058 | .22457 | .21879 | .21324 | .20791 | .20278 | .19785 | .19310 | .18854 | .18414 |
| 57 | .24167 | .23554 | .22965 | .22399 | .21854 | .21329 | .20824 | .20338 | .19870 | .19419 |
| 58 | .25314 | .24690 | .24090 | .23512 | .22956 | .22420 | .21904 | .21407 | .20927 | .20464 |
| 59 | .26497 | .25863 | .25252 | .24664 | .24097 | .23550 | .23023 | .22515 | .22024 | .21551 |
| 60 | .27712 | .27068 | .26448 | .25849 | .25272 | .24716 | .24178 | .23659 | .23158 | .22674 |
| 61 | .28956 | .28304 | .27674 | .27067 | .26480 | .25913 | .25366 | .24837 | .24325 | .23831 |
| 62 | .30228 | .29567 | .28929 | .28312 | .27717 | .27141 | .26584 | .26045 | .25524 | .25020 |
| 63 | .31525 | .30857 | .30211 | .29586 | .28982 | .28397 | .27832 | .27284 | .26754 | .26240 |
| 64 | .32851 | .32176 | .31522 | .30890 | .30278 | .29685 | .29111 | .28555 | .28016 | .27493 |
| 65 | .34209 | .33528 | .32868 | .32229 | .31610 | .31010 | .30429 | .29865 | .29317 | .28787 |
| 66 | .35604 | .34918 | .34253 | .33609 | .32983 | .32377 | .31788 | .31217 | .30663 | .30124 |
| 67 | .37037 | .36347 | .35678 | .35028 | .34398 | .33786 | .33191 | .32614 | .32053 | .31508 |
| 68 | .38508 | .37815 | .37142 | .36489 | .35854 | .35237 | .34638 | .34055 | .33488 | .32937 |
| 69 | .40008 | .39313 | .38638 | .37982 | .37344 | .36724 | .36120 | .35533 | .34961 | .34405 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 8.2% | 8.4% | 8.6% | 8.8% | 9.0% | 9.2% | 9.4% | 9.6% | 9.8% | 10.0% |
| 70 | .41533 | .40838 | .40162 | .39504 | .38864 | .38241 | .37634 | .37043 | .36468 | .35907 |
| 71 | .43076 | .42382 | .41705 | .41047 | .40405 | .39780 | .39171 | .38578 | .38000 | .37436 |
| 72 | .44638 | .43945 | .43269 | .42611 | .41969 | .41344 | .40733 | .40138 | .39558 | .38991 |
| 73 | .46218 | .45527 | .44854 | .44197 | .43556 | .42931 | .42321 | .41725 | .41143 | .40575 |
| 74 | .47823 | .47137 | .46466 | .45812 | .45173 | .44549 | .43940 | .43345 | .42763 | .42195 |
| 75 | .49459 | .48777 | .48112 | .47462 | .46826 | .46205 | .45598 | .45004 | .44424 | .43856 |
| 76 | .51127 | .50452 | .49793 | .49148 | .48517 | .47900 | .47297 | .46706 | .46129 | .45563 |
| 77 | .52823 | .52157 | .51505 | .50867 | .50243 | .49632 | .49033 | .48447 | .47873 | .47311 |
| 78 | .54541 | .53885 | .53242 | .52613 | .51996 | .51392 | .50800 | .50220 | .49652 | .49094 |
| 79 | .56267 | .55621 | .54989 | .54369 | .53762 | .53166 | .52582 | .52009 | .51448 | .50897 |
| 80 | .57987 | .57354 | .56733 | .56125 | .55527 | .54941 | .54366 | .53802 | .53248 | .52705 |
| 81 | .59685 | .59065 | .58457 | .57860 | .57274 | .56699 | .56134 | .55579 | .55035 | .54499 |
| 82 | .61351 | .60746 | .60151 | .59567 | .58993 | .58429 | .57875 | .57331 | .56796 | .56270 |
| 83 | .62978 | .62387 | .61806 | .61236 | .60675 | .60123 | .59581 | .59047 | .58523 | .58007 |
| 84 | .64567 | .63992 | .63426 | .62869 | .62321 | .61783 | .61253 | .60731 | .60218 | .59713 |
| 85 | .66125 | .65565 | .65014 | .64472 | .63938 | .63413 | .62896 | .62387 | .61886 | .61392 |
| 86 | .67636 | .67092 | .66557 | .66030 | .65511 | .65000 | .64496 | .64000 | .63511 | .63030 |
| 87 | .69081 | .68554 | .68034 | .67522 | .67018 | .66520 | .66031 | .65548 | .65071 | .64602 |
| 88 | .70468 | .69957 | .69453 | .68956 | .68466 | .67983 | .67507 | .67037 | .66574 | .66117 |
| 89 | .71821 | .71326 | .70838 | .70357 | .69882 | .69414 | .68952 | .68495 | .68045 | .67601 |
| 90 | .73153 | .72676 | .72204 | .71739 | .71280 | .70827 | .70379 | .69938 | .69502 | .69071 |
| 91 | .74447 | .73986 | .73532 | .73083 | .72640 | .72202 | .71770 | .71343 | .70921 | .70504 |
| 92 | .75669 | .75225 | .74787 | .74354 | .73927 | .73504 | .73087 | .72674 | .72267 | .71864 |
| 93 | .76807 | .76379 | .75957 | .75540 | .75127 | .74719 | .74317 | .73918 | .73524 | .73135 |
| 94 | .77849 | .77437 | .77030 | .76627 | .76229 | .75835 | .75446 | .75061 | .74680 | .74303 |
| 95 | .78792 | .78394 | .78001 | .77611 | .77226 | .76845 | .76468 | .76096 | .75727 | .75362 |
| 96 | .79630 | .79244 | .78863 | .78485 | .78112 | .77742 | .77377 | .77015 | .76657 | .76303 |
| 97 | .80391 | .80016 | .79646 | .79280 | .78917 | .78559 | .78203 | .77852 | .77504 | .77160 |
| 98 | .81076 | .80712 | .80352 | .79996 | .79643 | .79294 | .78948 | .78606 | .78267 | .77931 |
| 99 | .81709 | .81354 | .81004 | .80657 | .80313 | .79972 | .79635 | .79302 | .78971 | .78644 |
| 100 | .82296 | .81950 | .81609 | .81270 | .80934 | .80602 | .80273 | .79947 | .79624 | .79304 |
| 101 | .82855 | .82518 | .82185 | .81854 | .81526 | .81201 | .80880 | .80561 | .80245 | .79932 |
| 102 | .83438 | .83110 | .82785 | .82462 | .82142 | .81826 | .81512 | .81200 | .80892 | .80586 |
| 103 | .84056 | .83737 | .83420 | .83106 | .82795 | .82487 | .82181 | .81878 | .81577 | .81279 |
| 104 | .84743 | .84433 | .84127 | .83822 | .83521 | .83221 | .82924 | .82630 | .82338 | .82048 |
| 105 | .85591 | .85295 | .85001 | .84709 | .84419 | .84132 | .83846 | .83563 | .83282 | .83003 |
| 106 | .86816 | .86540 | .86266 | .85993 | .85723 | .85454 | .85187 | .84922 | .84659 | .84397 |
| 107 | .88592 | .88348 | .88105 | .87863 | .87623 | .87384 | .87147 | .86911 | .86676 | .86443 |
| 108 | .91493 | .91306 | .91119 | .90934 | .90749 | .90566 | .90383 | .90201 | .90020 | .89840 |
| 109 | .96211 | .96125 | .96041 | .95956 | .95872 | .95788 | .95704 | .95620 | .95537 | .95455 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 10.2% | 10.4% | 10.6% | 10.8% | 11.0% | 11.2% | 11.4% | 11.6% | 11.8% | 12.0% |
| 0 | .01891 | .01864 | .01838 | .01814 | .01791 | .01770 | .01750 | .01732 | .01715 | .01698 |
| 1 | .00770 | .00741 | .00715 | .00690 | .00667 | .00646 | .00626 | .00608 | .00590 | .00574 |
| 2 | .00751 | .00721 | .00693 | .00667 | .00643 | .00620 | .00600 | .00580 | .00562 | .00544 |
| 3 | .00760 | .00728 | .00699 | .00671 | .00646 | .00622 | .00600 | .00579 | .00560 | .00541 |
| 4 | .00786 | .00752 | .00721 | .00692 | .00665 | .00639 | .00616 | .00594 | .00573 | .00554 |
| 5 | .00824 | .00788 | .00755 | .00724 | .00695 | .00668 | .00643 | .00620 | .00598 | .00578 |
| 6 | .00869 | .00832 | .00796 | .00764 | .00733 | .00705 | .00678 | .00654 | .00630 | .00608 |
| 7 | .00923 | .00883 | .00846 | .00811 | .00779 | .00749 | .00720 | .00694 | .00669 | .00646 |
| 8 | .00986 | .00943 | .00904 | .00867 | .00833 | .00801 | .00771 | .00743 | .00716 | .00692 |
| 9 | .01059 | .01014 | .00972 | .00933 | .00897 | .00863 | .00831 | .00801 | .00773 | .00747 |
| 10 | .01142 | .01095 | .01051 | .01009 | .00971 | .00935 | .00901 | .00869 | .00840 | .00812 |
| 11 | .01239 | .01189 | .01142 | .01098 | .01057 | .01019 | .00983 | .00950 | .00918 | .00889 |
| 12 | .01345 | .01292 | .01243 | .01197 | .01154 | .01113 | .01075 | .01040 | .01007 | .00975 |
| 13 | .01457 | .01401 | .01349 | .01300 | .01255 | .01212 | .01172 | .01135 | .01100 | .01067 |
| 14 | .01567 | .01508 | .01453 | .01402 | .01354 | .01309 | .01267 | .01227 | .01190 | .01155 |
| 15 | .01672 | .01610 | .01552 | .01498 | .01448 | .01400 | .01356 | .01314 | .01275 | .01238 |
| 16 | .01772 | .01707 | .01646 | .01589 | .01536 | .01486 | .01439 | .01396 | .01354 | .01315 |
| 17 | .01866 | .01798 | .01734 | .01674 | .01618 | .01566 | .01516 | .01470 | .01427 | .01386 |
| 18 | .01958 | .01886 | .01818 | .01755 | .01697 | .01641 | .01590 | .01541 | .01495 | .01452 |
| 19 | .02050 | .01974 | .01903 | .01837 | .01775 | .01717 | .01662 | .01611 | .01563 | .01517 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 10.2% | 10.4% | 10.6% | 10.8% | 11.0% | 11.2% | 11.4% | 11.6% | 11.8% | 12.0% |
| 20 | .02143 | .02064 | .01989 | .01919 | .01854 | .01793 | .01735 | .01681 | .01630 | .01582 |
| 21 | .02238 | .02154 | .02075 | .02002 | .01933 | .01868 | .01807 | .01750 | .01696 | .01646 |
| 22 | .02336 | .02247 | .02164 | .02087 | .02014 | .01946 | .01882 | .01821 | .01764 | .01711 |
| 23 | .02438 | .02345 | .02257 | .02176 | .02099 | .02027 | .01959 | .01895 | .01835 | .01778 |
| 24 | .02550 | .02451 | .02359 | .02273 | .02192 | .02115 | .02044 | .01976 | .01913 | .01853 |
| 25 | .02673 | .02569 | .02472 | .02381 | .02295 | .02214 | .02138 | .02067 | .01999 | .01936 |
| 26 | .02811 | .02701 | .02598 | .02502 | .02411 | .02326 | .02246 | .02170 | .02098 | .02031 |
| 27 | .02965 | .02849 | .02741 | .02639 | .02543 | .02452 | .02367 | .02287 | .02211 | .02140 |
| 28 | .03134 | .03013 | .02898 | .02790 | .02689 | .02593 | .02503 | .02418 | .02338 | .02262 |
| 29 | .03322 | .03193 | .03072 | .02958 | .02851 | .02750 | .02654 | .02564 | .02479 | .02398 |
| 30 | .03527 | .03391 | .03264 | .03143 | .03030 | .02923 | .02821 | .02726 | .02635 | .02550 |
| 31 | .03753 | .03610 | .03475 | .03348 | .03228 | .03115 | .03008 | .02907 | .02811 | .02720 |
| 32 | .04000 | .03849 | .03707 | .03573 | .03446 | .03326 | .03213 | .03105 | .03004 | .02907 |
| 33 | .04269 | .04111 | .03961 | .03819 | .03685 | .03558 | .03438 | .03325 | .03217 | .03115 |
| 34 | .04561 | .04394 | .04236 | .04087 | .03946 | .03812 | .03685 | .03565 | .03451 | .03342 |
| 35 | .04877 | .04702 | .04535 | .04378 | .04229 | .04087 | .03953 | .03826 | .03706 | .03591 |
| 36 | .05215 | .05031 | .04856 | .04690 | .04533 | .04384 | .04242 | .04108 | .03980 | .03859 |
| 37 | .05578 | .05384 | .05200 | .05025 | .04860 | .04703 | .04553 | .04411 | .04276 | .04148 |
| 38 | .05965 | .05761 | .05568 | .05385 | .05211 | .05045 | .04888 | .04738 | .04595 | .04460 |
| 39 | .06379 | .06165 | .05962 | .05770 | .05587 | .05412 | .05247 | .05089 | .04939 | .04795 |
| 40 | .06820 | .06596 | .06383 | .06181 | .05989 | .05806 | .05631 | .05465 | .05307 | .05155 |
| 41 | .07288 | .07054 | .06832 | .06620 | .06418 | .06226 | .06042 | .05868 | .05701 | .05541 |
| 42 | .07784 | .07539 | .07306 | .07085 | .06873 | .06671 | .06479 | .06295 | .06119 | .05952 |
| 43 | .08308 | .08052 | .07808 | .07576 | .07355 | .07143 | .06941 | .06748 | .06564 | .06387 |
| 44 | .08861 | .08594 | .08340 | .08097 | .07865 | .07644 | .07432 | .07230 | .07036 | .06851 |
| 45 | .09445 | .09167 | .08901 | .08648 | .08406 | .08174 | .07953 | .07741 | .07538 | .07343 |
| 46 | .10060 | .09770 | .09494 | .09230 | .08977 | .08735 | .08503 | .08281 | .08068 | .07865 |
| 47 | .10707 | .10406 | .10119 | .09843 | .09579 | .09327 | .09085 | .08853 | .08630 | .08417 |
| 48 | .11386 | .11073 | .10774 | .10487 | .10213 | .09949 | .09697 | .09455 | .09222 | .08999 |
| 49 | .12094 | .11769 | .11458 | .11160 | .10874 | .10600 | .10337 | .10084 | .09842 | .09609 |
| 50 | .12831 | .12494 | .12172 | .11862 | .11565 | .11280 | .11006 | .10743 | .10490 | .10247 |
| 51 | .13600 | .13251 | .12917 | .12596 | .12288 | .11991 | .11706 | .11432 | .11169 | .10915 |
| 52 | .14405 | .14044 | .13698 | .13366 | .13046 | .12738 | .12442 | .12157 | .11883 | .11619 |
| 53 | .15247 | .14875 | .14517 | .14172 | .13841 | .13522 | .13215 | .12919 | .12635 | .12360 |
| 54 | .16124 | .15740 | .15370 | .15014 | .14671 | .14341 | .14023 | .13717 | .13421 | .13136 |
| 55 | .17039 | .16642 | .16261 | .15893 | .15539 | .15198 | .14868 | .14551 | .14244 | .13948 |
| 56 | .17991 | .17583 | .17190 | .16811 | .16445 | .16092 | .15752 | .15423 | .15106 | .14799 |
| 57 | .18984 | .18564 | .18160 | .17769 | .17392 | .17029 | .16677 | .16338 | .16010 | .15692 |
| 58 | .20018 | .19587 | .19172 | .18770 | .18382 | .18007 | .17645 | .17295 | .16956 | .16628 |
| 59 | .21093 | .20652 | .20225 | .19812 | .19414 | .19028 | .18655 | .18294 | .17945 | .17606 |
| 60 | .22206 | .21753 | .21316 | .20893 | .20483 | .20087 | .19703 | .19332 | .18972 | .18624 |
| 61 | .23353 | .22890 | .22442 | .22009 | .21589 | .21182 | .20788 | .20407 | .20037 | .19678 |
| 62 | .24532 | .24059 | .23601 | .23158 | .22728 | .22311 | .21907 | .21515 | .21135 | .20767 |
| 63 | .25742 | .25260 | .24793 | .24339 | .23900 | .23473 | .23060 | .22658 | .22268 | .21890 |
| 64 | .26987 | .26495 | .26019 | .25556 | .25107 | .24671 | .24248 | .23837 | .23438 | .23050 |
| 65 | .28271 | .27771 | .27286 | .26815 | .26357 | .25912 | .25480 | .25059 | .24651 | .24254 |
| 66 | .29601 | .29093 | .28600 | .28120 | .27654 | .27200 | .26760 | .26331 | .25913 | .25507 |
| 67 | .30978 | .30462 | .29961 | .29474 | .29000 | .28539 | .28090 | .27653 | .27227 | .26813 |
| 68 | .32401 | .31879 | .31371 | .30877 | .30396 | .29927 | .29471 | .29027 | .28593 | .28171 |
| 69 | .33863 | .33336 | .32822 | .32322 | .31835 | .31359 | .30896 | .30445 | .30005 | .29576 |
| 70 | .35361 | .34829 | .34310 | .33804 | .33311 | .32830 | .32361 | .31903 | .31457 | .31021 |
| 71 | .36886 | .36349 | .35826 | .35316 | .34818 | .34332 | .33858 | .33394 | .32942 | .32500 |
| 72 | .38439 | .37899 | .37373 | .36858 | .36356 | .35866 | .35387 | .34919 | .34461 | .34015 |
| 73 | .40021 | .39479 | .38950 | .38432 | .37927 | .37433 | .36950 | .36478 | .36016 | .35565 |
| 74 | .41639 | .41096 | .40565 | .40046 | .39538 | .39042 | .38556 | .38081 | .37616 | .37161 |
| 75 | .43301 | .42758 | .42226 | .41706 | .41198 | .40699 | .40212 | .39734 | .39267 | .38809 |
| 76 | .45009 | .44467 | .43937 | .43417 | .42908 | .42410 | .41921 | .41443 | .40974 | .40514 |
| 77 | .46761 | .46221 | .45693 | .45175 | .44667 | .44170 | .43682 | .43203 | .42734 | .42274 |
| 78 | .48548 | .48013 | .47488 | .46973 | .46468 | .45972 | .45486 | .45009 | .44541 | .44082 |
| 79 | .50356 | .49826 | .49306 | .48795 | .48294 | .47802 | .47319 | .46845 | .46379 | .45922 |
| 80 | .52171 | .51647 | .51133 | .50628 | .50132 | .49644 | .49166 | .48695 | .48233 | .47779 |
| 81 | .53974 | .53457 | .52950 | .52451 | .51961 | .51479 | .51006 | .50541 | .50083 | .49633 |
| 82 | .55753 | .55245 | .54745 | .54254 | .53771 | .53296 | .52828 | .52369 | .51917 | .51472 |
| 83 | .57500 | .57001 | .56510 | .56026 | .55551 | .55083 | .54623 | .54170 | .53724 | .53285 |
| 84 | .59216 | .58726 | .58245 | .57770 | .57304 | .56844 | .56391 | .55945 | .55506 | .55074 |
| 85 | .60906 | .60428 | .59956 | .59492 | .59034 | .58583 | .58139 | .57702 | .57270 | .56845 |
| 86 | .62555 | .62088 | .61627 | .61173 | .60725 | .60284 | .59849 | .59420 | .58997 | .58580 |
| 87 | .64139 | .63683 | .63233 | .62790 | .62352 | .61921 | .61495 | .61076 | .60661 | .60253 |
| 88 | .65666 | .65221 | .64783 | .64350 | .63923 | .63502 | .63086 | .62675 | .62270 | .61871 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 10.2% | 10.4% | 10.6% | 10.8% | 11.0% | 11.2% | 11.4% | 11.6% | 11.8% | 12.0% |
| 89 | .67163 | .66730 | .66304 | .65882 | .65466 | .65055 | .64650 | .64249 | .63854 | .63463 |
| 90 | .68646 | .68226 | .67812 | .67402 | .66998 | .66599 | .66204 | .65814 | .65430 | .65049 |
| 91 | .70093 | .69686 | .69285 | .68888 | .68496 | .68108 | .67725 | .67347 | .66973 | .66604 |
| 92 | .71466 | .71073 | .70684 | .70300 | .69920 | .69545 | .69173 | .68806 | .68444 | .68085 |
| 93 | .72750 | .72370 | .71994 | .71622 | .71254 | .70890 | .70530 | .70174 | .69822 | .69474 |
| 94 | .73931 | .73562 | .73198 | .72838 | .72481 | .72129 | .71780 | .71434 | .71093 | .70755 |
| 95 | .75001 | .74644 | .74291 | .73941 | .73595 | .73253 | .72914 | .72579 | .72247 | .71919 |
| 96 | .75953 | .75606 | .75262 | .74923 | .74586 | .74253 | .73924 | .73598 | .73275 | .72955 |
| 97 | .76819 | .76481 | .76147 | .75816 | .75489 | .75165 | .74844 | .74526 | .74211 | .73899 |
| 98 | .77599 | .77270 | .76944 | .76621 | .76302 | .75986 | .75672 | .75362 | .75054 | .74750 |
| 99 | .78319 | .77998 | .77680 | .77365 | .77053 | .76744 | .76437 | .76134 | .75833 | .75535 |
| 100 | .78987 | .78673 | .78362 | .78054 | .77748 | .77446 | .77146 | .76849 | .76555 | .76263 |
| 101 | .79622 | .79315 | .79010 | .78708 | .78409 | .78113 | .77819 | .77528 | .77239 | .76953 |
| 102 | .80283 | .79983 | .79685 | .79390 | .79097 | .78807 | .78519 | .78234 | .77951 | .77671 |
| 103 | .80983 | .80690 | .80399 | .80111 | .79825 | .79541 | .79260 | .78981 | .78705 | .78430 |
| 104 | .81760 | .81475 | .81192 | .80912 | .80633 | .80357 | .80083 | .79810 | .79541 | .79273 |
| 105 | .82726 | .82451 | .82178 | .81907 | .81638 | .81371 | .81106 | .80843 | .80582 | .80322 |
| 106 | .84137 | .83879 | .83623 | .83368 | .83115 | .82863 | .82614 | .82366 | .82119 | .81874 |
| 107 | .86211 | .85981 | .85751 | .85523 | .85297 | .85071 | .84847 | .84624 | .84403 | .84182 |
| 108 | .89660 | .89481 | .89304 | .89127 | .88950 | .88775 | .88601 | .88427 | .88254 | .88081 |
| 109 | .95372 | .95290 | .95208 | .95126 | .95045 | .94964 | .94883 | .94803 | .94723 | .94643 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 12.2% | 12.4% | 12.6% | 12.8% | 13.0% | 13.2% | 13.4% | 13.6% | 13.8% | 14.0% |
| 0 | .01683 | .01669 | .01655 | .01642 | .01630 | .01618 | .01607 | .01596 | .01586 | .01576 |
| 1 | .00559 | .00544 | .00531 | .00518 | .00506 | .00494 | .00484 | .00473 | .00464 | .00454 |
| 2 | .00528 | .00513 | .00499 | .00485 | .00473 | .00461 | .00449 | .00439 | .00428 | .00419 |
| 3 | .00524 | .00508 | .00493 | .00479 | .00465 | .00453 | .00441 | .00429 | .00419 | .00408 |
| 4 | .00536 | .00519 | .00503 | .00488 | .00473 | .00460 | .00447 | .00435 | .00423 | .00412 |
| 5 | .00558 | .00540 | .00523 | .00507 | .00492 | .00477 | .00464 | .00451 | .00439 | .00427 |
| 6 | .00588 | .00569 | .00550 | .00533 | .00517 | .00502 | .00487 | .00473 | .00460 | .00448 |
| 7 | .00624 | .00604 | .00584 | .00566 | .00549 | .00532 | .00517 | .00502 | .00488 | .00475 |
| 8 | .00668 | .00646 | .00626 | .00606 | .00588 | .00570 | .00554 | .00538 | .00523 | .00509 |
| 9 | .00722 | .00699 | .00677 | .00656 | .00636 | .00617 | .00600 | .00583 | .00567 | .00552 |
| 10 | .00785 | .00761 | .00737 | .00715 | .00694 | .00674 | .00655 | .00637 | .00620 | .00604 |
| 11 | .00861 | .00835 | .00810 | .00786 | .00764 | .00743 | .00723 | .00704 | .00686 | .00668 |
| 12 | .00946 | .00918 | .00891 | .00866 | .00843 | .00820 | .00799 | .00779 | .00760 | .00741 |
| 13 | .01035 | .01006 | .00978 | .00951 | .00927 | .00903 | .00880 | .00859 | .00839 | .00819 |
| 14 | .01122 | .01091 | .01061 | .01034 | .01007 | .00982 | .00958 | .00936 | .00914 | .00894 |
| 15 | .01203 | .01171 | .01140 | .01110 | .01082 | .01056 | .01031 | .01007 | .00985 | .00963 |
| 16 | .01279 | .01244 | .01211 | .01181 | .01151 | .01123 | .01097 | .01072 | .01048 | .01025 |
| 17 | .01347 | .01311 | .01276 | .01244 | .01213 | .01184 | .01156 | .01130 | .01104 | .01081 |
| 18 | .01411 | .01373 | .01336 | .01302 | .01270 | .01239 | .01210 | .01182 | .01155 | .01130 |
| 19 | .01474 | .01434 | .01396 | .01359 | .01325 | .01293 | .01262 | .01233 | .01205 | .01178 |
| 20 | .01537 | .01494 | .01454 | .01415 | .01379 | .01345 | .01313 | .01282 | .01252 | .01224 |
| 21 | .01598 | .01553 | .01510 | .01470 | .01432 | .01396 | .01361 | .01329 | .01298 | .01268 |
| 22 | .01660 | .01613 | .01568 | .01525 | .01485 | .01446 | .01410 | .01375 | .01343 | .01312 |
| 23 | .01725 | .01674 | .01627 | .01581 | .01539 | .01498 | .01460 | .01423 | .01388 | .01355 |
| 24 | .01796 | .01742 | .01692 | .01644 | .01599 | .01556 | .01515 | .01476 | .01439 | .01404 |
| 25 | .01876 | .01819 | .01765 | .01714 | .01666 | .01621 | .01577 | .01536 | .01497 | .01460 |
| 26 | .01967 | .01907 | .01850 | .01796 | .01745 | .01696 | .01650 | .01606 | .01565 | .01525 |
| 27 | .02072 | .02008 | .01948 | .01890 | .01836 | .01784 | .01735 | .01688 | .01644 | .01601 |
| 28 | .02190 | .02122 | .02057 | .01996 | .01938 | .01883 | .01831 | .01781 | .01734 | .01689 |
| 29 | .02322 | .02249 | .02181 | .02116 | .02054 | .01996 | .01940 | .01887 | .01836 | .01788 |
| 30 | .02469 | .02392 | .02319 | .02250 | .02184 | .02122 | .02062 | .02006 | .01952 | .01900 |
| 31 | .02634 | .02552 | .02475 | .02401 | .02331 | .02264 | .02201 | .02140 | .02083 | .02028 |
| 32 | .02816 | .02729 | .02647 | .02568 | .02494 | .02423 | .02355 | .02291 | .02229 | .02170 |
| 33 | .03018 | .02926 | .02838 | .02755 | .02675 | .02600 | .02528 | .02459 | .02393 | .02331 |
| 34 | .03239 | .03142 | .03048 | .02960 | .02875 | .02795 | .02718 | .02645 | .02575 | .02508 |
| 35 | .03482 | .03378 | .03279 | .03185 | .03095 | .03009 | .02928 | .02850 | .02775 | .02704 |
| 36 | .03743 | .03633 | .03528 | .03428 | .03333 | .03242 | .03155 | .03072 | .02992 | .02916 |
| 37 | .04026 | .03909 | .03798 | .03692 | .03591 | .03494 | .03401 | .03313 | .03228 | .03147 |
| 38 | .04330 | .04207 | .04089 | .03977 | .03869 | .03767 | .03668 | .03574 | .03484 | .03398 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 12.2% | 12.4% | 12.6% | 12.8% | 13.0% | 13.2% | 13.4% | 13.6% | 13.8% | 14.0% |
| 39 | .04658 | .04528 | .04403 | .04284 | .04170 | .04061 | .03957 | .03857 | .03762 | .03670 |
| 40 | .05011 | .04873 | .04741 | .04615 | .04495 | .04379 | .04269 | .04163 | .04061 | .03964 |
| 41 | .05389 | .05244 | .05104 | .04971 | .04844 | .04721 | .04604 | .04492 | .04384 | .04281 |
| 42 | .05791 | .05638 | .05491 | .05350 | .05216 | .05086 | .04962 | .04844 | .04729 | .04620 |
| 43 | .06219 | .06057 | .05902 | .05754 | .05612 | .05475 | .05344 | .05218 | .05098 | .04981 |
| 44 | .06673 | .06503 | .06340 | .06184 | .06034 | .05890 | .05752 | .05619 | .05491 | .05368 |
| 45 | .07157 | .06978 | .06806 | .06642 | .06484 | .06332 | .06186 | .06046 | .05911 | .05781 |
| 46 | .07669 | .07481 | .07301 | .07128 | .06962 | .06802 | .06649 | .06501 | .06358 | .06221 |
| 47 | .08212 | .08015 | .07826 | .07645 | .07470 | .07302 | .07140 | .06984 | .06834 | .06690 |
| 48 | .08784 | .08578 | .08380 | .08190 | .08006 | .07830 | .07660 | .07496 | .07338 | .07186 |
| 49 | .09384 | .09169 | .08961 | .08762 | .08570 | .08384 | .08206 | .08034 | .07868 | .07708 |
| 50 | .10013 | .09787 | .09570 | .09361 | .09160 | .08966 | .08779 | .08598 | .08424 | .08256 |
| 51 | .10671 | .10436 | .10209 | .09991 | .09780 | .09577 | .09381 | .09192 | .09009 | .08832 |
| 52 | .11365 | .11120 | .10883 | .10655 | .10435 | .10222 | .10017 | .09819 | .09628 | .09442 |
| 53 | .12095 | .11840 | .11593 | .11355 | .11126 | .10904 | .10689 | .10482 | .10282 | .10088 |
| 54 | .12860 | .12595 | .12338 | .12090 | .11851 | .11619 | .11396 | .11179 | .10970 | .10767 |
| 55 | .13663 | .13386 | .13120 | .12862 | .12613 | .12372 | .12138 | .11912 | .11694 | .11482 |
| 56 | .14503 | .14217 | .13940 | .13672 | .13413 | .13162 | .12919 | .12683 | .12456 | .12235 |
| 57 | .15385 | .15089 | .14801 | .14523 | .14254 | .13994 | .13741 | .13496 | .13259 | .13029 |
| 58 | .16311 | .16004 | .15706 | .15418 | .15139 | .14868 | .14606 | .14352 | .14105 | .13866 |
| 59 | .17279 | .16961 | .16654 | .16355 | .16066 | .15786 | .15514 | .15250 | .14994 | .14745 |
| 60 | .18286 | .17958 | .17640 | .17332 | .17033 | .16743 | .16462 | .16188 | .15922 | .15664 |
| 61 | .19330 | .18992 | .18665 | .18347 | .18038 | .17738 | .17447 | .17164 | .16889 | .16622 |
| 62 | .20409 | .20061 | .19724 | .19396 | .19078 | .18768 | .18467 | .18175 | .17891 | .17614 |
| 63 | .21522 | .21165 | .20818 | .20480 | .20152 | .19833 | .19523 | .19221 | .18928 | .18642 |
| 64 | .22672 | .22306 | .21949 | .21602 | .21265 | .20937 | .20617 | .20306 | .20003 | .19708 |
| 65 | .23867 | .23491 | .23125 | .22769 | .22423 | .22085 | .21757 | .21437 | .21125 | .20821 |
| 66 | .25112 | .24727 | .24353 | .23988 | .23632 | .23286 | .22948 | .22619 | .22299 | .21986 |
| 67 | .26409 | .26016 | .25633 | .25260 | .24896 | .24541 | .24195 | .23857 | .23528 | .23206 |
| 68 | .27760 | .27359 | .26968 | .26586 | .26214 | .25851 | .25497 | .25151 | .24814 | .24484 |
| 69 | .29157 | .28748 | .28350 | .27961 | .27581 | .27211 | .26849 | .26495 | .26150 | .25812 |
| 70 | .30596 | .30181 | .29775 | .29379 | .28992 | .28614 | .28245 | .27884 | .27532 | .27187 |
| 71 | .32069 | .31648 | .31236 | .30833 | .30440 | .30055 | .29679 | .29312 | .28952 | .28600 |
| 72 | .33578 | .33151 | .32733 | .32325 | .31925 | .31535 | .31152 | .30778 | .30412 | .30054 |
| 73 | .35123 | .34691 | .34269 | .33855 | .33450 | .33054 | .32666 | .32286 | .31914 | .31550 |
| 74 | .36715 | .36279 | .35852 | .35434 | .35024 | .34623 | .34230 | .33845 | .33468 | .33098 |
| 75 | .38360 | .37921 | .37491 | .37069 | .36656 | .36250 | .35853 | .35464 | .35082 | .34708 |
| 76 | .40064 | .39623 | .39190 | .38765 | .38349 | .37941 | .37540 | .37148 | .36762 | .36384 |
| 77 | .41823 | .41381 | .40947 | .40521 | .40103 | .39692 | .39290 | .38895 | .38507 | .38126 |
| 78 | .43632 | .43189 | .42755 | .42329 | .41910 | .41499 | .41095 | .40698 | .40309 | .39926 |
| 79 | .45473 | .45032 | .44599 | .44173 | .43755 | .43344 | .42940 | .42543 | .42153 | .41770 |
| 80 | .47333 | .46894 | .46463 | .46040 | .45623 | .45213 | .44811 | .44414 | .44025 | .43642 |
| 81 | .49191 | .48755 | .48328 | .47907 | .47493 | .47085 | .46684 | .46290 | .45902 | .45520 |
| 82 | .51034 | .50603 | .50179 | .49762 | .49351 | .48947 | .48549 | .48157 | .47772 | .47392 |
| 83 | .52852 | .52427 | .52008 | .51595 | .51189 | .50788 | .50394 | .50006 | .49623 | .49246 |
| 84 | .54648 | .54228 | .53815 | .53407 | .53006 | .52610 | .52221 | .51836 | .51458 | .51084 |
| 85 | .56426 | .56013 | .55606 | .55205 | .54810 | .54420 | .54035 | .53656 | .53282 | .52913 |
| 86 | .58169 | .57764 | .57364 | .56970 | .56581 | .56197 | .55818 | .55445 | .55076 | .54713 |
| 87 | .59850 | .59452 | .59060 | .58673 | .58291 | .57913 | .57541 | .57174 | .56811 | .56453 |
| 88 | .61476 | .61086 | .60702 | .60322 | .59947 | .59577 | .59212 | .58851 | .58494 | .58142 |
| 89 | .63078 | .62697 | .62321 | .61950 | .61583 | .61220 | .60862 | .60508 | .60159 | .59813 |
| 90 | .64674 | .64302 | .63935 | .63573 | .63215 | .62861 | .62511 | .62165 | .61823 | .61485 |
| 91 | .66238 | .65877 | .65520 | .65167 | .64819 | .64474 | .64133 | .63795 | .63462 | .63132 |
| 92 | .67730 | .67379 | .67032 | .66689 | .66350 | .66014 | .65682 | .65354 | .65029 | .64708 |
| 93 | .69130 | .68789 | .68452 | .68119 | .67789 | .67463 | .67140 | .66820 | .66504 | .66191 |
| 94 | .70421 | .70090 | .69762 | .69438 | .69118 | .68800 | .68486 | .68175 | .67867 | .67563 |
| 95 | .71594 | .71272 | .70954 | .70639 | .70326 | .70017 | .69712 | .69409 | .69109 | .68812 |
| 96 | .72638 | .72325 | .72014 | .71707 | .71403 | .71101 | .70803 | .70507 | .70215 | .69925 |
| 97 | .73590 | .73285 | .72982 | .72682 | .72385 | .72090 | .71799 | .71510 | .71224 | .70941 |
| 98 | .74448 | .74149 | .73853 | .73560 | .73269 | .72981 | .72696 | .72414 | .72134 | .71856 |
| 99 | .75240 | .74948 | .74658 | .74371 | .74086 | .73805 | .73525 | .73248 | .72974 | .72702 |
| 100 | .75974 | .75687 | .75403 | .75121 | .74842 | .74566 | .74292 | .74020 | .73751 | .73484 |
| 101 | .76669 | .76388 | .76109 | .75833 | .75559 | .75287 | .75018 | .74751 | .74486 | .74223 |
| 102 | .77393 | .77117 | .76844 | .76573 | .76304 | .76037 | .75773 | .75511 | .75251 | .74993 |
| 103 | .78158 | .77888 | .77620 | .77355 | .77091 | .76830 | .76571 | .76313 | .76058 | .75805 |
| 104 | .79007 | .78743 | .78482 | .78222 | .77964 | .77709 | .77455 | .77203 | .76953 | .76705 |
| 105 | .80065 | .79809 | .79556 | .79304 | .79054 | .78805 | .78559 | .78314 | .78071 | .77829 |
| 106 | .81631 | .81389 | .81149 | .80911 | .80674 | .80438 | .80204 | .79972 | .79741 | .79511 |
| 107 | .83963 | .83745 | .83529 | .83313 | .83099 | .82886 | .82674 | .82463 | .82254 | .82045 |

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

| Age | Interest rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 12.2% | 12.4% | 12.6% | 12.8% | 13.0% | 13.2% | 13.4% | 13.6% | 13.8% | 14.0% |
| 108 | .87910 | .87739 | .87569 | .87400 | .87232 | .87064 | .86897 | .86731 | .86566 | .86401 |
| 109 | .94563 | .94484 | .94405 | .94326 | .94248 | .94170 | .94092 | .94014 | .93937 | .93860 |

TABLE 80CNSMT.—APPLICABLE AFTER APRIL 30, 1989

| Age × (1) | 1(×) (2) | Age × (1) | 1(×) (2) | Age × (1) | 1(×) (2) |
|---|---|---|---|---|---|
| 0 | 100000 | 37 | 95492 | 74 | 59279 |
| 1 | 98740 | 38 | 95317 | 75 | 56799 |
| 2 | 98648 | 39 | 95129 | 76 | 54239 |
| 3 | 98584 | 40 | 94926 | 77 | 51599 |
| 4 | 98535 | 41 | 94706 | 78 | 48878 |
| 5 | 98495 | 42 | 94465 | 79 | 46071 |
| 6 | 98459 | 43 | 94201 | 80 | 43180 |
| 7 | 98426 | 44 | 93913 | 81 | 40208 |
| 8 | 98396 | 45 | 93599 | 82 | 37172 |
| 9 | 98370 | 46 | 93256 | 83 | 34095 |
| 10 | 98347 | 47 | 92882 | 84 | 31012 |
| 11 | 98328 | 48 | 92472 | 85 | 27960 |
| 12 | 98309 | 49 | 92021 | 86 | 24961 |
| 13 | 98285 | 50 | 91526 | 87 | 22038 |
| 14 | 98248 | 51 | 90986 | 88 | 19235 |
| 15 | 98196 | 52 | 90402 | 89 | 16598 |
| 16 | 98129 | 53 | 89771 | 90 | 14154 |
| 17 | 98047 | 54 | 89087 | 91 | 11908 |
| 18 | 97953 | 55 | 88348 | 92 | 9863 |
| 19 | 97851 | 56 | 87551 | 93 | 8032 |
| 20 | 97741 | 57 | 86695 | 94 | 6424 |
| 21 | 97623 | 58 | 85776 | 95 | 5043 |
| 22 | 97499 | 59 | 84789 | 96 | 3884 |
| 23 | 97370 | 60 | 83726 | 97 | 2939 |
| 24 | 97240 | 61 | 82581 | 98 | 2185 |
| 25 | 97110 | 62 | 81348 | 99 | 1598 |
| 26 | 96982 | 63 | 80024 | 100 | 1150 |
| 27 | 96856 | 64 | 78609 | 101 | 815 |
| 28 | 96730 | 65 | 77107 | 102 | 570 |
| 29 | 96604 | 66 | 75520 | 103 | 393 |
| 30 | 96477 | 67 | 73846 | 104 | 267 |
| 31 | 96350 | 68 | 72082 | 105 | 179 |
| 32 | 96220 | 69 | 70218 | 106 | 119 |
| 33 | 96088 | 70 | 68248 | 107 | 78 |
| 34 | 95951 | 71 | 66165 | 108 | 51 |
| 35 | 95808 | 72 | 63972 | 109 | 33 |
| 36 | 95655 | 73 | 61673 | 110 | 0 |

(e) *Effective date.* This section is effective as of May 1, 1989.

[T.D. 8540, 59 FR 30152, June 10, 1994]

### § 20.2031–8 Valuation of certain life insurance and annuity contracts; valuation of shares in an open-end investment company.

(a) *Valuation of certain life insurance and annuity contracts.* (1) The value of a contract for the payment of an annuity, or an insurance policy on the life of a person other than the decedent, issued by a company regularly engaged in the selling of contracts of that character is established through the sale by that company of comparable contracts. An annuity payable under a combination annuity contract and life insurance policy on the decedent's life (e.g., a ''retirement income'' policy with death benefit) under which there was no insurance element at the time of the decedent's death (see paragraph (d) of § 20.2039–1) is treated like a contract for the payment of an annuity for purposes of this section.

(2) As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when, at the date of the decedent's death, the contract has been in force for some time and further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve at the date of the decedent's death the proportionate part of the gross premium last paid before the date of the decedent's death which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such an approximation is not reasonably close to the full value of the contract, this method may not be used.

(3) The application of this section may be illustrated by the following examples. In each case involving an insurance contract, it is assumed that there are no accrued dividends or outstanding indebtedness on the contract.

*Example (1).* X purchased from a life insurance company a joint and survivor annuity contract under the terms of which X was to receive payments of $1,200 annually for his life and, upon X's death, his wife was to receive payments of $1,200 annually for her life. Five years after such purchase, when his wife was 50 years of age, X died. The value of the annuity contract at the date of X's death is the amount which the company would charge for an annuity providing for the payment of $1,200 annually for the life of a female 50 years of age.

*Example (2).* Y died holding the incidents of ownership in a life insurance policy on the life of his wife. The policy was one on which no further payments were to be made to the company (e.g., a single premium policy or a paid-up policy). The value of the insurance policy at the date of Y's death is the amount which the company would charge for a single premium contract of the same specified amount on the life of a person of the age of the insured.

*Example (3).* Z died holding the incidents of ownership in a life insurance policy on the life of his wife. The policy was an ordinary life policy issued nine years and four months prior to Z's death and at a time when Z's wife was 35 years of age. The gross annual premium is $2,811 and the decedent died four months after the last premium due date. The value of the insurance policy at the date of Z's death is computed as follows:

| | |
|---|---|
| Terminal reserve at end of tenth year | $14,601.00 |
| Terminal reserve at end of ninth year | 12,965.00 |
| Increase | 1,636.00 |
| One-third of such increase (Z having died four months following the last preceding premium date) is | 545.33 |
| Terminal reserve at end of ninth year | 12,965.00 |
| Interpolated terminal reserve at date of Z's death | 13,510.33 |
| Two-thirds of gross premium (⅔×$2,811) | 1,874.00 |
| Value of the insurance policy | 15,384.33 |

(b) *Valuation of shares in an open-end investment company.* (1) 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, the last public redemption price quoted by the company for the date of death shall be presumed to be the applicable public redemption price. If the alternate valuation method under 2032 is elected, the last public redemption price quoted by the company for the alternate valuation date shall be 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 ''exdividend'' 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.

(2) The provisions of this paragraph shall apply with respect to estates of decedents dying after August 16, 1954.

[T.D. 6680, 28 FR 10872, Oct. 10, 1963, as amended by T.D. 7319, 39 FR 26723, July 23, 1974]

**§ 20.2031–9 Valuation of other property.**

The valuation of any property not specifically described in §§ 20.2031–2 to 20.2031–8 is made in accordance with the general principles set forth in § 20.2031–1. For example, a future interest in property not subject to valuation in accordance with the actuarial principles set forth in § 20.2031–7 is to be valued in accordance with the general principles set forth in § 20.2031–1.

**§ 20.2032–1 Alternate valuation.**

(a) *In general.* In general, section 2032 provides for the valuation of a decedent's gross estate at a date other than the date of the decedent's death. More specifically, if an executor elects the alternate valuation method under section 2032, the property included in the decedent's gross estate on the date of his death is valued as of whichever of the following dates is applicable:

(1) Any property distributed, sold, exchanged, or otherwise disposed of within 6 months (1 year, if the decedent died on or before December 31, 1970) after the decedent's death is valued as of the date on which it is first distributed, sold, exchanged, or otherwise disposed of;

(2) Any property not distributed, sold, exchanged, or otherwise disposed of within 6 months (1 year, if the decedent died on or before December 31, 1970) after the decedent's death is valued as of the date 6 months (1 year, if the decedent died on or before December 31, 1970) after the date of the decedent's death;

(3) Any property, interest, or estate which is affected by mere lapse of time is valued as of the date of the decedent's death, but adjusted for any difference in its value not due to mere lapse of time as of the date 6 months (1 year, if the decedent died on or before December 31, 1970) after the decedent's death, or as of the date of its distribution, sale, exchange, or other disposition, whichever date first occurs.

(b) *Method and effect of election.* (1) While it is the purpose of section 2032 to permit a reduction in the amount of tax that would otherwise be payable if the gross estate has suffered a shrinkage in its aggregate value in the 6 months (1 year, if the decedent died on or before Decembe 31, 1970) following the decedent's death, the alternate valuation method is not automatic but must be elected. Furthermore, the alternate valuation method may be elected whether or not there has been a shrinkage in the aggregate value of the estate. However, the election is not effective for any purpose unless the value of the gross estate at the time of the decedent's death exceeded $60,000, so that an estate tax return is required to be filed under section 6018.

(2) If the alternate valuation method under section 2032 is to be used, section 2032(c) requires that the executor must so elect on the estate tax return required under section 6018, filed within 9 months (15 months, if the decedent died on or before December 31, 1970) from the date of the decedent's death or within the period of any extension of time granted by the district director under section 6081. In no case may the election be exercised, or a previous election changed, after the expiration of such time. If the election is made, it applies to all the property included in the gross estate, and cannot be applied to only a portion of the property.

(c) *Meaning of ''distributed, sold, exchanged, or otherwise disposed of''.* (1) The phrase ''distributed, sold, exchanged, or otherwise disposed of'' comprehends 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 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 in exchange for its stock in a transaction with respect to which no gain or loss would be recognizable for income tax purposes under 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 section 368 (a) or 355, with respect to which no gain or loss is recognizable for income tax purposes under section 354 or 355.

(2) Property may be ''distributed'' either by the executor, or by a trustee of property included in the gross estate under section 2035 through 2038, or section 2041. Property is considered as ''distributed'' upon the first to occur of the following:

(i) The entry of an order or decree of distribution, if the order or decree subsequently becomes final;

(ii) The segregation or separation of the property from the estate or trust so that it becomes unqualifiedly subject to the demand or disposition of the distributee; or

(iii) The actual paying over or delivery of the property to the distributee.

(3) Property may be ''sold, exchanged, or otherwise disposed of'' by:

(i) The executor;

(ii) A trustee or other donee to whom the decedent during his lifetime transferred property included in his gross estate under sections 2035 through 2038, or section 2041;

(iii) An heir or devisee to whom title to property passes directly under local law;

(iv) A surviving joint tenant or tenant by the entirety; or

(v) Any other person.

If a binding contract for the sale, exchange, or other disposition of property is entered into, the property is considered as sold, exchanged, or otherwise disposed of on the effective date of the contract, unless the contract is not subsequently carried out substantially in accordance with its terms. The effective date of a contract is normally the date it is entered into (and not the date it is consummated, or the date legal title to the property passes) unless the contract specifies a different effective date.

(d) *''Included property'' and ''excluded property''.* If the executor elects the alternate valuation method under section 2432, all property interests existing at the date of decedent's death which form a part of his gross estate as determined under sections 2033 through 2044 are valued in accordance with the provisions of this section. Such property interests are referred to in this section as ''included property''. Furthermore, such property interests remain ''included property'' for the purpose of valuing the gross estate under the alternate valuation method even though they change in form during the alternate valuation period by being actually received, or disposed of, in whole or in part, by the estate. On the other hand, 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 any property interest existing at the date of the decedent's death, which does not represent a form of ''included property'' itself or the receipt of ''included property'' is excluded in valuing the gross estate under the alternate valuation method. Such property is referred to in this section as ''excluded property''. Illustrations of ''included property'' and ''excluded property'' are contained in the subparagraphs (1) to (4) of this paragraph:

(1) *Interest-bearing obligations.* Interest-bearing obligations, such as bonds or notes, may comprise two elements of ''included property'' at the date of the decedent's death, namely, (i) the principal of the obligation itself, and (ii) interest accrued to the date of death. Each of these elements is to be separately valued as of the applicable valuation date. Interest accrued after the date of death and before the subsequent valuation date constitutes ''excluded property''. However, any part payment or 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) *Leased property.* The principles set forth in subparagraph (1) of this paragraph with respect 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) *Noninterest-bearing obligations.* 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.

(4) *Stock of a corporation.* 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 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 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 includible 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''.

(e) *Illustrations of ''included property'' and ''excluded property''.* The application of paragraph (d) of this section may be further illustrated by the following example in which it is assumed that the decedent died on January 1, 1955:

| Description | Subsequent valuation date | Alternate value | Value at date of death |
|---|---|---|---|
| Bond, par value $1,000, bearing interest at 4 percent payable quarterly on Feb. 1, May 1, Aug. 1, and Nov. 1. Bond distributed to legatee on Mar. 1, 1955. | Mar. 1, 1955 | $1,000.00 | $1,000.00 |
| Interest coupon of $10 attached to bond and not cashed at date of death although due and payable Nov. 1, 1954. Cashed by executor on Feb. 1, 1955. | Feb. 1, 1955 | 10.00 | 10.00 |
| Interest accrued from Nov. 1, 1954, to Jan. 1, 1955, collected on Feb. 1, 1955 ..... | Feb. 1, 1955 | 6.67 | 6.67 |
| Real estate, not disposed of within year following death. Rent of $300 due at the end of each quarter, Feb. 1, May 1, Aug. 1, and Nov. 1. | Jan. 1, 1956 | 11,000.00 | 12,000.00 |
| Rent due for quarter ending Nov. 1, 1954, but not collected until Feb. 1, 1955 ..... | Feb. 1, 1955 | 300.00 | 300.00 |
| Rent accrued for November and December 1954, collected on Feb. 1, 1955 ..... | Feb. 1, 1955 | 200.00 | 200.00 |
| Common stock, X Corporation, 500 shares, not disposed of within year following decedent's death. | Jan. 1, 1956 | 47,500.00 | 50,000.00 |
| Dividend of $2 per share declared Dec. 10, 1954, and paid on Jan. 10, 1955, to holders of record on Dec. 30, 1954. | Jan. 10, 1955 | 1,000.00 | 1,000.00 |

(f) *Mere lapse of time.* In order to eliminate changes in value due only to mere lapse of time, section 2032(a)(3) provides that any interest or estate ''affected by mere lapse of time'' is included in a decedent's gross estate under the alternate valuation method at its value as of the date of the decedent's death, but with adjustment for any difference in its value as of the subsequent valuation date not due to mere lapse of time. Properties, interests, or estates which are ''affected by mere lapse of time'' include patents, estates for the life of a person other than the decedent, remainders, reversions, and other like properties, interests, or estates. 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 passing of time. However, such an obligation, like any other property, may become affected by lapse of time when made the subject of a bequest or transfer which itself is creative of an interest or estate so affected. The application of this paragraph is illustrated in subparagraphs (1) and (2) of this paragraph:

(1) *Life estates, remainders, and similar interests.* The values of life estates, remainders, and similar interests are to be obtained by applying the methods prescribed in § 20.2031–7, using (i) the age of each person, the duration of whose life may affect the value of the interest, as of the date of the decedent's death, and (ii) the value of the property as of the alternate date. For example, assume that the decedent or his estate was entitled to receive property upon the death of his elder brother who was entitled to receive the income therefrom for life. At the date of the decedent's death, the property was worth $50,000 and the elder brother was 31 years old. The value of the decedent's remainder interest at the date of the decedent's death would, as explained in paragraph (d) of § 20.2031–7(A)(d), be $2,373 ($50,000×.04746). If, because of economic conditions, the property declined in value and was worth only $40,000 6 months after the date of the decedent's death, the value of the remainder interest would be $1,898.40 ($40,000×.04746), even though the elder brother may be 32 years old on the alternate date.

(2) *Patents.* To illustrate the alternate valuation of a patent, assume that the decedent owned a patent which, on the date of the decedent's death, had an unexpired term of ten years and a value of $78,000. Six months after the date of the decedent's death, the patent was sold, because of lapse of time and other causes, for $60,000. The alternate value thereof would be obtained by dividing $60,000 by 0.95 (ratio of the remaining life of the patent at the alternate date to the remaining life of the patent at the date of the decedent's death), and would, therefore, be $63,157.89.

(g) *Effect of election on deductions.* If the executor elects the alternate valuation method under section 2032, any deduction for administration expenses under section 2053(b) (pertaining to property not subject to claims) or losses under section 2054 (or section 2106(a)(1), relating to estates of nonresidents not citizens) is allowed only to the extent that it is not otherwise in effect allowed in determining the value of the gross estate. Furthermore, the amount of any charitable deduction under section 2055 (or section 2106(a)(2), relating to the estates of nonresidents not citizens) or the amount of any marital deduction under section 2056 is determined by the value of the property with respect to which the deduction is allowed as of the date of the decedent's death, adjusted, however, for any difference in its value as of the date 6 months (1 year, if the decedent died on or before December 31, 1970) after death, or as of the date of its distribution, sale, exchange, or other disposition, whichever first occurs. However, no such adjustment may take into account any difference in value due to lapse of time or to the occurrence or nonoccurrence of a contingency.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 7238, 37 FR 28718, Dec. 29, 1972; T.D. 7955, 49 FR 19995, May 11, 1984; T.D. 8540, 59 FR 30103, June 10, 1994]

**§ 20.2032A–3 Material participation requirements for valuation of certain farm and closely-held business real property.**

(a) *In general.* Under section 2032A, an executor may, for estate tax purposes, make a special election concerning valuation of qualified real property (as defined in section 2032A(b)) used as a farm for farming purposes or in another trade or business. If this election is made, the property will be valued on the basis of its value for its qualified use in farming or the other trade or business, rather than its fair market value determined on the basis of highest and best use (irrespective of whether its highest and best use is the use in farming or other business). For the special valuation rules of section 2032A to apply, the deceased owner and/or a member of the owner's family (as defined in section 2032A (e) (2)) must materially participate in the operation of the farm or other business. Whether the required material participation occurs is a factual determination, and the types of activities and financial risks which will support such a finding will vary with the mode of ownership of both the property itself and of any business in which it is used. Passively collecting rents, salaries, draws, dividends, or other income from the farm or other business is not sufficient for material participation, nor is merely advancing capital and reviewing a crop plan or other business proposal and financial reports each season or business year.

(b) *Types of qualified property*—(1) *In general.* Real property valued under section 2032A must pass from the decendent to a qualified heir or be acquired from the decedent by a qualified heir. The real property may be owned directly or may be owned indirectly through ownership of an interest in a corporation, a partnership, or a trust. Where the ownership is indirect, however, the decedent's interest in the business must, in addition to meeting the tests for qualification under section 2032A, qualify under the tests of section 6166 (b) (1) as an interest in a closely-held business on the date of the decedent's death and for sufficient other time (combined with periods of direct ownership) to equal at least 5 years of the 8 year period preceding the death. All specially valued property must be used in a trade or business. Directly owned real property that is leased by a decedent to a separate closely held business is considered to be qualified real property, but only if the separate business qualifies as a closely held business under section 6166 (b) (1) with respect to the decedent on the date of his or her death and for sufficient other time (combined with periods during which the property was operated as a proprietorship) to equal at least 5 years of the 8 year period preceding the death. For example, real property owned by the decedent and leased to a farming corporation or partnership owned and operated entirely by the decedent and fewer than 15 members of the decedent's family is eligible for special use valuation. Under section 2032A, the term trade or business applies only to an active business such as a manufacturing, mercantile, or service enterprise, or to the raising of agricultural or horticultural commodities, as distinguished from passive investment activities. The mere passive rental of property to a party other than a member of the decedent's family will not qualify. The decedent or a member of the decedent's family must own an equity interest in the farm operation. A trade or business is not necessarily present even though an office and regular hours are maintained for management of income producing assets, as the term ''business'' is not as broad under section 2032A as under section 162. Additionally, no trade or business is present in the case of activities not engaged in for profit. *See* section 183.

(2) *Structures and other real property improvements.* Qualified real property includes residential buildings and other structures and real property improvements occupied or used on a regular basis by the owner or lessee of real property (or by employees of the owner or lessee) for the purpose of operating the farm or other closely held business. A farm residence occupied by the decedent owner of the specially valued property is considered to be occupied for the purpose of operating the farm even though a family member (not the decedent) was the person materially

participating in the operation of the farm as required under section 2032A (b) (1) (C).

(c) *Period material participation must last.* The required participation must last—

(1) For periods totalling 5 years or more during the 8 years immediately preceding the date of the decedent's death; and

(2) For periods totalling 5 years or more during any 8 year period ending after the date of the decedent's death (up to a maximum of 15 years after decedent's death, when the additional estate tax provisions of section 2032A(c) cease to apply).

In determining whether the material participation requirement is satisfied, no exception is made for periods during which real property is held by the decedent's estate. Additionally, contemporaneous material participation by 2 or more family members during a period totalling a year will not result in that year being counted as 2 or more years for purposes of satisfying the requirements of this paragraph (c). Death of a qualified heir (as defined in section 2032A(e)(1)) before the requisite time has passed ends any material participation requirement for that heir's portion of the property as to the origninal decedent's estate if the heir received a separate, joint or other undivided property interest from the decedent. If qualified heirs receive successive interests in specially valued property (e.g. life estate and remainder interests) from the decedent, the material participation requirement does not end with respect to any part of the property until the death of the last qualified heir (or, if earlier, the expiration of 15 years from the date of the decedent's death). The requirements of section 2032A will fully apply to an heir's estate if an election under this section is made for the same property by the heir's executor. In general, to determine whether the required participation has occurred, brief periods (*e.g.*, periods of 30 days or less) during which there was no material participation may be disregarded. This is so only if these periods were both preceded and followed by substantial periods (*e.g.* periods of more than 120 days) in which there was uninterrupted material participation. *See* paragraph (e)(1) of this section which provides a special rule for periods when little or no activity is necessary to manage fully a farm.

(d) *Period property must be owned by decedent and family members.* Only real property which is actually owned by any combination of the decedent, members of the decedent's family, and qualified closely held businesses for periods totalling at least 5 of the 8 years preceding the date of decedent's death may be valued under section 2032A. For example, replacement property acquired in like-kind exchange under section 1031 is considered to be owned only from the date on which the replacement property is actually acquired. On the other hand, replacement property acquired as a result of an involuntary conversion in a transfer that would meet the requirements of section 2032A(h) if it occurred after the date of the decedent's death is considered to have been owned from the date in which the involuntarily converted property was acquired. Property transferred from a proprietorship to a corporation or a partnership during the 8-year period ending on the date of the decedent's death is considered to be continuously owned to the extent of the decedent's equity interest in the corporation or partnership if, (1) the transfer meets the requirements of section 351 or 721, respectively, and (2) the decedent's interest in the corporation or partnership meets the requirements for indirectly held property contained in paragraph (b)(1) of this section. Likewise, property transferred to a trust is considered to be continuously owned if the beneficial ownership of the trust property is such that the requirements of section 6166(b)(1)(C) would be so satisfied if the property were owned by a corporation and all beneficiaries having vested interests in the trust were shareholders in the corporation. Any periods following the transfer during which the interest in the corporation, partnership, or trust does not meet the requirements of section 6166(b)(1) may not be counted for purposes of satisfying the ownership requirements of this paragraph (d).

(e) *Required activities*—(1) *In general.* Actual employment of the decedent (or of a member of the decedent's family)

on a substantially full-time basis (35 hours a week or more) or to any lesser extent necessay personally to manage fully the farm or business in which the real property to be valued under section 2032A is used constitutes material participation. For example, many farming operations require only seasonal activity. Material participation is present as long as all necessary functions are performed even though little or no actual activity occurs during nonproducing seasons. In the absence of this direct involvement in the farm or other business, the activities of either the decedent or family members must meet the standards prescribed in this paragraph and those prescribed in the regulations issued under section 1402(a)(1). Therefore, if the participant (or participants) is self-employed with respect to the farm or other trade or business, his or her income from the farm or other business must be earned income for purposes of the tax on self-employment income before the participant is considered to be materially participating under section 2032A. Payment of the self-employment tax is not conclusive as to the presence of material participation. If no self-employment taxes have been paid, however, material participation is presumed not to have occurred unless the executor demonstrates to the satisfaction of the Internal Revenue Service that material participation did in fact occur and informs the Service of the reason no such tax was paid. In addition, all such taxes (including interest and penalties) determined to be due must be paid. In determining whether the material participation requirement is satisfied, the activities of each participant are viewed separately from the activities of all other participants, and at any given time, the activities of at least one participant must be material. If the involvement is less than full-time, it must be pursuant to an arrangement providing for actual participation in the production or management of production where the land is used by any nonfamily member, or any trust or business entity, in farming or another business. The arrangement may be oral or written, but must be formalized in some manner capable of proof. Activities not contemplated by the arrangement will not support a finding of material participation under section 2032A, and activities of any agent or employee other than a family member may not be considered in determining the presence of material participation. Activities of family members are considered only if the family relationship existed at the time the activities occurred.

(2) *Factors considered.* No single factor is determinative of the presence of material participation, but physical work and participation in management decisions are the principal factors to be considered. As a minimum, the decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and/or family members must participate in making a substantial number of these decisions. Additionally, production activities on the land should be inspected regularly by the family participant, and funds should be advanced and financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of a farm, the furnishing by the owner or other family members of a substantial portion of the machinery, implements, and livestock used in the production activities is an important factor to consider in finding material participation. With farms, hotels, or apartment buildings, the operation of which qualifies as a trade or business, the participating decedent or heir's maintaining his or her principal place of residence on the premises is a factor to consider in determining whether the overall participation is material. Retention of a professional farm manager will not by itself prevent satisfaction of the material participation requirement by the decedent and family members. However, the decedent and/or a family member must personally materially participate under the terms of arrangement with the professional farm manager to satisfy this requirement.

(f) *Special rules for corporations, partnerships, and trusts*—(1) *Required arrangement.* With indirectly owned property as with property that is directly

owned, there must be an arrangement calling for material participation in the business by the decedent owner or a family member. Where the real property is indirectly owned, however, even full-time involvement must be pursuant to an arrangement between the entity and the decedent or family member specifying the services to be performed. Holding an office in which certain material functions are inherent may constitute the necessary arrangement for material participation. Where property is owned by a trust, the arrangement will generally be found in one or more of four situations. First, the arrangement may result from appointment as a trustee. Second, the arrangement may result from an employer-employee relationship in which the participant is employed by a qualified closely held business owned by the trust in a position requiring his or her material participation in its activities. Third, the participants may enter into a contract with the trustees to manage, or take part in managing, the real property for the trust. Fourth, where the trust agreement expressly grants the management rights to the beneficial owner, that grant is sufficient to constitute the arrangement required under this section.

(2) *Required activities.* The same participation standards apply under section 2032A where property is owned by a qualified closely held business as where the property is directly owned. In the case of a corporation, a partnership, or a trust where the participating decedent and/or family members are employees and thereby not subject to self-employment income taxes, they are to be viewed as if they were self-employed, and their activities must be activities that would subject them to self-employment income taxes were they so. Where property is owned by a corporation, a partnership or a trust, participation in the management and operation of the real property itself as a component of the closely held business is the determinative factor. Nominally holding positions as a corporate officer or director and receiving a salary therefrom or merely being listed as a partner and sharing in profits and losses will not alone support a finding of material participation. This is so even though, as partners, the participants pay self-employment income taxes on their distributive shares of partnership earnings under § 1.1402(a)–2. Further, it is especially true for corporate directors in states where the board of directors need not be an actively functioning entity or need only act informally. Corporate offices held by an owner are, however, factors to be considered with all other relevant facts in judging the degree of participation. When real property is directly owned and is leased to a corporation or partnership in which the decedent owns an interest which qualified as an interest in a trade or business within the meaning of section 6166(b)(1), the presence of material participation is determined by looking at the activities of the participant with regard to the property in whatever capacity rendered. During any periods when qualified real property is held by an estate, material participation is to be determined in the same manner as if the property were owned by a trust.

(g) *Examples.* The rules for determining material participation may be illustrated by the following examples. Additional illustrations may be found in examples (1) through (6) in § 1.1402(a)–4.

*Example (1).* A, the decedent, actively operated his 100-acre farm on a full-time basis for 20 years. He then leased it to B for the 10 years immediately preceding his death. By the terms of the lease, A was to consult with B on where crops were to be planted, to supervise marketing of the crop, and to share equally with B in expenses and earnings. A was present on the farm each spring for consultation; however, once planting was completed, he left for his retirement cottage where he remained until late summer, at which time he returned to the farm to supervise the marketing operation. A at all times maintained the farm home in which he had lived for the time he had owned the farm and lived there when at the farm. In light of his activities, assumption of risks, and valuable knowledge of proper techniques for the particular land gained over 20 years of full-time farming on the land involved, A is deemed to have materially participated in the farming business.

*Example (2).* D is the 70-year old widow of farmer C. She lives on a farm for which special valuation has been elected and has lived there for 20 years. D leases the land to E

under an arrangement calling for her participation in the operation of the farm. D annually raises a vegetable garden, chickens, and hogs. She also inspects the tobacco fields (which produce approximately 50 percent of farm income) weekly and informs E if she finds any work that needs to be done. D and E share expenses and income equally. Other decisions such as what fields to plant and when to plant and harvest crops are left to E, but D does occasionally make suggestions. During the harvest season, D prepares and serves meals for all temporary farm help. D is deemed to participate materially in the farm operations based on her farm residence and her involvement with the main money crop.

*Example (3).* Assume that D in example (2) moved to a nursing home 1 year after her husband's death. E completely operated the farm for her for 6 years following her move. If E is not a member of D's family, material participation ceases when D moves; however, if E is a member of D's family, E's material participation will prevent disqualification even if D owns the property. Further, upon D's death, the section 2032A valuation could be elected for her estate if E were a member of her family and the other requirements of section 203A were satisfied.

*Example (4).* F, a qualified heir, owned a specially valued farm. He contracted with G to manage the farm for him as F, a lawyer, lived and worked 15 miles away in a nearby town. F supplied all machinery and equipment and assumed financial responsiblity for the expenses of the farm operation. The contract specified that G was to submit a crop plan and a list of expenses and earnings for F's approval. It also called for F to inspect the farm regularly and to approve all expenditures over $100. In practice, F visited the farm weekly during the growing season to inspect and discuss operations. He actively participated in making important management decisions such as what fields to plant or pasture and how to utilize the subsidy program. F is deemed to have materially participated in the farm operation as his personal involvement amounted to more than managing an investment. Had F not regularly inspected the farm and participated in management decisions, however, he would not be considered to be materially participating. This would be true even though F did assume financial responsibility for the operation and did review annual crop plans.

*Example (5).* Decedent I owned 90 percent of all outstanding stock of X Corporation, a qualified closely-held business which owns real property to be specially valued. I held no formal position in the corporation and there was no arrangement for him to participate in daily business operations. I regularly spent several hours each day at the corporate offices and made decisions on many routine matters. I is not deemed to have materially participated in the X Corporation despite his activity because there was no arrangement requiring him to act in the manner in which he did.

*Example (6).* Decedent J was a senior partner in the law firm of X, Y, and Z, which is a qualified closely held business owning the building in which its offices are located. J ceased to practice law actively 5 years before his death in 1977; however, he remained a full partner and annually received a share of firm profits. J is not deemed to have materially participated under section 2032A even though he still may have reported his distributive share of partnership income for self-employment income tax purposes if the payments were not made pursuant to any retirement agreement. This is so because J does not meet the requirement of actual personal material participation.

*Example (7).* K, the decedent, owned a tree farm. He contracted with L, a professional forester, to manage the property for him as K, a doctor, lived and worked in a town 50 miles away. The activities of L are not considered in determining whether K materially participated in the tree farm operation. During the 5 years preceding K's death, there was no need for frequent inspections of the property or consultation concerning it, inasmuch as most of the land had been reforested and the trees were in the beginning stages of their growing cycle. However, once every year, L submitted for K's approval a proposed plan for the management of the property over the next year. K actively participated in making important management decisions, such as where and whether a precommercial thinning should be conducted, whether the timber was adequately protected from fire and disease, whether fire lines needed to be plowed around the new trees, and whether boundary lines were properly maintained around the property. K inspected the property at least twice every year and assumed financial responsibility for the expenses of the tree farm. K also reported his income from the tree farm as earned income for purposes of the tax on self-employment income. Over a period of several years, K had harvested and marketed timber from certain tracts of the tree farm and had supervised replanting of the areas where trees were removed. K's history of harvesting, marketing, and replanting of trees showed him to be in the business of tree farming rather than merely passively investing in timber land. If the history of K's tree farm did not show such an active business operation, however, the tree farm would not qualify for special use valuation. In light of all these facts, K is deemed to have materially participated in the farm as his personal involvement amounted to more than managing an investment.

*Example (8).* Decedent M died on January 1, 1978, owning a farm for which special use valuation under section 2032A has been elected. M owned the farm real property for 15 years before his death. During the 4 years preceding M's death (January 1, 1974 through December 31, 1977), the farm was rented to N, a non-family member, and neither M nor any member of his family materially participated in the farming operation. From January 1, 1970, until December 31, 1973, both M and his daughter, O, materially participated in the farming operation. The material participation requirement of section 2032A(b)(1)(C)(ii) is not satisfied because material participation did not occur for periods aggregating at least 5 different years of the 8 years preceding M's death.

[T.D. 7710, 45 FR 50739, July 31, 1980, as amended by T.D. 7786, 46 FR 43037, Aug. 26, 1981]

### § 20.2032A–4 Method of valuing farm real property.

(a) *In general.* Unless the executor of the decedent's estate elects otherwise under section 2032A(e)(7)(B)(ii) or fails to document comparable rented farm property meeting the requirements of this section, the value of the property which is used for farming purposes and which is subject to an election under section 2032A is determined by—

(1) Subtracting the average annual state and local real estate taxes on actual tracts of comparable real property in the same locality from the average annual gross cash rental for that same comparable property, and

(2) Dividing the result so obtained by the average annual effective interest rate charged on new Federal land bank loans.

The computation of each average annual amount is to be based on the 5 most recent calendar years ending before the date of the decedent's death.

(b) *Gross cash rental*—(1) *Generally.* Gross cash rental is the total amount of cash received for the use of actual tracts of comparable farm real property in the same locality as the property being specially valued during the period of one calendar year. This amount is not diminished by the amount of any expenses or liabilities associated with the farm operation or the lease. *See,* paragraph (d) of this section for a definition of comparable property and rules for property on which buildings or other improvements are located and farms including multiple property types. Only rentals from tracts of comparable farm property which are rented solely for an amount of cash which is not contingent upon production are acceptable for use in valuing real property under section 2032A (e) (7). The rentals considered must result from an arm's-length transaction as defined in this section. Additionally, rentals received under leases which provide for payment solely in cash are not acceptable as accurate measures of cash rental value if involvement by the lessor (or a member of the lessor's family who is other than a lessee) in the management or operation of the farm to an extent which amounts to material participation under the rules of section 2032A is contemplated or actually occurs. In general, therefore, rentals for any property which qualifies for special use valuation cannot be used to compute gross cash rentals under this section because the total amount received by the lessor does not reflect the true cash rental value of the real property.

(2) *Special rules*—(i) *Documentation required of executor.* The executor must identify to the Internal Revenue Service actual comparable property for all specially valued property and cash rentals from that property if the decedent's real property is valued under section 2032A(e)(7). If the executor does not identify such property and cash rentals, all specially valued real property must be valued under the rules of section 2032A(e)(8) if special use valuation has been elected. *See,* however, § 20.2032A–8(d) for a special rule for estates electing section 2032A treatment on or before August 30, 1980.

(ii) *Arm's-length transaction required.* Only those cash rentals which result from a lease entered into in an arm's-length transaction are acceptable under section 2032A(e)(7). For these purposes, lands leased from the Federal government, or any state or local government, which are leased for less than the amount that would be demanded by a private individual leasing for profit are not leased in an arm's-length transaction. Additionally, leases between family members (as defined in section 2032A(e)(2)) which do not provide a return on the property commensurate

with that received under leases between unrelated parties in the locality are not acceptable under this section.

(iii) *In-kind rents, statements of appraised rental value, and area averages.* Rents which are paid wholly or partly in kind (*e.g.,* crop shares) may not be used to determine the value of real property under section 2032A

(e)(7). Likewise, appraisals or other statements regarding rental value as well as area-wide averages of rentals (*i.e.,* those compiled by the United States Department of Agriculture) may not be used under section 2032A

(e)(7) because they are not true measures of the actual cash rental value of comparable property in the same locality as the specially valued property.

(iv) *Period for which comparable real property must have been rented solely for cash.* Comparable real property rented solely for cash must be identified for each of the five calendar years preceding the year of the decedent's death if section 2032A(e)(7) is used to value the decedent's real property. Rentals from the same tract of comparable property need not be used for each of these 5 years, however, provided an actual tract of property meeting the requirements of this section is identified for each year.

(v) *Leases under which rental of personal property is included.* No adjustment to the rents actually received by the lessor is made for the use of any farm equipment or other personal property the use of which is included under a lease for comparable real property unless the lease specifies the amount of the total rental attributable to the personal property and that amount is reasonable under the circumstances.

(c) *State and local real estate taxes.* For purposes of the farm valuation formula under section 2032A(e)(7) state and local taxes are taxes which are assessed by a state or local government and which are allowable deductions under section 164. However, only those taxes on the comparable real property from which cash rentals are determined may be used in the formula valuation.

(d) *Comparable real property defined.* Comparable real property must be situated in the same locality as the specially valued property. This requirement is not to be viewed in terms of mileage or political divisions alone, but rather is to be judged according to generally accepted real property valuation rules. The determination of properties which are comparable is a factual one and must be based on numerous factors, no one of which is determinative. It will, therefore, frequently be necessary to value farm property in segments where there are different uses or land characteristics included in the specially valued farm. For example, if section 2032A(e)(7) is used, rented property on which comparable buildings or improvements are located must be identified for specially valued property on which buildings or other real property improvements are located. In cases involving multiple areas or land characteristics, actual comparable property for each segment must be used, and the rentals and taxes from all such properties combined (using generally accepted real property valuation rules) for use in the valuation formula given in this section. However, any premium or discount resulting from the presence of multiple uses or other characteristics in one farm is also to be reflected. All factors generally considered in real estate valuation are to be considered in determining comparability under section 2032A. While not intended as an exclusive list, the following factors are among those to be considered in determining comparability—

(1) Similarity of soil as determined by any objective means, including an official soil survey reflected in a soil productivity index;

(2) Whether the crops grown are such as would deplete the soil in a similar manner;

(3) The types of soil conservation techniques that have been practiced on the two properties;

(4) Whether the two properties are subject to flooding;

(5) The slope of the land;

(6) In the case of livestock operations, the carrying capacity of the land;

(7) Where the land is timbered, whether the timber is comparable to that on the subject property;

(8) Whether the property as a whole is unified or whether it is segmented, and where segmented, the availability

of the means necessary for movement among the different segments;

(9) The number, types, and conditions of all buildings and other fixed improvements located on the properties and their location as it affects efficient management and use of property and value per se; and

(10) Availability of, and type of, transportation facilities in terms of costs and of proximity of the properties to local markets.

(e) *Effective interest rate defined*—(1) *Generally*. The annual effective interest rate on new Federal land bank loans is the average billing rate charged on new agricultural loans to farmers and ranchers in the farm credit district in which the real property to be valued under section 2032A is located, adjusted as provided in paragraph (e)(2) of this section. This rate is to be a single rate for each district covering the period of one calendar year and is to be computed to the nearest one-hundredth of one percent. In the event that the district billing rates of interest on such new agricultural loans change during a year, the rate for that year is to be weighted to reflect the portion of the year during which each such rate was charged. If a district's billing rate on such new agricultural loans varies according to the amount of the loan, the rate applicable to a loan in an amount resulting from dividing the total dollar amount of such loans closed during the year by the total number of the loans closed is to be used under section 2032A. Applicable rates may be obtained from the district director of internal revenue.

(2) *Adjustment to billing rate of interest.* The billing rate of interest determined under this paragraph is to be adjusted to reflect the increased cost of borrowing resulting from the required purchase of land bank association stock. For section 2032A purposes, the rate of required stock investment is the average of the percentages of the face amount of new agricultural loans to farmers and ranchers required to be invested in such stock by the applicable district bank during the year. If this percentage changes during a year, the average is to be adjusted to reflect the period when each percentage requirement was effective. The percentage is viewed as a reduction in the loan proceeds actually received from the amount upon which interest is charged.

(3) *Example.* The determination of the effective interest rate for any year may be illustrated as follows:

*Example.* District X of the Federal land bank system charged an 8 percent billed interest rate on new agricultural loans for 8 months of the year, 1976, and an 8.75 percent rate for 4 months of the year. The average billing rate was, therefore, 8.25 percent [(1.08 × 8/12) + (1.0875 × 4/12)=1.0825]. The district required stock equal to 5 percent of the face amount of the loan to be purchased as a precondition to receiving a loan. Thus, the borrower only received 95 percent of the funds upon which he paid interest. The applicable annual interest rate for 1976 of 8.68 percent is computed as follows:

8.25 percent × 1.00 (total loan amount)=8.25 percent (billed interest rate) divided by 0.95 (percent of loan proceeds received by borrower) = 8.68 percent (effective interest rate for 1976).

[T.D. 7710, 45 FR 50742, July 31, 1980]

### § 20.2032A–8 Election and agreement to have certain property valued under section 2032A for estate tax purposes.

(a) *Election of special use valuation*—(1) *In general.* An election under section 2032A is made as prescribed in paragraph (a)(3) of this section and on Form 706, United States Estate Tax Return. Once made, this election is irrevocable; however, see paragraph (d) of this section for a special rule for estates for which elections are made on or before August 30, 1980. Under section 2032A(a)(2), special use valuation may not reduce the value of the decedent's estate by more than $500,000. This election is available only if, at the time of death, the decedent was a citizen or resident of the United States.

(2) *Elections to specially value less than all qualified real property included in an estate.* An election under section 2032A need not include all real property included in an estate which is eligible for special use valuation, but sufficient property to satisfy the threshold requirements of section 2032A(b)(1)(B) must be specially valued under the election. If joint or undivided interests (e.g. interests as joint tenants or tenants in common) in the same property

are received from a decedent by qualified heirs, an election with respect to one heir's joint or undivided interest need not include any other heir's interest in the same property if the electing heir's interest plus other property to be specially valued satisfy the requirements of section 2032A(b)(1)(B). If successive interests (e.g. life estates and remainder interests) are created by a decedent in otherwise qualified property, an election under section 2032A is available only with respect to that property (or portion thereof) in which qualified heirs of the decedent receive all of the successive interests, and such an election must include the interests of all of those heirs. For example, if a surviving spouse receives a life estate in otherwise qualified property and the spouse's brother receives a remainder interest in fee, no part of the property may be valued pursuant to an election under section 2032A. Where successive interests in specially valued property are created, remainder interests are treated as being received by qualified heirs only if such remainder interests are not contingent upon surviving a nonfamily member or are not subject to divestment in favor of a nonfamily member.

(3) *Time and manner of making election.* An election under this section is made by attaching to a timely filed estate tax return the agreement described in paragraph (c)(1) of this section and a notice of election which contains the following information:

(i) The decedent's name and taxpayer identification number as they appear on the estate tax return;

(ii) The relevant qualified use;

(iii) The items of real property shown on the estate tax return to be specially valued pursuant to the election (identified by schedule and item number);

(iv) The fair market value of the real property to be specially valued under section 2032A and its value based on its qualified use (both values determined without regard to the adjustments provided by section 2032A

(b)(3)(B));

(v) The adjusted value (as defined in section 2032A(b)(3)(B)) of all real property which is used in a qualified use and which passes from the decedent to a qualified heir and the adjusted value of all real property to be specially valued;

(vi) The items of personal property shown on the estate tax return that pass from the decedent to a qualified heir and are used in a qualified use under section 2032A (identified by schedule and item number) and the total value of such personal property adjusted as provided under section 2032A(b)(3)(B);

(vii) The adjusted value of the gross estate, as defined in section 2032A-(b)(3)(A);

(viii) The method used in determining the special value based on use;

(ix) Copies of written appraisals of the fair market value of the real property;

(x) A statement that the decedent and/or a member of his or her family has owned all specially valued real property for at least 5 years of the 8 years immediately preceding the date of the decedent's death;

(xi) Any periods during the 8-year period preceding the date of the decedent's death during which the decedent or a member of his or her family did not own the property, use it in a qualified use, or materially participate in the operation of the farm or other business within the meaning of section 2032A(e)(6);

(xii) The name, address, taxpayer identification number, and relationship to the decedent of each person taking an interest in each item of specially valued property, and the value of the property interests passing to each such person based on both fair market value and qualified use;

(xiii) Affidavits describing the activities constituting material participation and the identity of the material participant or participants; and

(xiv) A legal description of the specially valued property.

If neither an election nor a protective election is timely made, special use valuation is not available to the estate. *See* sections 2032A(d)(1), 6075(a), and 6081(a).

(b) *Protective election.* A protective election may be made to specially value qualified real property. The availability of special use valuation pursuant to this election is contingent upon values as finally determined (or

agreed to following examination of a return) meeting the requirements of section 2032A. A protective election does not, however, extend the time for payment of any amount of tax. Rules for such extensions are contained in sections 6161, 6163, 6166, and 6166A. The protective election is to be made by a notice of election filed with a timely estate tax return stating that a protective election under section 2032A is being made pending final determination of values. This notice is to include the following information:

(1) The decedent's name and taxpayer identification number as they appear on the estate tax return;

(2) The relevant qualified use; and

(3) The items of real and personal property shown on the estate tax return which are used in a qualified use, and which pass to qualified heirs (identified by schedule and item number).

If it is found that the estate qualifies for special use valuation based upon values as finally determined (or agreed to following examination of a return), an additional notice of election must be filed within 60 days after the date of such determination. This notice must set forth the information required under paragraph (a)(3) of this section and is to be attached, together with the agreement described in paragraph (c)(1) of this section, to an amended estate tax return. The new return is to be filed with the Internal Revenue Service office where the original return was filed.

(c) *Agreement to special valuation by persons with an interest in property*—(1) *In general.* The agreement required under section 2032A (a)(1)(B) and (d)(2) must be executed by all parties who have any interest in the property being valued based on its qualified use as of the date of the decedent's death. In the case of a qualified heir, the agreement must express consent to personal liability under section 2032A(c) in the event of certain early dispositions of the property or early cessation of the qualified use. *See* section 2032A(c)(6). In the case of parties (other than qualified heirs) with interests in the property, the agreement must express consent to collection of any additional estate tax imposed under section 2032A(c) from the qualified property. The agreement is to be in a form that is binding on all parties having an interest in the property. It must designate an agent with satisfactory evidence of authority to act for the parties to the agreement in all dealings with the Internal Revenue Service on matters arising under section 2032A and must indicate the address of that agent.

(2) *Persons having an interest in designated property.* An interest in property is an interest which, as of the date of the decedent's death, can be asserted under applicable local law so as to affect the disposition of the specially valued property by the estate. Any person in being at the death of the decedent who has any such interest in the property, whether present or future, or vested or contingent, must enter into the agreement. Included among such persons are owners of remainder and executory interests, the holders of general or special powers of appointment, beneficiaries of a gift over in default of exercise of any such power, co-tenants, joint tenants and holders of other undivided interests when the decedent held only a joint or undivided interest in the property or when only an undivided interest is specially valued, and trustees of trusts holding any interest in the property. An heir who has the power under local law to caveat (challenge) a will and thereby affect disposition of the property is not, however, considered to be a person with an interest in property under section 2032A solely by reason of that right. Likewise, creditors of an estate are not such persons solely by reason of their status as creditors.

(3) *Consent on behalf of interested party.* If any person required to enter into the agreement provided for by paragraph (c)(1) either desires that an agent act for him or her or cannot legally bind himself or herself due to infancy or other incompetency, or to death before the election under section 2032A is timely exercised, a representative authorized under local law to bind such person in an agreement of this nature is permitted to sign the agreement on his or her behalf.

(4) *Duties of agent designated in agreement.* The Internal Revenue Service will contact the agent designated in the agreement under paragraph (c)(1)

on all matters relating to continued qualification under section 2032A of the specially valued real property and on all matters relating to the special lien arising under section 6324B. It is the duty of the agent as attorney-in-fact for the parties with interests in the specially valued property to furnish the Service with any requested information and to notify the Service of any disposition or cessation of qualified use of any part of the property.

(d) *Special rule for estates for which elections under section 2032A are made on* or before August 30, 1980. An election to specially value real property under section 2032A that is made on or before August 30, 1980, may be revoked. To revoke an election, the executor must file a notice of revocation with the Internal Revenue Service office where the original estate tax return was filed on or before January 31, 1981 (or if earlier, the date on which the period of limitation for assessment expires). This notice of revocation must contain the decedent's name, date of death, and taxpayer identification number, and is to be accompanied by remittance of any additional amount of estate tax and interest determined to be due as a result of valuation of the qualified property based upon its fair market value. Elections that are made on or before August 30, 1980, that do not comply with this section as proposed on July 13, 1978 (43 FR 30070), and amended on December 21, 1978 (43 FR 59517), must be conformed to this final regulation by means of an amended return before the original estate tax return can be finally accepted by the Internal Revenue Service.

[T.D. 7710, 45 FR 50743, July 31, 1980, as amended by T.D. 7786, 46 FR 43037, Aug. 26, 1981]

### § 20.2033–1 Property in which the decedent had an interest.

(a) *In general.* The gross estate of a decedent who was a citizen or resident of the United States at the time of his death includes under 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. (For certain exceptions in the case of real property situated outside the United States, see paragraphs (a) and (c) of § 20.2031–1.) Real property is included whether it came into the possession and control of the executor or administrator or passed directly to heirs or devisees. Various statutory provisions which exempt bonds, notes, bills, and certificates of indebtedness of the Federal Government or its agencies and the interest thereon from taxation are generally not applicable to the estate tax, since such tax is an excise tax on the transfer of property at death and is not a tax on the property transferred.

(b) *Miscellaneous examples.* A cemetery lot owned by the decedent is part of his gross estate, but its value is limited to the salable value of that part of the lot which is not designed for the interment of the decedent and the members of his family. Property subject to homestead or other exemptions under local law is included in the gross estate. Notes or other claims held by the decedent are likewise included even though they are cancelled by the decedent's will. 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.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6684, 28 FR 11409, Oct. 24, 1963]

### § 20.2034–1 Dower or curtesy interests.

A decedent's gross estate includes under section 2034 any interest in property of the decedent's surviving spouse existing at the time of the decedent's death as dower or curtesy, or any interest created by statute in lieu thereof (although such other interest may differ in character from dower or curtesy). Thus, the full value of property is included in the decedent's gross estate, without deduction of such an interest of the surviving husband or wife, and without regard to when the right to such an interest arose.

**§ 20.2036–1 Transfers with retained life estate.**

(a) *In general.* A decedent's gross estate includes under section 2036 the value of any interest in property transferred by the decedent after March 3, 1931, whether in trust or otherwise, except to the extent that the transfer was for an adequate and full consideration in money or money's worth (see § 20.2043–1), if the decedent retained or reserved (1) for his life, or (2) for any period not ascertainable without reference to his death (if the transfer was made after June 6, 1932), or (3) for any period which does not in fact end before his death:

(i) The use, possession, right to the income, or other enjoyment of the transferred property, or

(ii) The right, either alone or in conjunction with any other person or persons, to designate the person or persons who shall possess or enjoy the transferred property or its income (except that, if the transfer was made before June 7, 1932, the right to designate must be retained by or reserved to the decedent alone).

If the decedent retained or reserved an interest or right with respect to all of the property transferred by him, the amount to be included in his gross estate under section 2036 is the value of the entire property, less only the value of any outstanding income interest which is not subject to the decedent's interest or right and which is actually being enjoyed by another person at the time of the decedent's death. If the decedent retained or reserved an interest or right with respect to a part only of the property transferred by him, the amount to be included in his gross estate under section 2036 is only a corresponding proportion of the amount described in the preceding sentence. An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express, or implied, that the interest or right would later be conferred.

(b) *Meaning of terms.* (1) A reservation by the decedent ''for any period not ascertainable without reference to his death'' may be illustrated by the following examples:

(i) A decedent reserved the right to receive the income from transferred property in quarterly payments, with the proviso that no part of the income between the last quarterly payment and the date of the decedent's death was to be received by the decedent or his estate; and

(ii) A decedent reserved the right to receive the income from transferred property after the death of another person who was in fact enjoying the income at the time of the decedent's death. In such a case, the amount to be included in the decedent's gross estate under this section does not include the value of the outstanding income interest of the other person. It may be noted that if the other person predeceased the decedent, the reservation by the decedent may be considered to be either for his life, or for a period which does not in fact end before his death.

(2) The ''use, possession, right to the income, or other enjoyment of the transferred property'' is considered as having been retained by or reserved to the decedent to the extent that the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit. The term ''legal obligation'' includes a legal obligation to support a dependent during the decedent's lifetime.

(3) The phrase ''right * * * to designate the person or persons who shall possess or enjoy the transferred property or the income therefrom'' includes a reserved power to designate the person or persons to receive the income from the transferred property, or to possess or enjoy nonincome-producing property, during the decedent's life or during any other period described in paragraph (a) of this section. With respect to such a power, it is immaterial (i) whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest; (ii) in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent; and (iii) whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the

death of another person during the decedent's lifetime). The phrase, however, does not include a power over the transferred property itself which does not affect the enjoyment of the income received or earned during the decedent's life. (See, however, section 2038 for the inclusion of property in the gross estate on account of such a power.) Nor does the phrase apply to a power held solely by a person other than the decedent. But, for example, if the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6501, 25 FR 10869, Nov. 16, 1960]

### § 20.2037–1 Transfers taking effect at death.

(a) *In general.* A decedent's gross estate includes under section 2037 the value of any interest in property transferred by the decedent after September 7, 1916, whether in trust or otherwise, except to the extent that the transfer was for an adequate and full consideration in money or money's worth (see § 20.2043–1), if—

(1) Possession or enjoyment of the property could, through ownership of the interest, have been obtained only by surviving the decedent,

(2) The decedent had retained a possibility (referred to in this section as a ''reversionary interest'') that the property, other than the income alone, would return to the decedent or his estate or would be subject to a power of disposition by him, and

(3) The value of the reversionary interest immediately before the decedent's death exceeded 5 percent of the value of the entire property.

However, if the transfer was made before October 8, 1949, section 2037 is applicable only if the reversionary interest arose by the express terms of the instrument of transfer and not by operation of law (see paragraph (f) of this section). See also paragraph (g) of this section with respect to transfers made between November 11, 1935, and January 29, 1940. The provisions of section 2037 do not apply to transfers made before September 8, 1916.

(b) *Condition of survivorship.* As indicated in paragraph (a) of this section, the value of an interest in transferred property is not included in a decedent's gross estate under section 2037 unless possession or enjoyment of the property could, through ownership of such interest, have been obtained only by surviving the decedent. Thus, property is not included in the decedent's gross estate if, immediately before the decedent's death, possession or enjoyment of the property could have been obtained by any beneficiary either by surviving the decedent or through the occurrence of some other event such as the expiration of a term of years. However, if a consideration of the terms and circumstances of the transfer as a whole indicates that the ''other event'' is unreal and if the death of the decedent does, in fact, occur before the ''other event'', the beneficiary will be considered able to possess or enjoy the property only by surviving the decedent. Notwithstanding the foregoing, an interest in transferred property is not includible in a decedent's gross estate under section 2037 if possession or enjoyment of the property could have been obtained by any beneficiary during the decedent's life through the exercise of a general power of appointment (as defined in section 2041) which in fact was exercisable immediately before the decedent's death. See examples (5) and (6) in paragraph (e) of this section.

(c) *Retention of reversionary interest.* (1) As indicated in paragraph (a) of this section, the value of an interest in transferred property is not included in a decedent's gross estate under section 2037 unless the decedent had retained a reversionary interest in the property, and the value of the reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the property.

(2) For purposes of section 2037, the term ''reversionary interest'' includes a possibility that property transferred by the decedent may return to him or his estate and a possibility that property transferred by the decedent may become subject to a power of disposition by him. The term is not used in a technical sense, but has reference to any reserved right under which the

transferred property shall or may be returned to the grantor. Thus, it encompasses an interest arising either by the express terms of the instrument of transfer or by operation of law. (See, however, paragraph (f) of this section with respect to transfers made before October 8, 1949.) The term ''reversionary interest'' does not include rights to income only, such as the right to receive the income from a trust after the death of another person. (However, see section 2036 for the inclusion of property in the gross estate on account of such rights.) Nor does the term ''reversionary interest'' include the possibility that the decedent during his lifetime might have received back an interest in transferred property by inheritance through the estate of another person. Similarly, a statutory right of a spouse to receive a portion of whatever estate a decedent may leave at the time of his death is not a ''reversionary interest''.

(3) For purposes of this section, the value of the decedent's reversionary interest is computed as of the moment immediately before his death, without regard to whether or not the executor elects the alternate valuation method under section 2032 and without regard to the fact of the decedent's death. The value is ascertained in accordance with recognized valuation principles for determining the value for estate tax purposes of future or conditional interests in property. (See §§ 20.2031–1, 20.2031–7, and 20.2031–9). For example, if the decedent's reversionary interest was subject to an outstanding life estate in his wife, his interest is valued according to the actuarial rules set forth in § 20.2031–7. On the other hand, if the decedent's reversionary interest was contingent on the death of his wife without issue surviving and if it cannot be shown that his wife is incapable of having issue (so that his interest is not subject to valuation according to the actuarial rules in § 20.2031–7), his interest is valued according to the general rules set forth in § 20.2031–1. A possibility that the decedent may be able to dispose of property under certain conditions is considered to have the same value as a right of the decedent to the return of the property under those same conditions.

(4) In order to determine whether or not the decedent retained a reversionary interest in transferred property of a value in excess of 5 percent, the value of the reversionary interest is compared with the value of the transferred property, including interests therein which are not dependent upon survivorship of the decedent. For example, assume that the decedent, A, transferred property in trust with the income payable to B for life and with the remainder payable to C if A predeceases B, but with the property to revert to A if B predeceases A. Assume further that A does, in fact, predecease B. The value of A's reversionary interest immediately before his death is compared with the value of the trust corpus, without deduction of the value of B's outstanding life estate. If, in the above example, A had retained a reversionary interest in one-half only of the trust corpus, the value of his reversionary interest would be compared with the value of one-half of the trust corpus, again without deduction of any part of the value of B's outstanding life estate.

(d) *Transfers partly taking effect at death.* If separate interests in property are transferred to one or more beneficiaries, paragraphs (a) to (c) of this section are to be separately applied with respect to each interest. For example, assume that the decedent transferred an interest in Blackacre to A which could be possessed or enjoyed only by surviving the decedent, and that the decedent transferred an interest in Blackacre to B which could be possessed or enjoyed only on the occurrence of some event unrelated to the decedent's death. Assume further that the decedent retained a reversionary interest in Blackacre of a value in excess of 5 percent. Only the value of the interest transferred to A is includible in the decedent's gross estate. Similar results would obtain if possession or enjoyment of the entire property could have been obtained only by surviving the decedent, but the decedent had retained a reversionary interest in a part only of such property.

(e) *Examples.* The provisions of paragraphs (a) to (d) of this section may be

further illustrated by the following examples. It is assumed that the transfers were made on or after October 8, 1949; for the significance of this date, see paragraphs (f) and (g) of this section:

*Example (1).* The decedent transferred property in trust with the income payable to his wife for life and, at her death, remainder to the decedent's then surviving children, or if none, to the decedent or his estate. Since each beneficiary can possess or enjoy the property without surviving the decedent, no part of the property is includible in the decedent's gross estate under section 2037, regardless of the value of the decedent's reversionary interest. (However, see section 2033 for inclusion of the value of the reversionary interest in the decedent's gross estate.)

*Example (2).* The decedent transferred property in trust with the income to be accumulated for the decedent's life, and at his death, principal and accumulated income to be paid to the decedent's then surviving issue, or, if none, to A or A's estate. Since the decedent retained no reversionary interest in the property, no part of the property is includible in the decedent's gross estate, even though possession or enjoyment of the property could be obtained by the issue only by surviving the decedent.

*Example (3).* The decedent transferred property in trust with the income payable to his wife for life and with the remainder payable to the decedent or, if he is not living at his wife's death, to his daughter or her estate. The daughter cannot obtain possession or enjoyment of the property without surviving the decedent. Therefore, if the decedent's reversionary interest immediately before his death exceeded 5 percent of the value of the property, the value of the property, less the value of the wife's outstanding life estate, is includible in the decedent's gross estate.

*Example (4).* The decedent transferred property in trust with the income payable to his wife for life and with the remainder payable to his son or, if the son is not living at the wife's death, to the decedent or, if the decedent is not then living, to X or X's estate. Assume that the decedent was survived by his wife, his son, and X. Only X cannot obtain possession or enjoyment of the property without surviving the decedent. Therefore, if the decedent's reversionary interest immediately before his death exceeded 5 percent of the value of the property, the value of X's remainder interest (with reference to the time immediately after the decedent's death) is includible in the decedent's gross estate.

*Example (5).* The decedent transferred property in trust with the income to be accumulated for a period of 20 years or until the decedent's prior death, at which time the principal and accumulated income was to be paid to the decedent's son if then surviving. Assume that the decedent does, in fact, die before the expiration of the 20-year period. If, at the time of the transfer, the decedent was 30 years of age, in good health, etc., the son will be considered able to possess or enjoy the property without surviving the decedent. If, on the other hand, the decedent was 70 years of age at the time of the transfer, the son will not be considered able to possess or enjoy the property without surviving the decedent. In this latter case, if the value of the decedent's reversionary interest (arising by operation of law) immediately before his death exceeded 5 percent of the value of the property, the value of the property is includible in the decedent's gross estate.

*Example (6).* The decedent transferred property in trust with the income to be accumulated for his life and, at his death, the principal and accumulated income to be paid to the decedent's then surviving children. The decedent's wife was given the unrestricted power to alter, amend, or revoke the trust. Assume that the wife survived the decedent but did not, in fact, exercise her power during the decedent's lifetime. Since possession or enjoyment of the property could have been obtained by the wife during the decedent's lifetime under the exercise of a general power of appointment, which was, in fact, exercisable immediately before the decedent's death, no part of the property is includible in the decedent's gross estate.

(f) *Transfers made before October 8, 1949.* (1) Notwithstanding any provisions to the contrary contained in paragraphs (a) to (e) of this section, the value of an interest in property transferred by a decedent before October 8, 1949, is included in his gross estate under section 2037 only if the decedent's reversionary interest arose by the express terms of the instrument and not by operation of law. For example, assume that the decedent, on January 1, 1947, transferred property in trust with the income payable to his wife for the decedent's life, and, at his death, remainder to his then surviving descendants. Since no provision was made for the contingency that no descendants of the decedent might survive him, a reversion to the decedent's estate existed by operation of law. The descendants cannot obtain possession or enjoyment of the property without surviving the decedent. However, since the decedent's reversionary interest arose by operation of law, no part of the property is includible in the decedent's gross estate under section 2037. If, in the above example, the transfer

had been made on or after October 8, 1949, and if the decedent's reversionary interest immediately before his death exceeded 5 percent of the value of the property, the value of the property would be includible in the decedent's gross estate.

(2) The decedent's reversionary interest will be considered to have arisen by the express terms of the instrument of transfer and not by operation of law if the instrument contains an express disposition which affirmatively creates the reversionary interest, even though the terms of the disposition do not refer to the decedent or his estate, as such. For example, where the disposition is, in its terms, to the next of kin of the decedent and such a disposition, under applicable local law, constitute a reversionary interest in the decedent's estate, the decedent's reversionary interest will be considered to have arisen by the express terms of the instrument of transfer and not by operation of law.

(g) *Transfers made after November 11, 1935, and before January 29, 1940.* The provisions of paragraphs (a) to (f) of this section are fully applicable to transfers made after November 11, 1935 (the date on which the Supreme Court decided *Helvering* v. *St. Louis Union Trust Co.* (296 U.S. 39) and *Becker* v. *St. Louis Union Trust Co.* (296 U.S. 48)), and before January 29, 1940 (the date on which the Supreme Court decided *Helvering* v. *Hallock* and companion cases (309 U.S. 106)), except that the value of an interest in property transferred between these dates is not included in a decedent's gross estate under section 2037 if—

(1) The Commissioner, whose determination shall be final, determines that the transfer is classifiable with the transfers involved in the *St. Louis Union Trust Co.* cases, rather than with the transfer involved in the case of *Klein* v. *United States* (283 U.S. 231), previously decided by the Supreme Court, and

(2) The transfer shall have been finally treated for all gift tax purposes, both as to the calendar year of the transfer and as to subsequent calendar years, as a gift in an amount measured by the value of the property undiminished by reason of a provision in the instrument of transfer by which the property, in whole or in part, is to revert to the decedent should he survive the donee or another person, or the reversion is conditioned upon some other contingency terminable by the decedent's death.

### § 20.2038–1 Revocable transfers.

(a) *In general.* A decedent's gross estate includes under section 2038 the value of any interest in property transferred by the decedent, whether in trust or otherwise, if the enjoyment of the interest was subject at the date of the decedent's death to any change through the exercise of a power by the decedent to alter, amend, revoke, or terminate, or if the decedent relinquished such a power in contemplation of death. However, section 2038 does not apply—

(1) To the extent that the transfer was for an adequate and full consideration in money or money's worth (see § 20.2043–1);

(2) If the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law; or

(3) To a power held solely by a person other than the decedent. But, for example, if the decedent had the unrestricted power to remove or discharge a trustee at any time and appoint himself trustee, the decedent is considered as having the powers of the trustee. However, this result would not follow if he only had the power to appoint himself trustee under limited conditions which did not exist at the time of his death. (See last two sentences of paragraph (b) of this section.)

Except as provided in this paragraph, it is immaterial in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent; whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest (unless the transfer was made before June 2, 1924; see paragraph (d) of this section); and at what time or from what source the decedent acquired his power (unless the transfer

was made before June 23, 1936; see paragraph (c) of this section). Section 2038 is applicable to any power affecting the time or manner of enjoyment of property or its income, even though the identity of the beneficiary is not affected. For example, section 2038 is applicable to a power reserved by the grantor of a trust to accumulate income or distribute it to A, and to distribute corpus to A, even though the remainder is vested in A or his estate, and no other person has any beneficial interest in the trust. However, only the value of an interest in property subject to a power to which section 2038 applies is included in the decedent's gross estate under section 2038.

(b) *Date of existence of power.* A power to alter, amend, revoke, or terminate will be considered to have existed at the date of the decedent's death even though the exercise of the power was subject to a precedent giving of notice or even though the alteration, amendment, revocation, or termination would have taken effect only on the expiration of a stated period after the exercise of the power, whether or not on or before the date of the decedent's death notice had been given or the power had been exercised. In determining the value of the gross estate in such cases, the full value of the property transferred subject to the power is discounted for the period required to elapse between the date of the decedent's death and the date upon which the alteration, amendment, revocation, or termination could take effect. In this connection, see especially § 20.2031–7. However, section 2038 is not applicable to a power the exercise of which was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the death of another person during the decedent's life). See, however, section 2036(a)(2) for the inclusion of property in the decedent's gross estate on account of such a power.

(c) *Transfers made before June 23, 1936.* Notwithstanding anything to the contrary in paragraphs (a) and (b) of this section, the value of an interest in property transferred by a decedent before June 23, 1936, is not included in his gross estate under section 2038 unless the power to alter, amend, revoke, or terminate was reserved at the time of the transfer. For purposes of this paragraph, the phrase ''reserved at the time of the transfer'' has reference to a power (arising either by the express terms of the instrument of transfer or by operation of law) to which the transfer was subject when made and which continued to the date of the decedent's death (see paragraph (b) of this section) to be exercisable by the decedent alone or by the decedent in conjunction with any other person or persons. The phrase also has reference to any understanding, express or implied, had in connection with the making of the transfer that the power would later be created or conferred.

(d) *Transfers made before June 2, 1924.* Notwithstanding anything to the contrary in paragraphs (a) to (c) of this section, if an interest in property was transferred by a decedent before the enactment of the Revenue Act of 1924. (June 2, 1924, 4:01 p.m., eastern standard time), and if a power reserved by the decedent to alter, amend, revoke, or terminate was exercisable by the decedent only in conjunction with a person having a substantial adverse interest in the transferred property, or in conjunction with several persons some or all of whom held such an adverse interest, there is included in the decedent's gross estate only the value of any interest or interests held by a person or persons not required to joint in the exercise of the power plus the value of any insubstantial adverse interest or interests of a person or persons required to join in the exercise of the power.

(e) *Powers relinquished in contemplation of death*—(1) *In general.* If a power to alter, amend, revoke, or terminate would have resulted in the inclusion of an interest in property in a decedent's gross estate under section 2038 if it had been held until the decedent's death, the relinquishment of the power in contemplation of the decedent's death within 3 years before his death results in the inclusion of the same interest in property in the decedent's gross estate, except to the extent that the power was relinquished for an adequate and full consideration in money or money's worth (see § 20.2043–1). For the meaning

of the phrase ''in contemplation of death'', see paragraph (c) of § 20.2035–1.

(2) *Transfers before June 23, 1936.* In the case of a transfer made before June 23, 1936, section 2038 applies only to a relinquishment made by the decedent. However, in the case of a transfer made after June 22, 1936, section 2038 also applies to a relinquishment made by a person or persons holding the power in conjunction with the decedent, if the relinquishment was made in contemplation of the decedent's death and had the effect of extinguishing the power.

(f) *Effect of disability to relinquish power in certain cases.* Notwithstanding anything to the contrary in paragraphs (a) through (e) of this section the provisions of this section do not apply to a transfer if—

(1) The relinquishment on or after January 1, 1940, and on or before December 31, 1947, of the power would, by reason of section 1000(e), of the Internal Revenue Code of 1939, be deemed not a transfer of property for the purpose of the gift tax under chapter 4 of the Internal Revenue Code of 1939, and

(2) The decedent was, for a continuous period beginning on or before September 30, 1947, and ending with his death, after August 16, 1954, under a mental disability to relinquish a power.

For the purpose of the foregoing provision, the term ''mental disability'' means mental incompetence, in fact, to release the power whether or not there was an adjudication of incompetence. Such provision shall apply even though a guardian could have released the power for the decedent. No interest shall be allowed or paid on any overpayment allowable under section 2038(c) with respect to amounts paid before August 7, 1959.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6600, 27 FR 4985, May 29, 1962]

### § 20.2039–1 Annuities.

(a) *In general.* A decedent's gross estate includes under section 2039 (a) and (b) the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under certain agreements or plans to the extent that the value of the annuity or other payment is attributable to contributions made by the decedent or his employer. Section 2039 (a) and (b), however, has no application to an amount which constitutes the proceeds of insurance under a policy on the decedent's life. Paragraph (b) of this section describes the agreements or plans to which section 2039 (a) and (b) applies; paragraph (c) of this section provides rules for determining the amount includible in the decedent's gross estate; and paragraph (d) of this section distinguishes proceeds of life insurance. The fact that an annuity or other payment is not includible in a decedent's gross estate under section 2039 (a) and (b) does not mean that it is not includible under some other section of Part III of Subchapter A of Chapter 11. However, see section 2039 (c) and (d) and § 20.2039–2 for rules relating to the exclusion from a decedent's gross estate of annuities and other payments under certain ''qualified plans''.

(b) *Agreements or plans to which section 2039 (a) and (b) applies.* (1) Section 2039 (a) and (b) applies to the value of an annuity or other payment receivable by any beneficiary under any form of contract or agreement entered into after March 3, 1931, under which—

(i) An annuity or other payment was payable to the decedent, either alone or in conjunction with another person or persons, 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, or

(ii) The decedent possessed, 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, the right to receive such an annuity or other payment, either alone or in conjunction with another person or persons.

The term ''annuity or other payment'' as used with respect to both the decedent and the beneficiary has reference to one or more payments extending over any period of time. The payments may be equal or unequal, conditional or unconditional, periodic or sporadic. The term ''contract or agreement'' includes any arrangement, understanding or plan, or any combination of arrangements, understandings

or plans arising by reason of the decedent's employment. An annuity or other payment ''was payable'' to the decedent if, at the time of his death, the decedent was in fact receiving an annuity or other payment, whether or not he had an enforceable right to have payments continued. The decedent ''possessed the right to receive'' an annuity or other payment if, immediately before his death, the decedent had an enforceable right to receive payments at some time in the future, whether or not, at the time of his death, he had a present right to receive payments. In connection with the preceding sentence, the decedent will be regarded as having had ''an enforceable right to receive payments at some time in the future'' so long as he had complied with his obligations under the contract or agreement up to the time of his death. For the meaning of the phrase ''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'', see section 2036 and § 20.2036–1.

(2) The application of this paragraph is illustrated and more fully explained in the following examples. In each example: (i) It is assumed that all transactions occurred after March 3, 1931, and (ii) the amount stated to be includible in the decedent's gross estate is determined in accordance with the provisions of paragraph (c) of this section.

*Example (1).* The decedent purchased an annuity contract under the terms of which the issuing company agreed to pay an annuity to the decedent for his life and, upon his death, to pay a specified lump sum to his designated beneficiary. The decedent was drawing his annuity at the time of his death. The amount of the lump sum payment to the beneficiary is includible in the decedent's gross estate under section 2039 (a) and (b).

*Example (2).* Pursuant to a retirement plan, the employer made contributions to a fund which was to provide the employee, upon his retirement at age 60, with an annuity for life, and which was to provide the employee's wife, upon his death after retirement, with a similar annuity for life. The benefits under the plan were completely forfeitable during the employee's life, but upon his death after retirement, the benefits to the wife were forfeitable only upon her remarriage. The employee had no right to originally designate or to ever change the employer's designation of the surviving beneficiary. The retirement plan at no time met the requirements of section 401(a) (relating to qualified plans). Assume that the employee died at age 61 after the employer started payment of his annuity as described above. The value of the wife's annuity is includible in the decedent's gross estate under section 2039 (a) and (b). Includibility in this case is based on the fact that the annuity to the decedent ''was payable'' at the time of his death. The fact that the decedent's annuity was forfeitable is of no consequence since, at the time of his death, he was in fact receiving payments under the plan. Nor is it important that the decedent had no right to choose the surviving beneficiary. The element of forfeitability in the wife's annuity may be taken into account only with respect to the valuation of the annuity in the decedent's gross estate.

*Example (3).* Pursuant to a retirement plan, the employer made contributions to a fund which was to provide the employee, upon his retirement at age 60, with an annuity of $100 per month for life, and which was to provide his designated beneficiary, upon the employee's death after retirement, with a similar annuity for life. The plan also provided that (a) upon the employee's separation from service before retirement, he would have a nonforfeitable right to receive a reduced annuity starting at age 60, and (b) upon the employee's death before retirement, a lump sum payment representing the amount of the employer's contributions credited to the employee's account would be paid to the designated beneficiary. The plan at no time met the requirements of section 401(a) (relating to qualified plans). Assume that the employee died at age 49 and that the designated beneficiary was paid the specified lump sum payment. Such amount is includible in the decedent's gross estate under section 2039 (a) and (b). Since immediately before his death, the employee had an enforceable right to receive an annuity commencing at age 60, he is considered to have ''possessed the right to receive'' an annuity as that term is used in section 2039 (a). If, in this example, the employee would not be entitled to any benefits in the event of his separation from service before retirement for any reason other than death, the result would be the same so long as the decedent had complied with his obligations under the contract up to the time of his death. In such case, he is considered to have had, immediately before his death, an enforceable right to receive an annuity commencing at age 60.

*Example (4).* Pursuant to a retirement plan, the employee made contributions to a fund which was to provide the employee, upon his retirement at age 60, with an annuity for life, and which was to provide his designated beneficiary, upon the employee's death after retirement, with a similar annuity for life. The plan provided, however, that no benefits

were payable in the event of the employee's death before retirement. The retirement plan at no time met the requirements of section 401(a) (relating to qualified plans). Assume that the employee died at age 59 but that the employer nevertheless started payment of an annuity in a slightly reduced amount to the designated beneficiary. The value of the annuity is not includible in the decedent's gross estate under section 2039 (a) and (b). Since the employee died before reaching the retirement age, the employer was under no obligation to pay the annuity to the employee's designated beneficiary. Therefore, the annuity was not paid under a ''contract or agreement'' as that term is used in section 2039 (a). If, however, it can be established that the employer has consistently paid an annuity under such circumstances, the annuity will be considered as having been paid under a ''contract or agreement''.

*Example (5).* The employer made contributions to a retirement fund which were credited to the employee's individual account. Under the plan, the employee was to receive one-half the amount credited to his account upon his retirement at age 60, and his designated beneficiary was to receive the other one-half upon the employee's death after retirement. If the employee should die before reaching the retirement age, the entire amount credited to his account at such time was to be paid to the designated beneficiary. The retirement plan at no time met the requirements of section 401(a) (relating to qualified plans). Assume that the employee received one-half the amount credited to his account upon reaching the retirement age and that he died shortly thereafter. Since the employee received all that he was entitled to receive under the plan before his death, no amount was payable to him for his life or for any period not ascertainable without reference to his death, or for any period which did not in fact end before his death. Thus, the amount of the payment to the designated beneficiary is not includible in the decedent's gross estate under section 2039 (a) and (b). If, in this example, the employee died before reaching the retirement age, the amount of the payment to the designated beneficiary would be includible in the decedent's gross estate under section 2039 (a) and (b). In this latter case, the decedent possessed the right to receive lump sum payment for a period which did not in fact end before his death.

*Example (6).* The employer made contributions to two different funds set up under two different plans. One plan was to provide the employee upon his retirement at age 60, with an annuity for life, and the other plan was to provide the employee's designated beneficiary, upon the employee's death, with a similar annuity for life. Each plan was established at a different time and each plan was administered separately in every respect. Neither plan at any time met the requirements of section 401(a) (relating to qualified plans). The value of the designated beneficiary's annuity is includible in the employee's gross estate. All rights and benefits accruing to an employee and to others by reason of the employment (except rights and benefits accruing under certain plans meeting the requirements of section 401(a) (see § 20.2039–2)) are considered together in determining whether or not section 2039 (a) and (b) applies. The scope of section 2039 (a) and (b) cannot be limited by indirection.

(c) *Amount includible in the gross estate.* The amount to be included in a decedent's gross estate under section 2039 (a) and (b) is an amount which bears the same ratio to the value at the decedent's death of the annuity or other payment receivable by the beneficiary as the contribution made by the decedent, or made by his employer (or former employer) for any reason connected with his employment, to the cost of the contract or agreement bears to its total cost. In applying this ratio, the value at the decedent's death of the annuity or other payment is determined in accordance with the rules set forth in §§ 20.2031–1, 20.2031–7, 20.2031–8, and 20.2031–9. The application of this paragraph may be illustrated by the following examples:

*Example (1).* On January 1, 1945, the decedent and his wife each contributed $15,000 to the purchase price of an annuity contract under the terms of which the issuing company agreed to pay an annuity to the decedent and his wife for their joint lives and to continue the annuity to the survivor for his life. Assume that the value of the survivor's annuity at the decedent's death (computed under § 20.2031–8) is $20,000. Since the decedent contributed one-half of the cost of the contract, the amount to be included in his gross estate under section 2039 (a) and (b) is $10,000.

*Example (2).* Under the terms of an employment contract entered into on January 1, 1945, the employer and the employee made contributions to a fund which was to provide the employee, upon his retirement at age 60, with an annuity for life, and which was to provide his designated beneficiary, upon the employee's death after retirement, with a similar annuity for life. The retirement fund at no time formed part of a plan meeting the requirements of section 401(a) (relating to qualified plans). Assume that the employer and the employee each contributed $5,000 to the retirement fund. Assume further, that the employee died after retirement at which

time the value of the survivor's annuity was $8,000. Since the employer's contributions were made by reason of the decedent's employment, the amount to be included in his gross estate under section 2039 (a) and (b) is the entire $8,000. If, in the above example, only the employer made contributions to the fund, the amount to be included in the gross estate would still be $8,000.

(d) *Insurance under policies on the life of the decedent.* If an annuity or other payment receivable by a beneficiary under a contract or agreement is in substance the proceeds of insurance under a policy on the life of the decedent, section 2039 (a) and (b) does not apply. For the extent to which such an annuity or other payment is includable in a decedent's gross estate, see section 2042 and § 20.2042–1. A combination annuity contract and life insurance policy on the decedent's life (e.g., a ''retirement income'' policy with death benefits) which matured during the decedent's lifetime so that there was no longer an insurance element under the contract at the time of the decedent's death is subject to the provisions of section 2039 (a) and (b). On the other hand, the treatment of a combination annuity contract and life insurance policy on the decedent's life which did not mature during the decedent's lifetime depends upon the nature of the contract at the time of the decedent's death. The nature of the contract is generally determined by the relation of the reserve value of the policy to the value of the death benefit at the time of the decedent's death. If the decedent dies before the reserve value equals the death benefit, there is still an insurance element under the contract. The contract is therefore considered, for estate tax purposes, to be an insurance policy subject to the provisions of section 2042. However, if the decedent dies after the reserve value equals the death benefit, there is no longer an insurance element under the contract. The contract is therefore considered to be a contract for an annuity or other payment subject to the provisions of section 2039 (a) and (b) or some other section of Part III of Subchapter A of Chapter 11. Notwithstanding the relation of the reserve value to the value of the death benefit, a contract under which the death benefit could never exceed the total premiums paid, plus interest, contains no insurance element.

*Example.* Pursuant to a retirement plan established January 1, 1945, the employer purchased a contract from an insurance company which was to provide the employee, upon his retirement at age 65, with an annuity of $100 per month for life, and which was to provide his designated beneficiary, upon the employee's death after retirement, with a similar annuity for life. The contract further provided that if the employee should die before reaching the retirement age, a lump sum payment of $20,000 would be paid to his designated beneficiary in lieu of the annuity described above. The plan at no time met the requirements of section 401(a) (relating to qualified plans). Assume that the reserve value of the contract at the retirement age would be $20,000. If the employee died after reaching the retirement age, the death benefit to the designated beneficiary would constitute an annuity, the value of which would be includable in the employee's gross estate under section 2039 (a) and (b). If, on the other hand, the employee died before reaching his retirement age, the death benefit to the designated beneficiary would constitute insurance under a policy on the life of the decedent since the reserve value would be less than the death benefit. Accordingly, its includability would depend upon section 2042 and § 20.2042–1.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7416, 41 FR 14514, Apr. 6, 1976]

### § 20.2039–1T Limitations and repeal of estate tax exclusion for qualified plans and individual retirement plans (IRAs) (temporary).

Q–1: Are there any exceptions to the general effective dates of the $100,000 limitation and the repeal of the estate tax exclusion for the value of interests under qualified plans and IRAs described in section 2039 (c) and (e)?

A–1: (a) Yes. Section 245 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) limited the estate tax exclusion to $100,000 for estates of decedents dying after December 31, 1982. Section 525 of the Tax Reform Act of 1984 (TRA of 1984) repealed the exclusion for estates of decedents dying after December 31, 1984.

(b) Section 525(b)(3) of the TRA of 1984 amended section 245 of TEFRA to provide that the $100,000 limitation on the exclusion for the value of a decedent's interest in a plan or IRA will not apply to the estate of any decedent

dying after December 31, 1982, to the extent that the decedent-participant was in pay status on December 31, 1982, with respect to such interest and irrevocably elected the form of benefit payable under the plan or IRA (including the form of any survivor benefits) with respect to such interest before January 1, 1983.

(c) Similarly, the TRA of 1984 provides that the repeal of the estate tax exclusion for the value of a decedent's interest in a plan or IRA will not apply to the estate of a decedent dying after December 31, 1984, to the extent that the decedent-participant was in pay status on December 31, 1984, with respect to such interest and irrevocably elected the form of benefit payable under the plan or IRA (including the form of any survivor benefits) with respect to such interest before July 18, 1984.

Q–2: What is the meaning of ''in pay status'' on the applicable date?

A–2: A participant was in pay status on the applicable date with respect to a portion of his or her interest in a plan or IRA if such portion is to be paid in a benefit form that has been elected on or before such date and the participant has received, on or before such date, at least one payment under such benefit form.

Q–3: What is required for an election of the form of benefit payable under the plan to have been irrevocable as of any applicable date?

A–3: As of any applicable date, an election of the form of benefit payable under a plan is irrevocable if, as of such date, it was a written irrevocable election that, with respect to all payments to be received after such date, specified the form of distribution (e.g., lump sum, level dollar annuity, formula annuity) and the period over which the distribution would be made (e.g., single life, joint and survivor, term certain). An election is not irrevocable as of any applicable date if, on or after such date, the form or period of the distribution could be determined or altered by any person or persons. An election does not fail to be irrevocable as of an applicable date merely because the beneficiaries were not designated as of such date or could be changed after such date. If any interest in any IRA may not, by law or contract, be subject to an irrevocable election described in this section, any election of the form of benefit payable under the IRA does not satisfy the requirement that an irrevocable election have been made.

[T.D. 8073, 51 FR 4335, Feb. 4, 1986]

### § 20.2039–2 Annuities under "qualified plans" and section 403(b) annuity contracts.

(a) *Section 2039(c) exclusion.* In general, in the case of a decedent dying after December 31, 1953, the value of an annuity or other payment receivable under a plan or annuity contract described in paragraph (b) of this section is excluded from the decedent's gross estate to the extent provided in paragraph (c) of this section. In the case of a plan described in paragraph (b) (1) or (2) of this section (a ''qualified plan''), the exclusion is subject to the limitation described in § 20.2039–3 (relating to lump sum distributions paid with respect to a decedent dying after December 31, 1976, and before January 1, 1979) or § 20.2039–4 (relating to lump sum distributions paid with respect to a decedent dying after December 31, 1978).

(b) *Plans and annuity contracts to which section 2039(c) applies.* Section 2039(c) excludes from a decedent's gross estate, to the extent provided in paragraph (c) of this section, the value of an annuity or other payment receivable by any beneficiary (except the value of an annuity or other payment receivable by or for the benefit of the decedent's estate) under—

(1) An employees' trust (or under a contract purchased by an employees' trust) forming part of a pension, stock bonus, or profit-sharing plan which, at the time of the decedent's separation from employment (whether by death or otherwise), or at the time of the earlier termination of the plan, met the requirements of section 401(a);

(2) A retirement annuity contract purchased by an employer (and not by an employees' trust) pursuant to a plan which, at the time of decedent's separation from employment (by death or otherwise), or at the time of the earlier termination of the plan, was a plan described in section 403(a);

(3) In the case of a decedent dying after December 31, 1957, a retirement annuity contract purchased for an employee by an employer which, for its taxable year in which the purchase occurred, is an organization referred to in section 170(b)(1)(A) (ii) or (iv) or which is a religious organization (other than a trust) and is exempt from tax under section 501(a);

(4) In the case of a decedent dying after December 31, 1965, an annuity under Chapter 73 of Title 10 of the United States Code (10 U.S.C. 1431, *et seq.*); or

(5) In the case of a decedent dying after December 31, 1962, a bond purchase plan described in section 405.

For the meaning of the term ''annuity or other payment'', see paragraph (b) of § 20.2039–1. For the meaning of the phrase ''receivable by or for the benefit of the decedent's estate'', see paragraph (b) of § 20.2042–1. The application of this paragraph may be illustrated by the following examples in each of which it is assumed that the amount stated to be excludable from the decedent's gross estate is determined in accordance with paragraph (c) of this section:

*Example (1).* Pursuant to a pension plan, the employer made contributions to a trust which was to provide the employee, upon his retirement at age 60, with an annuity for life, and which was to provide his wife, upon the employee's death after retirement, with a similar annuity for life. At the time of the employee's retirement, the pension trust formed part of a plan meeting the requirements of section 401(a). Assume that the employee died at age 61 after the trustee started payment of his annuity as described above. Since the wife's annuity was receivable under a qualified pension plan, no part of the value of such annuity is includable in the decedent's gross estate by reason of the provisions of section 2039(c). If, in this example, the employer provided other benefits under nonqualified plans, the result would be the same since the exclusion under section 2039(c) is confined to the benefits provided for under the qualified plan.

*Example (2).* Pursuant to a profit-sharing plan, the employer made contributions to a trust which were allocated to the employee's individual account. Under the plan, the employee would, upon retirement at age 60, receive a distribution of the entire amount credited to the account. If the employee should die before reaching retirement age, the amount credited to the account would be distributed to the employee's designated beneficiary. Assume that the employee died before reaching the retirement age and that at such time the plan met the requirements of section 401(a). Since the payment to the designated beneficiary is receivable under a qualified profit-sharing plan, the provisions of section 2039(c) apply. However, if the payment is a lump sum distribution to which § 20.2039–3 or § 20.2039–4 applies, the payment is excludable from the decedent's gross estate only as provided in such section.

*Example (3).* Pursuant to a pension plan, the employer made contributions to a trust which were used by the trustee to purchase a contract from an insurance company for the benefit of an employee. The contract was to provide the employee, upon retirement at age 65, with an annuity of $100 per month for life, and was to provide the employee's designated beneficiary upon the employee's death after retirement, with a similar annuity for life. The contract further provided that if the employee should die before reaching retirement age, a lump sum payment equal to the greater of (a) $10,000 or (b) the reserve value of the policy would be paid to the designated beneficiary in lieu of the annuity. Assume that the employee died before reaching the retirement age and that at such time the plan met the requirements of section 401(a). Since the payment to the designated beneficiary is receivable under a qualified pension plan, the provisions of section 2039(c) apply. However, if the payment is a lump sum distribution to which § 20.2039–3 or § 20.2039–4 applies, the payment is excludable from the decedent's gross estate only as provided in such section. It should be noted that for purposes of the exclusion under section 2039(c) it is immaterial whether or not the payment constitutes the proceeds of life insurance under the principles set forth in § 20.2039–1(d).

*Example (4).* Pursuant to a profit-sharing plan, the employer made contributions to a trust which were allocated to the employee's individual account. Under the plan, the employee would, upon his retirement at age 60, be given the option to have the amount credited to his account (a) paid to him in a lump sum, (b) used to purchase a joint and survivor annuity for him and his designated beneficiary, or (c) left with the trustee under an arrangement whereby interest would be paid to him for his lifetime with the principal to be paid, at his death, to his designated beneficiary. The plan further provided that if the third method of settlement were selected, the employee would retain the right to have the principal paid to himself in a lump sum up to the time of his death. At the time of the employee's retirement, the profit-sharing plan met the requirements of section 401(a). Assume that the employee, upon reaching his retirement age, elected to have the amount credited to his account left

with the trustee under the interest arrangement. Assume, further, that the employee did not exercise his right to have such amount paid to him before his death. Under such circumstances, the employee is considered as having constructively received the amount credited to his account upon his retirement. Thus, such amount is not considered as receivable by the designated beneficiary under the profit-sharing plan and the exclusion of section 2039(c) is not applicable.

*Example (5).* An employer purchased a retirement annuity contract for an employee which was to provide the employee, upon his retirement at age 60, with an annuity for life and which was to provide his wife, upon the employee's death after retirement, with a similar annuity for life. The employer, for its taxable year in which the annuity contract was purchased, was an organization referred to in section 170(b)(1)(ii), and was exempt from tax under section 501(a). The entire amount of the purchase price of the annuity contract was excluded from the employee's gross income under section 403(b). No part of the value of the survivor annuity payable after the employee's death is includible in the decedent's gross estate by reason of the provisions of section 2039(c).

(c) *Amounts excludable from the gross estate.* (1) The amount to be excluded from a decedent's gross estate under section 2039(c) is an amount which bears the same ratio to the value at the decedent's death of an annuity or other payment receivable by the beneficiary as the employer's contribution (or a contribution made on the employer's behalf) on the employee's account to the plan or towards the purchase of the annuity contract bears to the total contributions on the employee's account to the plan or towards the purchase of the annuity contract. In applying this ratio—

(i) Payments or contributions made by or on behalf of the employer towards the purchase of an annuity contract described in paragraph (b)(3) of this section are considered to include only such payments or contributions as are, or were, excludable from the employee's gross income under section 403(b).

(ii) In the case of a decedent dying before January 1, 1977, payments or contributions made under a plan described in paragraph (b) (1), (2) or (5) of this section on behalf of the decedent for a period for which the decedent was self-employed, within the meaning of section 401(c)(1), with respect to the plan are considered payments or contributions made by the decedent and not by the employer.

(iii) In the case of a decedent dying after December 31, 1976, however, payments or contributions made under a plan described in paragraph (b) (1), (2) or (5) of this section on behalf of the decedent for a period for which the decedent was self-employed, within the meaning of section 401(c)(1), with respect to the plan are considered payments or contributions made by the employer to the extent the payments or contributions are, or were, deductible under section 404 or 405(c). Contributions or payments attributable to that period which are not, or were not, so deductible are considered made by the decedent.

(iv) In the case of a plan described in paragraph (b) (1) or (2) of this section, a rollover contribution described in section 402(a)(5), 403(a)(4), 409(d)(3)(A)(ii) or 409(b)(3)(C) is considered an amount contributed by the employer.

(v) In the case of an annuity contract described in paragraph (b)(3) of this section, a rollover contribution described in section 403(b)(8) is considered an amount contributed by the employer.

(vi) In the case of a plan described in paragraph (b) (1), (2) or (5) of this section, an amount includable in the gross income of an employee under section 1379(b) (relating to shareholder-employee beneficiaries under certain qualified plans) is considered an amount paid or contributed by the decedent.

(vii) Amounts payable under paragraph (b)(4) of this section are attributable to payments or contributions made by the decedent only to the extent of amounts deposited by the decedent pursuant to section 1438 or 1452(d) of Title 10 of the United States Code.

(viii) The value at the decedent's death of the annuity or other payment is determined under the rules of §§ 20.2031–1 and 20.2031–7 or, for certain prior periods, § 20.2031–7A.

(2) In certain cases, the employer's contribution (or a contribution made

on his behalf) to a plan on the employee's account and thus the total contributions to the plan on the employee's account cannot be readily ascertained. In order to apply the ratio stated in subparagraph (1) of this paragraph in such a case, the method outlined in the following two sentences must be used unless a more precise method is presented. In such a case, the total contributions to the plan on the employee's account is the value of any annuity or other payment payable to the decedent and his survivor computed as of the time the decedent's rights first mature (or as of the time the survivor's rights first mature if the decedent's rights never mature) and computed in accordance with the rules set forth in §§ 20.2031–1, 20.2031–7, 20.2031–8, and 20.2031–9. By subtracting from such value the amount of the employee's contribution to the plan, the amount of the employer's contribution to the plan on the employee's account may be obtained. The application of this paragraph may be illustrated by the following example.

*Example.* Pursuant to a pension plan, the employer and the employee contributed to a trust which was to provide the employee, upon his retirement at age 60, with an annuity for life, and which was to provide his wife, upon the employee's death after retirement, with a similar annuity for life. At the time of the employee's retirement, the pension trust formed part of a plan meeting the requirements of section 401(a). Assume the following: (i) That the employer's contributions to the fund were not credited to the accounts of individual employees; (ii) that the value of the employee's annuity and his wife's annuity, computed as of the time of the decedent's retirement, was $40,000; (iii) that the employee contributed $10,000 to the plan; and (iv) that the value at the decedent's death of the wife's annuity was $16,000. On the basis of these facts, the total contributions to the fund on the employee's account are presumed to be $40,000 and the employer's contribution to the plan on the employee's account is presumed to be $30,000 ($40,000 less $10,000). Since the wife's annuity was receivable under a qualified pension plan, that part of the value of such annuity which is attributable to the employer's contributions ($30,000÷$40,000×$16,000), or $12,000 is excludable from the decedent's gross estate by reason of the provisions of section 2039(c). Compare this result with the results reached in the examples set forth in paragraph (b) of this section in which all contributions to the plans were made by the employer.

(d) *Exclusion of certain annuity interests created by community property laws.* (1) In the case of an employee on whose behalf contributions or payments were made by his employer or former employer under an employees' trust forming part of a pension, stock bonus, or profit-sharing plan described in section 2039(c)(1), under an employee's retirement annuity contract described in section 2039(c)(2), or toward the purchase of an employee's retirement annuity contract described in section 2039(c)(3), which under section 2039(c) are not considered as contributed by the employee, if the spouse of such employee predeceases him, then, notwithstanding the provisions of section 2039 or of any other provision of law, there shall be excluded from the gross estate of such spouse the value of any interest of such spouse in such plan or trust or such contract, to the extent such interest—

(i) Is attributable to such contributions or payments, and

(ii) Arises solely by reason of such spouse's interest in community income under the community property laws of a State.

(2) Section 2039(d) and this paragraph do not provide any exclusion for such spouse's property interest in the plan, trust or contract to the extent it is attributable to the contributions of the employee spouse. Thus, the decedent's community property interest in the plan, trust, or contract which is attributable to contributions made by the employee spouse are includible in the decendent's gross estate. See paragraph (c) of this section.

(3) Section 2039(d) and this paragraph apply to the estate of a decedent who dies on or after October 27, 1972, and to the estate of a decedent who died before October 27, 1972, if the period for filing a claim for credit or refund of an overpayment of the estate tax ends on or after October 27, 1972. Interest will

not be allowed or paid on any overpayment of tax resulting from the application of section 2039(d) and this paragraph for any period prior to April 26, 1973.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6526, 26 FR 416, Jan. 19, 1961; T.D. 7043, 35 FR 8480, June 2, 1970; T.D. 7416, 41 FR 14514, Apr. 6, 1976; T.D. 7428, 41 FR 34628, Aug. 16, 1976; T.D. 7562, 43 FR 38820, Aug. 31, 1978; T.D. 7761, 46 FR 7303, Jan. 23, 1981; T.D. 8540, 59 FR 30103, June 10, 1994]

### § 20.2039–3 Lump sum distributions under "qualified plans;" decedents dying after December 31, 1976, and before January 1, 1979.

(a) *Limitation of section 2039(c) exclusion.* This section applies in the case of a decedent dying after December 31, 1976, and before January 1, 1979. If a lump sum distribution is paid with respect to the decedent under a plan described in § 20.2039–2(b) (1) or (2) (a ''qualified plan''), no amount payable with respect to the decedent under the plan is excludable from the decedent's gross estate under § 20.2039–2.

(b) *''Lump sum distribution'' defined.* For purposes of this section the term ''lump sum distribution'' means a lump sum distribution defined in section 402(e)(4)(A) that satisfies the requirements of section 402(e)(4)(C), relating to the aggregation of certain trusts and plans. The distribution of an annuity contract is not a lump sum distribution for purposes of this section, and § 20.2039–2 will apply with respect to the distribution of an annuity contract without regard to whether the contract is included in a distribution that is otherwise a lump sum distribution under this paragraph (b). A distribution is a lump sum distribution for purposes of this section without regard to the election described in section 402(e)(4)(B).

(c) *Amounts payable as a lump sum distribution.* If on the date the estate tax return is filed, an amount under a qualified plan is payable with respect to the decedent as a lump sum distribution (whether at the election of a beneficiary or otherwise), for purposes of this section the amount is deemed paid as a lump sum distribution no later than on such date. Accordingly, no portion of the amount payable under the plan is excludable from the value of the decedent's gross estate under § 20.2039–2. If, however, the amount payable as a lump sum distribution is not, in fact, thereafter paid as a lump sum distribution, there shall be allowed a credit or refund of any tax paid which is attributable to treating such amount as a lump sum distribution under this paragraph. Any claim for credit or refund filed under this paragraph must be filed within the time prescribed by section 6511, and must provide satisfactory evidence that the amount originally payable as a lump sum distribution is no longer payable in such form.

(d) *Filing date.* For purposes of paragraph (c) of this section, ''the date the estate tax return is filed'' means the earlier of—

(1) The date the estate tax return is actually filed, or

(2) The date nine months after the decedent's death, plus any extension of time for filing the estate tax return granted under section 6081.

[T.D. 7761, 46 FR 7304, Jan. 23, 1981]

### § 20.2039–4 Lump sum distributions from "qualified plans;" decedents dying after December 31, 1978.

(a) *Limitation on section 2039(c) exclusion.* This section applies in the case of a decedent dying after December 31, 1978. If a lump sum distribution is paid or payable with respect to a decedent under a plan described in § 20.2039–2(b) (1) or (2) (a ''qualified plan''), no amount paid or payable with respect to the decedent under the plan is excludable from the decedent's gross estate under § 20.2039–2, unless the recipient of the distribution makes the section 402(a)/403(a) taxation election described in paragraph (c) of this section. For purposes of this section, an amount is payable as a lump sum distribution under a plan if, as of the date the estate tax return is filed (as determined under § 20.2039–3(d)), it is payable as a lump sum distribution at the election of the recipient or otherwise.

(b) *''Lump sum distribution'' defined; treatment of annuity contracts.* For purposes of this section the term ''lump sum distribution'' means a lump sum distribution defined in section 402(e)(4)(A) that satisfies the requirements of section 402(e)(4)(C), relating to the aggregation of certain trusts

and plans. A distribution is a lump sum distribution for purposes of this section without regard to the election described in section 402(e)(4)(B). The distribution of an annuity contract is not a lump sum distribution for purposes of this section, and the limitation described in this section does not apply to an annuity contract distributed under a plan. Accordingly, if the amount payable with respect to a decedent under a plan is paid to a recipient partly by the distribution of an annuity contract, and partly by the distribution of an amount that is a lump sum distribution within the meaning of this paragraph (b), § 20.2039–2 shall apply with respect to the annuity contract without regard to whether the recipient makes the section 402(a)/403(a) taxation election with respect to the remainder of the distribution.

(c) *Recipient's section 402(a)/403(a) taxation election.* The section 402(a)/403(a) taxation election is the election by the recipient of a lump sum distribution to treat the distribution as—

(1) Taxable under section 402(a), without regard to section 402(a)(2), to the extent includable in gross income (in the case of a distribution under a qualified plan described in § 20.2039–2(b)(1)),

(2) Taxable under section 403(a), without regard to section 403(a)(2), to the extent includable in gross income (in the case of a distribution under a qualified annuity contract described in § 20.2039–2(b)(2)), or

(3) A rollover contribution, in whole or in part, under section 402(a)(7) (relating to rollovers by a decedent's surviving spouse).

Accordingly, if a recipient makes the election, no portion of the distribution is taxable to the recipient under the 10-year averaging provisions of section 402(e) or as long-term capital gain under section 402(a)(2). However, a recipient's election under this paragraph (c) does not preclude the application of section 402(e)(4)(J) to any securities of the employer corporation included in the distribution.

(d) *Method of election*—(1) *General rule.* The recipient of a lump sum distribution shall make the section 402(a)/403(a) taxation election by:

(i) Determining the income tax liability on the income tax return (or amended return) for the taxable year of the distribution in a manner consistent with paragraph (c) (1) or (2) of this section,

(ii) Rolling over all or any part of the distribution under section 402(a)(7), or

(iii) Filing a section 2039(f)(2) election statement described in paragraph (d)(2) of this section.

(2) *Election statement.* A recipient may file a section 2039(f)(2) election statement indicating that the recipient elects to treat a lump sum distribution in the manner described in paragraph (c) of this section. The statement must be filed where the recipient would file the income tax return for the taxable year of the distribution. The statement must be signed by the recipient and include the individual's name, address, social security number, the name of the decedent, and a statement indicating the election is being made. A section 2039(f)(2) election statement may be filed at any time prior to making the election under paragraph (d)(1)(i) or (ii) of this section.

(3) *Effect on estate tax return.* If the date the estate tax return is filed precedes the date on which the recipient makes the section 402(a)/403(a) taxation election with respect to a lump sum distribution, the estate tax return may not reflect the election. However, if after the estate tax return is filed, the recipient makes the section 402(a)/403(a) taxation election, the executor of the estate may file a claim for refund or credit of an overpayment of the Federal estate tax within the time prescribed in section 6511. See also, § 20.6081–1 for rules relating to obtaining an extension of time for filing the estate tax return.

(e) *Election irrevocable.* If a recipient of a lump sum distribution files a section 2039(f)(2) election statement, an income tax return (or amended return) or makes a rollover contribution that constitutes the section 402(a)/403(a) taxation election described in paragraphs (c) and (d), the election may not be revoked. Accordingly, a subsequent and amended income tax return filed by the recipient that is inconsistent with the prior election will not be given effect for purposes of section 2039 and section 402 or 403.

(f) *Lump sum distribution to multiple recipients.* In the case of a lump sum distribution paid or payable under a qualified plan with respect to the decedent to more than one recipient, the exclusion under § 20.2039–2 applies to so much of the distribution as is paid or payable to a recipient who makes the section 402(a)/403(a) taxation election.

(g) *Distributions of annuity contracts included in multiple distributions.* Notwithstanding that a recipient makes the section 402(a)/403(a) taxation election with respect to a lump sum distribution that includes the distribution of an annuity contract, the distribution of the annuity contract is to be taken into account by the recipient for purposes of the multiple distribution rules under section 402(e).

[T.D. 7761, 46 FR 7304, Jan. 23, 1981, as amended by T.D. 7956, 49 FR 20284, May 14, 1984]

### § 20.2039–5 Annuities under individual retirement plans.

(a) *Section 2039(e) exclusion*—(1) *In general.* In the case of a decedent dying after December 31, 1976, section 2039 (e) excludes from the decedent's gross estate, to the extent provided in paragraph (c) of this section, the value of a ''qualifying annuity'' receivable by a beneficiary under an individual retirement plan. The term ''individual retirement plan'' means—

(i) An individual retirement account described in section 408(a).

(ii) An individual retirement annuity described in section 408(b), or

(iii) A retirement bond described in section 409(a).

(2) *Limitations.* (i) Section 2039(e) applies only with respect to the gross estate of a decedent on whose behalf the individual retirement plan was established. Accordingly, section 2039(e) does not apply with respect to the estate of a decedent who was only a beneficiary under the plan.

(ii) Section 2039(e) does not apply to an annuity receivable by or for the benefit of the decedent's estate. For the meaning of the term ''receivable by or for the benefit of the decedent's estate,'' see § 20.2042–1(b).

(b) *Qualifying annuity.* For purposes of this section, the term ''qualifying annuity'' means an annuity contract or other arrangement providing for a series of substantially equal periodic payments to be made to a beneficiary for the beneficiary's life or over a period ending at least 36 months after the decedent's death. The term ''annuity contract'' includes an annuity purchased for a beneficiary and distributed to the beneficiary, if under section 408 the contract is not included in the gross income of the beneficiary upon distribution. The term ''other arrangement'' includes any arrangement arising by reason of the decedent's participation in the program providing the individual retirement plan. Payments shall be considered ''periodic'' if under the arrangement or contract (including a distributed contract) payments are to be made to the beneficiary at regular intervals. If the contract or arrangement provides optional payment provisions, not all of which provide for periodic payments, payments shall be considered periodic only if an option providing periodic payments is elected not later than the date the estate tax return is filed (as determined under § 20.2039–3(d)). For this purpose, the right to surrender a contract (including a distributed contract) for a cash surrender value will not be considered an optional payment provision. Payments shall be considered ''substantially equal'' even though the amounts receivable by the beneficiary may vary. Payments shall not be considered substantially equal, however, if more than 40% of the total amount payable to the beneficiary under the individual retirement plan, determined as of the date of the decedent's death and excluding any postmortem increase, is payable to the beneficary in any 12-month period.

(c) *Amount excludible from gross estate*—(1) *In general.* Except as otherwise described in this paragraph (c), the amount excluded from the decedent's gross estate under section 2039 (e) is the entire value of the qualifying annuity (as determined under §§ 20.2031–1 and 20.2031–7 or, for certain prior periods, § 20.2031–7A) payable under the individual retirement plan.

(2) *Excess contribution.* In any case in which there exists, on the date of the decedent's death, an excess contribution (as defined in section 4973(b)) with respect to the individual retirement

plan, the amount excluded from the value of the decedent's gross estate is determined under the following formula:

$$E = A - A(X \div C - R)$$

Where:

E=The amount excluded from the decedent's gross estate under section 2039(e),

A=The value of the qualifying annuity at the decedent's death (as determined under §§ 20.2031–1 and 20.2031–7 or, for certain prior periods, § 20.2031–7A),

X=The amount which is an excess contribution at the decedent's death (as determined under section 4973(b)),

C=The total amount contributed by or on behalf of the decedent to the individual retirement plan, and

R=The total of amounts paid or distributed from the individual retirement plan before the death of the decedent which were either includable in the gross income of the recipient under section 408(d)(1) and represented the payment or distribution of an excess contribution, or were payments or distributions described in section 408(d)(4) or (5) (relating to returned excess contributions).

(3) *Certain section 403(b)(8) rollover contributions.* This subparagraph (3) applies if the decedent made a rollover contribution to the individual retirement plan under section 403(b)(8), and the contribution was attributable to a distribution under an annuity contract other than an annuity contract described in § 20.2039–2(b)(3). If such a rollover contribution was the only contribution made to the plan, no part of the value of the qualifying annuity payable under the plan is excluded from the decedent's gross estate under section 2039(e). If a contribution other than such a rollover contribution was made to the plan, the amount excluded from the decedent's gross estate is determined under the formula described in subparagraph (2) of this paragraph, except that for purposes of that formula, X includes the amount that was a rollover contribution under section 403(b)(8) attributable to a distribution under an annuity contract not described in § 20.2039–2(b)(3).

(4) *Surviving spouse's rollover contribution.* This subparagraph (4) applies if the decedent made a rollover contribution to the individual retirement plan under section 402(a)(7), relating to rollovers by a surviving spouse. If the rollover contribution under section 402(a)(7) was the only contribution made by the decedent to the plan, no part of the value of the qualifying annuity payable under the plan is excluded from the decedent's gross estate under section 2039(e). If a contribution other than a rollover contribution under section 402(a)(7) was made by the decedent to the plan, the amount excluded from the decedent's gross estate is determined under the formula described in subparagraph (2) of this paragraph, except that for purposes of that formula, X includes the amount that was a rollover contribution under section 402(a)(7).

(5) *Election under § 1.408–2(b)(7)(ii).* This subparagraph (5) applies if the decedent at any time made the election described in § 1.408–2(b)(7)(ii) with respect to an amount in the individual retirement plan. If this subparagraph (5) applies, the amount excluded from the decedent's gross estate is determined under the formula described in subparagraph (2), except that for purposes of that formula, X and C include the amount with respect to which the election was made.

(6) *Plan-to-plan rollovers.* (i) This subparagraph (6) applies if the individual retirement plan is a transferee plan. A ''transferee plan'' is a plan that was the recipient of a contribution described in section 408(d)(3)(A)(i) or 409(b)(3)(C) (relating to rollovers from one individual retirement plan to another) made by the decedent. The amount of the contribution described in section 408(d)(3)(A)(i) or 409(b)(3)(C) is the ''rollover amount.'' The plan from which the rollover amount was paid or distributed to the decedent is the ''transferor plan.''

(ii) If the decedent made a contribution described in subparagraph (3) or (4) to the transferor plan, the amount excluded from the decedent's gross estate with respect to the transferee plan is determined under the formula described in subparagraph (2), except that for purposes of that formula, X includes so much of the rollover amount as was attributable to the contribution to the transferor plan that was described in subparagraph (3) or (4). The extent to which a rollover amount is attributable to a contribution described in subparagraph (3) or (4) that

was made to the transferor plan is determined by multiplying the rollover amount by a fraction, the numerator of which is the amount of such contribution, and the denominator of which is the sum of all amounts contributed by the decedent to the transferor plan (if not returned as described under R in subparagraph (2)), and any amount in the transferor plan to which the election described in subparagraph (5) applied.

(iii) If the decedent made the election described in subparagraph (5) with respect to an amount in the transferor plan, the amount excluded from the decedent's gross estate with respect to the transferee plan is determined under the formula described in subparagraph (2), except that for purposes of that formula, X includes so much of the rollover amount as was attributable to the amount in the transferor plan to which the election applied. The extent to which a rollover amount is attributable to an amount in the transferor plan to which the election applied is determined by multiplying the rollover amount by a fraction, the numerator of which is the amount to which the election applied, and the denominator of which is the sum of all amounts contributed by the decedent to the transferor plan (if not returned as described under R in subparagraph (2)), and the amount in the transferor plan to which the election applied.

(iv) If a transferor plan described in this subparagraph (6) was also a transferee plan, then the rules described in this subparagraph (6) are to be applied with respect to both the rollover amount paid to the plan and the rollover amount thereafter paid from the plan.

(d) *Examples.* The provisions of this section are illustrated by the following examples:

*Example (1).* (1) A establishes an individual retirement account described in section 408 (a) on January 1, 1976, when A is age 65. A's only contribution to the account is a rollover contribution described in section 402(a)(5). The trust agreement provides that A may at any time elect to have the balance in the account distributed in one of the following methods:

(i) A single sum payment of the account,

(ii) Equal or substantially equal semiannual payments over a period equal to A's life expectancy, or

(iii) Equal or substantially equal semiannual payments over a period equal to the life expectancy of A and A's spouse.

(2) The trust agreement further provides that although semiannual payments have commenced under option (ii) or (iii), A (or A's surviving spouse) may, by written notice to the trustee, receive all or a part of the balance remaining in the account. In addition, under option (ii), any balance remaining in the account at A's death is payable in a single sum to A's designated beneficiary. Under option (iii), any balance remaining in the account at the death of the survivor of A or A's spouse is payable in a single sum to a beneficiary designated by A or A's surviving spouse.

(3) A elects option (iii), and the first semiannual payment is made to A on July 1, 1976. On that date, A's life expectancy is 15 years, and that of A's spouse is 22 years. Under option (iii), the semiannual payments to A or A's surviving spouse will continue until July 1, 1998.

(4) A dies on November 20, 1978. On December 15, 1978, the trust agreement is modified so that A's surviving spouse no longer may elect to receive all or part of the balance remaining in the account. The value of the semiannual payments payable to A's spouse is excluded from A's gross estate under section 2039(e).

(5) A's spouse dies July 12, 1981, and the single sum payment payable on account of the death of A's spouse is paid to the designated beneficiary on August 1, 1981. Notwithstanding that the balance in the account was paid to the designated beneficiary within 36 months after A's death, the value of the semiannual payments payable to A's spouse are excluded from A's gross estate, since at A's death those semiannual payments were to be paid over a period extending beyond 36 months. Section 2039(e) does not apply to exclude any amount from the estate of A's spouse, because A's spouse was only a beneficiary and not the individual on whose behalf the account was established.

*Example (2).* Assume the same facts as in example (1), except that the trust agreement is not modified so that A's surviving spouse no longer may elect to receive all or part of the balance remaining in the account (see (2) and (4) in example (1)). Instead, the balance of the account is applied toward the purchase of a contract providing an immediate annuity, the contract is distributed to A's surviving spouse on December 15, 1978, and under section 408 the contract is not included in the gross income of the spouse upon its distribution. The value of the annuity contract is excluded from A's gross estate, if the contract provides for a series of

substantially equal periodic payments (within the meaning of paragraph (b) of this section) to be made over the life of A's surviving spouse or over a period not ending before the date 36 months after A's death.

*Example (3).* (1) B establishes an individual retirement plan described in section 408(a) (''IRA B'') on February 6, 1981, in order to receive a $220,000 rollover contribution from a qualified plan, as described in section 402(a)(5). B dies August 14, 1981. C, an individual, is the sole beneficiary under IRA B. The amount in IRA B ($238,000) is payable to C in whole or part as C may elect. Because the amount in IRA B is payable to C as other than a qualifying annuity, within the meaning of paragraph (b) of this section, no amount is excluded from B's gross estate under section 2039(e).

(2) On October 17, 1981, C contributes $1,500 on C's own behalf to IRA B. Under § 1.408–2(b)(7)(ii), C's contribution will cause IRA B to be treated as being maintained by and on behalf of C (''IRA C'') and C's making the contribution constitutes an election to which paragraph (c)(5) of this section applies. The balance in IRA C immediately before C's contribution is $240,000. Accordingly, the amount with respect to which C made the election is $240,000.

(3) C dies January 19, 1982. E, an individual, is the sole beneficiary under the plan, and the amounts payable to E ($242,000) are payable as a qualifying annuity, within the meaning of paragraph (b) of this section.

(4) The rules described in section 2039(e) and this section are applied with respect to the gross estate of C without regard to whether amounts now payable under IRA C were or were not excluded from B's gross estate. Under paragraph (c) of this section, the amount not excluded from C's gross estate is the value of the qualifying annuity payable to E ($242,000), multiplied by the fraction $240,000/($240,000+$1,500). Thus, the amount not excluded from C's gross estate is $240,497. [($242,000) ($240,000 ($240,000+$1,500))=$240,497.] The amount excluded is therefore $1,503 ($242,000 − $240,497).

*Example (4).* (1) F, an individual, establishes an individual retirement plan (''IRA F1'') in 1977 and makes $1,250 annual contributions for 1977, 1978, 1979 and 1980 (4×$1,250=$5,000), each of which is deducted by F under section 219. In February 1980, F receives an $85,000 distribution on account of the death of G, F's spouse, from the qualified plan of G's former employer, and rolls it over into IRA F1, under section 402(a)(7). Because IRA F1 includes a rollover contribution under section 402(a)(7), paragraph (c)(4) of this section applies. In 1981, F's entire interest in IRA F1, $100,000, is paid to F and contributed to another individual retirement plan (''IRA F2'') under section 408(d)(3)(A)(i). IRA F2 is a transferee plan to which paragraph (c)(6) of this section applies because of the rollover. F makes a $1,500 deductible contribution to IRA F2 for 1981.

(2) F dies in 1984. The balance in IRA F2 ($146,000) is payable to G, an individual, as a qualifying annuity, within the meaning of paragraph (b) of this section.

(3) Under paragraph (c) of this section, the amount *not* excluded from F's gross estate is the value of the qualifying annuity payable under IRA F2 multiplied by the fraction $96,700/$101,500. Accordingly, the amount not excluded is $139,096. [($146,000) ($96,700/$101,500)=$139,096.] The amount excluded is $6,904 ($146,000 − $139,096).

(4) The numerator of the fraction ($96,700) is determined by multiplying the amount rolled over from IRA F1 to IRA F2 ($100,000) by a fraction, the numerator of which is the amount of the rollover contribution to IRA F1 ($85,000), and the denominator of which is the total contributions to IRA F1 ($85,000+$5,000=$90,000). [($100,000) ($85,000/$90,000)=$96,700.]

(5) The denominator of the fraction ($101,500) is the sum of the contributions to IRA F2 (the $100,000 rollover contribution from IRA F1, and the $1,500 annual contribution to IRA F2).

[T.D. 7761, 46 FR 7305, Jan. 23, 1981; 46 FR 17191, Mar. 18, 1981, as amended by T.D. 8540, 59 FR 30103, June 10, 1994]

### § 20.2040–1 Joint interests.

(a) *In general.* A decedent's gross estate includes under section 2040 the value of property held jointly at the time of the decedent's death by the decedent and another person or persons with right of survivorship, as follows:

(1) To the extent that the property was acquired by the decedent and the other joint owner or owners by gift, devise, bequest, or inheritance, the decedent's fractional share of the property is included.

(2) In all other cases, the entire value of the property is included except such part of the entire value as is attributable to the amount of the consideration in money or money's worth furnished by the other joint owner or owners. See § 20.2043–1 with respect to adequacy of consideration. Such part of the entire value is that portion of the entire value of the property at the decedent's death (or at the alternate valuation date described in section 2032 which the consideration in money or money's worth furnished by the other joint owner or owners bears to the

total cost of acquisition and capital additions. In determining the consideration furnished by the other joint owner or owners, there is taken into account only that portion of such consideration which is shown not to be attributable to money or other property acquired by the other joint owner or owners from the decedent for less than a full and adequate consideration in money or money's worth.

The entire value of jointly held property is included in a decedent's gross estate unless the executor submits facts sufficient to show that property was not acquired entirely with consideration furnished by the decedent, or was acquired by the decedent and the other joint owner or owners by gift, bequest, devise, or inheritance.

(b) *Meaning of ''property held jointly''.* Section 2040 specifically covers property held jointly by the decedent and any other person (or persons), property held by the decedent and spouse as tenants by the entirety, and a deposit of money, or a bond or other instrument, in the name of the decedent and any other person and payable to either or the survivor. The section applies to all classes of property, whether real or personal, and regardless of when the joint interests were created. Furthermore, it makes no difference that the survivor takes the entire interest in the property by right of survivorship and that no interest therein forms a part of the decedent's estate for purposes of administration. The section has no application to property held by the decedent and any other person (or persons) as tenants in common.

(c) *Examples.* The application of this section may be explained in the following examples in each of which it is assumed that the other joint owner or owners survived the decedent:

(1) If the decedent furnished the entire purchase price of the jointly held property, the value of the entire property is included in his gross estate;

(2) If the decedent furnished a part only of the purchase price, only a corresponding portion of the value of the property is so included;

(3) If the decedent furnished no part of the purchase price, no part of the value of the property is so included;

(4) If the decedent, before the acquisition of the property by himself and the other joint owner, gave the latter a sum of money or other property which thereafter became the other joint owner's entire contribution to the purchase price, then the value of the entire property is so included, notwithstanding the fact that the other property may have appreciated in value due to market conditions between the time of the gift and the time of the acquisition of the jointly held property;

(5) If the decedent, before the acquisition of the property by himself and the other joint owner, transferred to the latter for less than an adequate and full consideration in money or money's worth other income-producing property, the income from which belonged to and became the other joint owner's entire contribution to the purchase price, then the value of the jointly held property less that portion attributable to the income which the other joint owner did furnish is included in the decedent's gross estate;

(6) If the property originally belonged to the other joint owner and the decedent purchased his interest from the other joint owner, only that portion of the value of the property attributable to the consideration paid by the decedent is included;

(7) If the decedent and his spouse acquired the property by will or gift as tenants by the entirety, one-half of the value of the property is included in the decedent's gross estate; and

(8) If the decedent and his two brothers acquired the property by will or gift as joint tenants, one-third of the value of the property is so included.

### § 20.2041–1 Powers of appointment; in general.

(a) *Introduction.* A decedent's gross estate includes under section 2041 the value of property in respect of which the decedent possessed, exercised, or released certain powers of appointment. This section contains rules of general application; § 20.2041–2 contains rules specifically applicable to general powers of appointment created on or before October 21, 1942; and § 20.2041–3 sets forth specific rules applicable to powers of appointment created after October 21, 1942.

(b) *Definition of ''power of appointment''*—(1) *In general.* The term ''power of appointment'' includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example, if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment. Similarly, a power given to a decedent to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust is a power of appointment. If the community property laws of a State confer upon the wife a power of testamentary disposition over property in which she does not have a vested interest she is considered as having a power of appointment. A power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, the decedent is considered as having a power of appointment. However, the decedent is not considered to have a power of appointment if he only had the power to appoint a successor, including himself, under limited conditions which did not exist at the time of his death, without an accompanying unrestricted power of removal. Similarly, a power to amend only the administrative provisions of a trust instrument, which cannot substantially affect the beneficial enjoyment of the trust property or income, is not a power of appointment. The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment. Further, the right in a beneficiary of a trust to assent to a periodic accounting, thereby relieving the trustee from further accountability, is not a power of appointment if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein.

(2) *Relation to other sections.* For purposes of §§ 20.2041–1 to 20.2041–3, the term ''power of appointment'' does not include powers reserved by the decedent to himself within the concept of sections 2036 through 2038. (See §§ 20.2036–1 to 20.2038–1.) No provision of section 2041 or of §§ 20.2041–1 to 20.2041–3 is to be construed as in any way limiting the application of any other section of the Internal Revenue Code or of these regulations. The power of the owner of a property interest already possessed by him to dispose of his interest, and nothing more, is not a power of appointment, and the interest is includable in his gross estate to the extent it would be includable under section 2033 or some other provision of Part III of Subchapter A of Chapter 11. For example, if a trust created by S provides for payment of the income to A for life with power in A to appoint the remainder by will and, in default of such appointment for payment of the income to A's widow, W, for her life and for payment of the remainder to A's estate, the value of A's interest in the remainder is includable in his gross estate under section 2033 regardless of its includability under section 2041.

(3) *Powers over a portion of property.* If a power of appointment exists as to part of an entire group of assets or only over a limited interest in property, section 2041 applies only to such part or interest. For example, if a trust created by S provides for the payment of income to A for life, then to W for life, with power in A to appoint the remainder by will and in default of appointment for payment of the remainder to B or his estate, and if A dies before W, section 2041 applies only to the value of the remainder interest excluding W's life estate. If A dies after W, section 2041 would apply to the value of the entire property. If the power were only over one-half the remainder interest, section 2041 would apply only to

one-half the value of the amounts described above.

(c) *Definition of ''general power of appointment''*—(1) *In general.* The term ''general power of appointment'' as defined in section 2041(b)(1) means any power of appointment exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, except (i) joint powers, to the extent provided in §§ 20.2041–2 and 20.2041–3, and (ii) certain powers limited by an ascertainable standard, to the extent provided in subparagraph (2) of this paragraph. A power of appointment exercisable to meet the estate tax, or any other taxes, debts, or charges which are enforceable against the estate, is included within the meaning of a power of appointment exercisable in favor of the decedent's estate, his creditors, or the creditors of his estate. A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit is considered a power of appointment exercisable in favor of the decedent or his creditors. However, for purposes of §§ 20.2041–1 to 20.2041–3, a power of appointment not otherwise considered to be a general power of appointment is not treated as a general power of appointment merely by reason of the fact that an appointee may, in fact, be a creditor of the decedent or his estate. A power of appointment is not a general power if by its terms it is either—

(*a*) Exercisable only in favor of one or more designated persons or classes other than the decedent or his creditors, or the decedent's estate or the creditors of his estate, or

(*b*) Expressly not exercisable in favor of the decedent or his creditors, or the decedent's estate or the creditors of his estate.

A decedent may have two powers under the same instrument, one of which is a general power of appointment and the other of which is not. For example, a beneficiary may have a power to withdraw trust corpus during his life, and a testamentary power to appoint the corpus among his descendants. The testamentary power is not a general power of appointment.

(2) *Powers limited by an ascertainable standard.* A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of section 2041(b)(1)(A), not a general power of appointment. 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. 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.

(3) *Certain powers under wills of decedents dying between January 1 and April 2, 1948.* Section 210 of the Technical Changes Act of 1953 provides that if a decedent died after December 31, 1947, but before April 3, 1948, certain property interests described therein may, if the decedent's surviving spouse so elects, be accorded special treatment in the determination of the marital deduction to be allowed the decedent's estate under the provisions of section 812(e) of the Internal Revenue Code of 1939. See § 81.47a (h) of Regulations 105 (26 CFR (1939) 81.47a(h)). The section further provides that property affected by the election shall, for the purpose of inclusion in the surviving spouse's gross estate, be considered property with respect to which she has a general power of appointment. Therefore, notwithstanding any other provision of

law or of §§ 20.2041–1 to 20.2041–3, if the present decedent (in her capacity as surviving spouse of a prior decedent) has made an election under section 210 of the Technical Changes Act of 1953, the property which was the subject of the election shall be considered as property with respect to which the present decedent has a general power of appointment created after October 21, 1942, exercisable by deed or will, to the extent it was treated as an interest passing to the surviving spouse and not passing to any other person for the purpose of the marital deduction in the prior decedent's estate.

(d) *Definition of ''exercise''.* Whether a power of appointment is in fact exercised may depend upon local law. For example, the residuary clause of a will may be considered under local law as an exercise of a testamentary power of appointment in the absence of evidence of a contrary intention drawn from the whole of the testator's will. However, regardless of local law, a power of appointment is considered as exercised for purposes of section 2041 even though the exercise is in favor of the taker in default of appointment, and irrespective of whether the appointed interest and the interest in default of appointment are identical or whether the appointee renounces any right to take under the appointment. A power of appointment is also considered as exercised even though the disposition cannot take effect until the occurrence of an event after the exercise takes place, if the exercise is irrevocable and, as of the time of the exercise, the condition was not impossible of occurrence. For example, if property is left in trust to A for life, with a power in B to appoint the remainder by will, and B dies before A, exercising his power by appointing the remainder to C if C survives A, B is considered to have exercised his power if C is living at B's death. On the other hand, a testamentary power of appointment is not considered as exercised if it is exercised subject to the occurrence during the decedent's life of an express or implied condition which did not in fact occur. Thus, if in the preceding example, C dies before B, B's power of appointment would not be considered to have been exercised. Similarly, if a trust provides for income to A for life, remainder as A appoints by will, and A appoints a life estate in the property to B and does not otherwise exercise his power, but B dies before A, A's power is not considered to have been exercised.

(e) *Time of creation of power.* A power of appointment created by will is, in general, considered as created on the date of the testator's death. However, section 2041(b)(3) provides that a power of appointment created by a will executed on or before October 21, 1942, is considered a power created on or before that date if the testator dies before July 1, 1949, without having republished the will, by codicil or otherwise, after October 21, 1942. A power of appointment created by an inter vivos instrument is considered as created on the date the instrument takes effect. Such a power is not considered as created at some future date merely because it is not exercisable on the date the instrument takes effect, or because it is revocable, or because the identity of its holders is not ascertainable until after the date the instrument takes effect. However, if the holder of a power exercises it by creating a second power, the second power is considered as created at the time of the exercise of the first. The application of this paragraph may be illustrated by the following examples:

*Example (1).* A created a revocable trust before October 22, 1942, providing for payment of income to B for life with remainder as B shall appoint by will. Even though A dies after October 21, 1942, without having exercised his power of revocation, B's power of appointment is considered a power created before October 22, 1942.

*Example (2).* C created an irrevocable inter vivos trust before October 22, 1942, naming T as trustee and providing for payment of income to D for life with remainder to E. T was given the power to pay corpus to D and the power to appoint a successor trustee. If T resigns after October 21, 1942, and appoints D as successor trustee, D is considered to have a power of appointment created before October 22, 1942.

*Example (3).* F created an irrevocable inter vivos trust before October 22, 1942, providing for payment of income to G for life with remainder as G shall appoint by will, but in default of appointment income to H for life with remainder as H shall appoint by will. If G died after October 21, 1942, without having exercised his power of appointment, H's power of appointment is considered a power

created before October 22, 1942, even though it was only a contingent interest until G's death.

*Example (4).* If in example (3) above G had exercised his power of appointment by creating a similar power in J, J's power of appointment would be considered a power created after October 21, 1942.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6582, 26 FR 11861, Dec. 12, 1961]

### § 20.2041–2 Powers of appointment created on or before October 21, 1942.

(a) *In general.* Property subject to a general power of appointment created on or before October 21, 1942, is includable in the gross estate of the holder of the power under section 2041 only if he exercised the power under specified circumstances. Section 2041(a)(1) requires that there be included in the gross estate of a decedent the value of property subject to such a power only if the power is exercised by the decedent either (1) by will, or (2) by a disposition which is of such nature that if it were a transfer of property owned by the decedent, the property would be includable in the decedent's gross estate under section 2035 (relating to transfers in contemplation of death), 2036 (relating to transfers with retained life estate), 2037 (relating to transfers taking effect at death), or 2038 (relating to revocable transfers). See paragraphs (b), (c), and (d) of § 20.2041–1 for the definition of various terms used in this section.

(b) *Joint powers created on or before October 21, 1942.* Section 2041(b)(1)(B) provides that a power created on or before October 21, 1942, which at the time of the exercise is not exercisable by the decedent except in conjunction with another person, is not deemed a general power of appointment.

(c) *Exercise during life.* The circumstances under which section 2041 applies to the exercise other than by will of a general power of appointment created on or before October 21, 1942, are set forth in paragraph (a) of this section. In this connection, the rules of sections 2035 through 2038 which are to be applied are those in effect on the date of the decedent's death which are applicable to transfers made on the date when the exercised of the power occurred. Those rules are to be applied in determining the extent to which and the conditions under which a disposition is considered a transfer of property. The application of this paragraph may be illustrated by the following examples:

*Example (1).* A decedent in 1951 exercised a general power of appointment created in 1940, reserving no interest in or power over the property subject to the general power. The decedent died in 1956. Since the exercise was not made within three years before the decedent's death, no part of the property is includable in his gross estate. See section 2035(b), relating to transfers in contemplation of death.

*Example (2).* S created a trust in 1930 to pay the income to A for life, remainder as B appoints by an instrument filed with the trustee during B's lifetime, and in default of appointment remainder to C. B exercised the power in 1955 by directing that after A's death the income be paid to himself for life with remainder to C. If B dies after A, the entire value of the trust property would be included in B's gross estate, since such a disposition if it were a transfer of property owned by B would cause the property to be included in his gross estate under section 2036(a)(1). If B dies before A, the value of the trust property less the value of A's life estate would be included in B's gross estate for the same reason.

*Example (3).* S created a trust in 1940 to pay the income to A for life, remainder as A appoints by an instrument filed with the trustee during A's lifetime. A exercised the trustee during A's lifetime. A exercised the power in 1955, five years before his death, reserving the right of revocation. The exercise, if not revoked before death, will cause the property subject to the power to be included in A's gross estate under section 2041(a)(1), since such a disposition if it were a transfer of property owned by A would cause the property to be included in his gross estate under section 2038. However, if the exercise were completely revoked, so that A died still possessed of the power, the property would not be included in A's gross estate for the reason that the power will not be treated as having been exercised.

*Example (4).* A decedent exercised a general power of appointment created in 1940 by making a disposition in trust under which possession or enjoyment of the property subject to the exercise could be obtained only by surviving the decedent and under which the decedent retained a reversionary interest in the property of a value of more than five percent. The exercise will cause the property subject to the power to be included in the decedent's gross estate, since such a disposition if it were a transfer of property owned by the decedent would cause the property to

be included in his gross estate under section 2037.

(d) *Release or lapse.* A failure to exercise a general power of appointment created on or before October 21, 1942, or a complete release of such a power is not considered to be an exercise of a general power of appointment. The phrase ''a complete release'' means a release of all powers over all or a portion of the property subject to a power of appointment, as distinguished from the reduction of a power of appointment to a lesser power. Thus, if the decedent completely relinquished all powers over one-half of the property subject to a power of appointment, the power is completely released as to that one-half. If at or before the time a power of appointment is relinquished, the holder of the power exercises the power in such a manner or to such an extent that the relinquishment results in the reduction, enlargement, or shift in a beneficial interest in property, the relinquishment will be considered to be an exercise and not a release of the power. For example, assume that A created a trust in 1940 providing for payment on the income to B for life and, upon B's death, remainder to C. Assume further that B was given the unlimited power to amend the trust instrument during his lifetime. If B amended the trust in 1948 by providing that upon his death the remainder was to be paid to D, and if he further amended the trust in 1950 by deleting his power to amend the trust, such relinquishment will be considered an exercise and not a release of a general power of appointment. On the other hand, if the 1948 amendment became ineffective before or at the time of the 1950 amendment, or if B in 1948 merely amended the trust by changing the purely ministerial powers of the trustee, his relinquishment of the power in 1950 will be considered as a release of a power of appointment.

(e) *Partial release.* If a general power of appointment created on or before October 21, 1942, is partially released so that it is not thereafter a general power of appointment, a subsequent exercise of the partially released power is not an exercise of a general power of appointment if the partial release occurs before whichever is the later of the following dates:

(1) November 1, 1951, or

(2) If the decedent was under a legal disability to release the power on October 21, 1942, the day after the expiration of 6 months following the termination of such legal disability.

However, if a general power created on or before October 21, 1942, is partially released on or after the later of these dates, a subsequent exercise of the power will cause the property subject to the power to be included in the holder's gross estate, if the exercise is such that if it were a disposition of property owned by the decedent it would cause the property to be included in his gross estate. The legal disability referred to in this paragraph is determined under local law and may include the disability of an insane person, a minor, or an unborn child. The fact that the type of general power of appointment possessed by the decedent actually was not generally releasable under the local law does not place the decedent under a legal disability within the meaning of this paragraph. In general, however, it is assumed that all general powers of appointment are releasable, unless the local law on the subject is to the contrary, and it is presumed that the method employed to release the power is effective, unless it is not in accordance with the local law relating specifically to releases or, in the absence of such local law, is not in accordance with the local law relating to similar transactions.

(f) *Partial exercise.* If a general power of appointment created on or before October 21, 1942, is exercised only as to a portion of the property subject to the power, section 2041 is applicable only to the value of that portion. For example, if a decedent had a general power of appointment exercisable by will created on or before October 21, 1942, over a trust fund valued at $200,000 at the date of his death, and if the decedent exercised his power either to the extent of directing the distribution of one-half of the trust property to B or of directing the payment of $100,000 to B, the trust property would be includable in the decedent's gross estate only to the extent of $100,000.

**§ 20.2041–3 Powers of appointment created after October 21, 1942.**

(a) *In general.* (1) Property subject to a power of appointment created after October 21, 1942, is includable in the gross estate of the holder of the power under varying conditions depending on whether the power is (i) general in nature, (ii) possessed at death, or (iii) exercised or released. See paragraphs (b), (c), and (d) of § 20.2041–1 for the definition of various terms used in this section. See paragraph (c) of this section for the rules applicable to determine the extent to which joint powers created after October 21, 1942, are to be treated as general powers of appointment.

(2) If the power is a general power of appointment, the value of an interest in property subject to such a power is includable in a decedent's gross estate under section 2041(a)(2) if either—

(i) The decedent has the power at the time of his death (and the interest exists at the time of his death), or

(ii) The decedent exercised or released the power, or the power lapsed, under the circumstances and to the extent described in paragraph (d) of this section.

(3) If the power is not a general power of appointment, the value of property subject to the power is includable in the holder's gross estate under section 2041(a)(3) only if it is exercised to create a further power under certain circumstances (see paragraph (e) of this section).

(b) *Existence of power at death.* For purposes of section 2041(a)(2), a power of appointment is considered to exist on the date of a decedent's death even though the exercise of the power is subject to the precedent giving of notice, or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the decedent's death notice has been given or the power has been exercised. However, a power which by its terms is exercisable only upon the occurrence during the decedent's lifetime of an event or a contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent's death. For example, if a decedent was given a general power of appointment exercisable only after he reached a certain age, only if he survived another person, or only if he died without descendants, the power would not be in existence on the date of the decedent's death if the condition precedent to its exercise had not occurred.

(c) *Joint powers created after October 21, 1942.* The treatment of a power of appointment created after October 21, 1942, which is exercisable only in conjunction with another person is governed by section 2041(b)(1)(C), which provides as follows:

(1) Such a power is not considered a general power of appointment if it is not exercisable by the decedent except with the consent or joinder of the creator of the power.

(2) Such power is not considered a general power of appointment if it is not exercisable by the decedent except with the consent or joinder of a person having a substantial interest in the property subject to the power which is adverse to the exercise of the power in favor of the decedent, his estate, his creditors, or the creditors of his estate. An interest adverse to the exercise of a power is considered as substantial if its value in relation to the total value of the property subject to the power is not insignificant. For this purpose, the interest is to be valued in accordance with the actuarial principles set forth in § 20.2031–7 or, if it is not susceptible to valuation under those provisions, in accordance with the general principles set forth in § 20.2031–1. A taker in default of appointment under a power has an interest which is adverse to an exercise of the power. A coholder of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a coholder of a power is considered as having an adverse interest where he may possess the power after the decedent's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. Thus, for example, if X, Y, and Z held a power jointly to appoint among a group of persons which includes themselves and if on the death of X the power will pass to Y and Z jointly, then Y and Z are considered to have interests adverse to the exercise

of the power in favor of X. Similarly, if on Y's death the power will pass to Z, Z is considered to have an interest adverse to the exercise of the power in favor of Y. The application of this subparagraph may be further illustrated by the following additional examples in each of which it is assumed that the value of the interest in question is substantial:

*Example (1).* The decedent and R were trustees of a trust under the terms of which the income was to be paid to the decedent for life and then to M for life, and the remainder was to be paid to R. The trustees had power to distribute corpus to the decedent. Since R's interest was substantially adverse to an exercise of the power in favor of the decedent the latter did not have a general power of appointment. If M and the decedent were the trustees, M's interest would likewise have been adverse.

*Example (2).* The decedent and L were trustees of a trust under the terms of which the income was to be paid to L for life and then to M for life, and the remainder was to be paid to the decedent. The trustees had power to distribute corpus to the decedent during L's life. Since L's interest was adverse to an exercise of the power in favor of the decedent, the decedent did not have a general power of appointment. If the decedent and M were the trustees, M's interest would likewise have been adverse.

*Example (3).* The decedent and L were trustees of a trust under the terms of which the income was to be paid to L for life. The trustees could designate whether corpus was to be distributed to the decedent or to A after L's death. L's interest was not adverse to an exercise of the power in favor of the decedent, and the decedent therefore had a general power of appointment.

(3) A power which is exercisable only in conjunction with another person, and which after application of the rules set forth in subparagraphs (1) and (2) of this paragraph constitutes a general power of appointment, will be treated as though the holders of the power who are permissible appointees of the property were joint owners of property subject to the power. The decedent, under this rule, will be treated as possessed of a general power of appointment over an aliquot share of the property to be determined with reference to the number of joint holders, including the decedent, who (or whose estates or creditors) are permissible appointees. Thus, for example, if X, Y, and Z hold an unlimited power jointly to appoint among a group of persons, including themselves, but on the death of X the power does not pass to Y and Z jointly, then Y and Z are not considered to have interests adverse to the exercise of the power in favor of X. In this case X is considered to possess a general power of appointment as to one-third of the property subject to the power.

(d) *Releases, lapses, and disclaimers of general powers of appointment.* (1) Property subject to a general power of appointment created after October 21, 1942, is includable in the gross estate of a decedent under section 2041(a)(2) even though he does not have the power at the date of his death, if during his life he exercised or released the power under circumstances such that, if the property subject to the power had been owned and transferred by the decedent, the property would be includable in the decedent's gross estate under section 2035, 2036, 2037, or 2038. Further, section 2041(b)(2) provides that the lapse of a power of appointment is considered to be a release of the power to the extent set forth in subparagraph (3) of this paragraph. A release of a power of appointment need not be formal or express in character. The principles set forth in § 20.2041–2 for determining the application of the pertinent provisions of sections 2035 through 2038 to a particular exercise of a power of appointment are applicable for purposes of determining whether or not an exercise or release of a power of appointment created after October 21, 1942, causes the property to be included in a decedent's gross estate under section 2041(a)(2). If a general power of appointment created after October 21, 1942, is partially released, a subsequent exercise or release of the power under circumstances described in the first sentence of this subparagraph, or its possession at death will nevertheless cause the property subject to the power to be included in the gross estate of the holder of the power.

(2) Section 2041(a)(2) is not applicable to the complete release of a general power of appointment created after October 21, 1942, whether exercisable during life or by will, if the release was not made in contemplation of death within the meaning of section 2035, and if after the release the holder of the

power retained no interest in or control over the property subject to the power which would cause the property to be included in his gross estate under sections 2036 through 2038 if the property had been transferred by the holder.

(3) The failure to exercise a power of appointment created after October 21, 1942, within a specified time, so that the power lapses, constitutes a release of the power. However, section 2041(b)(2) provides that such a lapse of a power of appointment during any calendar year during the decedent's life is treated as a release for purposes of inclusion of property in the gross estate under section 2041(a)(2) only to the extent that the property which could have been appointed by exercise of the lapsed power exceeds the greater of (i) $5,000 or (ii) 5 percent of the aggregate value, at the time of the lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed power could have been satisfied. For example, assume that A transferred $200,000 worth of securities in trust providing for payment of income to B for life with remainder to B's issue. Assume further that B was given a noncumulative right to withdraw $10,000 a year from the principal of the trust fund (which neither increased nor decreased in value prior to B's death). In such case, the failure of B to exercise his right of withdrawal will not result in estate tax with respect to the power to withdraw $10,000 which lapses each year before the year of B's death. At B's death there will be included in his gross estate the $10,000 which he was entitled to withdraw for the year in which his death occurs less any amount which he may have taken during that year. However, if in the above example B had possessed the right to withdraw $15,000 of the principal annually, the failure to exercise such power in any year will be considered a release of the power to the extent of the excess of the amount subject to withdrawal over 5 percent of the trust fund (in this example, $5,000, assuming that the trust fund is worth $200,000 at the time of the lapse). Since each lapse is treated as though B had exercised dominion over the trust property by making a transfer of principal reserving the income therefrom for his life, the value of the trust property (but only to the extent of the excess of the amount subject to withdrawal over 5 percent of the trust fund) is includable in B's gross estate (unless before B's death he has disposed of his right to the income under circumstances to which sections 2035 through 2038 would not be applicable). The extent to which the value of the trust property is included in the decedent's gross estate is determined as provided in subparagraph (4) of this paragraph.

(4) The purpose of section 2041(b)(2) is to provide a determination, as of the date of the lapse of the power, of the proportion of the property over which the power lapsed which is an exempt disposition for estate tax purposes and the proportion which, if the other requirements of sections 2035 through 2038 are satisfied, will be considered as a taxable disposition. Once the taxable proportion of any disposition at the date of lapse has been determined, the valuation of that proportion as of the date of the decedent's death (or, if the executor has elected the alternate valuation method under section 2032, the value as of the date therein provided), is to be ascertained in accordance with the principles which are applicable to the valuation of transfers of property by the decedent under the corresponding provisions of sections 2035 through 2038. For example, if the life beneficiary of a trust had a right exercisable only during one calendar year to draw down $50,000 from the corpus of a trust, which he did not exercise, and if at the end of the year the corpus was worth $800,000, the taxable portion over which the power lapsed is $10,000 (the excess of $50,000 over 5 percent of the corpus), or 1/80 of the total value. On the decedent's death, if the total value of the corpus of the trust (excluding income accumulated after the lapse of the power) on the applicable valuation date was $1,200,000, $15,000 (1/80 of $1,200,000) would be includable in the decedent's gross estate. However, if the total value was then $600,000, only $7,500 (1/80 of $600,000) would be includable.

(5) If the failure to exercise a power, such as a right of withdrawal, occurs in more than a single year, the proportion

of the property over which the power lapsed which is treated as a taxable disposition will be determined separately for each such year. The aggregate of the taxable proportions for all such years, valued in accordance with the above principles, will be includable in the gross estate by reason of the lapse. The includable amount, however, shall not exceed the aggregate value of the assets out of which, or the proceeds of which, the exercise of the power could have been satisfied, valued as of the date of the decedent's death (or, if the executor has elected the alternate valuation method under section 2032, the value as of the date therein provided).

(6)(i) A disclaimer or renunciation of a general power of appointment created in a transfer made after December 31, 1976, is not considered to be the release of the power if the disclaimer or renunciation is a qualified disclaimer as described in section 2518 and the corresponding regulations. For rules relating to when the transfer creating the power occurs, see § 25.2518–2(c)(3) of this chapter. If the disclaimer or renunciation is not a qualified disclaimer, it is considered a release of the power by the disclaimant.

(ii) The disclaimer or renunication of a general power of appointment created in a taxable transfer before January 1, 1977, in the person disclaiming is not considered to be a release of the power. The disclaimer or renunciation must be unequivocal and effective under local law. A disclaimer is a complete and unqualified refusal to accept the rights to which one is entitled. There can be no disclaimer or renunciation of a power after its acceptance. In the absence of facts to the contrary, the failure to renounce or disclaim within a reasonable time after learning of its existence will be presumed to constitute an acceptance of the power. In any case where a power is purported to be disclaimed or renounced as to only a portion of the property subject to the power, the determination as to whether or not there has been a complete and unqualified refusal to accept the rights to which one is entitled will depend on all the facts and circumstances of the particular case, taking into account the recognition and effectiveness of such a disclaimer under local law. Such rights refer to the incidents of the power and not to other interests of the decedent in the property. If effective under local law, the power may be disclaimed or renounced without disclaiming or renouncing such other interests.

(iii) The first and second sentences of paragraph (d)(6)(i) of this section are applicable for transfers creating the power to be disclaimed made on or after December 31, 1997.

(e) *Successive powers.* (1) Property subject to a power of appointment created after October 21, 1942, which is not a general power, is includable in the gross estate of the holder of the power under section 2041(a)(3) if the power is exercised, and if both of the following conditions are met:

(i) If the exercise is (*a*) by will, or (*b*) by a disposition which is of such nature that if it were a transfer of property owned by the decedent, the property would be includable in the decedent's gross estate under sections 2035 through 2037; and

(ii) If the power is exercised by creating another power of appointment which, under the terms of the instruments creating and exercising the first power and under applicable local law, can be validly exercised so as to (*a*) postpone the vesting of any estate or interest in the property for a period ascertainable without regard to the date of the creation of the first power, or (*b*) (if the applicable rule against perpetuities is stated in terms of suspension of ownership or of the power of alienation, rather than of vesting) suspend the absolute ownership or the power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.

(2) For purposes of the application of section 2041(a)(3), the value of the property subject to the second power of appointment is considered to be its value unreduced by any precedent or subsequent interest which is not subject to the second power. Thus, if a decedent has a power to appoint by will $100,000 to a group of persons consisting of his children and grandchildren and exercises the power by making an outright appointment of $75,000 and by giving one appointee a power to appoint

$25,000, no more than $25,000 will be includable in the decedent's gross estate under section 2041(a)(3). If, however, the decedent appoints the income from the entire fund to a beneficiary for life with power in the beneficiary to appoint the remainder by will, the entire $100,000 will be includable in the decedent's gross estate under section 2041(a)(3) if the exercise of the second power can validly postpone the vesting of any estate or interest in the property or can suspend the absolute ownership or power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.

(f) *Examples.* The application of this section may be further illustrated by the following examples, in each of which it is assumed, unless otherwise stated, that S has transferred property in trust after October 21, 1942, with the remainder payable to R at L's death, and that neither L nor R has any interest in or power over the enjoyment of the trust property except as is indicated separately in each example:

*Example (1).* Income is directed to be paid to L during his lifetime at the end of each year, if living. L has an unrestricted power during his lifetime to cause the income to be distributed to any other person, but no power to cause it to be accumulated. At L's death, no part of the trust property is includable in L's gross estate since L had a power to dispose of only his income interest, a right otherwise possessed by him.

*Example (2).* Income is directed to be accumulated during L's life but L has a noncumulative power to distribute $10,000 of each year's income to himself. Unless L's power is limited to himself. Unless L's power is limited by an ascertainable standard (relating to his health, etc.), as defined in paragraph (c)(2) of § 20.2041–1, he has a general power of appointment over $10,000 of each year's income, the lapse of which may cause a portion of any income not distriibuted to be included in his gross estate under section 2041. See subparagraphs (3), (4), and (5) of paragraph (d) of this section. Thus, if the trust income during the year amounts to $20,000, L's failure to distribute any of the income to himself constitutes a lapse as to $5,000 (*i.e.*, the amount by which $10,000 exceeds $5,000). If L's power were cumulative (*i.e.*, if the power did not lapse at the end of each year but lapsed only by reason of L's death), the total accumulations which L chose not to distribute to himself immediately before his death would be includable in his gross estate under section 2041.

*Example (3).* L is entitled to all the income during his lifetime and has an unrestricted power to cause corpus to be distributed to himself. L had a general power of appointment over the corpus of the trust, and the entire corpus as of the time of his death is includable in his gross estate under section 2041.

*Example (4).* Income was payable to L during his lifetime. R has an unrestricted power to cause corpus to be distributed to L. R dies before L. In such case, R has only a power to dispose of his remainder interest, the value of which is includable in his gross estate under section 2033, and nothing in addition would be includable under section 2041. If in this example R's remainder were contingent on his surviving L, nothing would be includable in his gross estate under either section 2033 or 2041. While R would have a power of appointment, it would not be a general power.

*Example (5).* Income was payable to L during his lifetime. R has an unrestricted power to cause corpus to be distributed to himself. R dies before L. While the value of R's remainder interest is includable in his gross estate under section 2033, R also has a general power of appointment over the entire trust corpus. Under such circumstances, the entire value of the trust corpus is includable in R's gross estate under section 2041.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8095, 51 FR 28367, Aug. 7, 1986; T.D. 8744, 62 FR 68184, Dec. 31, 1997]

## § 20.2042–1 Proceeds of life insurance.

(a) *In general.* (1) Section 2042 provides for the inclusion in a decedent's gross estate of the proceeds of insurance on the decedent's life (i) receivable by or for the benefit of the estate (see paragraph (b) of this section) and (ii) receivable by other beneficiaries (see paragraph (c) of this section). The term ''insurance'' refers to life insurance of every description, including death benefits paid by fraternal beneficial societies operating under the lodge system.

(2) Proceeds of life insurance which are not includable in the gross estate under section 2042 may, depending upon the facts of the particular case, be includable under some other section of Part III of Subchapter A of Chapter 11. For example, if the decedent possessed incidents of ownership in an insurance policy on his life but gratuitously transferred all rights in the policy in contemplation of death, the proceeds would be includable under section 2035.

Section 2042 has no application to the inclusion in the gross estate of the value of rights in an insurance policy on the life of a person other than the decedent, or the value of rights in a combination annuity contract and life insurance policy on the decedent's life (*i.e.*, a ''retirement income'' policy with death benefit or an ''endowment'' policy) under which there was no insurance element at the time of the decedent's death (see paragraph (d) of § 20.2039–1).

(3) Except as provided in paragraph (c)(6), the amount to be included in the gross estate under section 2042 is the full amount receivable under the policy. If the proceeds of the policy are made payable to a beneficiary in the form of an annuity for life or for a term of years, the amount to be included in the gross estate is the one sum payable at death under an option which could have been exercised either by the insured or by the beneficiary, or if no option was granted, the sum used by the insurance company in determining the amount of the annuity.

(b) *Receivable by or for the benefit of the estate.* (1) Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent's life receivable by the executor or administrator, or payable to the decedent's estate. It makes no difference whether or not the estate is specifically named as the beneficiary under the terms of the policy. Thus, if under the terms of an insurance policy the proceeds are receivable by another beneficiary but are subject to an obligation, legally binding upon the other beneficiary, to pay taxes, debts, or other charges enforceable against the estate, then the amount of such proceeds required for the payment in full (to the extent of the beneficiary's obligation) of such taxes, debts, or other charges is includable in the gross estate. Similarly, if the decedent purchased an insurance policy in favor of another person or a corporation as collateral security for a loan or other accommodation, its proceeds are considered to be receivable for the benefit of the estate. The amount of the loan outstanding at the date of the decedent's death, with interest accrued to that date, will be deductible in determining the taxable estate. See § 20.2053–4.

(2) If the proceeds of an insurance policy made payable to the decedent's estate are community assets under the local community property law and, as a result, one-half of the proceeds belongs to the decedent's spouse, then only one-half of the proceeds is considered to be receivable by or for the benefit of the decedent's estate.

(c) *Receivable by other beneficiaries.* (1) Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent's life not receivable by or for the benefit of the estate if the decedent possessed at the date of his death any of the incidents of ownership in the policy, exercisable either alone or in conjunction with any other person. However, if the decedent did not possess any of such incidents of ownership at the time of his death nor transfer them in contemplation of death, no part of the proceeds would be includible in his gross estate under section 2042. Thus, if the decedent owned a policy of insurance on his life and, 4 years before his death, irrevocably assigned his entire interest in the policy to his wife retaining no reversionary interest therein (see subparagraph (3) of this paragraph), the proceeds of the policy would not be includible in his gross estate under section 2042.

(2) For purposes of this paragraph, the term ''incidents of ownership'' is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. See subparagraph (6) of this paragraph for rules relating to the circumstances under which incidents of ownership held by a corporation are attributable to a decedent through his stock ownership.

(3) The term ''incidents of ownership'' also includes a reversionary interest in the policy or its proceeds, whether arising by the express terms of

the policy or other instrument or by operation of law, but only if the value of the reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy.

As used in this subparagraph, the term ''reversionary interest'' includes a possibility that the policy or its proceeds may return to the decedent or his estate and a possibility that the policy or its proceeds may become subject to a power of disposition by him. In order to determine whether or not the value of a reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy, the principles contained in paragraph (c) (3) and (4) of § 20.2037–1, insofar as applicable, shall be followed under this subparagraph. In that connection, there must be specifically taken into consideration any incidents of ownership-held by others immediately before the decedent's death which would affect the value of the reversionary interest. For example, the decedent would not be considered to have a reversionary interest in the policy of a value in excess of 5 percent if the power to obtain the cash surrender value existed in some other person immediately before the decedent's death and was exercisable by such other person alone and in all events. The terms ''reversionary interest'' and ''incidents of ownership'' do not include the possibility that the decedent might receive a policy or its proceeds by inheritance through the estate of another person, or as a surviving spouse under a statutory right of election or a similar right.

(4) A decedent is considered to have an ''incident of ownership'' in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust. Moreover, assuming the decedent created the trust, such a power may result in the inclusion in the decedent's gross estate under section 2036 or 2038 of other property transferred by the decedent to the trust if, for example, the decedent has the power to surrender the insurance policy and if the income otherwise used to pay premiums on the policy would become currently payable to a beneficiary of the trust in the event that the policy were surrendered.

(5) As an additional step in determining whether or not a decedent possessed any incidents of ownership in a policy or any part of a policy, regard must be given to the effect of the State or other applicable law upon the terms of the policy. For example, assume that the decedent purchased a policy of insurance on his life with funds held by him and his surviving wife as community property, designating their son as beneficiary but retaining the right to surrender the policy. Under the local law, the proceeds upon surrender would have inured to the marital community. Assuming that the policy is not surrendered and that the son receives the proceeds on the decedent's death, the wife's transfer of her one-half interest in the policy was not considered absolute before the decedent's death. Upon the wife's prior death, one-half of the value of the policy would have been included in her gross estate. Under these circumstances, the power of surrender possessed by the decedent as agent for his wife with respect to one-half of the policy is not, for purposes of this section, an ''incident of ownership'', and the decedent is, therefore, deemed to possess an incident of ownership in only one-half of the policy.

(6) In the case of economic benefits of a life insurance policy on the decedent's life that are reserved to a corporation of which the decedent is the sole or controlling stockholders, the corporations' incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation. Any proceeds payable to a third party for a valid business purpose, such as in satisfaction of a business debt of the corporation, so that the net worth of the corporation is increased by the amount of such proceeds, shall be deemed to be payable to the corporation for purposes of the preceeding sentence. See § 20.2031–2(f) for a rule providing that

the proceeds of certain life insurance policies shall be considered in determining the value of the decedent's stock. Except as hereinafter provided with respect to a group-term life insurance policy, if any part of the proceeds of the policy are not payable to or for the benefit of the corporation, and thus are not taken into account in valuing the decedent's stock holdings in the corporation for purposes of section 2031, any incidents of ownership held by the corporation as to that part of the proceeds will be attributed to the decedent through his stock ownership where the decedent is the sole or controlling stockholder. Thus, for example, if the decedent is the controlling stockholder in a corporation, and the corporation owns a life insurance policy on his life, the proceeds of which are payable to the decedent's spouse, the incidents of ownership held by the corporation will be attributed to the decedent through his stock ownership and the proceeds will be included in his gross estate under section 2042. If in this example the policy proceeds had been payable 40 percent to decedent's spouse and 60 percent to the corporation, only 40 percent of the proceeds would be included in decedent's gross estate under section 2042. For purposes of this subparagraph, the decedent will not be deemed to be the controlling stockholder of a corporation unless, at the time of his death, he owned stock possessing more than 50 percent of the total combined voting power of the corporation. Solely for purposes of the preceding sentence, a decedent shall be considered to be the owner of only the stock with respect to which legal title was held, at the time of his death, by (i) the decedent (or his agent or nominee); (ii) the decedent and another person jointly (but only the proportionate number of shares which corresponds to the portion of the total consideration which is considered to be furnished by the decedent for purposes of section 2040 and the regulations thereunder); and (iii) by a trustee of a voting trust (to the extent of the decedent's beneficial interest therein) or any other trust with respect to which the decedent was treated as an owner under Subpart E, Part I, Subchapter J, Chapter I of the Code immediately prior to his death. In the case of group-term life insurance, as defined in the regulations under section 79, the power to surrender or cancel a policy held by a corporation shall not be attributed to any decedent through his stock ownership.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960 as amended by T.D. 7312, 39 FR 14949, Apr. 29, 1974; T.D. 7623, 44 FR 28800, May 17, 1979]

### § 20.2043–1 Transfers for insufficient consideration.

(a) *In general.* The transfers, trusts, interests, rights or powers enumerated and described in sections 2035 through 2038 and section 2041 are not subject to the Federal estate tax if made, created, exercised, or relinquished in a transaction which constituted a bona fide sale for an adequate and full consideration in money or money's worth. To constitute a bona fide sale for an adequate and full consideration in money or money's worth, the transfer must have been made in good faith, and the price must have been an adequate and full equivalent reducible to a money value. If the price was less than such a consideration, only the excess of the fair market value of the property (as of the applicable valuation date) over the price received by the decedent is included in ascertaining the value of his gross estate.

(b) *Marital rights and support obligations.* For purposes of chapter 11, a relinquishment or promised relinquishment or dower, curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, is not to any extent a consideration in ''money or money's worth.''

### § 20.2044–1 Certain property for which marital deduction was previously allowed.

(a) *In general.* Section 2044 generally provides for the inclusion in the gross estate of property in which the decedent had a qualifying income interest for life and for which a deduction was allowed under section 2056(b)(7) or 2523(f). The value of the property included in the gross estate under section 2044 is not reduced by the amount of

any section 2503(b) exclusion that applied to the transfer creating the interest. See section 2207A, regarding the right of recovery against the persons receiving the property that is applicable in certain cases.

(b) *Passed from.* For purposes of section 1014 and chapters 11 and 13 of subtitle B of the Internal Revenue Code, property included in a decedent's gross estate under section 2044 is considered to have been acquired from or to have passed from the decedent to the person receiving the property upon the decedent's death. Thus, for example, the property is treated as passing from the decedent for purposes of determining the availability of the charitable deduction under section 2055, the marital deduction under section 2056, and special use valuation under section 2032A. In addition, the tax imposed on property includible under section 2044 is eligible for the installment payment of estate tax under section 6166.

(c) *Presumption.* Unless established to the contrary, section 2044 applies to the entire value of the trust at the surviving spouse's death. If a marital deduction is taken on either the estate or gift tax return with respect to the transfer which created the qualifying income interest, it is presumed that the deduction was allowed for purposes of section 2044. To avoid the inclusion of property in the decedent-spouse's gross estate under this section, the executor of the spouse's estate must establish that a deduction was not taken for the transfer which created the qualifying income interest. For example, to establish that a deduction was not taken, the executor may produce a copy of the estate or gift tax return filed with respect to the transfer by the first spouse or the first spouse's estate establishing that no deduction was taken under section 2523(f) or section 2056(b)(7). In addition, the executor may establish that no return was filed on the original transfer by the decedent because the value of the first spouse's gross estate was below the threshold requirement for filing under section 6018. Similarly, the executor could establish that the transfer creating the decedent's qualifying income interest for life was made before the effective date of section 2056(b)(7) or section 2523(f).

(d) *Amount included*—(1) *In general.* The amount included under this section is the value of the entire interest in which the decedent had a qualifying income interest for life, determined as of the date of the decedent's death (or the alternate valuation date, if applicable). If, in connection with the transfer of property that created the decedent's qualifying income interest for life, a deduction was allowed under section 2056(b)(7) or section 2523(f) for less than the entire interest in the property (i.e., for a fractional or percentage share of the entire interest in the transferred property), the amount includible in the decedent's gross estate under this section is equal to the fair market value of the entire interest in the property on the date of the decedent's death (or the alternate valuation date, if applicable) multiplied by the fractional or percentage share of the interest for which the deduction was taken.

(2) *Inclusion of income.* If any income from the property for the period between the date of the transfer creating the decedent-spouse's interest and the date of the decedent-spouse's death has not been distributed before the decedent-spouse's death, the undistributed income is included in the decedent-spouse's gross estate under this section to the extent that the income is not so included under any other section of the Internal Revenue Code.

(3) *Reduction of includible share in certain cases.* If only a fractional or percentage share is includible under this section, the includible share is appropriately reduced if—

(i) The decedent-spouse's interest was in a trust and distributions of principal were made to the spouse during the spouse's lifetime;

(ii) The trust provides that the distributions are to be made from the qualified terminable interest share of the trust; and

(iii) The executor of the decedent-spouse's estate can establish the reduction in that share based on the fair market value of the trust assets at the time of each distribution.

(4) *Interest in previously severed trust.* If the decedent-spouse's interest was in

a trust consisting of only qualified terminable interest property and the trust was severed (in compliance with § 20.2056(b)–7(b) or § 25.2523(f)–1(b) of this chapter) from a trust that, after the severance, held only property that was not qualified terminable interest property, only the value of the property in the severed portion of the trust is includible in the decedent-spouse's gross estate.

(e) *Examples.* The following examples illustrate the principles in paragraphs (a) through (d) of this section, where the decedent, D, was survived by spouse, S.

*Example 1. Inclusion of trust subject to election.* Under D's will, assets valued at $800,000 in D's gross estate (net of debts, expenses and other charges, including death taxes, payable from the property) passed in trust with income payable to S for life. Upon S's death, the trust principal is to be distributed to D's children. D's executor elected under section 2056(b)(7) to treat the entire trust property as qualified terminable interest property and claimed a marital deduction of $800,000. S made no disposition of the income interest during S's lifetime under section 2519. On the date of S's death, the fair market value of the trust property was $740,000. S's executor did not elect the alternate valuation date. The amount included in S's gross estate pursuant to section 2044 is $740,000.

*Example 2. Inclusion of trust subject to partial election.* The facts are the same as in *Example 1,* except that D's executor elected under section 2056(b)(7) with respect to only 50 percent of the value of the trust ($400,000). Consequently, only the equivalent portion of the trust is included in S's gross estate; i.e., $370,000 (50 percent of $740,000).

*Example 3. Spouse receives qualifying income interest in a fraction of trust income.* Under D's will, assets valued at $800,000 in D's gross estate (net of debts, expenses and other charges, including death taxes, payable from the property) passed in trust with 20 percent of the trust income payable to S for S's life. The will provides that the trust principal is to be distributed to D's children upon S's death. D's executor elected to deduct, pursuant to section 2056(b)(7), 50 percent of the amount for which the election could be made; i.e., $80,000 (50 percent of 20 percent of $800,000). Consequently, on the death of S, only the equivalent portion of the trust is included in S's gross estate; i.e., $74,000 (50 percent of 20 percent of $740,000).

*Example 4. Distribution of corpus during spouse's lifetime.* The facts are the same as in *Example 3,* except that S was entitled to receive all the trust income but the executor of D's estate elected under section 2056(b)(7) with respect to only 50 percent of the value of the trust ($400,000). Pursuant to authority in the will, the trustee made a discretionary distribution of $100,000 of principal to S in 1995 and charged the entire distribution to the qualified terminable interest share. Immediately prior to the distribution, the fair market value of the trust property was $1,100,000 and the qualified terminable interest portion of the trust was 50 percent. Immediately after the distribution, the qualified terminable interest portion of the trust was 45 percent ($450,000 divided by $1,000,000). Provided S's executor can establish the relevant facts, the amount included in S's gross estate is $333,000 (45 percent of $740,000).

*Example 5. Spouse assigns a portion of income interest during life.* Under D's will, assets valued at $800,000 in D's gross estate (net of debts, expenses and other charges, including death taxes, payable from the property) passed in trust with all the income payable to S, for S's life. The will provides that the trust principal is to be distributed to D's children upon S's death. D's executor elected under section 2056(b)(7) to treat the entire trust property as qualified terminable interest property and claimed a marital deduction of $800,000. During the term of the trust, S transfers to C the right to 40 percent of the income from the trust for S's life. Because S is treated as transferring the entire remainder interest in the trust corpus under section 2519 (as well as 40 percent of the income interest under section 2511), no part of the trust is includible in S's gross estate under section 2044. However, if S retains until death an income interest in 60 percent of the trust corpus (which corpus is treated pursuant to section 2519 as having been transferred by S for both gift and estate tax purposes), 60 percent of the property will be includible in S's gross estate under section 2036(a) and a corresponding adjustment is made in S's adjusted taxable gifts.

*Example 6. Inter vivos trust subject to election under section 2523(f).* D transferred $800,000 to a trust providing that trust income is to be paid annually to S, for S's life. The trust provides that upon S's death, $100,000 of principal is to be paid to X charity and the remaining principal distributed to D's children. D elected to treat all of the property transferred to the trust as qualified terminable interest property under section 2523(f). At the time of S's death, the fair market value of the trust is $1,000,000. S's executor does not elect the alternate valuation date. The amount included in S's gross estate is $1,000,000; i.e., the fair market value at S's death of the entire trust property. The $100,000 that passes to X charity on S's death is treated as a transfer by S to X charity for purposes of section 2055. Therefore, S's estate is allowed a charitable deduction for the $100,000 transferred from the trust to the charity to the same extent that a deduction

would be allowed by section 2055 for a bequest by S to X charity.

*Example 7. Spousal interest in the form of an annuity.* D died prior to October 24, 1992, the effective date of the Energy Policy Act of 1992 (Pub. L. 102–486). See § 20.2056(b)–7(e). Under D's will, assets valued at $500,000 in D's gross estate (net of debts, expenses and other charges, including death taxes, payable from the property) passed in trust pursuant to which an annuity of $20,000 a year was payable to S for S's life. Trust income not paid to S as an annuity is to be accumulated in the trust and may not be distributed during S's lifetime. D's estate deducted $200,000 under section 2056(b)(7) and § 20.2056(b)–7(e)(2). S did not assign any portion of S's interest during S's life. At the time of S's death, the value of the trust property is $800,000. S's executor does not elect the alternate valuation date. The amount included in S's gross estate pursuant to section 2044 is $320,000 ([$200,000/$500,000] x $800,000).

*Example 8. Inclusion of trust property when surviving spouse dies before first decedent's estate tax return is filed.* D dies on July 1, 1997. Under the terms of D's will, a trust is established for the benefit of D's spouse, S. The will provides that S is entitled to receive the income from that portion of the trust that the executor elects to treat as qualified terminable interest property. The remaining portion of the trust passes as of D's date of death to a trust for the benefit of C, D's child. The trust terms otherwise provide S with a qualifying income interest for life under section 2056(b)(7)(B)(ii). S dies on February 10, 1998. On April 1, 1998, D's executor files D's estate tax return on which an election is made to treat a portion of the trust as qualified terminable interest property under section 2056(b)(7). S's estate tax return is filed on November 10, 1998. The value on the date of S's death of the portion of the trust for which D's executor made a QTIP election is includible in S's gross estate under section 2044.

[T.D. 8522, 59 FR 9646, Mar. 1, 1994, as amended by T.D. 8779, 63 FR 44393, Aug. 19, 1998]

### § 20.2044–2 Effective dates.

Except as specifically provided in *Example 7* of § 20.2044–1(e), the provisions of § 20.2044–1 are effective with respect to estates of a decedent-spouse dying after March 1, 1994. With respect to estates of decedent-spouses dying on or before such date, taxpayers may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of § 20.2044–1 (as well as project LR–211–76, 1984–1 C.B., page 598, see § 601.601(d)(2)(ii)(*b*) of this chapter), are considered a reasonable interpretation of the statutory provisions.

[T.D. 8522, 59 FR 9647, Mar. 1, 1994]

### § 20.2045–1 Applicability to pre-existing transfers or interests.

Sections 2034 through 2042 are applicable regardless of when the interests and events referred to in those sections were created or took place, except as otherwise provided in those sections and the regulations thereunder.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958; 25 FR 14021, Dec. 31, 1960. Redesignated by T.D. 8522, 59 FR 9646, Mar. 1, 1994]

### § 20.2046–1 Disclaimed property.

(a) This section shall apply to the disclaimer or renunciation of an interest in the person disclaiming by a transfer made after December 31, 1976. For rules relating to when the transfer creating the interest occurs, see § 25.2518–2(c)(3) and (c)(4) of this chapter. If a qualified disclaimer is made with respect to such a transfer, the Federal estate tax provisions are to apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer. See section 2518 and the corresponding regulations for rules relating to a qualified disclaimer.

(b) The first and second sentences of this section are applicable for transfers creating the interest to be disclaimed made on or after December 31, 1997.

[T.D. 8744, 62 FR 68184, Dec. 31, 1997]

## ACTUARIAL TABLES APPLICABLE BEFORE MAY 1, 1989

### § 20.2031–7A Valuation of annuities, interests for life or term of years, and remainder or reversionary interests for estates of decedents for which the valuation date of the gross estate is before May 1, 1989.

(a) *Valuation of annuities, interests for life or term of years, and remainder or reversionary interests for estates of decedents for which the valuation date of the gross estate is before January 1, 1952.* Except as otherwise provided in § 20.2031–7(b), if the valuation date of the decedent's gross estate is before January 1, 1952, the present value of annuities, life estates, terms for years, remainders, and reversions is their present value

determined under this section. If the valuation of the interest involved is dependent upon the continuation or termination of one or more lives or upon a term certain concurrent with one or more lives, the factor for the present value is computed on the basis of interest at the rate of 4 percent a year, compounded annually, and life contingencies as to each life involved from values that are based on the Actuaries' or Combined Experience Table of Mortality, as extended. This table and related factors are described in former § 81.10 (as contained in the 26 CFR part 81 edition revised as of April 1, 1958). The present value of an interest measured by a term of years is computed on the basis of interest at the rate of 4 percent a year.

(b) *Valuation of annuities, interests for life or term of years, and remainder or reversionary interests for estates of decedents for which the valuation date of the gross estate is after December 31, 1951, and before January 1, 1971.* Except as otherwise provided in § 20.2031–7(b), if the valuation date for the decedent's gross estate is after December 31, 1951, and before January 1, 1971, the present value of annuities, life estates, terms of years, remainders, and reversions is their present value determined under this section. If the valuation of the interest involved is dependent upon the continuation or termination of one or more lives, or upon a term certain concurrent with one or more lives, the factor for the present value is computed on the basis of interest at the rate of 3½ percent a year, compounded annually, and life contingencies as to each life involved are taken from U.S. Life Table 38. This table and related factors are set forth in former § 20.2031–7 (as contained in the 26 CFR part 20 edition revised as of April 1, 1984). Special factors involving one and two lives may be found in or computed with the use of tables contained in the publication entitled ''Actuarial Values for Estate and Gift Tax,'' Internal Revenue Service Publication Number 11 (Rev. 5–59). This publication is no longer available for purchase from the Superintendent of Documents. However, it may be obtained by requesting a copy from: CC:DOM:CORP:T:R (IRS Publication 11), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. The present value of an interest measured by a term of years is computed on the basis of interest at the rate of 3½ percent a year.

(c) *Valuation of annuities, interests for life or term of years, and remainder or reversionary interests for estates of decedents for which the valuation date of the gross estate is after December 31, 1970, and before December 1, 1983.* Except as otherwise provided in § 20.2031–7(b), if the valuation date of the decedent's gross estate is after December 31, 1970, and before December 1, 1983, the present value of annuities, life estates, terms of years, remainders, and reversions is their present value determined under this section. If the valuation of the interest involved is dependent upon the continuation of or termination of one or more lives or upon a term certain concurrent with one or more lives, the factor for the present value is computed on the basis of interest at the rate of 6 percent a year, compounded annually, and life contingencies are determined as to each male and female life involved, from values that are set forth in Table LN. Table LN contains values that are taken from the life table for total males and the life table for total females appearing as Tables 2 and 3, respectively, in United States Life Tables: 1959– 1960, published by the Department of Health and Human Services, Public Health Service. Table LN and related factors are set forth in former § 20.2031–10 (as contained in the 26 CFR part 20 edition revised as of April 1, 1994). Special factors involving one and two lives may be found in or computed with the use of tables contained in Internal Revenue Service Publication 723, ''Actuarial Values I: Valuation of Last Survivor Charitable Remainders,'' (12–70), and Internal Revenue Service Publication 723A, ''Actuarial Values II: Factors at 6 Percent Involving One and Two Lives,'' (12–70). These publications are no longer available for purchase from the Superintendent of Documents. However, a copy of each may be obtained from: CC:DOM:CORP:T:R (IRS Publication 723/723A), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044.

(d) *Valuation of annuities, interests for life or term of years, and remainder or reversionary interests for estates of decedents for which the valuation date of the gross estate is after November 30, 1983, and before May 1, 1989*—(1) *In general.* (i) Except as otherwise provided in § 20.2031–7(b), if the decedent died after November 30, 1983, and the valuation date for the gross estate is before May 1, 1989, the fair market value of annuities, life estates, terms of years, remainders, and reversions is their present value determined under this section. If the decedent died after November 30, 1983, and before August 9, 1984, or, in cases where the valuation date of the decedent's gross estate is before May 1, 1989, if, on December 1, 1983, the decedent was mentally incompetent so that the disposition of the decedent's property could not be changed, and the decedent died on or after December 1, 1983, without having regained competency to dispose of the decedent's property, or if the decedent died within 90 days of the date on which the decedent first regained competency, the fair market value of annuities, life estates, terms for years, remainders, and reversions included in the gross estate of such decedent is their present value determined under either this section or § 20.2031–7A(c), at the option of the taxpayer. The value of annuities issued by companies regularly engaged in their sale, and of insurance policies on the lives of persons other than the decedent, is determined under § 20.2031–8. The fair market value of a remainder interest in a charitable remainder unitrust, as defined in § 1.664–3 of this chapter, is its present value determined under § 1.664–4 of this chapter. The fair market value of a life interest or term for years in a charitable remainder unitrust is the fair market value of the property as of the date of valuation less the fair market value of the remainder interest on such date determined under § 1.664–4 of this chapter. The fair market value of the interests in a pooled income fund, as defined in § 1.642(c)–5 of this chapter, is their value determined under § 1.642(c)–6 of this chapter.

(ii) The present value of an annuity, life estate, remainder, or reversion determined under this section which is dependent on the continuation or termination of the life of one person is computed by the use of Table A in paragraph (d)(6) of this section. The present value of an annuity, term for years, remainder, or reversion dependent on a term certain is computed by the use of Table B in paragraph (d)(6) of this section. If the interest to be valued is dependent upon more than one life or there is a term certain concurrent with one or more lives, see paragraph (d)(5) of this section. For purposes of the computations described in this section, the age of a person is to be taken as the age of that person at his or her nearest birthday.

(iii) In all examples set forth in this section, the decedent is assumed to have died on or after August 9, 1984, with the valuation date of the decedent's gross estate before May 1, 1989, and to have been competent to change the disposition of the property on December 1, 1983.

(2) *Annuities.* (i) If an annuity is payable annually at the end of each year during the life of an individual (as for example if the first payment is due one year after the decedent's death), the amount payable annually is multiplied by the figure in column 2 of Table A opposite the number of years in coumn 1 nearest the age of the individual whose life measures the duration of the annuity. If the annuity is payable annually at the end of each of year for a definite number of years, the amount payable annually is multiplied by the figure in column 2 of Table B opposite the number of years in column 1 representing the duration of the annuity. The application of this paragraph (d)(2)(i) may be illustrated by the following examples:

*Example (1).* The decedent received, under the terms of the decedent's father's will an annuity of $10,000 a year payable annually for the life of the decedent's elder brother. At the time the decedent died, an annual payment had just been made. The brother at the decedent's death was 40 years eight months old. By reference to Table A, the figure in column 2 opposite 41 years, the number nearest to the brother's actual age, is found to be 9.1030. The present value of the annuity at the date of the decedent's death is, therefore, $91,030 ($10,000 x 9.1030).

*Example (2).* The decedent was entitled to receive an annuity of $10,000 a year payable

annually throughout a term certain. At the time the decedent died, the annual payment had just been made and five more annual payments were still to be made. By reference to Table B, it is found that the figure in column 2 opposite five years is 3.7908. The present value of the annuity is, therefore, $37,908 ($10,000 x 3.7808).

(ii) If an annuity is payable at the end of semiannual, quarterly, monthly, or weekly periods during the life of an individual (as for example if the first payment is due one month after the decedent's death), the aggregate amount to be paid within a year is first multiplied by the figure in column 2 of Table A opposite the number of years in column 1 nearest the age of the individual whose life measures the duration of the annuity. The product so obtained is then multiplied by whichever of the following factors is appropriate:

1.0244 for semiannual payments,
1.0368 for quarterly payments,
1.0450 for monthly payments,
1.0482 for weekly payments.

If the annuity is payable at the end of semiannual, quarterly, monthly, or weekly periods for a definite number of years, the aggregate amount to be paid within a year is first multiplied by the figure in column 2 of Table B opposite the number of years in column 1 representing the duration of the annuity. The product so obtained is then multiplied by whichever of the above factors is appropriate. The application of this paragraph (d)(2)(ii) may be illustrated by the following example:

*Example.* The facts are the same as those contained in example (1) set forth in paragraph (d)(2)(i) of this section, except that the annuity is payable semiannually. The aggregate annual amount, $10,000, is multiplied by the factor 9.1030 and the product multiplied by 1.0244. The present value of the annuity at the date of the decedent's death is, therefore, $93,251.13 ($10,000 x 9.1030 x 1.0244).

(iii)(A) If the first payment of an annuity for the life of an individual is due at the beginning of the annual or other payment period rather than at the end (as for example if the first payment is to be made immediately after the decedent's death), the value of the annuity is the sum of (A) the first payment plus (B) the present value of a similar annuity, the first payment of which is not to be made until the end of the payment period, determined as provided in paragraphs (d)(2)(i) or (ii) of this section. the application of this paragraph (d)(2)(iii)(A) may be illustrated by the following example:

*Example.* The decedent was entitled to receive an annuity of $50 a month during the life of another person. The decedent died on the date the payment was due. At the date of the decedent's death, the person whose life measures the duration of the annuity was 50 years of age. The value of the annuity at the date of the decedent's death is $50 plus the product of $50×12×8.4743 (see Table A)×1.0450 (See paragraph (d)(2)(ii) of this section). That is $50 plus $5,313.39, or $5,363.39.

(B) If the first payment of an annuity for a definite number of years is due at the beginning of the annual or other payment period, the applicable factor is the product of the factor shown in Table B multiplied by whichever of the following factors is appropriate:

1.1000 for annual payments,
1.0744 for semiannual payments,
1.0618 for quarterly payments,
1.0534 for monthly payments,
1.0502 for weekly payments.

The application of this paragraph (d)(2)(iii)(B) may be illustrated by the following example:

*Example.* The decedent was the beneficiary of an annuity of $50 a month. On the day a payment was due, the decedent died. There were 300 payments to be made, including the payment due. The value of the annuity as of the date of decedent's death is the product of $50×12×9.0770 (see Table B)×1.0534, or $5,737.03.

(3) *Life estates and terms for years.* If the interest to be valued is the right of a person for his or her life, or for the life of another person, to receive the income of certain property or to use nonincome-producing property, the value of the interest is the value of the property multiplied by the figure in column 3 of Table A opposite the number of years nearest to the actual age of the measuring life. If the interest to be valued is the right to receive income of property or to use nonincome-producing property for a term of years, column 3 of Table B is used. The application of this paragraph (d)(3) may be illustrated by the following example:

*Example.* The decedent or the decedent's estate was entitled to receive the income from a fund of $50,000 during the life of the decedent's elder brother. Upon the brother's

death, the remainder is to go to B. The brother was 31 years, five months old at the time of decedent's death. By reference to Table A the figure in column 3 opposite 31 years is found to be 0.95254. The present value of the decedent's interest is, therefore, $47,627 ($50,000×0.95254).

(4) *Remainders or reversionary interests.* If a decedent had, at the time of the decedent's death, a remainder or a reversionary interest in property to take effect after an estate for the life of another, the present value of the decedent's interest is obtained by multiplying the value of the property by the figure in column 4 of Table A opposite the number of years nearest to the actual age of the person whose life measures the preceding estate. If the remainder or reversion is to take effect at the end of the term for years, column 4 of Table B is used. The application of this paragraph (d)(4) may be illustrated by the following example:

*Example.* The decedent was entitled to receive certain property worth $50,000 upon the death of the decedent's elder sister, to whom the income was bequeathed for life. At the time of the decedent's death, the elder sister was 31 years five months old. By reference to Table A the figure in column 4 opposite 31 years is found to be .04746. The present value of the remainder interest at the date of the decedent's death is, therefore, $2,373 ($50,000×.04746).

(5) *Actuarial computations by the Internal Revenue Service.* If the valuation of the interest involved is dependent upon the continuation or the termination of more than one life or upon a term certain concurrent with one or more lives a special factor must be used. The factor is to be computed on the basis of interest at the rate of 10 percent a year, compounded annually, and life contingencies determined, as to each person involved, from the values of lx that are set forth in column 2 of Table LN of paragraph (d)(6). Table LN contains values of *lx* taken from the life table for the total population appearing as Table 1 of United States Life Tables: 1969–71, published by the Department of Health and Human Services, Public Health Service. Many special factors involving one and two lives may be found in or computed with the use of the tables contained in Internal Revenue Service Publication 723E, ''Actuarial Values II: Factors at 10 Percent Involving One and Two Lives,'' (12–83). This publication is no longer available for purchase from the Superintendent of Documents. However, it may be obtained by requesting a copy from: CC:DOM:CORP:T:R (IRS Publication 723E), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. However, if a special factor is required in the case of an actual decedent, the Commissioner will furnish the factor to the executor upon request. The request must be accompanied by a statement of the date of birth of each person, the duration of whose life may affect the value of the interest, and by copies of the relevant instruments. Special factors are not furnished for prospective transfers.

(6) *Tables.* The following tables shall be used in the application of the provisions of this section:

TABLE A—SINGLE LIFE, UNISEX, 10 PERCENT—TABLE SHOWING THE PRESENT WORTH OF AN ANNUITY, OF A LIFE ESTATE, AND A REMAINDER INTEREST—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

| (1) Age | (2) Annuity | (3) Life estate | (4) Remainder |
|---|---|---|---|
| 0 | 9.7188 | .97188 | .02812 |
| 1 | 9.8988 | .98988 | .01012 |
| 2 | 9.9017 | .99017 | .00983 |
| 3 | 9.9008 | .99008 | .00992 |
| 4 | 9.8981 | .98981 | .01019 |
| 5 | 9.8938 | .98938 | .01062 |
| 6 | 9.8884 | .98884 | .01116 |
| 7 | 9.8822 | .98822 | .01178 |
| 8 | 9.8748 | .98748 | .01252 |
| 9 | 9.8663 | .98663 | .01337 |
| 10 | 9.8565 | .98565 | .01435 |
| 11 | 9.8453 | .98453 | .01547 |
| 12 | 9.8329 | .98329 | .01671 |
| 13 | 9.8198 | .98198 | .01802 |
| 14 | 9.8066 | .98066 | .01934 |
| 15 | 9.7937 | .97937 | .02063 |
| 16 | 9.7815 | .97815 | .02185 |
| 17 | 9.7700 | .97700 | .02300 |
| 18 | 9.7590 | .97590 | .02410 |
| 19 | 9.7480 | .97480 | .02520 |
| 20 | 9.7365 | .97365 | .02635 |
| 21 | 9.7245 | .97245 | .02755 |
| 22 | 9.7120 | .97120 | .02880 |
| 23 | 9.6986 | .96986 | .03014 |
| 24 | 9.6841 | .96841 | .03159 |
| 25 | 9.6678 | .96678 | .03322 |
| 26 | 9.6495 | .96495 | .03505 |
| 27 | 9.6290 | .96290 | .03710 |
| 28 | 9.6062 | .96062 | .03938 |
| 29 | 9.5813 | .95813 | .04187 |
| 30 | 9.5543 | .95543 | .04457 |
| 31 | 9.5254 | .95254 | .04746 |
| 32 | 9.4942 | .94942 | .05058 |
| 33 | 9.4608 | .94608 | .05392 |
| 34 | 9.4250 | .94250 | .05750 |
| 35 | 9.3868 | .93868 | .06132 |

TABLE A—SINGLE LIFE, UNISEX, 10 PERCENT—TABLE SHOWING THE PRESENT WORTH OF AN ANNUITY, OF A LIFE ESTATE, AND A REMAINDER INTEREST—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989—Continued

| (1) Age | (2) Annuity | (3) Life estate | (4) Remainder |
|---|---|---|---|
| 36 | 9.3460 | .93460 | .06540 |
| 37 | 9.3026 | .93026 | .06974 |
| 38 | 9.2567 | .92567 | .07433 |
| 39 | 9.2083 | .92083 | .07917 |
| 40 | 9.1571 | .91571 | .08429 |
| 41 | 9.1030 | .91030 | .08970 |
| 42 | 9.0457 | .90457 | .09543 |
| 43 | 8.9855 | .89855 | .10145 |
| 44 | 8.9221 | .89221 | .10779 |
| 45 | 8.8558 | .88558 | .11442 |
| 46 | 8.7863 | .87863 | .12137 |
| 47 | 8.7137 | .87137 | .12863 |
| 48 | 8.6374 | .86374 | .13626 |
| 49 | 8.5578 | .85578 | .14422 |
| 50 | 8.4743 | .84743 | .15257 |
| 51 | 8.3874 | .83874 | .16126 |
| 52 | 8.2969 | .82969 | .17031 |
| 53 | 8.2028 | .82028 | .17972 |
| 54 | 8.1054 | .81054 | .18946 |
| 55 | 8.0046 | .80046 | .19954 |
| 56 | 7.9006 | .79006 | .20994 |
| 57 | 7.7931 | .77931 | .22069 |
| 58 | 7.6822 | .76822 | .23178 |
| 59 | 7.5675 | .75675 | .24325 |
| 60 | 7.4491 | .74491 | .25509 |
| 61 | 7.3267 | .73267 | .26733 |
| 62 | 7.2002 | .72002 | .27998 |
| 63 | 7.0696 | .70696 | .29304 |
| 64 | 6.9352 | .69352 | .30648 |
| 65 | 6.7970 | .67970 | .32030 |
| 66 | 6.6551 | .66551 | .33449 |
| 67 | 6.5098 | .65098 | .34902 |
| 68 | 6.3610 | .63610 | .36390 |
| 69 | 6.2086 | .62086 | .37914 |
| 70 | 6.0522 | .60522 | .39478 |
| 71 | 5.8914 | .58914 | .41086 |
| 72 | 5.7261 | .57261 | .42739 |
| 73 | 5.5571 | .55571 | .44429 |
| 74 | 5.3862 | .53862 | .46138 |
| 75 | 5.2149 | .52149 | .47851 |
| 76 | 5.0441 | .50441 | .49559 |
| 77 | 4.8742 | .48742 | .51258 |
| 78 | 4.7049 | .47049 | .52951 |
| 79 | 4.5357 | .45357 | .54643 |
| 80 | 4.3659 | .43659 | .56341 |
| 81 | 4.1967 | .41967 | .58033 |
| 82 | 4.0295 | .40295 | .59705 |
| 83 | 3.8642 | .38642 | .61358 |
| 84 | 3.6998 | .36998 | .63002 |
| 85 | 3.5359 | .35359 | .64641 |
| 86 | 3.3764 | .33764 | .66236 |
| 87 | 3.2262 | .32262 | .67738 |
| 88 | 3.0859 | .30859 | .69141 |
| 89 | 2.9526 | .29526 | .70474 |
| 90 | 2.8221 | .28221 | .71779 |
| 91 | 2.6955 | .26955 | .73045 |
| 92 | 2.5771 | .25771 | .74229 |
| 93 | 2.4692 | .24692 | .75308 |
| 94 | 2.3728 | .23728 | .76272 |
| 95 | 2.2887 | .22887 | .77113 |
| 96 | 2.2181 | .22181 | .77819 |
| 97 | 2.1550 | .21550 | .78450 |
| 98 | 2.1000 | .21000 | .79000 |
| 99 | 2.0486 | .20486 | .79514 |
| 100 | 1.9975 | .19975 | .80025 |

TABLE A—SINGLE LIFE, UNISEX, 10 PERCENT—TABLE SHOWING THE PRESENT WORTH OF AN ANNUITY, OF A LIFE ESTATE, AND A REMAINDER INTEREST—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989—Continued

| (1) Age | (2) Annuity | (3) Life estate | (4) Remainder |
|---|---|---|---|
| 101 | 1.9532 | .19532 | .80468 |
| 102 | 1.9054 | .19054 | .80946 |
| 103 | 1.8437 | .18437 | .81563 |
| 104 | 1.7856 | .17856 | .82144 |
| 105 | 1.6962 | .16962 | .83038 |
| 106 | 1.5488 | .15488 | .84512 |
| 107 | 1.3409 | .13409 | .86591 |
| 108 | 1.0068 | .10068 | .89932 |
| 109 | .4545 | .04545 | .95455 |

TABLE B—TERM CERTAIN, UNISEX, 10 PERCENT—TABLE SHOWING THE PRESENT WORTH OF AN ANNUITY FOR A TERM CERTAIN, OF AN INCOME INTEREST FOR A TERM CERTAIN, AND OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

| (1) Number of years | (2) Annuity | (3) Term certain | (4) Remainder |
|---|---|---|---|
| 1 | .9091 | .090909 | .909091 |
| 2 | 1.7355 | .173554 | .826446 |
| 3 | 2.4869 | .248685 | .751315 |
| 4 | 3.1699 | .316987 | .683013 |
| 5 | 3.7908 | .379079 | .620921 |
| 6 | 4.3553 | .435526 | .564474 |
| 7 | 4.8684 | .486842 | .513158 |
| 8 | 5.3349 | .533493 | .466507 |
| 9 | 5.7590 | .575902 | .424098 |
| 10 | 6.1446 | .614457 | .385543 |
| 11 | 6.4951 | .649506 | .350494 |
| 12 | 6.8137 | .681369 | .318631 |
| 13 | 7.1034 | .710336 | .289664 |
| 14 | 7.3667 | .736669 | .263331 |
| 15 | 7.6061 | .760608 | .239392 |
| 16 | 7.8237 | .782371 | .217629 |
| 17 | 8.0216 | .802155 | .197845 |
| 18 | 8.2014 | .820141 | .179859 |
| 19 | 8.3649 | .836492 | .163508 |
| 20 | 8.5136 | .851356 | .148644 |
| 21 | 8.6487 | .864869 | .135131 |
| 22 | 8.7715 | .877154 | .122846 |
| 23 | 8.8832 | .888322 | .111678 |
| 24 | 8.9847 | .898474 | .101526 |
| 25 | 9.0770 | .907704 | .092296 |
| 26 | 9.1609 | .916095 | .083905 |
| 27 | 9.2372 | .923722 | .076278 |
| 28 | 9.3066 | .930657 | .069343 |
| 29 | 9.3696 | .936961 | .063039 |
| 30 | 9.4269 | .942691 | .057309 |
| 31 | 9.4790 | .947901 | .052099 |
| 32 | 9.5264 | .952638 | .047362 |
| 33 | 9.5694 | .956943 | .043057 |
| 34 | 9.6086 | .960857 | .039143 |
| 35 | 9.6442 | .964416 | .035584 |
| 36 | 9.6765 | .967651 | .032349 |
| 37 | 9.7059 | .970592 | .029408 |
| 38 | 9.7327 | .973265 | .026735 |
| 39 | 9.7570 | .975696 | .024304 |
| 40 | 9.7791 | .977905 | .022095 |

TABLE B—TERM CERTAIN, UNISEX, 10 PERCENT—TABLE SHOWING THE PRESENT WORTH OF AN ANNUITY FOR A TERM CERTAIN, OF AN INCOME INTEREST FOR A TERM CERTAIN, AND OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989—Continued

| (1) Number of years | (2) Annuity | (3) Term certain | (4) Remainder |
|---|---|---|---|
| 41 | 9.7991 | .979914 | .020086 |
| 42 | 9.8174 | .981740 | .018260 |
| 43 | 9.8340 | .983400 | .016600 |
| 44 | 9.8491 | .984909 | .015091 |
| 45 | 9.8628 | .986281 | .013719 |
| 46 | 9.8753 | .987528 | .012472 |
| 47 | 9.8866 | .988662 | .011338 |
| 48 | 9.8969 | .989693 | .010307 |
| 49 | 9.9063 | .990630 | .009370 |
| 50 | 9.9140 | .991481 | .008519 |
| 51 | 9.9226 | .992256 | .007744 |
| 52 | 9.9296 | .992960 | .007040 |
| 53 | 9.9360 | .993600 | .006400 |
| 54 | 9.9418 | .994182 | .005818 |
| 55 | 9.9471 | .994711 | .005289 |
| 56 | 9.9519 | .995191 | .004809 |
| 57 | 9.9563 | .995629 | .004371 |
| 58 | 9.9603 | .996026 | .003974 |
| 59 | 9.9639 | .996387 | .003613 |
| 60 | 9.9672 | .996716 | .003284 |

TABLE LN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

| (1) Age X | (2) lx |
|---|---|
| 0 | 100,000 |
| 1 | 97,998 |
| 2 | 97,876 |
| 3 | 97,792 |
| 4 | 97,724 |
| 5 | 97,668 |
| 6 | 97,619 |
| 7 | 97,573 |
| 8 | 97,531 |
| 9 | 97,494 |
| 10 | 97,460 |
| 11 | 97,430 |
| 12 | 97,401 |
| 13 | 97,367 |
| 14 | 97,322 |
| 15 | 97,261 |
| 16 | 97,181 |
| 17 | 97,083 |
| 18 | 96,970 |
| 19 | 96,846 |
| 20 | 96,716 |
| 21 | 96,580 |
| 22 | 96,438 |
| 23 | 96,292 |
| 24 | 96,145 |
| 25 | 96,000 |
| 26 | 95,859 |
| 27 | 95,721 |
| 28 | 95,586 |
| 29 | 95,448 |
| 30 | 95,307 |
| 31 | 95,158 |
| 32 | 95,003 |
| 33 | 94,840 |

TABLE LN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989—Continued

| (1) Age X | (2) lx |
|---|---|
| 34 | 94,666 |
| 35 | 94,482 |
| 36 | 94,285 |
| 37 | 94,073 |
| 38 | 93,843 |
| 39 | 93,593 |
| 40 | 93,322 |
| 41 | 93,028 |
| 42 | 92,712 |
| 43 | 92,368 |
| 44 | 91,995 |
| 45 | 91,587 |
| 46 | 91,144 |
| 47 | 90,662 |
| 48 | 90,142 |
| 49 | 89,579 |
| 50 | 88,972 |
| 51 | 88,315 |
| 52 | 87,605 |
| 53 | 86,838 |
| 54 | 86,007 |
| 55 | 85,110 |
| 56 | 84,142 |
| 57 | 83,103 |
| 58 | 81,988 |
| 59 | 80,798 |
| 60 | 79,529 |
| 61 | 78,181 |
| 62 | 76,751 |
| 63 | 75,236 |
| 64 | 73,631 |
| 65 | 71,933 |
| 66 | 70,139 |
| 67 | 68,246 |
| 68 | 66,254 |
| 69 | 64,166 |
| 70 | 61,984 |
| 71 | 59,715 |
| 72 | 57,360 |
| 73 | 54,913 |
| 74 | 52,363 |
| 75 | 49,705 |
| 76 | 46,946 |
| 77 | 44,101 |
| 78 | 41,192 |
| 79 | 38,245 |
| 80 | 35,285 |
| 81 | 32,323 |
| 82 | 29,375 |
| 83 | 26,469 |
| 84 | 23,638 |
| 85 | 20,908 |
| 86 | 18,282 |
| 87 | 15,769 |
| 88 | 13,407 |
| 89 | 11,240 |
| 90 | 9,297 |
| 91 | 7,577 |
| 92 | 6,070 |
| 93 | 4,773 |
| 94 | 3,682 |
| 95 | 2,786 |
| 96 | 2,068 |
| 97 | 1,511 |
| 98 | 1,087 |
| 99 | 772 |
| 100 | 542 |
| 101 | 375 |
| 102 | 257 |
| 103 | 175 |

TABLE LN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989—Continued

| (1) Age X | (2) lx |
|---|---|
| 104 | 117 |
| 105 | 78 |
| 106 | 52 |
| 107 | 34 |
| 108 | 22 |
| 109 | 14 |
| 110 | 0 |

[T.D. 8540, 59 FR 30151, June 10, 1994, as amended at 59 FR 30152, June 10, 1994]

TAXABLE ESTATE

### § 20.2051–1 Definition of taxable estate.

The taxable estate of a decedent who was a citizen or resident (see paragraph (b)(1) of § 20.0–1) of the United States at the time of his death is determined by subtracting the total amount of the deductions authorized by sections 2052 through 2056 from the total amount which must be included in the gross estate under sections 2031 through 2044. These deductions are in general as follows:

(a) An exemption of $60,000 (section 2052);

(b) Funeral and administration expenses and claims against the estate (including certain taxes and charitable pledges) (section 2053);

(c) Losses from casualty or theft during the administration of the estate (section 2054);

(d) Charitable transfers (section 2055); and

(e) The marital deduction (section 2056).

See section 2106 and the regulations thereunder for the computation of the taxable estate of a decedent who was not a citizen or resident of the United States. See also § 1.642(g)–1 of this chapter concerning the disallowance for income tax purposes of certain deductions allowed for estate tax purposes.

### § 20.2052–1 Exemption.

An exemption of $60,000 is allowed as a deduction under section 2052 from the gross estate of a decedent who was a citizen or resident of the United States at the time of his death. For the amount of the exemption allowed as a deduction from the gross estate of a decedent who was a nonresident not a citizen of the United States, see paragraph (a)(3) of § 20.2106–1.

### § 20.2053–1 Deductions for expenses, indebtedness, and taxes; in general.

(a) *General rule.* In determining the taxable estate of a decedent who was a citizen or resident of the United States at the time of his death, there are allowed as deductions under section 2053 (a) and (b) amounts falling within the following two categories (subject to the limitations contained in this section and in §§ 20.2053–2 through 20.2053–9):

(1) *First category.* Amounts which are payable out of property subject to claims and which are allowable by the law of the jurisdiction, whether within or without the United States, under which the estate is being administered for—

(i) Funeral expenses;

(ii) Administration expenses;

(iii) Claims against the estate (including taxes to the extent set forth in § 20.2053–6 and charitable pledges to the extent set forth in § 20.2053–5); and

(iv) Unpaid mortgages on, or any indebtedness in respect of, property, the value of the decedent's interest in which is included in the value of the gross estate undiminished by the mortgage or indebtedness.

As used in this subparagraph, the phrase ''allowable by the law of the jurisdiction'' means allowable by the law governing the administration of decedents' estates. The phrase has no reference to amounts allowable as deductions under a law which imposes a State death tax. See further §§ 20.2053–2 through 20.2053–7.

(2) *Second category.* Amounts representing expenses incurred in administering property which is included in the gross estate but which is not subject to claims and which—

(i) Would be allowed as deductions in the first category if the property being administered were subject to claims; and

(ii) Were paid before the expiration of the period of limitation for assessment provided in section 6501.

See further § 20.2053–8.

(b) *Provisions applicable to both categories*—(1) *In general.* If the item is not one of those described in paragraph (a)

of this section, it is not deductible merely because payment is allowed by the local law. If the amount which may be expended for the particular purpose is limited by the local law no deduction in excess of that limitation is permissible.

(2) *Effect of court decree.* The decision of a local court as to the amount and allowability under local law of a claim or administration expense will ordinarily be accepted if the court passes upon the facts upon which deductibility depends. If the court does not pass upon those facts, its decree will, of course, not be followed. For example, if the question before the court is whether a claim should be allowed, the decree allowing it will ordinarily be accepted as establishing the validity and amount of the claim. However, the decree will not necessarily be accepted even though it purports to decide the facts upon which deductibility depends. It must appear that the court actually passed upon the merits of the claim. This will be presumed in all cases of an active and genuine contest. If the result reached appears to be unreasonable, this is some evidence that there was not such a contest, but it may be rebutted by proof to the contrary. If the decree was rendered by consent, it will be accepted, provided the consent was a bona fide recognition of the validity of the claim (and not a mere cloak for a gift) and was accepted by the court as satisfactory evidence upon the merits. It will be presumed that the consent was of this character, and was so accepted, if given by all parties having an interest adverse to the claimant. The decree will not be accepted if it is at variance with the law of the State; as, for example, an allowance made to an executor in excess of that prescribed by statute. On the other hand, a deduction for the amount of a bona fide indebtedness of the decedent, or of a reasonable expense of administration, will not be denied because no court decree has been entered if the amount would be allowable under local law.

(3) *Estimated amounts.* An item may be entered on the return for deduction though its exact amount is not then known, provided it is ascertainable with reasonable certainty, and will be paid. No deduction may be taken upon the basis of a vague or uncertain estimate. If the amount of a liability was not ascertainable at the time of final audit of the return by the district director and, as a consequence, it was not allowed as a deduction in the audit, and subsequently the amount of the liability is ascertained, relief may be sought by a petition to the Tax Court or a claim for refund as provided by sections 6213(a) and 6511, respectively.

(c) *Provision applicable to first category only.* Deductions of the first category (described in paragraph (a)(1) of this section) are limited under section 2053(a) to amounts which would be property allowable out of property subject to claims by the law of the jurisdiction under which the decedent's estate is being administered. Further, the total allowable amount of deductions of the first category is limited by section 2053(c)(2) to the sum of—

(1) The value of property included in the decedent's gross estate and subject to claims, plus

(2) Amounts paid, out of property not subject to claims against the decedent's estate, within 9 months (15 months in the case of the estate of a decedent dying before January 1, 1971) after the decedent's death (the period within which the estate tax return must be filed under section 6075), or within any extension of time for filing the return granted under section 6081.

The term ''property subject to claims'' is defined in section 2053(c)(2) as meaning the property includible in the gross estate which, or the avails of which, under the applicable law, would bear the burden of the payment of these deductions in the final adjustment and settlement of the decedent's estate. However, for the purposes of this definition, the value of property subject to claims is first reduced by the amount of any deduction allowed under section 2054 for any losses from casualty or theft incurred during the settlement of the estate attributable to such property. The application of this paragraph may be illustrated by the following examples:

*Example (1).* The only item in the gross estate is real property valued at $250,000 which the decedent and his surviving spouse held as tenants by the entirety. Under the local law

this real property is not subject to claims. Funeral expenses of $1,200 and debts of the decedent in the amount of $1,500 are allowable under local law. Before the prescribed date for filing the estate tax return, the surviving spouse paid the funeral expenses and $1,000 of the debts. The remaining $500 of the debts was paid by her after the prescribed date for filing the return. The total amount allowable as deductions under section 2053 is limited to $2,200, the amount paid prior to the prescribed date for filing the return.

*Example (2).* The only two items in the gross estate were a bank deposit of $20,000 and insurance in the amount of $150,000. The insurance was payable to the decedent's surviving spouse and under local law was not subject to claims. Funeral expenses of $1,000 and debts in the amount of $29,000 were allowable under local law. A son was executor of the estate and before the prescribed date for filing the estate tax return he paid the funeral expenses of $9,000 of the debts, using therefor $5,000 of the bank deposit and $5,000 supplied by the surviving spouse. After the prescribed date for filing the return, the executor paid the remaining $20,000 of the debts, using for that purpose the $15,000 left in the bank account plus an additional $5,000 supplied by the surviving spouse. The total amount allowable as deductions under section 2053 is limited to $25,000 ($20,000 of property subject to claims plus the $5,000 additional amount which, before the prescribed date for filing the return, was paid out of property not subject to claims).

(d) *Disallowance of double deductions.* See section 642(g) and § 1.642(g)–1 with respect to the disallowance for income tax purposes of certain deductions unless the right to take such deductions for estate tax purposes is waived.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 7238, 37 FR 28719, Dec. 29, 1972]

### § 20.2053–2 Deduction for funeral expenses.

Such amounts for funeral expenses are allowed as deductions from a decedent's gross estate as (a) are actually expended, (b) would be properly allowable out of property subject to claims under the laws of the local jurisdiction, and (c) satisfy the requirements of paragraph (c) of § 20.2053–1. A reasonable expenditure for a tombstone, monument, or mausoleum, or for a burial lot, either for the decedent or his family, including a reasonable expenditure for its future care, may be deducted under this heading, provided such an expenditure is allowable by the local law. Included in funeral expenses is the cost of transportation of the person bringing the body to the place of burial.

### § 20.2053–3 Deduction for expenses of administering estate.

(a) *In general.* The amounts deductible from a decedent's gross estate as ''administration expenses'' of the first category (see paragraphs (a) and (c) of § 20.2053–1) are limited to such expenses as are actually and necessarily, incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it. The expenses contemplated in the law are such only as attend the settlement of an estate and the transfer of the property of the estate to individual beneficiaries or to a trustee, whether the trustee is the executor or some other person. 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. Administration expenses include (1) executor's commissions; (2) attorney's fees; and (3) miscellaneous expenses. Each of these classes is considered separately in paragraphs (b) through (d) of this section.

(b) *Executor's commissions.* (1) The executor or administrator, in filing the estate tax return, may deduct his commissions in such an amount as has actually been paid or in an amount which at the time of filing the estate tax return may reasonably be expected to be paid, but no deduction may be taken if no commissions are to be collected. If the amount of the commissions has not been fixed by decree of the proper court, the deduction will be allowed on the final audit of the return, to the extent that all three of the following conditions are satisfied:

(i) The district director is reasonably satisfied that the commissions claimed will be paid;

(ii) The amount claimed as a deduction is within the amount allowable by the laws of the jurisdiction in which the estate is being administered; and

(iii) It is in accordance with the usually accepted practice in the jurisdiction to allow such an amount in estates of similar size and character.

If the deduction is disallowed in whole or in part on final audit, the disallowance will be subject to modification as the facts may later require. If the deduction is allowed in advance of payment and payment is thereafter waived, it shall be the duty of the executor to notify the district director and to pay the resulting tax, together with interest.

(2) A bequest or devise to the executor in lieu of commissions is not deductible. If, however, the decedent fixed by his will the compensation payable to the executor for services to be rendered in the administration of the estate, deduction may be taken to the extent that the amount so fixed does not exceed the compensation allowable by the local law or practice.

(3) Except to the extent that a trustee is in fact performing services with respect to property subject to claims which would normally be performed by an executor, amounts paid as trustees' commissions do not constitute expenses of administration under the first category, and are only deductible as expenses of the second category to the extent provided in § 20.2053–8.

(c) *Attorney's fees.* (1) The executor or administrator, in filing the estate tax return, may deduct such an amount of attorney's fees as has actually been paid, or an amount which at the time of filing may reasonably be expected to be paid. If on the final audit of a return the fees claimed have not been awarded by the proper court and paid, the deduction will, nevertheless, be allowed, if the district director is reasonably satisfied that the amount claimed will be paid and that it does not exceed a reasonable remuneration for the services rendered, taking into account the size and character of the estate and the local law and practice. If the deduction is disallowed in whole or in part on final audit, the disallowance will be subject to modification as the facts may later require.

(2) A deduction for attorneys' fees incurred in contesting an asserted deficiency or in prosecuting a claim for refund should be claimed at the time the deficiency is contested or the refund claim is prosecuted. A deduction for reasonable attorneys' fees actually paid in contesting an asserted deficiency or in prosecuting a claim for refund will be allowed even though the deduction, as such, was not claimed in the estate tax return or in the claim for refund. A deduction for these fees shall not be denied, and the sufficiency of a claim for refund shall not be questioned, solely by reason of the fact that the amount of the fees to be paid was not established at the time that the right to the deduction was claimed.

(3) Attorneys' fees incurred by beneficiaries incident to litigation as to their respective interests are not deductible if the litigation is not essential to the proper settlement of the estate within the meaning of paragraph (a) of this section. An attorney's fee not meeting this test is not deductible as an administration expense under section 2053 and this section, even if it is approved by a probate court as an expense payable or reimbursable by the estate.

(d) *Miscellaneous administration expenses.* (1) Miscellaneous administration expenses include such expenses as court costs, surrogates' fees, accountants' fees, appraisers' fees, clerk hire, etc. Expenses necessarily incurred in preserving and distributing the estate are deductible, including the cost of storing or maintaining property of the estate, if it is impossible to effect immediate distribution to the beneficiaries. Expenses for preserving and caring for the property may not include outlays for additions or improvements; nor will such expenses be allowed for a longer period than the executor is reasonably required to retain the property.

(2) 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. 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. Where an item included in the gross estate is disposed of in a bona fide sale (including a

redemption) to a dealer in such items at a price below its fair market value, for purposes of this paragraph there shall be treated as an expense for selling the item whichever of the following amounts is the lesser: (i) The amount by which the fair market value of the property on the applicable valuation date exceeds the proceeds of the sale, or (ii) the amount by which the fair market value of the property on the date of the sale exceeds the proceeds of the sale. The principles used in determining the value at which an item of property is included in the gross estate shall be followed in arriving at the fair market value of the property for purposes of this paragraph. See §§ 20.2031–1 through 20.2031–9.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6826, 30 FR 7708, June 15, 1965; 44 FR 23525, Apr. 20, 1979]

### § 20.2053–4 Deduction for claims against the estate; in general.

The amounts that may be deducted as claims against a decedent's estate are such only as represent personal obligations of the decedent existing at the time of his death, whether or not then matured, and interest thereon which had accrued at the time of death. Only interest accrued at the date of the decedent's death is allowable even though the executor elects the alternate valuation method under section 2032. Only claims enforceable against the decedent's estate may be deducted. Except as otherwise provided in § 20.2053–5 with respect to pledges or subscriptions, section 2053(c)(1)(A) provides that the allowance of a deduction for a claim founded upon a promise or agreement is limited to the extent that the liability was contracted bona fide and for an adequate and full consideration in money or money's worth. See § 20.2043–1. Liabilities imposed by law or arising out of torts are deductible.

### § 20.2053–5 Deductions for charitable, etc., pledges or subscriptions.

A pledge or a subscription, evidenced by a promissory note or otherwise, even though enforceable against the estate, is deductible only to the extent that—

(a) Liability therefor was contracted bona fide and for an adequate and full consideration in cash or its equivalent, or

(b) It would have constituted an allowable deduction under section 2055 (relating to charitable, etc., deductions) if it had been a bequest.

### § 20.2053–6 Deduction for taxes.

(a) *In general.* Taxes are deductible in computing a decedent's gross estate only as claims against the estate (except to the extent that excise taxes may be allowable as administration expenses), and only to the extent not disallowed by section 2053(c)(1)(B) (see the remaining paragraphs of this section). However, see § 20.2053–9 with respect to the deduction allowed for certain State death taxes on charitable, etc., transfers.

(b) *Property taxes.* Property taxes are not deductible unless they accrued before the decedent's death. However, they are not deductible merely because they have accrued in an accounting sense. Property taxes in order to be deductible must be an enforceable obligation of the decedent at the time of his death.

(c) *Death taxes.* No estate, succession, legacy or inheritance tax payable by reason of the decedent's death is deductible, except as provided in § 20.2053–9 with respect to certain State death taxes on charitable, etc., transfers. However, see sections 2011 and 2014 and the regulations thereunder with respect to credits for death taxes.

(d) *Gift taxes.* Unpaid gift taxes on gifts made by a decedent before his death are deductible. If a gift is considered as made one-half by the decedent and one-half by his spouse under section 2513, the entire amount of the gift tax, unpaid at the decedent's death, attributable to a gift in fact made by the decedent is deductible. No portion of the tax attributable to a gift in fact made by the decedent's spouse is deductible except to the extent that the obligation is enforced against the decedent's estate and his estate has no effective right of contribution against his spouse. (See section 2012 and § 20.2012–1 with respect to credit for gift taxes paid upon gifts of property included in a decedent's gross estate.)

(e) *Excise taxes.* Excise taxes incurred in selling property of a decedent's estate are deductible as an expense of administration if the sale is necessary in order to (1) pay the decedent's debts, expenses of administration, or taxes, (2) preserve the estate, or (3) effect distribution. Excise taxes incurred in distributing property of the estate in kind are also deductible.

(f) *Income taxes.* Unpaid income taxes are deductible if they are on income property includible in an income tax return of the decedent for a period before his death. Taxes on income received after the decedent's death are not deductible. If income received by a decedent during his lifetime is included in a joint income tax return filed by the decedent and his spouse, or by the decedent's estate and his surviving spouse, the portion of the joint liability for the period covered by the return for which a deduction will be allowed is the amount for which the decedent's estate would be liable under local law, as between the decedent and his spouse, after enforcement of any effective right of reimbursement or contribution. In the absence of evidence to the contrary, the deductible amount is presumed to be an amount bearing the same ratio to the total joint tax liability for the period covered by the return that the amount of income tax for which the decedent would have been liable if he had filed a separate return for that period bears to the total of the amounts for which the decedent and his spouse would have been liable if they had both filed separate returns for that period. Thus, in the absence of evidence to the contrary, the deductible amount equals: Decedent's separate tax÷Both separate taxes×Joint tax.

However, the deduction cannot in any event exceed the lesser of—

(1) The decedent's liability for the period (as determined in this paragraph) reduced by the amounts already contributed by the decedent toward payment of the joint liability, or

(2) If there is an enforceable agreement between the decedent and his spouse or between the executor and the spouse relative to the payment of the joint liability, the amount which pursuant to the agreement is to be contributed by the estate toward payment of the joint liability.

If the decedent's estate and his surviving spouse are entitled to a refund on account of an overpayment of a joint income tax liability, the overpayment is an asset includible in the decedent's gross estate under section 2033 in the amount to which the estate would be entitled under local law, as between the estate and the surviving spouse. In the absence of evidence to the contrary, the includible amount is presumed to be the amount by which the decedent's contributions toward payment of the joint tax exceeds his liability determined in accordance with the principles set forth in this paragraph (other than subparagraph (1) of this paragraph).

### § 20.2053–7 Deduction for unpaid mortgages.

A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money's worth. See § 20.2043–1. Only interest accrued to the date of the decedent's death is allowable even though the alternate valuation method under section 2032 is selected. In any case where real property situated outside the United States no

deduction may be taken of any mortgage thereon or any other indebtedness does not form a part of the gross estate, in respect thereof.

[T.D. 6684, 28 FR 11409, Oct. 24, 1963]

### § 20.2053–8 Deduction for expenses in administering property not subject to claims.

(a) Expenses incurred in administering property included in a decedent's gross estate but not subject to claims fall within the second category of deductions set forth in § 20.2053–1, and may be allowed as deductions if they—

(1) Would be allowed as deductions in the first category if the property being administered were subject to claims; and

(2) Were paid before the expiration of the period of limitation for assessment provided in section 6501.

Usually, these expenses are incurred in connection with the administration of a trust established by a decedent during his lifetime. They may also be incurred in connection with the collection of other assets or the transfer or clearance of title to other property included in a decedent's gross estate for estate tax purposes but not included in his probate estate.

(b) These expenses may be allowed as deductions only to the extent that they would be allowed as deductions under the first category if the property were subject to claims. See § 20.2053–3. The only expenses in administering property not subject to claims which are allowed as deductions are those occasioned by the decedent's death and incurred in settling the decedent's interest in the property or vesting good title to the property in the beneficiaries. Expenses not coming within the description in the preceding sentence but incurred on behalf of the transferees are not deductible.

(c) The principles set forth in paragraphs (b), (c), and (d) of § 20.2053–3 (relating to the allowance of executor's commissions, attorney's fees, and miscellaneous administration expenses of the first category) are applied in determining the extent to which trustee's commissions, attorney's and accountant's fees, and miscellaneous administration expenses are allowed in connection with the administration of property not subject to claims.

(d) The application of this section may be illustrated by the following examples:

*Example (1).* In 1940, the decedent made an irrevocable transfer of property to the X Trust Company, as trustee. The instrument of transfer provided that the trustee should pay the income from the property to the decedent for the duration of his life and upon his death, distribute the corpus of the trust among designated beneficiaries. The property was included in the decedent's gross estate under the provisions of section 2036. Three months after the date of death, the trustee distributed the trust corpus among the beneficiaries, except for $6,000 which it withheld. The amount withheld represented $5,000 which it retained as trustee's commissions in connection with the termination of the trust and $1,000 which it had paid to an attorney for representing it in connection with the termination. Both the trustee's commissions and the attorney's fees were allowable under the law of the jursidiction in which the trust was being administered, were reasonable in amount, and were in accord with local custom. Under these circumstances, the estate is allowed a deduction of $6,000.

*Example (2).* In 1945, the decedent made an irrevocable transfer of property to Y Trust Company, as trustee. The instrument of transfer provided that the trustee should pay the income from the property to the decedent during his life. If the decedent's wife survived him, the trust was to continue for the duration of her life, with Y Trust Company and the decedent's son as co-trustees, and with income payable to the decedent's wife for the duration of her life. Upon the death of both the decedent and his wife, the corpus is to be distributed among designated remaindermen. The decedent was survived by his wife. The property was included in the decedent's gross estate under the provisions of section 2036. In accordance with local custom, the trustee made an accounting to the court as of the date of the decedent's death. Following the death of the decedent, a controversy arose among the remaindermen as to their respective rights under the instrument of transfer, and a suit was brought in court to which the trustee was made a party. As part of the accounting, the court approved the following expenses which the trustee had paid within 3 years following the date of death: $10,000, trustee's commissions; $5,000, accountant's fees; $25,000, attorney's fees; and $2,500, representing fees paid to the guardian of a remainderman who was a minor. The trustee's commissions and accountant's fees were for services in connection with the usual issues involved in a trust

accounting as also were one-half of the attorney's and guardian's fees. The remainder of the attorney's and guardian's fees were for services performed in connection with the suit brought by the remaindermen. The amount allowed as a deduction is the $28,750 ($10,000, trustee's commissions; $5,000, accountant's fees; $12,500, attorney's fees; and $1,250, guardian's fees) incurred as expenses in connection with the usual issues involved in a trust accounting. The remaining expenses are not allowed as deductions since they were incurred on behalf of the transferees.

*Example (3).* Decedent in 1950 made an irrevocable transfer of property to the Z Trust Company, as trustee. The instrument of transfer provided that the trustee should pay the income from the property to the decedent's wife for the duration of her life. If the decedent survived his wife the trust corpus was to be returned to him but if he did not survive her, then upon the death of the wife, the trust corpus was to be distributed among their children. The decedent predeceased his wife and the transferred property, less the value of the wife's outstanding life estate, was included in his gross estate under the provisions of section 2037 since his reversionary interest therein immediately before his death was in excess of 5 percent of the value of the property. At the wife's request, the court ordered the trustee to render an accounting of the trust property as of the date of the decedent's death. No deduction will be allowed the decedent's estate for any of the expenses incurred in connection with the trust accounting, since the expenses were incurred on behalf of the wife.

*Example (4).* If, in the preceding example, the decedent died without other property and no executor or administrator of his estate was appointed, so that it was necessary for the trustee to prepare an estate tax return and participate in its audit, or if the trustee required accounting proceedings for its own protection in accordance with local custom, trustees', attorneys', and guardians' fees in connection with the estate tax or accounting proceedings would be deductible to the same extent that they would be deductible if the property were subject to claims. Deductions incurred under similar circumstances by a surviving joint tenant or the recipient of life insurance proceeds would also be deductible.

### § 20.2053–9 Deduction for certain State death taxes.

(a) *General rule.* A deduction is allowed a decedent's estate under section 2053(d) for the amount of any estate, succession, legacy, or inheritance tax imposed by a State, Territory, or the District of Columbia, or, in the case of a decedent dying before September 3, 1958, a possession of the United States upon a transfer by the decedent for charitable, etc., uses described in section 2055 or 2106(a)(2) (relating to the estates of nonresidents not citizens), but only if (1) the conditions stated in paragraph (b) of this section are met, and (2) an election is made in accordance with the provisions of paragraph (c) of this section. See section 2011(e) and § 20.2011–2 for the effect which the allowance of this deduction has upon the credit for State death taxes.

(b) *Condition for allowance of deduction.* (1) The deduction is not allowed unless either—

(i) The entire decrease in the Federal estate tax resulting from the allowance of the deduction inures solely to the benefit of a charitable, etc., transferee described in section 2055 or 2106(a)(2), or

(ii) The Federal estate tax is equitably apportioned among all the transferees (including the decedent's surviving spouse and the charitable, etc., transferees) of property included in the decedent's gross estate.

For allowance of the credit, it is sufficient if either of these conditions is satisfied. Thus, in a case where the entire decrease in Federal estate tax inures to the benefit of a charitable transferee, the deduction is allowable even though the Federal estate tax is not equitably apportioned among all the transferees of property included in the decedent's gross estate. Similarly, if the Federal estate tax is equitably apportioned among all the transferees of property included in the decedent's gross estate, the deduction is allowable even though a noncharitable transferee receives some benefit from the allowance of the deduction.

(2) For purposes of this paragraph, the Federal estate tax is considered to be equitably apportioned among all the transferees (including the decedent's surviving spouse and the charitable, etc., transferees) of property included in the decedent's gross estate only if each transferee's share of the tax is based upon the net amount of his transfer subjected to the tax (taking into account any exemptions, credits, or deductions allowed by Chapter 11).

See examples (2) through (5) of paragraph (e) of this section.

(c) *Exercise of election.* The election to take a deduction for a State death tax imposed upon a transfer for charitable, etc., uses shall be exercised by the executor by the filing of a written notification to that effect with the district director of internal revenue in whose district the estate tax return for the decedent's estate was filed. The notification shall be filed before the expiration of the period of limitation for assessment provided in section 6501 (usually 3 years from the last day for filing the return). The election may be revoked by the executor by the filing of a written notification to that effect with the district director at any time before the expiration of such period.

(d) *Amount of State death tax imposed upon a transfer.* If a State death tax is imposed upon the transfer of the decedent's entire estate and not upon the transfer of a particular share thereof, the State death tax imposed upon a transfer for charitable, etc., uses is deemed to be an amount, E, which bears the same ratio to F (the amount of the State death tax imposed with respect to the transfer of the entire estate) as G (the value of the charitable, etc., transfer, reduced as provided in the next sentence) bears to H (the total value of the properties, interests, and benefits subjected to the State death tax received by all persons interested in the estate, reduced as provided in the last sentence of this paragraph). In arriving at amount G of the ratio, the value of the charitable, etc., transfer is reduced by the amount of any deduction or exclusion allowed with respect to such property in determining the amount of the State death tax. In arriving at amount H of the ratio, the total value of the properties, interests, and benefits subjected to State death tax received by all persons interested in the estate is reduced by the amount of all deductions and exclusions allowed in determining the amount of the State death tax on account of the nature of a beneficiary or a beneficiary's relationship to the decedent.

(e) *Examples.* The application of this section may be illustrated by the following examples:

*Example (1).* The decedent's gross estate was valued at $200,000. He bequeathed $90,000 to a nephew, $10,000 to Charity A, and the remainder of his estate to Charity B. State inheritance tax in the amount of $13,500 was imposed upon the bequest to the nephew, $1,500 upon the bequest to Charity A, and $15,000 upon the bequest to Charity B. Under the will and local law, each legatee is required to pay the State inheritance tax on his bequest, and the Federal estate tax is to be paid out of the residuary estate. Since the entire burden of paying the Federal estate tax falls on Charity B, it follows that the decrease in the Federal estate tax resulting from the allowance of deductions for State death taxes in the amounts of $1,500 and $15,000 would inure solely for the benefit of Charity B. Therefore, deductions of $1,500 and $15,000 are allowable under section 2053(d). If, in this example, the State death taxes as well as the Federal estate tax were to be paid out of the residuary estate, the result would be the same.

*Example (2).* The decedent's gross estate was valued at $350,000. Expenses, indebtedness, etc., amounted to $50,000. The entire estate was bequeathed in equal shares to a son, a daughter, and Charity C. State inheritance tax in the amount of $2,000 was imposed upon the bequest to the son, $2,000 upon the bequest to the daughter, and $5,000 upon the bequest to Charity C. Under the will and local law, each legatee is required to pay his own State inheritance tax and his proportionate share of the Federal estate tax determined by taking into consideration the net amount of his bequest subjected to the tax. Since each legatee's share of the Federal estate tax is based upon the net amount of his bequest subjected to the tax (note that the deductions under sections 2053(d) and 2055 will have the effect of reducing Charity C's proportionate share of the tax), the tax is considered to be equitably apportioned. Thus, a deduction of $5,000 is allowable under section 2053(d). This deduction together with a deduction of $95,000 under section 2055 (charitable deduction) will mean that none of Charity C's bequest is subjected to Federal estate tax. Hence, the son and the daughter will bear the entire estate tax.

*Example (3).* The decedent bequeathed his property in equal shares, after payment of all expenses, to a son, a daughter, and a charity. State inheritance tax of $2,000 was imposed upon the bequest to the son, $2,000 upon the bequest to the daughter, and $15,000 upon the bequest to the charity. Under the will and local law, each beneficiary pays the State inheritance tax on his bequest and the Federal estate tax is to be paid out of the estate as an administration expense. If the deduction for State death tax on the charitable bequest is allowed in this case, some portion of the decrease in the Federal estate tax would inure to the benefit of the son and the

daughter. The Federal estate tax is not considered to be equitably apportioned in this case since each legatee's share of the Federal estate tax is not based upon the net amount of his bequest subjected to the tax (note that the deductions under sections 2053(d) and 2055 will not have the effect of reducing the charity's proportionate share of the tax). Inasmuch as some of the decrease in the Federal estate tax payable would inure to the benefit of the son and the daughter, and inasmuch as there is no equitable apportionment of the tax, no deduction is allowable under section 2053(d).

*Example (4).* The decedent bequeathed his entire residuary estate in trust to pay the income to X for life with remainder to charity. The State imposed inheritance taxes of $2,000 upon the bequest to X and $10,000 upon the bequest to charity. Under the will and local law, all State and Federal taxes are payable out of the residuary estate and therefore they would reduce the amount which would become the corpus of the trust. If the deduction for the State death tax on the charitable bequest is allowed in this case, some portion of the decrease in the Federal estate tax would inure to the benefit of X since the allowance of the deduction would increase the size of the corpus from which X is to receive the income for life. Also, the Federal estate tax is not considered to be equitably apportioned in this case since each legatee's share of the Federal estate tax is not based upon the net amount of his bequest subjected to the tax (note that the deductions under sections 2053(d) and 2055 will not have the effect of reducing the charity's proportionate share of the tax). Inasmuch as some of the decrease in the Federal estate tax payable would inure to the benefit of X, and inasmuch as there is no equitable apportionment of the tax, no deduction is allowable under section 2053(d).

*Example (5).* The decedent's gross estate was valued at $750,000. Expenses, indebtedness, etc., amounted to $500,000. The decedent bequeathed $350,000 of his estate to his surviving spouse and the remainder of his estate equally to his son and Charity D. State inheritance tax in the amount of $7,000 was imposed upon the bequest to the surviving spouse, $26,250 upon the bequest to the son, and $26,250 upon the bequest to Charity D. The will was silent concerning the payment of taxes. In such a case, the local law provides that each legatee shall pay his own State inheritance tax. The local law further provides for an apportionment of the Federal estate tax among the legatees of the estate. Under the apportionment provisions, the surviving spouse is not required to bear any part of the Federal estate tax with respect to her $350,000 bequest. It should be noted, however, that the marital deduction allowed to the decedent's estate by reason of the bequest to the surviving spouse is limited to $343,000 ($350,000 bequest less $7,000 State inheritance tax payable by the surviving spouse). Thus, the bequest to the surviving spouse is subjected to the Federal estate tax in the net amount of $7,000. If the deduction for State death tax on the charitable bequest is allowed in this case, some portion of the decrease in the Federal estate tax would inure to the benefit of the son. The Federal estate tax is not considered to be equitably apportioned in this case since each legatee's share of the Federal estate tax is not based upon the net amount of his bequest subjected to the tax (note that the surviving spouse is to pay no tax). Inasmuch as some of the decrease in the Federal estate tax payable would inure to the benefit of the son, and inasmuch as there is no equitable apportionment of the tax, no deduction is allowable under section 2053(d).

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6526, 26 FR 417, Jan. 19, 1961; T.D. 6666, 28 FR 7251, July 16, 1963]

### § 20.2053–10 Deduction for certain foreign death taxes.

(a) *General rule.* A deduction is allowed the estate of a decedent dying on or after July 1, 1955, under section 2053(d) for the amount of any estate, succession, legacy, or inheritance tax imposed by and actually paid to any foreign country, in respect of any property situated within such foreign country and included in the gross estate of a citizen or resident of the United States, upon a transfer by the decedent for charitable, etc., uses described in section 2055, but only if (1) the conditions stated in paragraph (b) of this section are met, and (2) an election is made in accordance with the provisions of paragraph (c) of this section. The determination of the country within which property is situated is made in accordance with the rules contained in sections 2104 and 2105 in determining whether property is situated within or without the United States. See section 2014(f) and § 20.2014–7 for the effect which the allowance of this deduction has upon the credit for foreign death taxes.

(b) *Condition for allowance of deduction.* (1) The deduction is not allowed unless either—

(i) The entire decrease in the Federal estate tax resulting from the allowance of the deduction inures solely to the benefit of a charitable, etc., transferee described in section 2055, or

(ii) The Federal estate tax is equitably apportioned among all the transferees (including the decedent's surviving spouse and the charitable, etc., transferees) of property included in the decedent's gross estate.

For allowance of the deduction, it is sufficient if either of these conditions is satisfied. Thus, in a case where the entire decrease in Federal estate tax inures to the benefit of a charitable transferee, the deduction is allowable even though the Federal estate tax is not equitably apportioned among all the transferees of property included in the decedent's gross estate. Similarly, if the Federal estate tax is equitably apportioned among all the transferees of property included in the decedent's gross estate, the deduction is allowable even though a noncharitable transferee receives some benefit from the allowance of the deduction.

(2) For purposes of this paragraph, the Federal estate tax is considered to be equitably apportioned among all the transferees (including the decedent's surviving spouse and the charitable, etc., transferees) of property included in the decedent's gross estate only if each transferee's share of the tax is based upon the net amount of his transfer subjected to the tax (taking into account any exemptions, credits, or deductions allowed by Chapter 11). See examples (2) through (5) of paragraph (e) of § 20.2053–9.

(c) *Exercise of election*. The election to take a deduction for a foreign death tax imposed upon a transfer for charitable, etc., uses shall be exercised by the executor by the filing of a written notification to that effect with the district director of internal revenue in whose district the estate tax return for the decedent's estate was filed. An election to take the deduction for foreign death taxes is deemed to be a waiver of the right to claim a credit under a treaty with any foreign country for any tax or portion thereof claimed as a deduction under this section. The notification shall be filed before the expiration of the period of limitation for assessment provided in section 6501 (usually 3 years from the last day for filing the return). The election may be revoked by the executor by the filing of a written notification to that effect with the district director at any time before the expiration of such period.

(d) *Amount of foreign death tax imposed upon a transfer*. If a foreign death tax is imposed upon the transfer of the entire part of the decedent's estate subject to such tax and not upon the transfer of a particular share thereof, the foreign death tax imposed upon a transfer for charitable, etc., uses is deemed to be an amount, J, which bears the same ratio to K (the amount of the foreign death tax imposed with respect to the transfer of the entire part of the decedent's estate subject to such tax) as M (the value of the charitable, etc., transfer, reduced as provided in the next sentence) bears to N (the total value of the properties, interests, and benefits subjected to the foreign death tax received by all persons interested in the estate, reduced as provided in the last sentence of this paragraph). In arriving at amount M of the ratio, the value of the charitable, etc., transfer is reduced by the amount of any deduction or exclusion allowed with respect to such property in determining the amount of the foreign death tax. In arriving at amount N of the ratio, the total value of the properties, interests, and benefits subjected to foreign death tax received by all persons interested in the estate is reduced by the amount of all deductions and exclusions allowed in determining the amount of the foreign death tax on account of the nature of a beneficiary or a beneficiary's relationship to the decedent.

[T.D. 6600, 27 FR 4985, May 29, 1962]

### § 20.2054–1 Deduction for losses from casualties or theft.

A deduction is allowed for losses incurred during the settlement of the estate arising from fires, storms, shipwrecks, or other casualties, or from theft, if the losses are not compensated for by insurance or otherwise. If the loss is partly compensated for, the excess of the loss over the compensation may be deducted. Losses which are not of the nature described are not deductible. In order to be deductible a loss must occur during the settlement of the estate. If a loss with respect to an asset occurs after its distribution to the distributee it may not be deducted.

Notwithstanding the foregoing, no deduction is allowed under this section if the estate has waived its right to take such a deduction pursuant to the provisions of section 642(g) in order to permit its allowance for income tax purposes. See further § 1.642(g)–1.

### § 20.2055–1 Deduction for transfers for public, charitable, and religious uses; in general.

(a) *General rule.* A deduction is allowed under section 2055(a) from the gross estate of a decedent who was a citizen or resident of the United States at the time of his death for the value of property included in the decedent's gross estate and transferred by the decedent during his lifetime or by will—

(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 any corporation or association organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art and for the prevention of cruelty to children or animals), if no part of the net earnings of the corporation or association inures to the benefit of any private stockholder or individual (other than as a legitimate object of such purposes), if the organization is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and if, in the case of transfers made after December 31, 1969, it does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office.

(3) To a trustee or trustees, or a fraternal society, order, or association operating under the lodge system, if the transferred property is to be used exclusively for religious, charitable, scientific, literary, or educational purposes (or for the prevention of cruelty to children or animals), if no substantial part of the activities of such transferree is carrying on propaganda, or otherwise attempting, to influence legislation, and if, in the case of transfers made after December 31, 1969, such transferee does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office; or

(4) To or for the use of any veterans' organization incorporated by act of Congress, or of any of its departments, local chapters, or posts, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

The deduction is not limited, in the case of estates of citizens or residents of the United States, to transfers to domestic corporations or associations, or to trustees for use within the United States. Nor is the deduction subject to percentage limitations such as are applicable to the charitable deduction under the income tax. An organization will not be considered to meet the requirements of subparagraph (2) or (3) of this paragraph if such organization engages in any activity which would cause it to be classified as an ''action'' organization under paragraph (c)(3) of § 1.501(c)(3)–1 of this chapter (Income Tax Regulations). See §§ 20.2055–4 and 20.2055–5 for rules relating to the disallowance of deductions to trusts and organizations which engage in certain prohibited transactions or whose governing instruments do not contain certain specified requirements.

(b) *Powers of appointment*—(1) *General rule.* A deduction is allowable under section 2055(b) for the value of property passing to or for the use of a transferee described in paragraph (a) of this section by the exercise, failure to exercise, release or lapse of a power of appointment by reason of which the property is includible in the decedent's gross estate under section 2041.

(2) *Certain bequests subject to power of appointment.* For the allowance of a deduction in the case of a bequest in trust where the decedent's surviving spouse (i) was over 80 years of age at the date of decedent's death, (ii) was entitled for life to all of the net income from the trust, and (iii) had a power of appointment over the corpus of the trust exercisable by will in favor of, among others, a charitable organization, see section 2055(b)(2). See also section 6503(e) for suspension of the period

of limitations for assessment or collection of any deficiency attributable to the allowance of the deduction.

(c) *Submission of evidence.* In establishing the right of the estate to the deduction authorized by section 2055, the executor should submit the following with the return:

(1) A copy of any instrument in writing by which the decedent made a transfer of property in his lifetime the value of which is required by statute to be included in his gross estate, for which a deduction under section 2055 is claimed. If the instrument is of record the copy should be certified, and if not of record, the copy should be verified.

(2) A written statement by the executor containing a declaration that it is made under penalties of perjury and stating whether any action has been instituted to construe or to contest the decedent's will or any provision thereof affecting the charitable deduction claimed and whether, according to his information and belief, any such action is designed or contemplated.

The executor shall also submit such other documents or evidence as may be requested by the district director.

(d) *Cross references.* (1) See section 2055(f) for certain cross references relating to section 2055.

(2) For treatment of bequests accepted by the Secretary of State or the Secretary of Commerce, for the purpose of organizing and holding an international conference to negotiate a Patent Corporation Treaty, as bequests to or for the use of the United States, see section 3 of Joint Resolution of December 24, 1969 (Pub. L. 91–160, 83 Stat. 443).

(3) For treatment of bequests accepted by the Secretary of the Department of Housing and Urban Development, for the purpose of aiding or facilitating the work of the Department, as bequests to or for the use of the United States, see section 7(k) of the Department of Housing and Urban Development Act (42 U.S.C. 3535), as added by section 905 of Pub. L. 91–609 (84 Stat. 1809).

(4) For treatment of certain property accepted by the Chairman of the Administrative Conference of the United States, for the purposes of aiding and facilitating the work of the Conference, as a devise or bequest to the United States, see 5 U.S.C. 575(c)(12), as added by section 1(b) of the Act of October 21, 1972 (Pub. L. 92–526, 86 Stat. 1048).

(5) For treatment of the Board for International Broadcasting as a corporation described in section 2055(a)(2), see section 7 of the Board for International Broadcasting Act of 1973 (Pub. L. 93–129, 87 Stat. 459).

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960 as amended by T.D. 8318, 39 FR 25452, July 11, 1974; T.D. 8308, 55 FR 35593, Aug. 31, 1990]

### § 20.2055–2 Transfers not exclusively for charitable purposes.

(a) *Remainders and similar interests.* If a trust is created or property is transferred for both a charitable and a private purpose, deduction may be taken of the value of the charitable beneficial interest only insofar as that interest is presently ascertainable, and hence severable from the noncharitable interest. Thus, in the case of decedent's dying before January 1, 1970, if money or property is placed in trust to pay the income to an individual during his life, or for a term of years, and then to pay the principal to a charitable organization, the present value of the remainder is deductible. See paragraph (e) of this section for limitations applicable to decedent's dying after December 31, 1969. See paragraph (f) of this section for rules relating to valuation of partial interests in property passing for charitable purposes.

(b) *Transfers subject to a condition or a power.* (1) If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an estate or interest has passed to, or is vested in, charity at the time of a decedent's death and the estate or interest would be defeated by the subsequent performance of some act or the happening of some event, the possibility of occurrence of which appeared at the time of the decedent's death to be so remote as to be negligible, the deduction is allowable. If

the legatee, devisee, donee, or trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, devised, or given by the decedent, the deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of the power.

(2) The application of this paragraph may be illustrated by the following examples:

*Example (1).* In 1965, A dies leaving certain property in trust in which charity is to receive the income for the life of his widow. The assets placed in trust by the decedent consist of stock in a corporation the fiscal policies of which are controlled by the decedent and his family. The trustees of the trust and the remaindermen are members of the decedent's family, and the governing instrument contains no adequate guarantee of the request income to the charitable organization. Under such circumstances, no deduction will be allowed. Similarly, if the trustees are not members of the decedent's family but have no power to sell or otherwise dispose of the closely held stock, or otherwise insure the requisite enjoyment of income to the charitable organization, no deduction will be allowed.

*Example (2).* C dies leaving a tract of land to a city government for as long as the land is used by the city for a public park. If the city accepts the tract and if, on the date of C's death, the possibility that the city will not use the land for a public park is so remote as to be negligible, a deduction will be allowed.

(c) *Disclaimers*—(1) *Decedents dying after December 31, 1976.* In the case of a bequest, devise, or transfer made by a decedent dying after December 31, 1976, the amount of a bequest, devise or transfer for which a deduction is allowable under section 2055 includes an interest which falls into the bequest, devise or transfer as the result of either—

(i) A qualified disclaimer (see section 2518 and the corresponding regulations for rules relating to a qualified disclaimer), or

(ii) The complete termination of a power to consume, invade, or appropriate property for the benefit of an individual by reason of the death of such individual or for any other reason, if the termination occurs within the period of time (including extensions) for filing the decedent's Federal estate tax return and before such power has been exercised.

(2) *Decedents dying before January 1, 1977.* In the case of a bequest, devise or transfer made by a decedent dying before January 1, 1977, the amount of a bequest, devise or transfer, for which a deduction is allowable under section 2055 includes an interest which falls into the bequest, devise or transfer as a result of either—

(i) A disclaimer of a bequest, devise, transfer, or power, if the disclaimer is made within 9 months (15 months if the decedent died on or before December 31, 1970) after the decedent's death (the period of time within which the estate tax return must be filed under section 6075) or within any extension of time for filing the return, granted pursuant to section 6081, and the disclaimer is irrevocable at the time the deduction is allowed, or

(ii) The complete termination of a power to consume, invade, or appropriate property for the benefit of an individual (whether the termination occurs by reason of the death of the individual, or otherwise) if the termination occurs within the period described in paragraph (c)(2)(i) of this section and before the power has been exercised. Ordinarily, a disclaimer made by a person not under any legal disability will be considered irrevocable when filed with the probate court. A disclaimer is a complete and unqualified refusal to accept the right to which one is entitled. Thus, if a beneficiary uses these rights for his own purposes, as by receiving a consideration for his formal disclaimer, he has not refused the rights to which he was entitled. There can be no disclaimer after an acceptance of these rights, expressly or impliedly. The disclaimer of a power is to be distinguished from the release or exercise of a power. The release or exercise of a power by the donee of the power in favor of a person or object described in paragraph (a) of § 20.2055–1 does not result in any deduction under section 2055 in the estate of the donor of a power (but see paragraph (b)(1) of § 20.2055–1 with respect to the donee's estate).

(d) *Payments in compromise.* If a charitable organization assigns or surrenders a part of a transfer to it pursuant to a compromise agreement in settlement of a controversy, the amount so assigned or surrendered is not deductible as a transfer to that charitable organization.

(e) *Limitation applicable to decedents dying after December 31, 1969*—(1) *Disallowance of deduction*—(i) *In general.* In the case of decedents dying after December 31, 1969, where an interest in property passes or has passed from the decedent for charitable purposes and an interest (other than an interest which is extinguished upon the decedent's death) in the same property passes or has passed from the decedent for private purposes (for less than an adequate and full consideration in money or money's worth) after October 9, 1969, no deduction is allowed under section 2055 for the value of the interest which passes or has passed for charitable purposes unless the interest in property is a deductible interest described in subparagraph (2) of this paragraph. The principles of section 2056 and the regulations thereunder shall apply for purposes of determining under this paragraph (e)(1)(i) whether an interest in property passes or has passed from the decedent. If however, as of the date of a decedent's death, a transfer for a private purpose is dependent upon the performance of some act on the happening of a precedent event in order that it might become effective, an interest in property will be considered to pass for a private purpose unless the possibility of occurrence of such act or event is so remote as to be negligible. The application of this paragraph (e)(1)(i) may be illustrated by the following examples, in each of which it is assumed that the interest in property which passes for private purposes does not pass for an adequate and full consideration in money or money's worth:

*Example (1).* In 1973, H creates a trust which is to pay the income of the trust to W for her life, the reversionary interest in the trust being retained by H. H predeceases W in 1975. H's will provide that the residue of his estate (including the reversionary interest in the trust) is to be transferred to charity. For purposes of this paragraph (e)(1)(i), interests in the same property have passed from H for charitable purposes and for private purposes.

*Example (2).* In 1973, H creates a trust which is to pay the income of the trust to W for her life and upon termination of the life estate to transfer the remainder to S. S predeceases W in 1975. S's will provides that the residue of his estate (including the remainder interest in the trust) is to be transferred to charity. For purposes of this paragraph (e)(1)(i), interests in the same property have not passed from H or S for charitable purposes and for private purposes.

*Example (3).* H transfers Blackacre to A by gift, reserving the right to the rentals of Blackacre for a term of 20 years. H dies within the 20-year term, bequeathing the right to the remaining rentals to charity. For purposes of this paragraph (e)(1)(i) the term ''property'' refers to Blackacre, and the right to rentals from Blackacre consist of an interest in Blackacre. An interest in Blackacre has passed from H for charitable purposes and for private purposes.

*Example (4).* H bequeaths the residue of his estate in trust for the benefit of A and a charity. An annuity of $5,000 a year is to be paid to charity for 20 years. Upon termination of the 20-year term the corpus is to be distributed to A if living. However, if A should die during the 20-year term, the corpus is to be distributed to charity upon termination of the term. An interest in the residue of the estate has passed from H for charitable purposes. In addition, an interest in the residue of the estate has passed from H for private purposes, unless the possibility that A will survive the 20-year term is so remote as to be negligible.

*Example (5).* H bequeaths the residue of his estate in trust. Under the terms of the trust an annuity of $5,000 a year is to be paid to charity for 20 years. Upon termination of the term, the corpus is to pass to such of A's children and their issue as A may appoint. However, if A should die during the 20-year term without exercising the power of appointment, the corpus is to be distributed to charity upon termination of the term. Since the possible appointees include private persons, an interest in the residue of the estate is considered to have passed from H for private purposes.

*Example (6).* H devises Blackacre to X charity. Under applicable local law, W, H's widow, is entitled to elect a dower interest in Blackacre. W elects to take her dower interest in Blackacre. For purposes of this paragraph (e)(1)(i), interests in the same property have passed from H for charitable purposes and for private purposes. If, however, W does not elect to take her dower interest in Blackacre, then, for purposes of this paragraph (e)(1)(i), interests in the same property have not passed from H for charitable purposes and for private purposes.

(ii) *Works of art and copyrights treated as separate properties*—(*a*) *In general.*

For purposes of paragraphs (e)(1)(i) and (e)(2) of this section, in the case of decedents dying after December 31, 1981, if a decedent makes a qualified contribution of a work of art, the work of art and the copyright on such work of art shall be treated as separate properties. Thus, a deduction is allowable under section 2055 for a qualified contribution of a work of art, whether or not the related copyright is simultaneously transferred to a charitable organization.

(*b*) *Work of art defined.* for purposes of paragraph (e)(1)(ii)(*a*) of this section, the term ''work of art'' means any tangible personal property with respect to which a copyright exists under Federal law.

(*c*) *Qualified contribution defined.* For purposes of paragraph (e)(1)(ii)(*a*) of this section, the term ''qualified contribution'' means any transfer of property to a qualified organization (as defined in paragraph (e)(1)(ii)(*d*) of this section) if the use of the property by the organization is related to the purpose or function constituting the basis for its exemption under section 501. The rules contained in §1.170A–4(b)(3) shall apply in determining if the use of property by an organization is related to such purpose or function.

(*d*) *Qualified organization defined.* For purposes of paragraph (e)(1)(ii)(*c*) of this section, the term ''qualified organization'' means any organization described in section 501(c)(3) other than a private foundation (as defined in section 509). A private operating foundation (as defined in section 4942(j)(3)) shall be considered a qualified organization under this paragraph.

(*e*) *Examples.* The application of paragraphs (e)(1)(i) and (e)(1)(ii) (*a*) through (*d*) of this section may be illustrated by the following examples:

*Example (1).* A, an artist, died in 1983. A work of art created by A and the copyright interest in that work of art were included in A's estate. Under the terms of A's will, the work of art is transferred to X charity, the only charitable beneficiary under A's will. X has no suitable use for the work of art and sells it. It is determined under the rules of §1.170A–4(b)(3) that the property is put to an unrelated use by X charity. Therefore, the rule of paragraph (e)(1)(ii)(*a*), which treats works of art and their copyrights as separate properties, does not apply because the transfer of the work of art to X is not a qualified contribution. To determine whether paragraph (e)(1)(i) of this section applies to disallow a deduction under section 2055, it must be determined which interests are treated as passing to X under local law.

(i) If under local law A's will is treated as fully transferring both the work of art and the copyright interest to X, then paragraph (e)(1)(i) of this section does not apply to disallow a deduction under section 2055 for the value of the work of art and the copyright interest.

(ii) If under local law A's will is treated as transferring only the work of art to X, and the copyright interest is treated as part of the residue of the estate, no deduction is allowable under section 2055 to A's estate for the value of the work of art because the transfer of the work of art is not a qualified contribution and paragraph (e)(1)(i) of this section applies to disallow the deduction.

*Example (2).* B, a collector of art, purchased a work of art from an artist who retained the copyright interest. B died in 1983. Under the terms of B's will the work of art is given to Y charity. Since B did not own the copyright interest, paragraph (e)(1)(i) of this section does not apply to disallow a deduction under section 2055 for the value of the work of art, regardless of whether or not the contribution is a qualified contribution under paragraph (e)(1)(ii)(*c*) of this section.

(2) *Deductible interests.* A deductible interest for purposes of subparagraph (1) of this paragraph is a charitable interest in property where—

(i) *Undivided portion of decedent's entire interest.* The charitable interest is an undivided portion, not in trust, of the decedent's entire interest in property. An undivided portion of a decedent's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the decedent in such property and must extend over the entire term of the decedent's interest in such property and in other property into which such property is converted. For example, if the decedent transferred a life estate in an office building to his wife for her life and retained a reversionary interest in the office building, the devise by the decedent of one-half of that reversionary interest to charity while his wife is still alive will not be considered the transfer of a deductible interest; because an interest in the same property has already passed from the decedent for private purposes, the reversionary interest will

not be considered the decedent's entire interest in the property. If, on the other hand, the decedent had been given a life estate in Blackacre for the life of his wife and the decedent had no other interest in Blackacre at any time during his life, the devise by the decedent of one-half of that life estate to charity would be considered the transfer of a deductible interest; because the life estate would be considered the decedent's entire interest in the property, the devise would be of an undivided portion of such entire interest. An undivided portion of a decedent's entire interest in the property includes an interest in property whereby the charity is given the right, as a tenant in common with the decedent's devisee or legatee, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property. However, except as provided in paragraphs (e)(2)(ii), (iii), and (iv) of this section, for purposes of this subdivision a charitable contribution of an interest in property not in trust where the decedent transfers some specific rights to one party and transfers other substantial rights to another party will not be considered a contribution of an undivided portion of the decedent's entire interest in property. A bequest to charity made on or before December 17, 1980, of an open space easement in gross in perpetuity shall be considered the transfer to charity of an undivided portion of the decedent's entire interest in the property. For the definition of an open space easement in gross in perpetuity, see § 1.170 A–7(b)(1)(ii) of this chapter (Income Tax Regulations).

(ii) *Remainder interest in personal residence.* The charitable interest is a remainder interest, not in trust, in a personal residence. Thus, for example, if the decedent devises to charity a remainder interest in a personal residence and bequeaths to his surviving spouse a life estate in such property, the value of the remainder interest is deductible under section 2055. For purposes of this subdivision, the term ''personal residence'' means any property which was used by the decedent as his personal residence even though it was not used as his principal residence. For example, a decedent's vacation home may be a personal residence for purposes of this subdivision. The term ''personal residence'' also includes stock owned by the decedent as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b) (1) and (2)) if the dwelling which the decedent was entitled to occupy as such stockholder was used by him as his personal residence.

(iii) *Remainder interest in a farm.* The charitable interest is a remainder interest, not in trust, in a farm. Thus, for example, if the decedent devises to charity a remainder interest in a farm and bequeaths to his daughter a life estate in such property, the value of the remainder interest is deductible under section 2055. For purposes of this subdivision, the term ''farm'' means any land used by the decedent or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock. The term ''livestock'' includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive furbearing animals, chickens, turkeys, pigeons, and other poultry. A farm includes the improvements thereon.

(iv) *Qualified conservation contribution.* The charitable interest is a qualified conservation contribution. For the definition of a qualified conservation contribution, see § 1.170A–14.

(v) *Charitable remainder trusts and pooled income funds.* The charitable interest is a remainder interest in a trust which is a charitable remainder annuity trust, as defined in section 664(d)(1) and § 1.664–2 of this chapter; a charitable remainder unitrust, as defined in section 664(d) (2) and (3) and § 1.664–3 of this chapter; or a pooled income fund, as defined in section 642(c)(5) and § 1.642(c)–5 of this chapter. The charitable organization to or for the use of which the remainder interest passes must meet the requirements of both section 2055(a) and section 642(c)(5)(A), section 664(d)(1)(C), or section 664(d)(2)(C), whichever applies. For example, the charitable organization to which the remainder interest in a charitable remainder annuity trust passes may not be a foreign corporation.

(vi) *Guaranteed annuity interest.* (*a*) The charitable interest is a guaranteed annuity interest, whether or not such

interest is in trust. For purposes of this subdivision (vi), the term ''guaranteed annuity interest'' means the right pursuant to the instrument of transfer to receive a guaranteed annuity. A guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually, for a specified term or for the life or lives of an individual or individuals, each of whom must be living at the date of death of the decedent and can be ascertained at such date. For example, the annuity may be paid for the life of A plus a term of years. An amount is determinable if the exact amount which must be paid under the conditions specified in the instrument of transfer can be ascertained as of the appropriate valuation date. For example, the amount to be paid may be a stated sum for a term, or for the life of an individual, at the expiration of which it may be changed by a specified amount, but it may not be redetermined by reference to a fluctuating index such as the cost of living index. In further illustration, the amount to be paid may be expressed in terms of a fraction or a percentage of the net fair market value, as finally determined for Federal estate tax purposes, of the residue of the estate on the appropriate valuation date, or it may be expressed in terms of a fraction or percentage of the cost of living index on the appropriate valuation date.

(*b*) A charitable interest is a guaranteed annuity interest only if it is a guaranteed annuity interest in every respect. For example, if the charitable interest is the right to receive from a trust each year a payment equal to the lesser of a sum certain or a fixed percentage of the net fair market value of the trust assets, determined annually, such interest is not a guaranteed annuity interest.

(*c*) Where a charitable interest in the form of a guaranteed annuity interest is not in trust, the interest will be considered a guaranteed annuity interest only if it is to be paid by an insurance company or by an organization regularly engaged in issuing annuity contracts.

(*d*) Where a charitable interest in the form of a guaranteed annuity interest is in trust, the governing instrument of the trust may provide that income of the trust which is in excess of the amount required to pay the guaranteed annuity interest shall be paid to or for the use of a charity. Nevertheless, the amount of the deduction under section 2055 shall be limited to the fair market value of the guaranteed annuity interest as determined under paragraph (f)(2)(iv) of this section.

(*e*) Where a charitable interest in the form of a guaranteed annuity interest is in trust and the present value, on the appropriate valuation date, of all the income interests for a charitable purpose exceeds 60 percent of the aggregate fair market value of all amounts in such trust (after the payment of estate taxes and all other liabilities), the charitable interest will not be considered a guaranteed annuity interest unless the governing instrument of the trust prohibits both the acquisition and the retention of assets which would give rise to a tax under section 4944 if the trustee had acquired such assets.

(*f*) Where a charitable interest in the form of a guaranteed annuity interest is in trust, the charitable interest will not be considered a guaranteed annuity interest if any amount other than an amount in payment of a guaranteed annuity interest may be paid by the trust for a private purpose before the expiration of all the income interests for a charitable purpose, unless such amount for a private purpose is paid from a group of assets which, pursuant to the governing instrument of the trust, are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947(a)(2)(B). The exception in the immediately preceding sentence with respect to any guaranteed annuity for a private purpose shall apply only if the obligation to pay the annuity for a charitable purpose begins as of the date of death of the decedent and the obligation to pay the guaranteed annuity for a private purpose does not precede in point of time the obligation to pay the annuity for a charitable purpose and only if the governing instrument of the trust does not provide for any preference or priority in respect of any payment of the guaranteed annuity for a private purpose as opposed to any

payment of any annuity for a charitable purpose. For purposes of this (*f*), an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See § 53.4947–1(c) of this chapter (Foundation Excise Tax Regulations) for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust.

(*g*) Neither the requirement in *(e)* of this subdivision (vi) for a prohibition in the governing instrument against the retention of assets which would give rise to a tax under section 4944 if the trustee had acquired the assets nor the provisions of *(f)* of this subdivision (v) shall apply to—

*(1)* A trust executed on or before May 21, 1972, if—

*(i)* The trust is irrevocable on such date,

*(ii)* The trust is revocable on such date and the decedent dies within 3 years after such date without having amended any dispositive provision of the trust after such date, or

*(iii)* The trust is revocable on such date and no dispositive provision of the trust is amended within a period ending 3 years after such date and the decedent is, at the end of such 3-year period and at all times thereafter, under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii) of this chapter) to amend the trust, or

*(2)* A will executed on or before May 21, 1972, if—

*(i)* The testator dies within 3 years after such date without having amended any dispositive provision of the will after such date, by codicil or otherwise,

*(ii)* The testator at no time after such date has the right to change the provisions of the will which pertain to the trust, or

*(iii)* No dispositive provision of the will is amended by the decedent, by codicil or otherwise, within a period ending 3 years after such date and the decedent is, at the end of such 3-year period and at all times thereafter, under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii) of this chapter) to amend the will by codicil or otherwise.

*(h)* For purposes of this subdivision (vi) and paragraph (f) of this section, the term ''appropriate valuation date'' means the date of death or the alternate valuation date determined pursuant to an election under section 2032.

*(i)* For rules relating to certain governing instrument requirements and to the imposition of certain excise taxes where the guaranteed annuity interest is in trust and for rules governing payment of private income interests by split-interest trusts, see section 4947(a)(2) and (b)(3)(A), and the regulations thereunder.

(vii) *Unitrust interest. (a)* The charitable interest is a unitrust interest, whether or not such interest is in trust. For purposes of this subdivision (vii), the term ''unitrust interest'' means the right pursuant to the instrument of transfer to receive payment, not less often than annually, of a fixed percentage of the net fair market value, determined annually, of the property which funds the unitrust interest. In computing the net fair market value of the property which funds the unitrust interest, all assets and liabilities shall be taken into account without regard to whether particular items are taken into account in determining the income from the property. The net fair market value of the property which funds the unitrust interest may be determined on any one date during the year or by taking the average of valuations made on more than one date during the year, provided that the same valuation date or dates and valuation methods are used each year. Where the charitable interest is a unitrust interest to be paid by a trust and the governing instrument of the trust does not specify the valuation date or dates, the trustee shall select such date or dates and shall indicate his selection on the first return on Form 1041 which the trust is required to file. Payments under a unitrust interest may be paid for a specified term or for the life or lives of an individual or individuals, each of whom must be living at the date of death of the decedent and can be ascertained at such date. For example, the unitrust interest may be paid for the life of A plus a term of years.

*(b)* A charitable interest is a unitrust interest only if it is a unitrust interest in every respect. For example, if the charitable interest is the right to receive from a trust each year a payment

equal to the lesser of a sum certain or a fixed percentage of the net fair market value of the trust assets, determined annually, such interest is not a unitrust interest.

*(c)* Where a charitable interest in the form of a unitrust interest is not in trust, the interest will be considered a unitrust interest only if it is to be paid by an insurance company or by an organization regularly engaged in issuing interests otherwise meeting the requirements of a unitrust interest.

*(d)* Where a charitable interest in the form of a unitrust interest is in trust, the governing instrument of the trust may provide that income of the trust which is in excess of the amount required to pay the unitrust interest shall be paid to or for the use of a charity. Nevertheless, the amount of the deduction under section 2055 shall be limited to the fair market value of the unitrust interest as determined under paragraph (f)(2)(v) of this section.

*(e)* Where a charitable interest in the form of a unitrust interest is in trust, the charitable interest will not be considered a unitrust interest if any amount other than an amount in payment of a unitrust interest may be paid by the trust for a private purpose before the expiration of all the income interests for a charitable purpose, unless such amount for a private purpose is paid from a group of assets which, pursuant to the governing instrument of the trust, are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947(a)(2)(B). The exception in the immediately preceding sentence with respect to any unitrust interest for a private purpose shall apply only if the obligation to pay the unitrust interest for a charitable purpose begins as of the date of death of the decedent and the obligation to pay the unitrust interest for private purpose does not precede in point of time the obligation to pay the unitrust interest for a charitable purpose and only if the governing instrument of the trust does not provide for any preference or priority in respect of any payment of the unitrust interest for a private purpose as opposed to any payment of any unitrust interest for a charitable purpose. For purposes of this *(e)*, an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See § 53.4947–1(c) of this chapter (Foundation Excise Tax Regulations) for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust.

*(f)* For rules relating to certain governing instrument requirements and to the imposition of certain excise taxes where the unitrust interest is in trust and for rules governing payment of private income interests by a split-interest trust, see section 4947(a)(2) and (b)(3)(A), and the regulations thereunder.

(3) *Effective date.* The provisions of this paragraph apply only in the case of decedents dying after December 31, 1969, except that they do not apply—

(i) In the case of property passing under the terms of a will executed on or before October 9, 1969—

*(a)* If the decedent dies after October 9, 1969, but before October 9, 1972, without having amended any dispositive provision of the will after October 9, 1969, by codicil or otherwise,

*(b)* If the decedent dies after October 9, 1969, and at no time after that date had the right to change the portions of the will which pertain to the passing of the property to, or for the use of, an organization described in section 2055(a), or

*(c)* If no dispositive provision of the will is amended by the decedent, by codicil or otherwise, after October 9, 1969, and before October 9, 1972, and the decedent is on October 9, 1972, and at all times thereafter under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii) of this chapter (Income Tax Regulations)) to amend the will by codicil or otherwise, or

(ii) In the case of property transferred in trust on or before October 9, 1969—

*(a)* If the decedent dies after October 9, 1969, but before October 9, 1972, without having amended, after October 9, 1969, any dispositive provision of the instrument governing the disposition of the property,

*(b)* If the property transferred was an irrevocable interest to, or for the use of, an organization described in section 2055(a), or

*(c)* If no dispositive provision of the instrument governing the disposition of the property is amended by the decedent after October 9, 1969, and before October 9, 1972, and the decedent is on October 9, 1972, and at all times thereafter under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii) of this chapter) to change the disposition of the property.

(4) *Amendment of dispositive provisions.* For purposes of subparagraphs (2) and (3) of this paragraph, an amendment shall generally be considered as one which amends the dispositive provisions of a will or trust if it results in a change in the persons to whom the funds are to be given or makes changes in the conditions under which the funds are given. Examples of amendments which do not amend the dispositive provisions of a will or trust include the substitution of one fiduciary for another to act in the capacity of executor or trustee and the change in the name of a legatee or beneficiary by reason of the legatee's or beneficiary's marriage. On the other hand, examples of amendments which do amend the dispositive provisions of a will or trust include an increase or decrease in the amount of a general bequest, an amendment which increases or decreases the power of a trustee to determine an allocation of income or corpus in such a way as to change the beneficiaries of the funds or a beneficiary's share of the funds, or a change in the allocation of, or in the right to allocate, receipts and expenditures between income and principal in such a way as to change the beneficiaries of the funds or a beneficiary's share of the funds.

(5) *Amendment of wills providing for pour-over into trusts.* For purposes of subparagraphs (2) and (3) of this paragraph, an amendment of a dispositive provision of a trust to which assets are to be transferred under a will shall be considered a dispositive amendment of such will.

(f) *Valuation of charitable interest*—(1) *In general.* The amount of the deduction in the case of a contribution of a partial interest in property to which this section applies is the fair market value of the partial interest at the appropriate valuation date, as defined in paragraph (e)(2)(vi)*(h)* of this section. The fair market value of an annuity, life estate, term for years, remainder, reversion, (or) unitrust interest is its present value.

(2) *Certain decedents dying after July 31, 1969.* In the case of a transfer of an interest described in subdivision (v), (vi), or (vii) of paragraph (e)(2) of this section by decedents dying after July 31, 1969, the present value of such interest is to be determined under the following rules:

(i) The present value of a remainder interest in a charitable remainder annuity trust is to be determined under § 1.664–2(c) of this chapter (Income Tax Regulations).

(ii) The present value of a remainder interest in a charitable remainder unitrust is to be determined under § 1.664–4 of this chapter.

(iii) The present value of a remainder interest in a pooled income fund is to be determined under § 1.642(c)–6 of this chapter.

(iv) The present value of a guaranteed annuity interest described in paragraph (e)(2)(vi) of this section is to be determined under § 20.2031–7 or, for certain prior periods, § 20.2031–7A, except that, if the annuity is issued by a company regularly engaged in the sale of annuities, the present value is to be determined under § 20.2031–8. If by reason of all the conditions and circumstances surrounding a transfer of an income interest in property in trust it appears that the charity may not receive the beneficial enjoyment of the interest, a deduction will be allowed under section 2055 only for the minimum amount it is evident the charity will receive.

*Example (1).* In 1975, B dies bequeathing $20,000 in trust with the requirement that a designated charity be paid a guaranteed annuity interest (as defined in paragraph (e)(2)(vi) of this section) of $4,100 a year, payable annually at the end of each year, for a period of 6 years and that the remainder be paid to his children. The fair market value of an annuity of $4,100 a year for a period of 6 years is $20,160.93 ($4,100×4.9173), as determined under Table B in § 20.2031–10(f). The deduction with respect to the guaranteed annuity interest will be limited to $20,000, which is the minimum amount it is evident the charity will receive.

*Example (2).* In 1975, C dies bequeathing $40,000 in trust with the requirement that D,

an individual, and X Charity be paid simultaneously guaranteed annuity interests (as defined in paragraph (e)(2)(vi) of this section) of $5,000 a year each, payable annually at the end of each year, for a period of 5 years and that the remainder be paid to C's children. The fair market value of two annuities of $5,000 each a year for a period of 5 years is $42,124 ([$5,000×4.2124]×2), as determined under Table B in § 20.2031– 10(f). The trust instrument provides that in the event the trust fund is insufficient to pay both annuities in a given year, the trust fund will be evenly divided between the charitable and private annuitants. The deduction with respect to the charitable annuity will be limited to $20,000, which is the minimum amount it is evident the charity will receive.

*Example (3).* In 1975, D dies bequeathing $65,000 in trust with the requirement that a guaranteed annuity interest (as defined in paragraph (e)(2)(vi) of this section) of $5,000 a year, payable annually at the end of each year, be paid to Y Charity for a period of 10 years and that a guaranteed annuity interest (as defined in paragraph (e)(2)(vi) of this section) of $5,000 a year, payable annually at the end of each year, be paid to W, his widow, aged 62, for 10 years or until her prior death. The annuities are to be paid simultaneously, and the remainder is to be paid to D's children. The fair market value of the private annuity is $33,877 ($5,000×6.7754), as determined pursuant to § 20.2031–10(e) and by the use of factors involving one life and a term of years as published in Publication 723A (12–70). The fair market value of the charitable annuity is $36,800.50 ($5,000×7.3601), as determined under Table B in § 20.2031–10(f). It is not evident from the governing instrument of the trust or from local law that the trustee would be required to apportion the trust fund between the widow and charity in the event the fund were insufficient to pay both annuities in a given year. Accordingly, the deduction with respect to the charitable annuity will be limited to $31,123 ($65,000 less $33,877 [the value of the private annuity]), which is the minimum amount it is evident the charity will receive.

*Example (4).* In 1975, E dies bequeathing $75,000 in trust with the requirement that an annuity of $5,000 a year, payable annually at the end of each year, be paid to B, an individual, for a period of 5 years and thereafter an annuity of $5,000 a year, payable annually at the end of each year, be paid to M Charity for a period of 5 years. The remainder is to be paid to C, an individual. No deduction is allowed under section 2055(a) with respect to the charitable annuity because it is not a ''guaranteed annuity interest'' within the meaning of paragraph (e)(2)(vi)*(f)* of this section.

(v) The present value of a unitrust interest described in paragraph (e)(2)(vii) of this section is to be determined by subtracting the present value of all interests in the transferred property other than the unitrust interest from the fair market value of the transferred property.

(3) *Certain decedents dying before August 1, 1969.* In the case of decedents dying before August 1, 1969, the present value of an interest described in subparagraph (2) of this paragraph is to be determined under § 20.2031–7 except that, if the interest is an annuity issued by a company regularly engaged in the sale of annuities, the present value is to be determined under § 20.2031–8.

(4) *Other decedents.* The present value of an interest not described in paragraph (f)(2) of this section is to be determined under § 20.2031–7(d) in the case of decedents where the valuation date of the gross estate is after April 30, 1989, or under § 20.2031–7A in the case of decedents where the valuation date of the gross estate is before May 1, 1989.

(5) *Special computations.* If the interest transferred is such that its present value is to be determined by a special computation, a request for a special factor, accompanied by a statement of the date of birth and sex of each individual the duration of whose life may affect the value of the interest, and by copies of the relevant instruments, may be submitted by the fiduciary to the Commissioner who may, if conditions permit, supply the factor requested. If the Commissioner furnishes the factor, a copy of the letter supplying the factor must be attached to the tax return in which the deduction is claimed. If the Commissioner does not furnish the factor, the claim for deduction must be supported by a full statement of the computation of the present value made in accordance with the principles set forth in this paragraph.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 7318, 39 FR 25453, July 11, 1974, 39 FR 26154, July 17, 1974; T.D. 7340, 40 FR 1240, Jan. 7, 1975; T.D. 7955, 49 FR 19995, May 11, 1984; T.D. 7957, 49 FR 20811, May 17, 1984; T.D. 8069, 51 FR 1507, Jan. 14, 1986; 51 FR 5323, Feb. 13, 1986; T.D. 8095, 51 FR 28368, Aug. 7, 1986; 51 FR 32071, Sept. 9, 1986; T.D 8540, 59 FR 30103, 30170, June 10, 1994]

**§ 20.2055–3 Death taxes payable out of charitable transfers.**

(a) If under the terms of the will or other governing instruments, the law of the jurisdiction under which the estate is administered, or the law of the jurisdiction imposing the particular tax, the Federal estate tax, or any estate, succession, legacy, or inheritance tax is payable in whole or in part out of any property the transfer of which would otherwise be allowable as a deduction under section 2055, section 2055(c) provides that the sum deductible is the amount of the transferred property reduced by the amount of the tax. Section 2055(c) in effect provides that the deduction is based on the amount actually available for charitable uses, that is, the amount of the fund remaining after the payment of all death taxes. Thus, if $50,000 is bequeathed for a charitable purpose and is subjected to a State inheritance tax of $5,000, payable out of the $50,000, the amount deductible is $45,000. If a life estate is bequeathed to an individual with remainder over to a charitable organization, and by the local law the inheritance tax upon the life estate is paid out of the corpus with the result that the charitable organization will be entitled to receive only the amount of the fund less the tax, the deduction is limited to the present value, as of the date of the testator's death, of the remainder of the fund so reduced. If a testator bequeaths his residuary estate, or a portion of it, to charity, and his will contains a direction that certain inheritance taxes, otherwise payable from legacies upon which they were imposed, shall be payable out of the residuary estate, the deduction may not exceed the bequest to charity thus reduced pursuant to the direction of the will. If a residuary estate, or a portion of it, is bequested to charity, and by the local law the Federal estate tax is payable out of the residuary estate, the deduction may not exceed that portion of the residuary estate bequeathed to charity as reduced by the Federal estate tax. The return should fully disclose the computation of the amount to be deducted. If the amount to be deducted is dependent upon the amount of any death tax which has not been paid before the filing of the return, there should be submitted with the return a computation of that tax.

(b) It should be noted that if the Federal estate tax is payable out of a charitable transfer so that the amount of the transfer otherwise passing to charity is reduced by the amount of the tax, the resultant decrease in the amount passing to charity will further reduce the allowable deduction. In such a case, the amount of the charitable deduction can be obtained only by a series of trial-and-error computations, or by a formula. If, in addition, interdependent State and Federal taxes are involved, the computation becomes highly complicated. Examples of methods of computation of the charitable deduction and the marital deduction (with which similar problems are encountered) in various situations are contained in supplemental instructions to the estate tax return.

(c) For the allowance of a deduction to a decedent's estate for certain State death taxes imposed upon charitable transfers, see section 2053(d) and § 20.2053–9.

**§ 20.2055–4 Disallowance of charitable, etc., deductions because of "prohibited transactions" in the case of decedents dying before January 1, 1970.**

(a) Sections 503(e) and 681(b)(5) provides that no deduction which would otherwise be allowable under section 2055 for the value of property transferred by the decedent during his lifetime or by will for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art and the prevention of cruelty to children or animals) is allowed if (1) the transfer is made in trust, and, for income tax purposes for the taxable year of the trust in which the transfer is made, the deduction otherwise allowable to the trust under section 642(c) is limited by section 681(b)(1) by reason of the trust having engaged in a prohibited transaction described in section 681(b)(2), or (2) the transfer is made to a corporation, community chest, fund or foundation which, for its taxable year in which the transfer is made, is not exempt from income tax under section 501(a) by reason of having engaged in a prohibited transaction described in section 503(c).

(b) For purposes of section 681(b)(5) and section 503(e), the term ''transfer'' includes any gift, contribution, bequest, devise, legacy, or other disposition. In applying such sections for estate tax purposes, a transfer, whether made during the decedent's lifetime or by will, is considered as having been made at the moment of the decedent's death.

(c) The income tax regulations contain the rules for the determination of the taxable year of the trust for which the deduction under section 642(c) is limited by section 681(b) and for the determination of the taxable year of the organization for which an exemption is denied under section 503(a). Generally, such taxable year is a taxable year subsequent to the taxable year during which the trust or organization has been notified by the Commissioner of Internal Revenue that it has engaged in a prohibited transaction. However, if the trust or organization during or prior to the taxable year entered into the prohibited transaction for the purpose of diverting its corpus or income from the charitable or other purposes by reason of which it is entitled to a deduction or exemption, and the transaction involves a substantial part of the income or corpus, then the deduction of the trust under section 642(c) for such taxable year is limited by section 681(b), or exemption of the organization for such taxable year is denied under section 503(a), whether or not the organization has previously received notification by the Commissioner of Internal Revenue that it is engaged in a prohibited transaction. In certain cases, the limitation of section 681 or 503 may be removed or the exemption may be reinstated for certain subsequent taxable years under the rules set forth in the income tax regulations under sections 681 and 503. In cases in which prior notification by the Commissioner of Internal Revenue is not required in order to limit the deduction of the trust under section 681(d) or to deny exemption of the organization under section 503, the deduction otherwise allowable under section 2055 is not disallowed in respect of transfers made during the same taxable year of the trust or organization in which a prohibited transaction occurred or in a prior taxable year unless the decedent or a member of his family was a party to the prohibited transaction. For the purpose of the preceding sentence, the members of the decedent's family include only his brothers and sisters, whether by whole or half blood, spouse, ancestors, and lineal descendants.

(d) This section applies only in the case of decedents dying before January 1, 1970. In the case of decedents dying after December 31, 1969, see § 20.2055–5.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960 as amended by T.D. 7318, 39 FR 25456, July 11, 1974]

### § 20.2055–5 Disallowance of charitable, etc., deductions in the case of decedents dying after December 31, 1969.

(a) *Organizations subject to section 507(c) tax.* Section 508(d)(1) provides that, in the case of decedents dying after December 31, 1969, a deduction which would otherwise be allowable under section 2055 for the value of property transferred by the decedent to or for the use of an organization upon which the tax provided by section 507(c) has been imposed shall not be allowed if the transfer is made by the decedent after notification is made under section 507(a) or if the decedent is a substantial contributor (as defined in section 507(d)(2)) who dies on or after the first day on which action is taken by such organization that culminates in the imposition of the tax under section 507(c). This paragraph does not apply if the entire amount of the unpaid portion of the tax imposed by section 507(c) is abated under section 507(g) by the Commissioner or his delegate.

(b) *Taxable private foundations, section 4947 trusts, etc.*—(1) *In general.* Section 508(d)(2) provides that, in the case of decedents dying after December 31, 1969, a deduction which would otherwise be allowable under section 2055 for the value of property transferred by the decedent shall not be allowed if the transfer is made to or for the use of—

(i) A private foundation or a trust described in section 4947(a)(2) in a taxable year of such organization for which such organization fails to meet the governing instrument requirements of

section 508(e) (determined without regard to section 508(e)(2) (B) and (C)), or

(ii) Any organization in a period for which it is not treated as an organization described in section 501(c)(3) by reason of its failure to give notification under section 508(a) of its status to the Commissioner.

For additional rules, see § 1.508–2(b) (1) of this chapter (Income Tax Regulations).

(2) *Transfers not covered by section 508(d)(2)(A)*—(i) *In general.* Any deduction which would otherwise be allowable under section 2055 for the value of property transferred by a decedent dying after December 31, 1969, will not be disallowed under section 508(d)(2)(A) and subparagraph (1)(i) of this paragraph—

*(a)* In the case of property passing under the terms of a will executed on or before October 9, 1969—

*(1)* If the decedent dies after October 9, 1969, but before October 9, 1972, without having amended any dispositive provision of the will after October 9, 1969, by codicil or otherwise,

*(2)* If the decedent dies after October 9, 1969, and at no time after that date had the right to change the portions of the will which pertain to the passing of the property to, or for the use of, an organization described in section 2055(a), or

*(3)* If no dispositive provision of the will is amended by the decedent, by codicil or otherwise, after October 9, 1969, and before October 9, 1972, and the decedent is on October 9, 1972, and at all times thereafter under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii) of this chapter) to amend the will by codicil or otherwise, or

*(b)* In the case of property transferred in trust on or before October 9, 1969—

*(1)* If the decedent dies after October 9, 1969, but before October 9, 1972, without having amended, after October 9, 1969, any dispositive provision of the instrument governing the disposition of the property,

*(2)* If the property transferred was an irrevocable interest to, or for the use of, an organization described in section 2055(a), or

*(3)* If no dispositive provision of the instrument governing the disposition of the property is amended by the decedent after October 9, 1969, and before October 9, 1972, and the decedent is on October 9, 1972, and at all times thereafter under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii) of this chapter) to change the disposition of the property.

(ii) *Amendment of dispositive provisions.* For purposes of subdivision (i) of this subparagraph, the provisions of paragraph (e) (4) and (5) of § 20.2055–2 shall apply in determining whether an amendment will be considered as one which amends the dispositive provisions of a will or trust.

(c) *Foreign organization with substantial support from foreign sources.* Section 4948(c)(4) provides that, in the case of decedents dying after December 31, 1969, a deduction which would otherwise be allowable under section 2055 for the value of property transferred by the decedent to or for the use of a foreign organization which has received substantially all of its support (other than gross investment income) from sources without the United States shall not be allowed if the transfer is made (1) after the date on which the Commissioner has published notice that he has notified such organization that it has engaged in a prohibited transaction, or (2) in a taxable year of such organization for which it is not exempt from taxation under section 501(a) because it has engaged in a prohibited transaction after December 31, 1969.

[T.D. 7318, 39 FR 25456, July 11, 1974]

### § 20.2055–6 Disallowance of double deduction in the case of qualified terminable interest property.

No deduction is allowed from the decedent's gross estate under section 2055 for property with respect to which a deduction is allowed by reason of section 2056(b)(7). See section 2056(b)(9) and § 20.2056(b)–9.

[T.D. 8522, 59 FR 9647, Mar. 1, 1994]

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(c) Effect of election by surviving spouse.
(d) Will contests.
(e) Survivorship.

*§20.2056(c)–3 Marital deduction; definition of passed from the decedent to a person other than his surviving spouse.*

*§20.2056(d)–1 Marital deduction; special rules for marital deduction if surviving spouse is not a United States citizen.*

*§20.2056(d)–2 Marital deduction; effect of disclaimers of post-December 31, 1976 transfers.*

(a) Disclaimer by a surviving spouse.
(b) Disclaimer by a person other than a surviving spouse.

*§20.2056(d)–3 Marital deduction; effect of disclaimers of pre-January 1, 1977 transfers.*

(a) Disclaimers by a surviving spouse.
(b) Disclaimer by a person other than a surviving spouse.
(1) Decedents dying after October 3, 1966, and before January 1, 1977.
(2) Decedents dying after September 30, 1963, and before October 4, 1966.
(3) Decedents dying before October 4, 1966.

[T.D. 8522, 59 FR 9647, Mar. 1, 1994, as amended by T. D. 8612, 60 FR 43538, Aug. 22, 1995]

## §20.2056(a)–1 Marital deduction; in general.

(a) *In general.* A deduction is allowed under section 2056 from the gross estate of a decedent for the value of any property interest which passes from the decedent to the decedent's surviving spouse if the interest is a *deductible interest* as defined in §20.2056(a)–2. With respect to decedents dying in certain years, a deduction is allowed under section 2056 only to the extent that the total of the deductible interests does not exceed the applicable limitations set forth in paragraph (c) of this section. The deduction allowed under section 2056 is referred to as the *marital deduction*. See also sections 2056(d) and 2056A for special rules applicable in the case of decedents dying after November 10, 1988, if the decedent's surviving spouse is not a citizen of the United States at the time of the decedent's death. In such cases, the marital deduction may not be allowed unless the property passes to a qualified domestic trust as described in section 2056A(a).

(b) *Requirements for marital deduction*—(1) *In general.* To obtain the marital deduction with respect to any property interest, the executor must establish the following facts—

(i) The decedent was survived by a spouse (see §20.2056(c)–2(e));

(ii) The property interest passed from the decedent to the spouse (see §§20.2056(b)–5 through 20.2056(b)–8 and 20.2056(c)–1 through 20.2056(c)–3);

(iii) The property interest is a *deductible interest* (see §20.2056(a)–2); and

(iv) The value of the property interest (see §20.2056(b)–4).

(2) *Burden of establishing requisite facts.* The executor must provide the facts relating to any applicable limitation on the amount of the allowable marital deduction under §20.2056(a)–1(c), and must submit proof necessary to establish any fact required under paragraph (b)(1), including any evidence requested by the district director.

(c) *Marital deduction; limitation on aggregate deductions*—(1) *Estates of decedents dying before 1977.* In the case of estates of decedents dying before January 1, 1977, the marital deduction is limited to one-half of the value of the *adjusted gross estate,* as that term was defined under section 2056(c)(2) prior to repeal by the Economic Recovery Tax Act of 1981.

(2) *Estates of decedents dying after December 31, 1976, and before January 1, 1982*— Except as provided in §2002(d)(1) of the Tax Reform Act of 1976 (Pub. L. 94–455), in the case of decedents dying after December 31, 1976, and before January 1, 1982, the marital deduction is limited to the greater of—

(i) $250,000; or

(ii) One-half of the value of the decedent's adjusted gross estate, adjusted for intervivos gifts to the spouse as prescribed by section 2056(c)(1)(B) prior

to repeal by the Economic Recovery Tax Act of 1981 (Pub. L. 97–34).

(3) *Estates of decedents dying after December 31, 1981.* In the case of estates of decedents dying after December 31, 1981, the marital deduction is limited as prescribed in paragraph (c)(2) of this section if the provisions of § 403(e)(3) of Pub. L. 97–34 are satisfied.

[T.D. 8522, 59 FR 9648, Mar. 1, 1994]

### § 20.2056(a)–2 Marital deduction; "deductible interests" and "nondeductible interests".

(a) *In general.* Property interests which passed from a decedent to his surviving spouse fall within two general categories:

(1) Those with respect to which the marital deduction is authorized, and

(2) Those with respect to which the marital deduction is not authorized.

These categories are referred to in this section and other sections of the regulations under section 2056 as ''deductible interests'' and ''nondeductible interests'', respectively (see paragraph (b) of this section). Subject to any applicable limitations set forth in § 20.2056(a)–1(c), the amount of the marital deduction is the aggregate value of the *deductible interests.*

(b) *Deductible interests.* An interest passing to a decedent's surviving spouse is a ''deductible interest'' if it does not fall within one of the following categories of ''nondeductible interests'';

(1) Any property interest which passed from the decedent to his surviving spouse is a ''nondeductible interest'' to the extent it is not included in the decedent's gross estate.

(2) If a deduction is allowed under section 2053 (relating to deductions for expenses and indebtedness) by reason of the passing of a property interest from the decedent to his surviving spouse, such interest is, to the extent of the deduction under section 2053, a ''nondeductible interest.'' Thus, a property interest which passed from the decedent to his surviving spouse in satisfaction of a deductible claim of the spouse against the estate is, to the extent of the claim, a ''nondeductible interest'' (see § 20.2056(b)–4). Similarly, amounts deducted under section 2053(a)(2) for commissioners allowed to the surviving spouse as executor are ''nondeductible interests''. As to the valuation, for the purpose of the marital deduction, of any property interest which passed from the decedent to his surviving spouse subject to a mortgage or other encumbrance, see § 20.2056(b)–4.

(3) If during settlement of the estate a loss deductible under section 2054 occurs with respect to a property interest, then that interest is, to the extent of the deductible loss, a ''nondeductible interest'' for the purpose of the marital deduction.

(4) A property interest passing to a decedent's surviving spouse which is a ''terminable interest'', as defined in § 20.2056(b)–1, is a ''nondeductible interest'' to the extent specified in that section.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8522, 59 FR 9649, Mar. 1, 1994]

### § 20.2056(b)–1 Marital deduction; limitation in case of life estate or other "terminable interest".

(a) *In general.* Section 2056(b) provides that no marital deduction is allowed with respect to certain property interests, referred to generally as ''terminable interests'', passing from a decedent to his surviving spouse. The phrase ''terminable interest'' is defined in paragraph (b) of this section. However, the fact that an interest in property passing to a decedent's surviving spouse is a ''terminable interest'' makes it nondeductible only (1) under the circumstances described in paragraph (c) of this section, and (2) if it does not come within one of the exceptions referred to in paragraph (d) of this section.

(b) *Terminable interests.* 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. However, a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity or a term for years, is not a terminable interest.

(c) *Nondeductible terminable interests.* (1) A property interest which constitutes a terminable interest, as defined in paragraph (b) of this section, is nondeductible if—

(i) Another interest in the same property passed from the decedent to some other person for less than an adequate and full consideration in money or money's worth, and

(ii) By reason of its passing, the other person or his heirs or assigns may possess or enjoy any part of the property after the termination or failure of the spouse's interest.

(2) Even though a property interest which constitutes a terminable interest is not nondeductible by reason of the rules stated in subparagraph (1) of this paragraph, such an interest is nondeductible if—

(i) The decedent has directed his executor or a trustee to acquire such an interest for the decedent's surviving spouse (see further paragraph (f) of this section), or

(ii) Such an interest passing to the decedent's surviving spouse may be satisfied out of a group of assets which includes a nondeductible interest (see further § 20.2056(b)–2. In this case, however, full nondeductibility may not result.

(d) *Exceptions.* A property interest passing to a decedent's surviving spouse is deductible (if it is not otherwise disqualified under § 20.2056(a)–2) even though it is a terminable interest, and even though an interest therein passed from the decedent to another person, if it is a terminable interest only because—

(1) It is conditioned on the spouse's surviving for a limited period, in the manner described in § 20.2056(b)–3;

(2) It is a right to income for life with a general power of appointment, meeting the requirements set forth in § 20.2056(b)–5;

(3) It consists of life insurance or annuity payments held by the insurer with a general power of appointment in the spouse, meeting the requirements set forth in § 20.2056(b)–6;

(4) It is qualified terminable interest property, meeting the requirements set forth in § 20.2056(b)–7; or

(5) It is an interest in a qualified charitable remainder trust in which the spouse is the only noncharitable beneficiary, meeting the requirements set forth in § 20.2056(b)–8.

(e) *Miscellaneous principles.* (1) In determining whether an interest passed from the decedent to some other person, it is immaterial whether interests in the same property passed to the decedent's spouse and another person at the same time, or under the same instrument.

(2) In determining whether an interest in the same property passed from the decedent both to his surviving spouse and to some other person, a distinction is to be drawn between ''property'', as such term is used in section 2056, and an ''interest in property''. The term ''property'' refers to the underlying property in which various interests exist; each such interest is not for this purpose to be considered as ''property''.

(3) Whether or not an interest is nondeductible because it is a terminable interest is to be determined by reference to the property interests which actually passed from the decedent. Subsequent conversions of the property are immaterial for this purpose. Thus, where a decedent bequeathed his estate to his wife for life with remainder to his children, the interest which passed to his wife is a nondeductible interest, even though the wife agrees with the children to take a fractional share of the estate in fee in lieu of the life interest in the whole, or sells the life estate for cash, or acquires the remainder interest of the children either by purchase or gift.

(4) The terms *passed from the decedent, passed from the decedent to his surviving spouse* and *passed from the decedent to a person other than his surviving spouse* are defined in §§ 20.2056(c)–1 through 20.2056(c)–3.

(f) *Direction to acquire a terminable interest.* No marital deduction is allowed with respect to a property interest which a decedent directs his executor or a trustee to covert after his death into a terminable interest for his surviving spouse. The marital deduction is not allowed even though no interest in the property subject to the terminable interest passes to another person and

even though the interest would otherwise come within the exceptions described in §§ 20.2056(b)–5 and 20.2056(b)–6 (relating to life estates and life insurance and annuity payments with powers of appointment). However, a general investment power, authorizing investments in both terminable interests and other property, is not a direction to invest in a terminable interest.

(g) *Examples.* The application of this section may be illustrated by the following examples. In each example, it is assumed that the executor made no election under section 2056(b)(7) (even if under the specific facts the election would have been available), that any property interest passing from the decedent to a person other than the surviving spouse passed for less than full and adequate consideration in money or money's worth, and that section 2056(b)(8) is inapplicable.

*Example (1).* H (the decedent) devised real property to W (his surviving wife) for life, with remainder to A and his heirs. The interest which passed from H to W is a nondeductible interest since it will terminate upon her death and A (or his heirs or assigns) will thereafter possess or enjoy the property.

*Example (2).* H bequeathed the residue of his estate in trust for the benefit of W and A. The trust income is to be paid to W for life, and upon her death the corpus is to be distributed to A or his issue. However, if A should die without issue, leaving W surviving, the corpus is then to be distributed to W. The interest which passed from H to W is a nondeductible interest since it will terminate in the event of her death if A or his issue survive, and A or his issue will thereafter possess or enjoy the property.

*Example (3).* H during his lifetime purchased an annuity contract providing for payments to himself for life and then to W for life if she should survive him. Upon the death of the survivor of H and W, the excess, if any, of the cost of the contract over the annuity payments theretofore made was to be refunded to A. The interest which passed from H to W is a nondeductible interest since A may possess or enjoy a part of the property following the termination of the interest of W. If, however, the contract provided for no refund upon the death of the survivor of H and W, or provided that any refund was to go to the estate of the survivor, then the interest which passed from H to W is (to the extent it is included in H's gross estate) a deductible interest.

*Example (4).* H, in contemplation of death, transferred a residence to A for life with remainder to W provided W survives A, but if W predeceases A, the property is to pass to B and his heirs. If it is assumed that H died during A's lifetime, and the value of the residence was included in determining the value of his gross estate, the interest which passed from H to W is a nondeductible interest since it will terminate if W predeceases A and the property will thereafter be possessed or enjoyed by B (or his heirs or assigns). This result is not affected by B's assignment of his interest during H's lifetime, whether made in favor of W or another person, since the term ''assigns'' (as used in section 2056(b)(1)(B)) includes such an assignee. However, if it is assumed that A predeceased H, the interest of B in the property was extinguished, and, viewed as of the time of the subsequent death of H, the interest which passed from him to W is the entire interest in the property and, therefore, a deductible interest.

*Example (5).* H transferred real property to A by gift (reserving the right to the rentals of the property for a term of 20 years. H died within the 20-year term, bequeathing the right to the remaining rentals to a trust for the benefit of W. The terms of the trust satisfy the five conditions stated in § 20.2056(b)–5, so that the property interest which passed in trust is considered to have passed from H to W. However, the interest is a nondeductible interest since it will terminate upon the expiration of the term and A will thereafter possess or enjoy the property.

*Example (6).* H bequeathed a patent to W and A as tenants in common. In this case, the interest of W will terminate upon the expiration of the term of the patent, but possession or enjoyment of the property by A must necessarily cease at the same time. Therefore, since A's possession or enjoyment cannot outlast the termination of W's interest, the latter is a deductible interest.

*Example (7).* A decedent bequeathed $100,000 to his wife, subject to a direction to his executor to use the bequest for the purchase of an annuity for the wife. The bequest is a nondeductible interest.

*Example (8).* Assume that pursuant to local law an allowance for support is payable to the decedent's surviving spouse during the period of the administration of the decedent's estate, but that upon her death or remarriage during such period her right to any further allowance will terminate. Assume further that the surviving spouse is sole beneficiary of the decedent's estate. Under such circumstances, the allowance constitutes a deductible interest since any part of the allowance not receivable by the surviving spouse during her lifetime will pass to her estate under the terms of the decedent's will. If, in this example, the decedent bequeathed only one-third of his residuary estate to his

surviving spouse, then two-thirds of the allowance for support would constitute a nondeductible terminable interest.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8522, 59 FR 9649, Mar. 1, 1994]

### § 20.2056(b)–2 Marital deduction; interest in unidentified assets.

(a) *In general.* Section 2056(b)(2) provides that if an interest passing to a decedent's surviving spouse may be satisfied out of assets (or their proceeds) which include a particular asset that would be a nondeductible interest if it passed from the decedent to his spouse, the value of the interest passing to the spouse is reduced, for the purpose of the marital deduction, by the value of the particular asset.

(b) *Application of section 2056(b)(2).* In order for section 2056(b)(2) to apply, two circumstances must coexist, as follows:

(1) The property interest which passed from the decedent to his surviving spouse must be payable out of a group of assets included in the gross estate. Examples of property interests payable out of a group of assets are a general legacy, a bequest of the residue of the decedent's estate or of a proportion of the residue, and a right to a share of the corpus of a trust upon its termination.

(2) The group of assets out of which the property interest is payable must include one or more particular assets which, if passing specifically to the surviving spouse, would be nondeductible interests. Therefore, section 2056(b)(2) is not applicable merely because the group of assets includes a terminable interest, but would only be applicable if the terminable interest were nondeductible under the provisions of § 20.2056(b)–1.

(c) *Interest nondeductible if circumstances present.* If both of the circumstances set forth in paragraph (b) of this section are present, the property interest payable out of the group of assets is (except as to any excess of its value over the aggregate value of the particular asset or assets which would not be deductible if passing specifically to the surviving spouse) a nondeductible interest.

(d) *Example.* The application of this section may be illustrated by the following example:

*Example.* A decedent bequeathed one-third of the residue of his estate to his wife. The property passing under the decedent's will included a right to the rentals of an office building for a term of years, reserved by the decedent under a deed of the building by way of gift to his son. The decedent did not make a specific bequest of the right to such rentals. Such right, if passing specifically to the wife, would be a nondeductible interest (see example (5) of paragraph (g) of § 20.2056(b)–1). It is assumed that the value of the bequest of one-third of the residue of the estate to the wife was $85,000, and that the right to the rentals was included in the gross estate at a value of $60,000. If the decedent's executor had the right under the decedent's will or local law to assign the entire lease in satisfaction of the bequest, the bequest is a nondeductible interest to the extent of $60,000. If the executor could only assign a one-third interest in the lease in satisfaction of the bequest, the bequest is a nondeductible interest to the extent of $20,000. If the decedent's will provided that his wife's bequest could not be satisfied with a nondeductible interest, the entire bequest is a deductible interest. If, in this example, the asset in question had been foreign real estate not included in the decedent's gross estate, the results would be the same.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8522, 59 FR 9649, Mar. 1, 1994]

### § 20.2056(b)–3 Marital deduction; interest of spouse conditioned on survival for limited period.

(a) *In general.* Generally, no marital deduction is allowable if the interest passing to the surviving spouse is a terminable interest as defined in paragraph (b) of § 20.2056(b)(1). However, section 2056(b)(3) provides an exception to this rule so as to allow a deduction if (1) the only condition under which it will terminate is the death of the surviving spouse within 6 months after the decedent's death, or her death as a result of a common disaster which also resulted in the decedent's death, and (2) the condition does not in fact occur.

(b) *Six months' survival.* If the only condition which will cause the interest taken by the surviving spouse to terminate is the death of the surviving spouse and the condition is of such nature that it can occur only within 6 months following the decedent's death,

the exception provided by section 2056(b)(3) will apply, provided the condition does not in fact occur. However, if the condition (unless it relates to death as a result of a common disaster) is one which may occur either within the 6-month period or thereafter, the exception provided by section 2056(b)(3) will not apply.

(c) *Common disaster.* If a property interest passed from the decedent to his surviving spouse subject to the condition that she does not die as a result of a common disaster which also resulted in the decedent's death, the exception provided by section 2056(b)(3) will not be applied in the final audit of the return if there is still a possibility that the surviving spouse may be deprived of the property interest by operation of the common disaster provision as given effect by the local law.

(d) *Examples.* The application of this section may be illustrated by the following examples:

*Example (1).* A decedent bequeathed his entire estate to his spouse on condition that she survive him by 6 months. In the event his spouse failed to survive him by 6 months, his estate was to go to his niece and her heirs. The decedent was survived by his spouse. It will be observed that, as of the time of the decedent's death, it was possible that the niece would, by reason of the interest which passed to her from the decedent possess or enjoy the estate after the termination of the interest which passed to the spouse. Hence, under the general rule set forth in § 20.2056(b)–1, the interest which passed to the spouse would be regarded as a nondeductible interest. If the surviving spouse in fact died within 6 months after the decedent's death, that general rule is to be applied, and the interest which passed to the spouse is a nondeductible interest. However, if the spouse in fact survived the decedent by 6 months, thus extinguishing the interest of the niece, the case comes within the exception provided by section 2056(b)(3), and the interest which passed to the spouse is a deductible interest. (It is assumed for the purpose of this example that no other factor which would cause the interest to be nondeductible is present.)

*Example (2).* The facts are the same as in example (1) except that the will provided that the estate was to go to the niece either in case the decedent and his spouse should both die as a result of a common disaster, or in case the spouse should fail to survive the decedent by 3 months. It is assumed that the decedent was survived by his spouse. In this example, the interest which passed from the decedent to his surviving spouse is to be regarded as a nondeductible interest if the surviving spouse in fact died either within 3 months after the decedent's death or as a result of a common disaster which also resulted in the decedent's death. However, if the spouse in fact survived the decedent by 3 months, and did not thereafter die as a result of a common disaster which also resulted in the decedent's death, the exception provided under section 2056(b)(3) will apply and the interest will be deductible.

*Example (3).* The facts are the same as in example (1) except that the will provided that the estate was to go to the niece if the decedent and his spouse should both die as a result of a common disaster and if the spouse failed to survive the decedent by 3 months. If the spouse in fact survived the decedent by 3 months, the interest of the niece is extinguished, and the interest passing to the spouse is a deductible interest.

*Example (4).* A decedent devised and bequeathed his residuary estate to his wife if she was living on the date of distribution of his estate. The devise and bequest is a nondeductible interest even though distribution took place within 6 months after the decedent's death and the surviving spouse in fact survived the date of distribution.

### § 20.2056(b)–4 Marital deduction; valuation of interest passing to surviving spouse.

(a) *In general.* The value, for the purpose of the marital deduction, of any deductible interest which passed from the decedent to his surviving spouse is to be determined as of the date of the decedent's death, except that if the executor elects the alternate valuation method under section 2032 the valuation is to be determined as of the date of the decedent's death but with the adjustment described in paragraph (a)(3) of § 20.2032–1. The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse, the same principles being applicable as if the amount of a gift to the spouse were being determined. In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to

pay expenses incurred in the administration of the estate.

(b) *Property interest subject to an encumbrance or obligation.* If a property interest passed from the decedent to his surviving spouse subject to a mortgage or other encumbrance, or if an obligation is imposed upon the surviving spouse by the decedent in connection with the passing of a property interest, the value of the property interest is to be reduced by the amount of the mortgage, other encumbrance, or obligation. However, if under the terms of the decedent's will or under local law the executor is required to discharge, out of other assets of the decedent's estate, a mortgage or other encumbrance on property passing from the decedent to his surviving spouse, or is required to reimburse the surviving spouse for the amount of the mortgage or other encumbrance, the payment or reimbursement constitutes an additional interest passing to the surviving spouse. The passing of a property interest subject to the imposition of an obligation by the decedent does not include a bequest, devise, or transfer in lieu of dower, curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate. The passing of a property interest subject to the imposition of an obligation by the decedent does, however, include a bequest, etc., in lieu of the interest of his surviving spouse under community property laws unless such interest was, immediately prior to the decedent's death, a mere expectancy. The following examples are illustrative of property interests which passed from the decedent to his surviving spouse subject to the imposition of an obligation by the decedent:

*Example (1).* A decedent devised a residence valued at $25,000 to his wife, with a direction that she pay $5,000 to his sister. For the purpose of the marital deduction, the value of the property interest passing to the wife is only $20,000.

*Example (2).* A decedent devised real property to his wife in satisfaction of a debt owing to her. The debt is a deductible claim under section 2053. Since the wife is obligated to relinquish the claim as a condition to acceptance of the devise, the value of the devise is, for the purpose of the marital deduction, to be reduced by the amount of the claim.

*Example (3).* A decedent bequeathed certain securities to his wife in lieu of her interest in property held by them as community property under the law of the State of their residence. The wife elected to relinquish her community property interest and to take the bequest. For the purpose of the marital deduction, the value of the bequest is to be reduced by the value of the community property interest relinquished by the wife.

(c) *Effect of death taxes.* (1) In the determination of the value of any property interest which passed from the decedent to his surviving spouse, there must be taken into account the effect which the Federal estate tax, or any estate, succession, legacy, or inheritance tax, has upon the net value to the surviving spouse of the property interest.

(2) For example, assume that the only bequest to the surviving spouse is $100,000 and the spouse is required to pay a State inheritance tax in the amount of $1,500. If no other death taxes affect the net value of the bequest, the value, for the purpose of the marital deduction, is $98,500.

(3) As another example, assume that a decedent devised real property to his wife having a value for Federal estate tax purposes of $100,000 and also bequeathed to her a nondeductible interest for life under a trust. The State of residence valued the real property at $90,000 and the life interest at $30,000, and imposed an inheritance tax (at graduated rates) of $4,800 with respect to the two interests. If it is assumed that the inheritance tax on the devise is required to be paid by the wife, the amount of tax to be ascribed to the devise is:

$$(90{,}000 \div 120{,}000) \times \$4{,}800 = \$3{,}600.$$

Accordingly, if no other death taxes affect the net value of the bequest, the value, for the purpose of the marital deduction, is $100,000 less $3,600, or $96,400.

(4) If the decedent bequeaths his residuary estate, or a portion of it, to his surviving spouse, and his will contains a direction that all death taxes shall be payable out of the residuary estate, the value of the bequest, for the purpose of the marital deduction, is based upon the amount of the residue as reduced

pursuant to such direction, if the residuary estate, or a portion of it, is bequeathed to the surviving spouse, and by the local law the Federal estate tax is payable out of the residuary estate, the value of the bequest, for the purpose of the marital deduction, may not exceed its value as reduced by the Federal estate tax. Methods of computing the deduction, under such circumstances, are set forth in supplemental instructions to the estate tax return.

(d) *Remainder interests.* If the income from property is made payable to another individual for life, or for a term of years, with remainder absolutely to the surviving spouse or to her estate, the marital deduction is based upon the present value of the remainder. The present value of the remainder is to be determined in accordance with the rules stated in § 20.2031–7. For example, if the surviving spouse is to receive $50,000 upon the death of a person aged 31 years, the present value of the remainder is $14,466. If the remainder is such that its value is to be determined by a special computation (see paragraph (b) of § 20.2031–7), a request for a specific factor may be submitted to the Commissioner. The request should be accompanied by a statement of the date of birth of each person, the duration of whose life may affect the value of the remainder, and copies of the relevant instruments. The Commissioner may, if conditions permit, supply the factor requested. If the Commissioner does not furnish the factor, the claim for deduction must be supported by a full statement of the computation of the present value made in accordance with the principles set forth in the applicable paragraphs of § 20.2031–7.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8522, 59 FR 9649, Mar. 1, 1994; T.D. 8540, 59 FR 30103, June 10, 1994]

### § 20.2056(b)–5 Marital deduction; life estate with power of appointment in surviving spouse.

(a) *In general.* Section 2056(b)(5) provides that if an interest in property passes from the decedent to his surviving spouse (whether or not in trust) and the spouse is entitled for life to all the income from the entire interest or all the income from a specific portion of the entire interest, with a power in her to appoint the entire interest or the specific portion, the interest which passes to her is a deductible interest, to the extent that it satisfies all five of the conditions set forth below (see paragraph (b) of this section if one or more of the conditions is satisfied as to only a portion of the interest):

(1) The surviving spouse must be entitled for life to all of the income from the entire interest or a specific portion of the entire interest, or to a specific portion of all the income from the entire interest.

(2) The income payable to the surviving spouse must be payable annually or at more frequent intervals.

(3) The surviving spouse must have the power to appoint the entire interest or the specific portion to either herself or her estate.

(4) The power in the surviving spouse must be exercisable by her alone and (whether exercisable by will or during life) must be exercisable in all events.

(5) The entire interest or the specific portion must not be subject to a power in any other person to appoint any part to any person other than the surviving spouse.

(b) *Specific portion; deductible amount.* If either the right to income or the power of appointment passing to the surviving spouse pertains only to a specific portion of a property interest passing from the decedent, the marital deduction is allowed only to the extent that the rights in the surviving spouse meet all of the five conditions described in paragraph (a) of this section. While the rights over the income and the power must coexist as to the same interest in property, it is not necessary that the rights over the income or the power as to such interest be in the same proportion. However, if the rights over income meeting the required conditions set forth in paragraph (a) (1) and (2) of the section extend over a smaller share of the property interest than the share with respect to which the power of appointment requirements set forth in paragraph (a) (3) through (5) of this section are satisfied, the deductible interest is limited to the smaller share. Correspondingly, if a power of appointment meeting all the

requirements extends to a smaller portion of the property interest than the portion over which the income rights pertain, the deductible interest cannot exceed the value of the portion to which such power of appointment applies. Thus, if the decedent leaves to his surviving spouse the right to receive annually all of the income from a particular property interest and a power of appointment meeting the specifications prescribed in paragraph (a) (3) through (5) of this section as to only one-half of the property interest, then only one-half of the property interest is treated as a deductible interest. Correspondingly, if the income interest of the spouse satisfying the requirements extends to only one-fourth of the property interest and a testamentary power of appointment satisfying the requirements extends to all of the property interest, then only one-fourth of the interest in the spouse qualifies as a deductible interest. Further, if the surviving spouse has no right to income from a specific portion of a property interest but a testamentary power of appointment which meets the necessary conditions over the entire interest, then none of the interest qualifies for the deduction. In addition, if, from the time of the decedent's death, the surviving spouse has a power of appointment meeting all of the required conditions over three-fourths of the entire property interest and the prescribed income rights over the entire interest, but with a power in another person to appoint one-half of the entire interest, the value of the interest in the surviving spouse over only one-half of the property interest will qualify as a deductible interest.

(c) *Meaning of specific portion*—(1) *In general.* Except as provided in paragraphs (c)(2) and (c)(3) of this section, a partial interest in property is not treated as a specific portion of the entire interest. In addition, any specific portion of an entire interest in property is nondeductible to the extent the specific portion is subject to invasion for the benefit of any person other than the surviving spouse, except in the case of a deduction allowable under section 2056(b)(5), relating to the exercise of a general power of appointment by the surviving spouse.

(2) *Fraction or percentage share.* Under section 2056(b)(10), a partial interest in property is treated as a specific portion of the entire interest if the rights of the surviving spouse in income, and the required rights as to the power described in § 20.2056(b)–5(a), constitute a fractional or percentage share of the entire property interest, so that the surviving spouse's interest reflects its proportionate share of the increase or decrease in the value of the entire property interest to which the income rights and the power relate. Thus, if the spouse's right to income and the spouse's power extend to a specified fraction or percentage of the property, or the equivalent, the interest is in a specific portion of the property. In accordance with paragraph (b) of this section, if the spouse has the right to receive the income from a specific portion of the trust property (after applying paragraph (c)(3) of this section) but has a power of appointment over a different specific portion of the property (after applying paragraph (c)(3) of this section), the marital deduction is limited to the lesser specific portion.

(3) *Special rule in the case of estates of decedents dying on or before October 24, 1992, and certain decedents dying after October 24, 1992, with wills or revocable trusts executed on or prior to that date.* (i) In the case of estates of decedents within the purview of the effective date and transitional rules contained in paragraphs (c)(3) (ii) and (iii) of this section:

(A) A specific sum payable annually, or at more frequent intervals, out of the property and its income that is not limited by the income of the property is treated as the right to receive the income from a specific portion of the property. The specific portion, for purposes of paragraph (c)(2) of this section, is the portion of the property that, assuming the interest rate generally applicable for the valuation of annuities at the time of the decedent's death, would produce income equal to such payments. However, a pecuniary amount payable annually to a surviving spouse is not treated as a right to the income from a specific portion of the trust property for purposes of this paragraph (c)(3)(i)(A) if any person other than the surviving spouse may

receive, during the surviving spouse's lifetime, any distribution of the property. To determine the applicable interest rate for valuing annuities, see sections 2031 and 7520 and the regulations under those sections.

(B) The right to appoint a pecuniary amount out of a larger fund (or trust corpus) is considered the right to appoint a specific portion of such fund or trust for purposes of paragraph (c)(2) in an amount equal to such pecuniary amount.

(ii) The rules contained in paragraphs (c)(3)(i) (A) and (B) of this section apply with respect to estates of decedents dying on or before October 24, 1992.

(iii) The rules contained in paragraphs (c)(3)(i) (A) and (B) of this section apply in the case of decedents dying after October 24, 1992, if property passes to the spouse pursuant to a will or revocable trust agreement executed on or before October 24, 1992, and either—

(A) On that date, the decedent was under a mental disability to change the disposition of the property and did not regain competence to dispose of such property before the date of death; or

(B) The decedent dies prior to October 24, 1995.

(iv) Notwithstanding paragraph (c)(3)(iii) of this section, paragraphs (c)(3)(i) (A) and (B) of this section do not apply if the will or revocable trust is amended after October 24, 1992, in any respect that increases the amount of the transfer qualifying for the marital deduction or alters the terms by which the interest so passes to the surviving spouse of the decedent.

(4) *Local law.* A partial interest in property is treated as a specific portion of the entire interest if it is shown that the surviving spouse has rights under local law that are identical to those the surviving spouse would have acquired had the partial interest been expressed in terms satisfying the requirements of paragraph (c)(2) (or paragraph (c)(3) if applicable) of this section.

(5) *Examples.* The following examples illustrate the application of paragraphs (a) through (c)(4) of this section:

*Example 1. Spouse entitled to the lesser of an annuity or a fraction of trust income.* The decedent, D, died prior to October 24, 1992. D bequeathed in trust 500 identical shares of X company stock, valued for estate tax purposes at $500,000. The trust provides that during the lifetime of D's spouse, S, the trustee is to pay annually to S the lesser of one-half of the trust income or $20,000. Any trust income not paid to S is to be accumulated in the trust and may not be distributed during S's lifetime. S has a testamentary general power of appointment over the entire trust principal. The applicable interest rate for valuing annuities as of D's date of death under section 7520 is 10 percent. For purposes of paragraphs (a) through (c) of this section, S is treated as receiving all of the income from the lesser of—

(i) One half of the stock ($250,000); or

(ii) $200,000, the specific portion of the stock which, as determined in accordance with § 20.2056(b)–5(c)(3)(i)(A), would produce annual income of $20,000 (20,000/.10). Accordingly, the marital deduction is limited to $200,000 (200,000/500,000 or ⅖ of the value of the trust).

*Example 2. Spouse possesses power and income interest over different specific portions of trust.* The facts are the same as in *Example 1* except that S's testamentary general power of appointment is exercisable over only ¼ of the trust principal. Consequently, under section 2056(b)(5), the marital deduction is allowable only for the value of ¼ of the trust ($125,000); i.e., the lesser of the value of the portion with respect to which S is deemed to be entitled to all of the income (⅖ of the trust or $200,000), or the value of the portion with respect to which S possesses the requisite power of appointment (¼ of the trust or $125,000).

*Example 3. Power of appointment over pecuniary amount.* The decedent, D, died prior to October 24, 1992. D bequeathed property valued at $400,000 for estate tax purposes in trust. The trustee is to pay annually to D's spouse, S, one-fourth of the trust income. Any trust income not paid to S is to be accumulated in the trust and may not be distributed during S's lifetime. The will gives S a testamentary general power of appointment over the sum of $160,000. Because D died prior to October 24, 1992, S's power of appointment over $160,000 is treated as a power of appointment over a specific portion of the entire trust interest. The marital deduction allowable under section 2056(b)(5) is limited to $100,000; that is, the lesser of—

(1) The value of the trust corpus ($400,000);

(2) The value of the trust corpus over which S has a power of appointment ($160,000); or

(3) That specific portion of the trust with respect to which S is entitled to all the income ($100,000).

*Example 4. Power of appointment over shares of stock constitutes a power over a specific portion.* Under D's will, 250 shares of Y company stock were bequeathed in trust pursuant to

which all trust income was payable annually to S, D's spouse, for life. S was given a testamentary general power of appointment over 100 shares of stock. The trust provides that if the trustee sells the Y company stock, S's general power of appointment is exercisable with respect to the sale proceeds or the property in which the proceeds are reinvested. Because the amount of property represented by a single share of stock would be altered if the corporation split its stock, issued stock dividends, made a distribution of capital, etc., a power to appoint 100 shares at the time of S's death is not necessarily a power to appoint the entire interest that the 100 shares represented on the date of D's death. If it is shown that, under local law, S has a general power to appoint not only the 100 shares designated by D but also 100/250 of any distributions by the corporation that are included in trust principal, the requirements of paragraph (c)(2) of this section are satisfied and S is treated as having a general power to appoint 100/250 of the entire interest in the 250 shares. In that case, the marital deduction is limited to 40 percent of the trust principal. If local law does not give S that power, the 100 shares would not constitute a specific portion under § 20.2056(b)–5(c) (including § 20.2056(b)–5(c)(3)(i)(B)). The nature of the asset is such that a change in the capitalization of the corporation could cause an alteration in the original value represented by the shares at the time of D's death and, thus, it does not represent a specific portion of the trust.

(d) *Meaning of entire interest.* Because a marital deduction is allowed for each separate qualifying interest in property passing from the decedent to the decedent's surviving spouse (subject to any applicable limitations in § 20.2056(a)–l(c)), for purposes of paragraphs (a) and (b) of this section, each property interest with respect to which the surviving spouse received any rights is considered separately in determining whether the surviving spouse's rights extend to the entire interest or to a specific portion of the entire interest. A property interest which consists of several identical units of property (such as a block of 250 shares of stock, whether the ownership is evidenced by one or several certificates) is considered one property interest, unless certain of the units are to be segregated and accorded different treatment, in which case each segregated group of items is considered a separate property interest. The bequest of a specified sum of money constitutes the bequest of a separate property interest if immediately following distribution by the executor and thenceforth it, and the investments made with it, must be so segregated or accounted for as to permit its identification as a separate item of property. The application of this paragraph may be illustrated by the following examples:

*Example (1).* The decedent transferred to a trustee three adjoining farms, Blackacre, Whiteacre, and Greenacre. His will provided that during the lifetime of the surviving spouse the trustee should pay her all of the income from the trust. Upon her death, all of Blackacre, a one-half interest in White- acre, and a one-third interest in Greenacre were to be distributed to the person or persons appointed by her in her will. The surviving spouse is considered as being entitled to all of the income from the entire interest in Blackacre, all of the income from the entire interest in Whiteacre, and all of the income from the entire interest in Greenacre. She also is considered as having a power of appointment over the entire interest in Blackacre, over one-half of the entire interest in Whiteacre, and over one-third of the entire interest in Greenacre.

*Example (2).* The decedent bequeathed $250,000 to C, as trustee. C is to invest the money and pay all of the income from the investments to W, the decedent's surviving spouse, annually. W was given a general power, exercisable by will, to appoint one-half of the corpus of the trust. Here, immediately following distribution by the executor, the $250,000 will be sufficiently segregated to permit its identification as a separate item, and the $250,000 will constitute an entire property interest. Therefore, W has a right to income and a power of appointment such that one-half of the entire interest is a deductible interest.

*Example (3).* The decedent bequeathed 100 shares of Z corporation stock to D, as trustee. W, the decedent's surviving spouse, is to receive all of the income of the trust annually and is given a general power, exercisable by will, to appoint out of the trust corpus the sum of $25,000. In this case the $25,000 is not, immediately following distribution, sufficiently segregated to permit its identification as a separate item of property in which the surviving spouse has the entire interest. Therefore, the $25,000 does not constitute the entire interest in a property for the purpose of paragraphs (a) and (b) of this section.

(e) *Application of local law.* In determining whether or not the conditions set forth in paragraph (a) (1) through (5) of this section are satisfied by the instrument of transfer, regard is to be had to the applicable provisions of the law of the jursidiction under which the

interest passes and, if the transfer is in trust, the applicable provisions of the law governing the administration of the trust. For example, silence of a trust instrument as to the frequency of payment will not be regarded as a failure to satisfy the condition set forth in paragraph (a)(2) of this section that income must be payable to the surviving spouse annually or more frequently unless the applicable law permits payment to be made less frequently than annually. The principles outlined in this paragraph and paragraphs (f) and (g) of this section which are applied in determining whether transfers in trust meet such conditions are equally applicable in ascertaining whether, in the case of interests not in trust, the surviving spouse has the equivalent in rights over income and over the property.

(f) *Right to income.* (1) If an interest is transferred in trust, the surviving spouse is ''entitled for life to all of the income from the entire interest or a specific portion of the entire interest'', for the purpose of the condition set forth in paragraph (a)(1) of this section, if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Such degree of enjoyment is given only if it was the decedent's intention, as manifested by the terms of the trust instrument and the surrounding circumstances, that the trust should produce for the surviving spouse during her life such an income, or that the spouse should have such use of the trust property as is consistent with the value of the trust corpus and with its preservation. The designation of the spouse as sole income beneficiary for life of the entire interest or a specific portion of the entire interest will be sufficient to qualify the trust unless the terms of the trust and the surrounding circumstances considered as a whole evidence an intention to deprive the spouse of the requisite degree of enjoyment. In determining whether a trust evidences that intention, the treatment required or permitted with respect to individual items must be considered in relation to the entire system provided for the administration of the trust.

(2) If the over-all effect of a trust is to give to the surviving spouse such enforceable rights as will preserve to her the requisite degree of enjoyment, it is immaterial whether that result is effected by rules specifically stated in the trust instrument, or, in their absence, by the rules for the management of the trust property and the allocation of receipts and expenditures supplied by the State law. For example, a provision in the trust instrument for amortization of bond premium by appropriate periodic charges to interest will not disqualify the interest passing in trust even though there is no State law specifically authorizing amortization, or there is a State law denying amortization which is applicable only in the absence of such a provision in the trust instrument.

(3) In the case of a trust, the rules to be applied by the trustee in allocation of receipts and expenses between income and corpus must be considered in relation to the nature and expected productivity of the assets passing in trust, the nature and frequency of occurrence of the expected receipts, and any provisions as to change in the form of investments. If it is evident from the nature of the trust assets and the rules provided for management of the trust that the allocation to income of such receipts as rents, ordinary cash dividends, and interest will give to the spouse the substantial enjoyment during life required by the statute, provisions that such receipts as stock dividends and proceeds from the conversion of trust assets shall be treated as corpus will not disqualify the interest passing in trust. Similarly, provision for a depletion charge against income in the case of trust assets which are subject to depletion will not disqualify the interest passing in trust, unless the effect is to deprive the spouse of the requisite beneficial enjoyment. The same principle is applicable in the case of depreciation, trustees' commissions, and other charges.

(4) Provisions granting administrative powers to the trustee will not have the effect of disqualifying an interest passing in trust unless the grant of

powers evidences the intention to deprive the surviving spouse of the beneficial enjoyment required by the statute. Such an intention will not be considered to exist if the entire terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers. Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus, the power to apply the income or corpus for the benefit of the spouse, and the power to retain the assets passing to the trust. For example, a power to retain trust assets which consist substantially of unproductive property will not disqualify the interest if the applicable rules for the administration of the trust require, or permit the spouse to require, that the trustee either make the property productive or convert it within a reasonable time. Nor will such a power disqualify the interest if the applicable rules for administration of the trust require the trustee to use the degree of judgment and care in the exercise of the power which a prudent man would use if he were owner of the trust assets. Further, a power to retain a residence or other property for the personal use of the spouse will not disqualify the interest passing in trust.

(5) An interest passing in trust will not satisfy the condition set forth in paragraph (a)(1) of this section that the surviving spouse be entitled to all the income if the primary purpose of the trust is to safeguard property without providing the spouse with the required beneficial enjoyment. Such trusts include not only trusts which expressly provide for the accumulation of the income but also trusts which indirectly accomplish a similar purpose. For example, assume that the corpus of a trust consists substantially of property which is not likely to be income producing during the life of the surviving spouse and that the spouse cannot compel the trustee to convert or otherwise deal with the property as described in subparagraph (4) of this paragraph. An interest passing to such a trust will not qualify unless the applicable rules for the administration require, or permit the spouse to require, that the trustee provide the required beneficial enjoyment such as by payments to the spouse out of other assets of the trust.

(6) If a trust is created during the decedent's life, it is immaterial whether or not the interest passing in trust satisfied the conditions set forth in paragraph (a) (1) through (5) of this section prior to the decedent's death. If a trust may be terminated during the life of the surviving spouse, under her exercise of a power of appointment or by distribution of the corpus to her, the interest passing in trust satisfies the condition set forth in paragraph (a)(1) of this section (that the spouse be entitled to all the income) if she (i) is entitled to the income until the trust terminates, or (ii) has the right, exercisable in all events, to have the corpus distributed to her at any time during her life.

(7) An interest passing in trust fails to satisfy the condition set forth in paragraph (a)(1) of this section, that the spouse be entitled to all the income, to the extent that the income is required to be accumulated in whole or in part or may be accumulated in the discretion of any person other than the surviving spouse; to the extent that the consent of any person other than the surviving spouse is required as a condition precedent to distribution of the income; or to the extent that any person other than the surviving spouse has the power to alter the terms of the trust so as to deprive her of her right to the income. An interest passing in trust will not fail to satisfy the condition that the spouse be entitled to all the income merely because its terms provide that the right of the surviving spouse to the income shall not be subject to assignment, alienation, pledge, attachment or claims of creditors.

(8) In the case of an interest passing in trust, the terms ''entitled for life'' and ''payable annually or at more frequent intervals,'' as used in the conditions set forth in paragraph (a) (1) and (2) of this section, require that under the terms of the trust the income referred to must be currently (at least annually; see paragraph (e) of this section) distributable to the spouse or

that she must have such command over the income that it is virtually hers. Thus, the conditions in paragraph (a)(1) and (2) of this section are satisfied in this respect if, under the terms of the trust instrument, the spouse has the right exercisable annually (or more frequently) to require distribution to herself of the trust income, and otherwise the trust income is to be accumulated and added to corpus. Similarly, as respects the income for the period between the last distribution date and the date of the spouse's death, it is sufficient if that income is subject to the spouse's power to appoint. Thus, if the trust instrument provides that income accrued or undistributed on the date of the spouse's death is to be disposed of as if it had been received after her death, and if the spouse has a power of appointment over the trust corpus, the power necessarily extends to the undistributed income.

(9) An interest is not to be regarded as failing to satisfy the conditions set forth in paragraph (a)(1) and (2) of this section (that the spouse be entitled to all the income and that it be payable annually or more frequently) merely because the spouse is not entitled to the income from estate assets for the period before distribution of those assets by the executor, unless the executor is, by the decedent's will, authorized or directed to delay distribution beyond the period reasonably required for administration of the decedent's estate. As to the valuation of the property interest passing to the spouse in trust where the right to income is expressly postponed, see § 20.2056(b)–4.

(g) *Power of appointment in surviving spouse.* (1) The conditions set forth in paragraph (a)(3) and (4) of this section, that is, that the surviving spouse must have a power of appointment exercisable in favor of herself or her estate and exercisable alone and in all events are not met unless the power of the surviving spouse to appoint the entire interest or a specific portion of it falls within one of the following categories:

(i) A power so to appoint fully exercisable in her own favor at any time following the decedent's death (as, for example, an unlimited power to invade); or

(ii) A power so to appoint exercisable in favor of her estate. Such a power, if exercisable during life, must be fully exercisable at any time during life, or, if exercisable by will, must be fully exercisable irrespective of the time of her death (subject in either case to the provisions of § 20.2053(b)–3, relating to interests conditioned on survival for a limited period); or

(iii) A combination of the powers described under subdivisions (i) and (ii) of this subparagraph. For example, the surviving spouse may, until she attains the age of 50 years, have a power to appoint to herself and thereafter have a power to appoint to her estate. However, the condition that the spouse's power must be exercisable in all events is not satisfied unless irrespective of when the surviving spouse may die the entire interest or a specific portion of it will at the time of her death be subject to one power or the other (subject to the exception in § 20.2053(b)–3, relating to interests contingent on survival for a limited period).

(2) The power of the surviving spouse must be a power to appoint the entire interest or a specific portion of it as unqualified owner (and free of the trust if a trust is involved, or free of the joint tenancy if a joint tenancy is involved) or to appoint the entire interest or a specific portion of it as a part of her estate (and free of the trust if a trust is involved), that is, in effect, to dispose of it to whomsoever she pleases. Thus, if the decedent devised property to a son and the surviving spouse as joint tenants with right of survivorship and under local law the surviving spouse has a power of severance exercisable without consent of the other joint tenant, and by exercising this power could acquire a one-half interest in the property as a tenant in common, her power of severance will satisfy the conditions set forth in paragraph (a)(3) of this section that she have a power of appointment in favor of herself or her estate. However, if the surviving spouse entered into a binding agreement with the decedent to exercise the power only in favor of their issue, that condition is not met. An interest passing in trust will not be regarded as failing to satisfy the condition merely because takers in default of the surviving

spouse's exercise of the power are designated by the decedent. The decedent may provide that, in default of exercise of the power, the trust shall continue for an additional period.

(3) A power is not considered to be a power exercisable by a surviving spouse alone and in all events as required by paragraph (a)(4) of this section if the exercise of the power in the surviving spouse to appoint the entire interest or a specific portion of it to herself or to her estate requires the joinder or consent of any other person. The power is not ''exercisable in all events'', if it can be terminated during the life of the surviving spouse by any event other than her complete exercise or release of it. Further, a power is not ''exercisable in all events'' if it may be exercised for a limited purpose only. For example, a power which is not exercisable in the event of the spouse's remarriage is not exercisable in all events. Likewise, if there are any restrictions, either by the terms of the instrument or under applicable local law, on the exercise of a power to consume property (whether or not held in trust) for the benefit of the spouse, the power is not exercisable in all events. Thus, if a power of invasion is exercisable only for the spouse's support, or only for her limited use, the power is not exercisable in all events. In order for a power of invasion to be exercisable in all events, the surviving spouse must have the unrestricted power exercisable at any time during her life to use all or any part of the property subject to the power, and to dispose of it in any manner, including the power to dispose of it by gift (whether or not she has power to dispose of it by will).

(4) The power in the surviving spouse is exercisable in all events only if it exists immediately following the decedent's death. For example, if the power given to the surviving spouse is exercisable during life, but cannot be effectively exercised before distribution of the assets by the executor, the power is not exercisable in all events. Similarly, if the power is exercisable by will, but cannot be effectively exercised in the event the surviving spouse dies before distribution of the assets by the executor, the power is not exercisable in all events. However, an interest will not be disqualified by the mere fact that, in the event the power is exercised during administration of the estate, distribution of the property to the appointee will be delayed for the period of administration. If the power is in existence at all times following the decedent's death, limitations of a formal nature will not disqualify an interest. Examples of formal limitations on a power exercisable during life are requirements that an exercise must be in a particular form, that it must be filed with a trustee during the spouse's life, that reasonable notice must be given, or that reasonable intervals must elapse between successive partial exercises. Examples of formal limitations on a power exercisable by will are that it must be exercised by a will executed by the surviving spouse after the decedent's death or that exercise must be by specific reference to the power.

(5) If the surviving spouse has the requisite power to appoint to herself or her estate, it is immaterial that she also has one or more lesser powers. Thus, if she has a testamentary power to appoint to her estate, she may also have a limited power of withdrawal or of appointment during her life. Similarly, if she has an unlimited power of withdrawal, she may have a limited testamentary power.

(h) *Requirement of survival for a limited period.* A power of appointment in the surviving spouse will not be treated as failing to meet the requirements of paragraph (a)(3) of this section even though the power may terminate, if the only conditions which would cause the termination are those described in paragraph (a) of § 20.2056(b)–3, and if those conditions do not in fact occur. Thus, the entire interest or a specific portion of it will not be disqualified by reason of the fact that the exercise of the power in the spouse is subject to a condition of survivorship described in § 20.2056(b)–3 if the terms of the condition, that is, the survivorship of the surviving spouse, or the failure to die in a common disaster, are fulfilled.

(i) [Reserved]

(j) *Existence of a power in another.* Paragraph (a)(5) of this section provides that a transfer described in paragraph (a) is nondeductible to the extent

that the decedent created a power in the trustee or in any other person to appoint a part of the interest to any person other than the surviving spouse. However, only powers in other persons which are in opposition to that of the surviving spouse will cause a portion of the interest to fail to satisfy the condition set forth in paragraph (a)(5) of this section. Thus, a power in a trustee to distribute corpus to or for the benefit of a surviving spouse will not disqualify the trust. Similarly, a power to distribute corpus to the spouse for the support of minor children will not disqualify the trust if she is legally obligated to support such children. The application of this paragraph may be illustrated by the following examples:

*Example (1).* Assume that a decedent created a trust, designating his surviving spouse as income beneficiary for life with an unrestricted power in the spouse to appoint the corpus during her life. The decedent further provided that in the event the surviving spouse should die without having exercised the power, the trust should continue for the life of his son with a power in the son to appoint the corpus. Since the power in the son could become exercisable only after the death of the surviving spouse, the interest is not regarded as failing to satisfy the condition set forth in paragraph (a)(5) of this section.

*Example (2).* Assume that the decedent created a trust, designating his surviving spouse as income beneficiary for life and as donee of a power to appoint by will the entire corpus. The decedent further provided that the trustee could distribute 30 percent of the corpus to the decedent's son when he reached the age of 35 years. Since the trustee has a power to appoint 30 percent of the entire interest for the benefit of a person other than the surviving spouse, only 70 percent of the interest placed in trust satisfied the condition set forth in paragraph (a)(5) of this section. If, in this case, the surviving spouse had a power, exercisable by her will, to appoint only one-half of the corpus as it was constituted at the time of her death, it should be noted that only 35 percent of the interest placed in the trust would satisfy the condition set forth in paragraph (a)(3) of this section.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8522, 59 FR 9649, Mar. 1, 1994]

**§ 20.2056(b)–6 Marital deduction; life insurance or annuity payments with power of appointment in surviving spouse.**

(a) *In general.* Section 2056(b)(6) provides that an interest in property passing from a decedent to his surviving spouse, which consists of proceeds held by an insurer under the terms of a life insurance, endowment, or annuity contract, is a ''deductible interest'' to the extent that is satisfied all five of the following conditions (see paragraph (b) of this section if one or more of the conditions is satisfied as to only a portion of the proceeds):

(1) The proceeds, or a specific portion of the proceeds, must be held by the insurer subject to an agreement either to pay the entire proceeds or a specific portion thereof in installments, or to pay interest thereon, and all or a specific portion of the installments or interest payable during the life of the surviving spouse must be payable only to her.

(2) The installments or interest payable to the surviving spouse must be payable annually, or more frequently, commencing not later than 13 months after the decedent's death.

(3) The surviving spouse must have the power to appoint all or a specific portion of the amounts so held by the insurer to either herself or her estate.

(4) The power in the surviving spouse must be exercisable by her alone and (whether exercisable by will or during life) must be exercisable in all events.

(5) The amounts or the specific portion of the amounts payable under such contract must not be subject to a power in any other person to appoint any part thereof to any person other than the surviving spouse.

(b) *Specific portion; deductible interest.* If the right to receive interest or installment payments or the power of appointment passing to the surviving spouse pertains only to a specific portion of the proceeds held by the insurer, the marital deduction is allowed only to the extent that the rights of the surviving spouse in the specific portion meet the five conditions described in paragraph (a) of this section. While the rights to interest, or to receive payment in installments, and the

power must coexist as to the proceeds of the same contract, it is not necessary that the rights to each be in the same proportion. If the rights to interest meeting the required conditions set forth in paragraph (a) (1) and (2) of this section extend over a smaller share of the proceeds than the share with respect to which the power of appointment requirements set forth in paragraph (a) (3) through (5) of this section are satisfied, the deductible interest is limited to the smaller share. Similarly, if the portion of the proceeds payable in installments is a smaller portion of the proceeds than the portion to which the power of appointment meeting such requirements relates, the deduction is limited to the smaller portion. In addition, if a power of appointment meeting all the requirements extends to a smaller portion of the proceeds than the portion over which the interest or installment rights pertain, the deductible interest cannot exceed the value of the portion to which such power of appointment applies. Thus, if the contract provides that the insurer is to retain the entire proceeds and pay all of the interest thereon annually to the surviving spouse and if the surviving spouse has a power of appointment meeting the specifications prescribed in paragraph (a) (3) through (5) of this section, as to only one-half of the proceeds held, then only one-half of the proceeds may be treated as a deductible interest. Correspondingly, if the rights of the spouse to receive installment payments or interest satisfying the requirements extend to only one-fourth of the proceeds and a testamentary power of appointment satisfying the requirements of paragraph (a) (3) through (5) of this section extends to all of the proceeds, then only one-fourth of the proceeds qualifies as a deductible interest. Further, if the surviving spouse has no right to installment payments (or interest) over any portion of the proceeds but a testamentary power of appointment which meets the necessary conditions over the entire remaining proceeds, then none of the proceeds qualifies for the deduction. In addition, if, from the time of the decedent's death, the surviving spouse has a power of appointment meeting all of the required conditions over three-fourths of the proceeds and the right to receive interest from the entire proceeds, but with a power in another person to appoint one-half of the entire proceeds, the value of the interest in the surviving spouse over only one-half of the proceeds will qualify as a deductible interest.

(c) *Applicable principles.* (1) The principles set forth in paragraph (c) of § 20.2056(b)–5 for determining what constitutes a ''specific portion of the entire interest'' for the purpose of section 2056(b)(5) are applicable in determining what constitutes a ''specific portion of all such amounts'' for the purpose of section 2056(b)(6). However, the interest in the proceeds passing to the surviving spouse will not be disqualified by the fact that the installment payments or interest to which the spouse is entitled or the amount of the proceeds over which the power of appointment is exercisable may be expressed in terms of a specific sum rather than a fraction or a percentage of the proceeds provided it is shown that such sums are a definite or fixed percentage or fraction of the total proceeds.

(2) The provisions of paragraph (a) of this section are applicable with respect to a property interest which passed from the decedent in the form of proceeds of a policy of insurance upon the decedent's life, a policy of insurance upon the life of a person who predeceased the decedent, a matured endowment policy, or an annuity contract, but only in case the proceeds are to be held by the insurer. With respect to proceeds under any such contract which are to be held by a trustee, with power of appointment in the surviving spouse, see § 20.2056(b)–5. As to the treatment of proceeds not meeting the requirements of § 20.2056(b)–5 or of this section, see § 20.2056(a)–2.

(3) In the case of a contract under which payments by the insurer commenced during the decedent's life, it is immaterial whether or not the conditions in subparagraphs (1) through (5) of paragraph (a) of this section were satisfied prior to the decedent's death.

(d) *Payments of installments or interest.* The conditions in subparagraphs (1) and (2) of paragraph (a) of this section relative to the payments of installments or interest to the surviving

spouse are satisfied if, under the terms of the contract, the spouse has the right exercisable annually (or more frequently) to require distribution to herself of installments of the proceeds or a specific portion thereof, as the case may be, and otherwise such proceeds or interest are to be accumulated and held by the insurer pursuant to the terms of the contract. A contract which otherwise requires the insurer to make annual or more frequent payments to the surviving spouse following the decedent's death, will not be disqualified merely because the surviving spouse must comply with certain formalities in order to obtain the first payment. For example, the contract may satisfy the conditions in subparagraphs (1) and (2) of paragraph (a) of this section even though it requires the surviving spouse to furnish proof of death before the first payment is made. The condition in paragraph (a)(1) of this section is satisfied where interest on the proceeds or a specific portion thereof is payable, annually or more frequently, for a term, or until the occurrence of a specified event, following which the proceeds or a specific portion thereof are to be paid in annual or more frequent installments.

(e) *Powers of appointment.* (1) In determining whether the terms of the contract satisfy the conditions in subparagraph (3), (4), or (5) of paragraph (a) of this section relating to a power of appointment in the surviving spouse or any other person, the principles stated in § 20.2056(b)–5 are applicable. As stated in § 20.2056(b)–5, the surviving spouse's power to appoint is ''exercisable in all events'' only if it is in existence immediately following the decedent's death, subject, however, to the operation of § 20.2056(b)–3 relating to interests conditioned on survival for a limited period.

(2) For examples of formal limitations on the power which will not disqualify the contract, see paragraph (g)(4) of § 20.2056(b)–5. If the power is exercisable from the moment of the decedent's death, the contract is not disqualified merely because the insurer may require proof of the decedent's death as a condition to making payment to the appointee. If the submission of proof of the decedent's death is a condition to the exercise of the power, the power will not be considered ''exercisable in all events'' unless in the event the surviving spouse had died immediately following the decedent, her power to appoint would have been considered to exist at the time of her death, within the meaning of section 2041(a)(2). See paragraph (b) of § 20.2041–3.

(3) It is sufficient for the purposes of the condition in paragraph (a)(3) of this section that the surviving spouse have the power to appoint amounts held by the insurer to herself or her estate if the surviving spouse has the unqualified power, exercisable in favor of herself or her estate, to appoint amounts held by the insurer which are payable after her death. Such power to appoint need not extend to installments or interest which will be paid to the spouse during her life. Further, the power to appoint need not be a power to require payment in a single sum. For example, if the proceeds of a policy are payable in installments, and if the surviving spouse has the power to direct that all installments payable after her death be paid to her estate, she has the requisite power.

(4) It is not necessary that the phrase ''power to appoint'' be used in the contract. For example, the condition in paragraph (a)(3) of this section that the surviving spouse have the power to appoint amounts held by the insurer to herself or her estate is satisfied by terms of a contract which give the surviving spouse a right which is, in substance and effect, a power to appoint to herself or her estate, such as a right to withdraw the amount remaining in the fund held by the insurer, or a right to direct that any amount held by the insurer under the contract at her death shall be paid to her estate.

### § 20.2056(b)–7 Election with respect to life estate for surviving spouse.

(a) *In general.* Subject to section 2056(d), a marital deduction is allowed under section 2056(b)(7) with respect to estates of decedents dying after December 31, 1981, for qualified terminable interest property as defined in paragraph (b) of this section. All of the

property for which a deduction is allowed under this paragraph (a) is treated as passing to the surviving spouse (for purposes of § 20.2056(a)–1), and no part of the property is treated as passing to any person other than the surviving spouse (for purposes of § 20.2056(b)–1).

(b) *Qualified terminable interest property*—(1) *In general.* Section 2056(b)(7)(B)(i) provides the definition of *qualified terminable interest property*.

(i) Terminable interests described in section 2056(b)(1)(C) cannot qualify as qualified terminable interest property. Thus, if the decedent directs the executor to purchase a terminable interest with estate assets, the terminable interest acquired will not qualify as qualified terminable interest property.

(ii) For purposes of section 2056(b)(7)(B)(i), the term *property* generally means the *entire interest in property* (within the meaning of § 20.2056(b)–5(d)) or a *specific portion of the entire interest* (within the meaning of § 20.2056(b)–5(c)).

(2) *Property for which an election may be made*—(i) *In general.* The election may relate to all or any part of property that meets the requirements of section 2056(b)(7)(B)(i), provided that any partial election must be made with respect to a fractional or percentage share of the property so that the elective portion reflects its proportionate share of the increase or decrease in value of the entire property for purposes of applying sections 2044 or 2519. The fraction or percentage may be defined by formula.

(ii) *Division of trusts*—(A) *In general.* A trust may be divided into separate trusts to reflect a partial election that has been made, or is to be made, if authorized under the governing instrument or otherwise permissible under local law. Any such division must be accomplished no later than the end of the period of estate administration. If, at the time of the filing of the estate tax return, the trust has not yet been divided, the intent to divide the trust must be unequivocally signified on the estate tax return.

(B) *Manner of dividing and funding trust.* The division of the trust must be done on a fractional or percentage basis to reflect the partial election. However, the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust.

(C) *Local law.* A trust may be divided only if the fiduciary is required, either by applicable local law or by the express or implied provisions of the governing instrument, to divide the trust on the basis of the fair market value of the assets of the trust at the time of the division.

(3) *Persons permitted to make the election.* The election referred to in section 2056(b)(7)(B)(i)(III) must be made by the executor that is appointed, qualified, and acting within the United States, within the meaning of section 2203, regardless of whether the property with respect to which the election is to be made is in the executor's possession. If there is no executor appointed, qualified, and acting within the United States, the election may be made by any person with respect to property in the actual or constructive possession of that person and may also be made by that person with respect to other property not in the actual or constructive possession of that person if the person in actual or constructive possession of such other property does not make the election. For example, in the absence of an appointed executor, the trustee of an intervivos trust (that is included in the gross estate of the decedent) can make the election.

(4) *Manner and time of making the election*—(i) *In general.* The election referred to in section 2056(b)(7)(B)(i)(III) and (v) is made on the return of tax imposed by section 2001 (or section 2101). For purposes of this paragraph, the term *return of tax imposed by section 2001* means the last estate tax return filed by the executor on or before the due date of the return, including extensions or, if a timely return is not filed, the first estate tax return filed by the executor after the due date.

(ii) *Election irrevocable.* The election, once made, is irrevocable, provided that an election may be revoked or modified on a subsequent return filed on or before the due date of the return, including extensions actually granted. If an executor appointed under local law has made an election on the return

of tax imposed by section 2001 (or section 2101) with respect to one or more properties, no subsequent election may be made with respect to other properties included in the gross estate after the return of tax imposed by section 2001 is filed. An election under section 2056(b)(7)(B)(v) is separate from any elections made under section 2056A(a)(3).

(c) *Protective elections*—(1) *In general.* A protective election may be made to treat property as qualified terminable interest property only if, at the time the federal estate tax return is filed, the executor of the decedent's estate reasonably believes that there is a bona fide issue that concerns whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive, i.e., whether property that is includible is eligible for the qualified terminable interest property election. The protective election must identify either the specific asset, group of assets, or trust to which the election applies and the specific basis for the protective election.

(2) *Protective election irrevocable.* The protective election, once made on the return of tax imposed by section 2001, cannot be revoked. For example, if a protective election is made on the basis that a bona fide question exists regarding the inclusion of a trust corpus in the gross estate and it is later determined that the trust corpus is so includible, the protective election becomes effective with respect to the trust corpus and cannot thereafter be revoked.

(d) *Qualifying income interest for life*—(1) *In general.* Section 2056(b)(7)(B)(ii) provides the definition of *qualifying income interest for life.* For purposes of section 2056(b)(7)(B)(ii)(II), the surviving spouse is included within the prohibited class of powerholders referred to therein.

(2) *Entitled for life to all income.* The principles of § 20.2056(b)–5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.

(3) *Contingent income interests.* (i) An income interest for a term of years, or a life estate subject to termination upon the occurrence of a specified event (e.g., remarriage), is not a qualifying income interest for life. However, a qualifying income interest for life that is contingent upon the executor's election under section 2056(b)(7)(B)(v) will not fail to be a qualifying income interest for life because of such contingency or because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse. This paragraph (d)(3)(i) applies with respect to estates of decedents whose estate tax returns are due after February 18, 1997. This paragraph (d)(3)(i) also applies to estates of decedents whose estate tax returns were due on or before February 18, 1997, that meet the requirements of paragraph (d)(3)(ii) of this section.

(ii) Estates of decedents whose estate tax returns were due on or before February 18, 1997, that did not make the election under section 2056(b)(7)(B)(v) because the surviving spouse's income interest in the property was contingent upon the election or because the nonelected portion of the property was to pass to a beneficiary other than the surviving spouse are granted an extension of time to make the QTIP election if the following requirements are satisfied:

(A) The period of limitations on filing a claim for credit or refund under section 6511(a) has not expired.

(B) A claim for credit or refund is filed on Form 843 with a revised Recapitulation and Schedule M, Form 706 (or 706NA) that signifies the QTIP election. Reference to this section should be made on the Form 843.

(C) The following statement is included with the Form 843: ''The undersigned certifies that the property with respect to which the QTIP election is being made will be included in the gross estate of the surviving spouse as provided in section 2044 of the Internal Revenue Code, in determining the federal estate tax liability on the spouse's death.'' The statement must be signed,

under penalties of perjury, by the surviving spouse, the surviving spouse's legal representative (if the surviving spouse is legally incompetent), or the surviving spouse's executor (if the surviving spouse is deceased).

(4) *Income between last distribution date and date of spouse's death.* An income interest does not fail to constitute a qualifying income interest for life solely because income between the last distribution date and the date of the surviving spouse's death is not required to be distributed to the surviving spouse or to the estate of the surviving spouse. See § 20.2044–1 relating to the inclusion of such undistributed income in the gross estate of the surviving spouse.

(5) *Pooled income funds.* An income interest in a pooled income fund described in section 642(c)(5) constitutes a qualifying income interest for life for purposes of section 2056(b)(7)(B)(ii).

(6) *Power to distribute principal to spouse.* An income interest in a trust will not fail to constitute a qualifying income interest for life solely because the trustee has a power to distribute principal to or for the benefit of the surviving spouse. The fact that property distributed to a surviving spouse may be transferred by the spouse to another person does not result in a failure to satisfy the requirement of section 2056(b)(7)(B)(ii)(II). However, if the surviving spouse is legally bound to transfer the distributed property to another person without full and adequate consideration in money or money's worth, the requirement of section 2056(b)(7)(B)(ii)(II) is not satisfied.

(e) *Annuities payable from trusts in the case of estates of decedents dying on or before October 24, 1992, and certain decedents dying after October 24, 1992, with wills or revocable trusts executed on or prior to that date*—(1) *In general.* In the case of estates of decedents within the purview of the effective date and transitional rules contained in § 20.2056(b)–7(e)(5), a surviving spouse's lifetime annuity interest payable from a trust or other group of assets passing from the decedent is treated as a qualifying income interest for life for purposes of section 2056(b)(7)(B)(ii).

(2) *Deductible interest.* The deductible interest, for purposes of § 20.2056(a)–2(b), is the specific portion of the property that, assuming the applicable interest rate for valuing annuities, would produce income equal to the minimum amount payable annually to the surviving spouse. If, based on the applicable interest rate, the entire property from which the annuity may be satisfied is insufficient to produce income equal to the minimum annual payment, the value of the deductible interest is the entire value of the property. The value of the deductible interest may not exceed the value of the property from which the annuity is payable. If the annual payment may increase, the increased amount is not taken into account in valuing the deductible interest.

(3) *Distributions permissible only to surviving spouse.* An annuity interest is not treated as a qualifying income interest for life for purposes of section 2056(b)(7)(B)(ii) if any person other than the surviving spouse may receive, during the surviving spouse's lifetime, any distribution of the property or its income (including any distribution under an annuity contract) from which the annuity is payable.

(4) *Applicable interest rate.* To determine the applicable interest rate for valuing annuities, see sections 2031 and 7520 and the regulations under those sections.

(5) *Effective dates.* (i) The rules contained in § 20.2056(b)–7(e) apply with respect to estates of decedents dying on or before October 24, 1992.

(ii) The rules contained in § 20.2056(b)–7(e) apply in the case of decedents dying after October 24, 1992, if property passes to the spouse pursuant to a will or revocable trust executed on or before October 24, 1992, and either—

(A) On that date, the decedent was 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 death; or

(B) The decedent dies prior to October 24, 1995.

(iii) Notwithstanding the foregoing, the rules contained in § 20.2056(b)–7(e) do not apply if the will or revocable trust is amended after October 24, 1992, in any respect that increases the amount of the transfer qualifying for

the marital deduction or alters the terms by which the interest so passes to the surviving spouse.

(f) *Joint and survivor annuities.* [Reserved]

(g) *Application of local law.* The provisions of local law are taken into account in determining whether the conditions of section 2056(b)(7)(B)(ii)(I) are satisfied. For example, silence of a trust instrument as to the frequency of payment is not regarded as a failure to satisfy the requirement that the income must be payable to the surviving spouse annually or more frequently unless applicable local law permits payments less frequently.

(h) *Examples.* The following examples illustrate the application of paragraphs (a) through (g) of this section. In each example, it is assumed that the decedent, D, was survived by S, D's spouse and that, unless stated otherwise, S is not the trustee of any trust established for S's benefit.

*Example 1.* Life estate in residence. D owned a personal residence valued at $250,000 for estate tax purposes. Under D's will, the exclusive and unrestricted right to use the residence (including the right to continue to occupy the property as a personal residence or to rent the property and receive the income) passes to S for life. At S's death, the property passes to D's children. Under applicable local law, S must consent to any sale of the property. If the executor elects to treat all of the personal residence as qualified terminable interest property, the deductible interest is $250,000, the value of the residence for estate tax purposes.

*Example 2. Power to make property productive.* D's will established a trust funded with property valued for estate tax purposes at $500,000. The assets include both income producing assets and non-productive assets. S was given the power, exercisable annually, to require distribution of all of the trust income to herself. No trust property may be distributed during S's lifetime to any person other than S. Applicable local law permits S to require that the trustee either make the trust property productive or sell the property and reinvest in productive property within a reasonable time after D's death. If the executor elects to treat all of the trust as qualified terminable interest property, the deductible interest is $500,000. If the executor elects to treat only 20 percent of the trust as qualified terminable interest property, the deductible interest is $100,000, i.e., 20 percent of $500,000.

*Example 3. Power of distribution over fraction of trust income.* The facts are the same as in *Example 2* except that S is given the right exercisable annually for S's lifetime to require distribution to herself of only 50 percent of the trust income for life. The remaining trust income is to be accumulated or distributed among S and the decedent's children in the trustee's discretion. The maximum amount that D's executor may elect to treat as qualified terminable interest property is $250,000; i.e., the estate tax value of the trust ($500,000) multiplied by the percentage of the trust in which S has a qualifying income interest for life (50 percent). If D's executor elects to treat only 20 percent of the portion of the trust in which S has a qualifying income interest as qualified terminable interest property, the deductible interest is $50,000, i.e., 20 percent of $250,000.

*Example 4. Power to distribute trust corpus to other beneficiaries.* D's will established a trust providing that S is entitled to receive at least annually all the trust income. The trustee is given the power to use annually during S's lifetime $5,000 from the trust for the maintenance and support of S's minor child, C. Any such distribution does not necessarily relieve S of S's obligation to support and maintain C. S does not have a qualifying income interest for life in any portion of the trust because the bequest fails to satisfy the condition that no person have a power, other than a power the exercise of which takes effect only at or after S's death, to appoint any part of the property to any person other than S. The trust would also be nondeductible under section 2056(b)(7) if S, rather than the trustee, held the power to appoint a portion of the principal to C. However, in the latter case, if S made a qualified disclaimer (within the meaning of section 2518) of the power to appoint to C, the trust could qualify for the marital deduction pursuant to section 2056(b)(7), assuming that the power is personal to S and S's disclaimer terminates the power. Similarly, in either case, if C made a qualified disclaimer of C's right to receive distributions from the trust, the trust would qualify under section 2056(b)(7), assuming that C's disclaimer effectively negates the trustee's power under local law.

*Example 5. Spouse's income interest terminable on remarriage.* D's will established a trust providing that all of the trust income is payable at least annually to S for S's lifetime, provided that, if S remarries, S's interest in the trust will pass to X. The trust is not deductible under section 2056(b)(7). S's income interest is not a *qualifying income interest for life* because it is not for life but, rather, is terminable upon S's remarriage.

*Example 6. Spouse's qualifying income interest for life contingent on executor's election.* D's will established a trust providing that S is entitled to receive the income, payable at least annually, from that portion of the trust that the executor elects to treat as qualified terminable interest property. The

portion of the trust which the executor does not elect to treat as qualified terminable interest property passes as of D's date of death to a trust for the benefit of C, D's child. Under these facts, the executor is not considered to have a power to appoint any part of the trust property to any person other than S during S's life.

*Example 7. Formula partial election.* D's will established a trust funded with the residue of D's estate. Trust income is to be paid annually to S for life, and the principal is to be distributed to D's children upon S's death. S has the power to require that all the trust property be made productive. There is no power to distribute trust property during S's lifetime to any person other than S. D's executor elects to deduct a fractional share of the residuary estate under section 2056(b)(7). The election specifies that the numerator of the fraction is the amount of deduction necessary to reduce the Federal estate tax to zero (taking into account final estate tax values) and the denominator of the fraction is the final estate tax value of the residuary estate (taking into account any specific bequests or liabilities of the estate paid out of the residuary estate). The formula election is of a fractional share. The value of the share qualifies for the marital deduction even though the executor's determinations to claim administration expenses as estate or income tax deductions and the final estate tax values will affect the size of the fractional share.

*Example 8. Formula partial election.* The facts are the same as in *Example 7* except that, rather than defining a fraction, the executor's formula states: ''I elect to treat as qualified terminable interest property that portion of the residuary trust, up to 100 percent, necessary to reduce the Federal estate tax to zero, after taking into account the available unified credit, final estate tax values and any liabilities and specific bequests paid from the residuary estate.'' The formula election is of a fractional share. The share is equivalent to the fractional share determined in *Example 7.*

*Example 9. Severance of QTIP trust.* D's will established a trust funded with the residue of D's estate. Trust income is to be paid annually to S for life, and the principal is to be distributed to D's children upon S's death. S has the power to require that all of the trust property be made productive. There is no power to distribute trust property during S's lifetime to any person other than S. D's will authorizes the executor to make the election under section 2056(b)(7) only with respect to the minimum amount of property necessary to reduce estate taxes on D's estate to zero, authorizes the executor to divide the residuary estate into two separate trusts to reflect the election, and authorizes the executor to charge any payment of principal to S to the qualified terminable interest trust. S is the sole beneficiary of both trusts during S's lifetime. The authorizations in the will do not adversely affect the allowance of the marital deduction. Only the property remaining in the marital deduction trust, after payment of principal to S, is subject to inclusion in S's gross estate under section 2044 or subject to gift tax under section 2519.

*Example 10. Payments to spouse from individual retirement account.* S is the life beneficiary of sixteen remaining annual installments payable from D's individual retirement account. The terms of the account provide for the payment of the account balance in nineteen annual installments that commenced when D reached age 70½. Each installment is equal to all the income earned on the remaining principal in the account plus a share of the remaining principal equal to 1/19 in the first year, 1/18 in the second year, 1/17 in the third year, etc. Under the terms of the account, S has no right to withdraw any other amounts from the account. Any payments remaining after S's death pass to D's children. S's interest in the account qualifies as a qualifying income interest for life under section 2056(b)(7)(B)(ii), without regard to the provisions of section 2056(b)(7)(C).

*Example 11. Spouse's interest in trust in the form of an annuity.* D died prior to October 24, 1992. D's will established a trust funded with income producing property valued at $500,000 for estate tax purposes. The trustee is required by the trust instrument to pay $20,000 a year to S for life. Trust income in excess of the annuity amount is to be accumulated in the trust and may not be distributed during S's lifetime. S's lifetime annuity interest is treated as a qualifying income interest for life. If the executor elects to treat the entire portion of the trust in which S has a qualifying income interest as qualified terminable interest property, the value of the deductible interest is (assuming that 10 percent is the applicable interest rate under section 7520 for valuing annuities on the appropriate valuation date) $200,000, because that amount would yield an income to S of $20,000 a year.

*Example 12. Value of spouse's annuity exceeds value of trust corpus.* The facts are the same as in *Example 11* except that the trustee is required to pay S $70,000 a year for life. If the executor elects to treat the entire portion of the trust in which S has a qualifying income interest as qualified terminable interest property, the value of the deductible interest is $500,000, which is the lesser of the entire value of the property ($500,000), or the amount of property that (assuming a 10 percent interest rate) would yield an income to S of $70,000 a year ($700,000).

*Example 13. Pooled income fund.* D's will provides for a bequest of $200,000 to a pooled income fund described in section 642(c)(5), designating S as the income beneficiary for life. If D's executor elects to treat the entire

$200,000 as qualified terminable interest property, the deductible interest is $200,000.

*Example 14. Funding severed QTIP trusts.* D's will established a trust satisfying the requirements of section 2056(b)(7). Pursuant to the authority in D's will and § 20.2056(b)–7(b)(2)(ii), D's executor indicates on the Federal estate tax return that an election under section 2056(b)(7) is being made with respect to 50 percent of the trust, and that the trust will subsequently be divided to reflect the partial election on the basis of the fair market value of the property at the time of the division. D's executor funds the trust at the end of the period of estate administration. At that time, the property available to fund the trusts consists of 100 shares of X Corporation stock with a current value of $400,000 and 200 shares of Y Corporation stock with a current value of $400,000. D may fund each trust with the stock of either or both corporations, in any combination, provided that the aggregate value of the stock allocated to each trust is $400,000.

[T.D. 8522, 59 FR 9651, Mar. 1, 1994, as amended by T.D. 8779, 63 FR 44393, Aug. 19, 1998]

### § 20.2056(b)–8 Special rule for charitable remainder trusts.

(a) *In general*—(1) *Surviving spouse only noncharitable beneficiary.* With respect to estates of decedents dying after December 31, 1981, subject to section 2056(d), if the surviving spouse of the decedent is the only noncharitable beneficiary of a charitable remainder annuity trust or a charitable remainder unitrust described in section 664 (qualified charitable remainder trust), section 2056(b)(1) does not apply to the interest in the trust that is transferred to the surviving spouse. Thus, the value of the annuity or unitrust interest passing to the spouse qualifies for a marital deduction under section 2056(b)(8) and the value of the remainder interest qualifies for a charitable deduction under section 2055. If an interest in property qualifies for a marital deduction under section 2056(b)(8), no election may be made with respect to the property under section 2056(b)(7). For purposes of this section, the term *non-charitable beneficiary* means any beneficiary of the qualified charitable remainder trust other than an organization described in section 170(c).

(2) *Interest for life or term of years.* The surviving spouse's interest need not be an interest for life to qualify for a marital deduction under section 2056(b)(8). However, for purposes of section 664, an annuity or unitrust interest payable to the spouse for a term of years cannot be payable for a term that exceeds 20 years.

(3) *Payment of state death taxes.* A deduction is allowed under section 2056(b)(8) even if the transfer to the surviving spouse is conditioned on the spouse's payment of state death taxes, if any, attributable to the qualified charitable remainder trust. See § 20.2056(b)–4(c) for the effect of such a condition on the amount of the deduction allowable.

(b) *Charitable remainder trusts where the surviving spouse is not the only noncharitable beneficiary.* In the case of a charitable remainder trust where the decedent's spouse is not the only noncharitable beneficiary (for example, where the noncharitable interest is payable to the decedent's spouse for life and then to another individual for life), the qualification of the interest as qualified terminable interest property is determined solely under section 2056(b)(7) and not under section 2056(b)(8). Accordingly, if the decedent died on or before October 24, 1992, or the trust otherwise comes within the purview of the transitional rules contained in § 20.2056(b)–7(e)(5), the spousal annuity or unitrust interest may qualify under § 20.2056(b)–(7)(e) as a qualifying income interest for life.

[T.D. 8522, 59 FR 9653, Mar. 1, 1994]

### § 20.2056(b)–9 Denial of double deduction.

The value of an interest in property may not be deducted for Federal estate tax purposes more than once with respect to the same decedent. For example, where a decedent transfers a life estate in a farm to the spouse with a remainder to charity, the entire property is, pursuant to the executor's election under section 2056(b)(7), treated as passing to the spouse. The entire value of the property qualifies for the marital deduction. No part of the value of the property qualifies for a charitable deduction under section 2055 in the decedent's estate.

[T.D. 8522, 59 FR 9654, Mar. 1, 1994]

### § 20.2056(b)–10 Effective dates.

Except as specifically provided in §§ 20.2056(b)–5(c)(3) (ii) and (iii), 20.2056(b)–7(d)(3), 20.2056(b)–7(e)(5), and 20.2056(b)–8(b), the provisions of §§ 20.2056(b)–5(c), 20.2056(b)–7, 20.2056(b)–8, and 20.2056(b)–9 are applicable with respect to estates of decedents dying after March 1, 1994. With respect to decedents dying on or before such date, the executor of the decedent's estate may rely on any reasonable interpretation of the statutory provisions.

[T.D. 8779, 63 FR 44393, Aug. 19, 1998]

### § 20.2056(c)–1 Marital deduction; definition of "passed from the decedent."

(a) *In general.* The following rules are applicable in determining the person to whom any property interest ''passed from the decedent'':

(1) Property interests devolving upon any person (or persons) as surviving co-owner with the decedent under any form of joint ownership under which the right of survivorship existed are considered as having passed from the decedent to such person (or persons).

(2) Property interests at any time subject to the decedent's power to appoint (whether alone or in conjunction with any person) are considered as having passed from the decedent to the appointee under his exercise of the power, or, in case of the lapse, release or nonexercise of the power, as having passed from the decedent to the taker in default of exercise.

(3) The dower or curtesy interest (or statutory interest in lieu thereof) of the decedent's surviving spouse is considered as having passed from the decedent to his spouse.

(4) The proceeds of insurance upon the life of the decedent are considered as having passed from the decedent to the person who, at the time of the decedent's death, was entitled to receive the proceeds.

(5) Any property interest transferred during life, bequeathed or devised by the decedent, or inherited from the decedent, is considered as having passed to the person to whom he transferred, bequeathed, or devised the interest, or to the person who inherited the interest from him.

(6) The survivor's interest in an annuity or other payment described in section 2039 (see §§ 20.2039–1 and 20.2039–2) is considered as having passed from the decedent to the survivor only to the extent that the value of such interest is included in the decedent's gross estate under that section. If only a portion of the entire annuity or other payment is included in the decedent's gross estate and the annuity or other payment is payable to more than one beneficiary, then the value of the interest considered to have passed to each beneficiary is that portion of the amount payable to each beneficiary that the amount of the annuity or other payment included in the decedent's gross estate bears to the total value of the annuity or other payment payable to all beneficiaries.

(b) *Expectant interest in property under community property laws.* If before the decedent's death the decedent's surviving spouse had merely an expectant interest in property held by her and the decedent under community property laws, that interest is considered as having passed from the decedent to the spouse.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 8522, 59 FR 9654, Mar. 1, 1994]

### § 20.2056(c)–2 Marital deduction; definition of "passed from the decedent to his surviving spouse."

(a) *In general.* In general, the definition stated in § 20.2056(c)–1 is applicable in determining the property interests which ''passed from the decedent to his surviving spouse''. Special rules are provided, however, for the following:

(1) In the case of certain interests with income for life to the surviving spouse with power of appointment in her (see § 20.2056(b)–5);

(2) In the case of certain interests with income for life to the surviving spouse that the executor elects to treat as qualified terminable interest property (see § 20.2056(b)–7);

(3) In the case of proceeds held by the insurer under a life insurance, endowment, or annuity contract with power of appointment in the surviving spouse (see § 20.2056(b)–6);

(4) In case of the disclaimer of an interest by the surviving spouse or by any other person (see § 20.2056(d)–1);

(5) In case of an election by the surviving spouse (see paragraph (c) of this section); and

(6) In case of a controversy involving the decedent's will, see paragraph (d) of this section.

A property interest is treated as passing to the surviving spouse only if it passes to the spouse as beneficial owner, except to the extent otherwise provided in §§ 20.2056(b)–5 through 20.2056(b)–7. For this purpose, where a property interest passed from the decedent in trust, such interest is considered to have passed from him to his surviving spouse to the extent of her beneficial interest therein. The deduction may not be taken with respect to a property interest which passed to such spouse merely as trustee, or subject to a binding agreement by the spouse to dispose of the interest in favor of a third person. An allowance or award paid to a surviving spouse pursuant to local law for her support during the administration of the decedent's estate constitutes a property interest passing from the decedent to his surviving spouse. In determining whether or not such an interest is deductible, however, see generally the terminable interest rules of § 20.2056(b)–1 and especially example (8) of paragraph (g) of that section.

(b) *Examples.* The following illustrate the provisions of paragraph (a) of this section:

(1) A property interest bequeathed in trust by H (the decedent) is considered as having passed from him to W (his surviving spouse)—

(i) If the trust income is payable to W for life and upon her death the corpus is distributable to her executors or administrators;

(ii) If W is entitled to the trust income for a term of years following which the corpus is to be paid to W or her estate;

(iii) If the trust income is to be accumulated for a term of years or for W's life and the augmented fund paid to W or her estate; or

(iv) If the terms of the transfer satisfy the requirements of § 20.2056(b)–5 or § 20.2056(b)–7.

(2) If H devised property—

(i) To A for life with remainder absolutely to W or her estate, the remainder interest is considered to have passed from H to W;

(ii) To W for life with remainder to her estate, the entire property is considered as having passed from H to W; or

(iii) Under conditions which satisfy the provisions of § 20.2056(b)–5 or 20.2056(b)–7, the entire property is considered as having passed from H to W.

(3) Proceeds of insurance upon the life of H are considered as having passed from H to W if the terms of the contract—

(i) Meet the requirements of § 20.2056(b)–6;

(ii) Provide that the proceeds are payable to W in a lump sum;

(iii) Provide that the proceeds are payable in installments to W for life and after her death any remaining installments are payable to her estate;

(iv) Provide that interest on the proceeds is payable to W for life and upon her death the principal amount is payable to her estate; or

(v) Provide that the proceeds are payable to a trustee under an arrangement whereby the requirements of § 20.2056(b)–5 or 20.2056(b)–7 are satisfied.

(c) *Effect of election by surviving spouse.* This paragraph contains rules applicable if the surviving spouse may elect between a property interest offered to her under the decedent's will or other instrument and a property interest to which she is otherwise entitled (such as dower, a right in the decedent's estate, or her interest under community property laws) of which adverse disposition was attempted by the decedent under the will or other instrument. If the surviving spouse elects to take against the will or other instrument, then the property interests offered thereunder are not considered as having ''passed from the decedent to his surviving spouse'' and the dower or other property interest retained by her is considered as having so passed (if it otherwise so qualifies under this section). If the surviving spouse elects to take under the will or other instrument, then the dower or other property

interest relinquished by her is not considered as having ''passed from the decedent to his surviving spouse'' (irrespective of whether it otherwise comes within the definition stated in paragraph (a) of this section) and the interest taken under the will or other instrument is considered as having so passed (if it otherwise so qualifies). As to the valuation of the property interest taken under the will or other instrument, see paragraph (b) of §20.2056(b)–4.

(d) *Will contests.* (1) If as a result of a controversy involving the decedent's will, or involving any bequest or devise thereunder, his surviving spouse assigns or surrenders a property interest in settlement of the controversy, the interest so assigned or surrendered is not considered as having ''passed from the decedent to his surviving spouse.''

(2) If as a result of the controversy involving the decedent's will, or involving any bequest or devise thereunder, a property interest is assigned or surrendered to the surviving spouse, the interest so acquired will be regarded as having ''passed from the decedent to his surviving spouse'' only if the assignment or surrender as a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate. Such a bona fide recognition will be presumed where the assignment or surrender was pursuant to a decision of a local court upon the merits in an adversary proceeding following a genuine and active contest. However, such a decree will be accepted only to the extent that the court passed upon the facts upon which deductibility of the property interest depends. If the assignment or surrender was pursuant to a decree rendered by consent, or pursuant to an agreement not to contest the will or not to probate the will, it will not necessarily be accepted as a bona fide evaluation of the rights of the spouse.

(e) *Survivorship.* If the order of deaths of the decedent and his spouse cannot be established by proof, a presumption (whether supplied by local law, the decedent's will, or otherwise) that the decedent was survived by his spouse will be recognized as satisfying paragraph (b)(1) of §20.2056(a)–1, but only to the extent that it has the effect of giving to the spouse an interest in property includible in her gross estate under Part III of Subchapter A of Chapter 11. Under these circumstances, if an estate tax return is required to be filed for the estate of the decedent's spouse, the marital deduction will not be allowed in the final audit of the estate tax return of the decedent's estate with respect to any property interest which has not been finally determined to be includible in the gross estate of his spouse.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 8522, 59 FR 9654, Mar. 1, 1994]

### §20.2056(c)–3 Marital deduction; definition of "passed from the decedent to a person other than his surviving spouse".

The expression ''passed from the decedent to a person other than his surviving spouse'' refers to any property interest which, under the definition stated in §20.2056(c)–1 is considered as having ''passed from the decedent'' and which under the rules referred to in §20.2056(c)–2 is not considered as having ''passed from the decedent to his surviving spouse.'' Interests which passed to a person other than the surviving spouse include interests so passing under the decedent's exercise, release, or nonexercise of a nontaxable power to appoint. It is immaterial whether the property interest which passed from the decedent to a person other than his surviving spouse is included in the decedent's gross estate. The term ''person other than his surviving spouse'' includes the possible unascertained takers of a property interest, as, for example, the members of a class to be ascertained in the future. As another example, assume that the decedent created a power of appointment over a property interest, which does not come within the purview of §20.2056(b)–5 or §20.2056(b)–6. In such a case, the term ''person other than his surviving spouse'' refers to the possible appointees and possible takers in default (other than the spouse) of such property interest. Whether or not there is a possibility that the ''person other than his surviving spouse'' (or the heirs or assigns of such person) may possess

or enjoy the property following termination or failure of the interest therein which passed from the decedent to his surviving spouse is to be determined as of the time of the decedent's death.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 8522, 59 FR 9654, Mar. 1, 1994]

### § 20.2056(d)–1 Marital deduction; special rules for marital deduction if surviving spouse is not a United States citizen.

Rules pertaining to the application of section 2056(d), including certain transition rules, are contained in §§ 20.2056A–1 through 20.2056A–13.

[T.D. 8612, 60 FR 43538, Aug. 22, 1995]

### § 20.2056(d)–2 Marital deduction; effect of disclaimers of post-December 31, 1976 transfers.

(a) *Disclaimer by a surviving spouse.* If a surviving spouse disclaims an interest in property passing to such spouse from the decedent, which interest was created in a transfer made after December 31, 1976, the effectiveness of the disclaimer will be determined by section 2518 and the corresponding regulations. For rules relating to when the transfer creating the interest occurs, see § 25.2518–2(c)(3) and (c)(4) of this chapter. If a qualified disclaimer is determined to have been made by the surviving spouse, the property interest disclaimed is treated as if such interest had never been transferred to the surviving spouse.

(b) *Disclaimer by a person other than a surviving spouse.* If an interest in property passes from a decedent to a person other than the surviving spouse, and the interest is created in a transfer made after December 31, 1976, and—

(1) The person other than the surviving spouse makes a qualified disclaimer with respect to such interest; and

(2) The surviving spouse is entitled to such interest in property as a result of such disclaimer, the disclaimed interest is treated as passing directly from the decedent to the surviving spouse. For rules relating to when the transfer creating the interest occurs, see § 25.2518–2(c)(3) and (c)(4) of this chapter.

(c) *Effective date.* The first and second sentences of paragraphs (a) and (b) of this section are applicable for transfers creating the interest to be disclaimed made on or after December 31, 1997.

[T.D. 8095, 51 FR 28368, Aug. 7, 1986. Redesignated by T.D. 8612, 60 FR 43538, Aug. 22, 1995, as amended by T.D. 8744, 62 FR 68184, Dec. 31, 1997]

### § 20.2056(d)–3 Marital deduction; effect of disclaimers of pre-January 1, 1977 transfers.

(a) *Disclaimer by a surviving spouse.* If an interest in property passes to a decedent's surviving spouse in a taxable transfer made by a decedent dying before January 1, 1977, and the decedent's surviving spouse makes a disclaimer of this property interest the disclaimed interest is considered as passing from the decedent to the person or persons entitled to receive the interest as a result of the disclaimer. A disclaimer is a complete and unqualified refusal to accept the rights to which one is entitled. It is, therefore, necessary to distinguish between the surviving spouse's disclaimer of a property interest and such surviving spouse's acceptance and subsequent disposal of a property interest. For example, if proceeds of insurance are payable to the surviving spouse and the proceeds are refused so that they consequently pass to an alternate beneficiary designated by the decedent, the proceeds are considered as having passed from the decedent to the alternate beneficiary. On the other hand, if the insurance company is directed by the surviving spouse to hold the proceeds at interest during such spouse's life and, upon this spouse's death, to pay the principal sum to another person designated by the surviving spouse, thus effecting a transfer of a remainder interest, the proceeds are considered as having passed from the decedent to the surviving spouse. See paragraph (c) of § 20.2056(e)–2 with respect to a spouse's exercise or failure to exercise a right to take against a decedent's will.

(b) *Disclaimer by a person other than a surviving spouse*—(1) *Decedents dying after October 3, 1966 and before January 1, 1977.* This paragraph (b)(1) applies in the case of a disclaimer of property passing to one other than the surviving

spouse from a decedent dying after October 3, 1966 and before January 1, 1977. If a surviving spouse is entitled to receive property from the decedent as a result of the timely disclaimer made by the disclaimant, the property received by the surviving spouse is to be treated as passing to the surviving spouse from the decedent. Both a disclaimer of property passing by the laws of intestacy or otherwise, as by insurance or by trust, and a disclaimer of bequests and devises under the will of a decedent are to be fully effective for purposes of computing the marital deduction under section 2056. A disclaimer is a complete and unqualified refusal to accept some or all of the rights to which one is entitled. It must be a valid refusal under State law and must be made without consideration. For example, a disclaimer for the benefit of a surviving spouse who promises to give or bequeath property to a child of the person who disclaims is not a disclaimer within the meaning of this paragraph (b)(1). The disclaimer must be made before the person disclaiming accepts any property under the disclaimed interest. In the case of property transferred by a decedent dying after December 31, 1970, and before January 1, 1977, the disclaimer must be made within 9 months after the decedent's death (or within any extension of time for filing the estate tax return granted pursuant to section 6081). In the case of property transferred by a decedent dying after October 3, 1966, and before January 1, 1971, the disclaimer must be made within 15 months after the decedent's death (or within any extension of time for filing the estate tax return granted pursuant to section 6081). If the disclaimer does not satisfy the requirements of this paragraph (b)(1), for the purpose of the marital deduction, the property is considered as passing from the decedent to the person who made the disclaimer as if the disclaimer had not been made.

(2) *Decedents dying after September 30, 1963 and before October 4, 1966.* This paragraph (b)(2) applies in the case of a disclaimer of property passing to one other than the surviving spouse from a decedent dying after September 30, 1963 and before October 4, 1966. If, as a result of the disclaimer by the disclaimant, the surviving spouse is entitled to receive the disclaimed property interest, then such interest shall, for the purposes of this paragraph (b)(2), be considered as passing from the decedent to the surviving spouse if the following conditions are met. First, the interest disclaimed was bequeathed or devised to the disclaimant. Second, the disclaimant disclaimed all bequests and devises under the will before the date prescribed for the filing of the estate tax return. Third, the disclaimant did not accept any property under the bequest or devise before making the disclaimer.

The interests passing by disclaimer to the surviving spouse under this paragraph (b)(2) are to qualify for the marital deduction only to the extent that, when added to any other allowable marital deduction without regard to this paragraph (b)(2), they do not exceed the greater of the deductions which would be allowable for the marital deduction without regard to the disclaimer if the surviving spouse exercised the election under State law to take against the will, or an amount equal to one-third of the decedent's adjusted gross estate. If the disclaimer does not satisfy the requirements of this paragraph (b)(2), the property is treated as passing from the decedent to the person who made the disclaimer, in the same manner as if the disclaimer had not been made.

(3) *Decedents dying before October 4, 1966.* Unless the rule of paragraph (b)(2) of this section applies, this paragraph (b)(3) applies in the case of a disclaimer of property passing to one other than the surviving spouse from a decedent dying before October 4, 1966. For the purpose of these transfers, it is unnecessary to distinguish for the purpose of the marital deduction between a disclaimer by a person other than the surviving spouse and a transfer by such person. If the surviving spouse becomes entitled to receive an interest in property from the decedent as a result of a disclaimer made by some other person, the interest is, nevertheless, considered as having passed from the decedent, not to the surviving spouse, but to the person who made the disclaimer, as though the disclaimer had not been made. If, as a result of a disclaimer

made by a person other than the surviving spouse, a property interest passes to the surviving spouse under circumstances which meet the conditions set forth in § 20.2056(b)–5 (relating to a life estate with a power of appointment), the rule stated in the preceding sentence applies, not only with respect to the portion of the interest which beneficially vests in the surviving spouse, but also with respect to the portion over which such spouse acquires a power to appoint. The rule applies also in the case of proceeds under a life insurance, endowment, or annuity contract which, as a result of a disclaimer made by a person other than the surviving spouse, are held by the insurer subject to the conditions set forth in § 20.2056(b)–6.

[T.D. 8095, 51 FR 28368, Aug. 7, 1986. Redesignated by T.D. 8612, 60 FR 43538, Aug. 22, 1995]

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[T.D. 8612, 60 FR 43538, Aug. 22, 1995, as amended by T.D. 8686, 61 FR 60553, Nov. 29, 1996]

## § 20.2056A–1 Restrictions on allowance of marital deduction if surviving spouse is not a United States citizen.

(a) *General rule.* Subject to the special rules provided in section 7815(d)(14) of the Omnibus Budget Reconciliation Act of 1989 (Pub. L. 101–239; 103 Stat. 2106), in the case of a decedent dying after November 10, 1988, the federal estate tax marital deduction is not allowed for property passing to or for the benefit of a surviving spouse who is not a United States citizen at the date of the decedent's death (whether or not the surviving spouse is a resident of the United States) unless—

(1) The property passes from the decedent to (or pursuant to)—

(i) A qualified domestic trust (QDOT) described in section 2056A and § 20.2056A–2;

(ii) A trust that, although not meeting all of the requirements for a QDOT, is reformed after the decedent's death to meet the requirements of a QDOT (see § 20.2056A–4(a));

(iii) The surviving spouse not in trust (e.g., by outright bequest or devise, by operation of law, or pursuant to the terms of an annuity or other similar plan or arrangement) and, prior to the date that the estate tax return is filed and on or before the last date prescribed by law that the QDOT election may be made (no more than one year after the time prescribed by law, including extensions, for filing the return), the surviving spouse either actually transfers the property to a QDOT or irrevocably assigns the property to a QDOT (see § 20.2056A–4(b)); or

(iv) A plan or other arrangement that would have qualified for the marital deduction but for section 2056(d)(1)(A), and whose payments are not assignable or transferable to a QDOT, if the requirements of § 20.2056A–4(c) are met; and

(2) The executor makes a timely QDOT election under § 20.2056A–3.

(b) *Marital deduction allowed if resident spouse becomes citizen.* For purposes of section 2056(d)(1) and paragraph (a) of this section, the surviving spouse is treated as a citizen of the United States at the date of the decedent's death if the requirements of section 2056(d)(4) are satisfied. For purposes of section 2056(d)(4)(A) and notwithstanding § 20.2056A–3(a), a return filed prior to the due date (including extensions) is considered filed on the last date that the return is required to be filed (including extensions), and a late return filed at any time after the due date is considered filed on the date that it is actually filed. A surviving spouse is a resident only if the spouse is a resident under chapter 11 of the Internal Revenue Code. See § 20.0–1(b)(1). The status of the spouse as a resident

under section 7701(b) is not relevant to this determination except to the extent that the income tax residency of the spouse is pertinent in applying § 20.0–1(b)(1).

(c) *Special rules in the case of certain transfers subject to estate and gift tax treaties.* Under section 7815(d)(14) of the Omnibus Budget Reconciliation Act of 1989 (Pub. L. 101–239, 103 Stat. 2106) certain special rules apply in the case of transfers governed by certain estate and gift tax treaties to which the United States is a party. In the case of the estate of, or gift by, an individual who was not a citizen or resident of the United States but was a resident of a foreign country with which the United States has a tax treaty with respect to estate, inheritance, or gift taxes, the amendments made by section 5033 of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100–647, 102 Stat. 3342) do not apply to the extent such amendments would be inconsistent with the provisions of such treaty relating to estate, inheritance, or gift tax marital deductions. Under this rule, the estate may choose either the statutory deduction under section 2056A or the marital deduction allowed under the treaty. Thus, the estate may not avail itself of both the marital deduction under the treaty and the marital deduction under the QDOT provisions of section 2056A and chapter 11 of the Internal Revenue Code with respect to the remainder of the marital property that is not deductible under the treaty.

[T.D. 8612, 60 FR 43539, Aug. 22, 1995]

### § 20.2056A–2 Requirements for qualified domestic trust.

(a) *In general.* In order to qualify as a qualified domestic trust (QDOT), the requirements of paragraphs (b) and (c) of this section, and the requirements of § 20.2056A–2T(d), must be satisfied. The executor of the decedent's estate and the U.S. Trustee shall establish in such manner as may be prescribed by the Commissioner on the estate tax return and applicable instructions that these requirements have been satisfied or are being complied with. In order to constitute a QDOT, the trust must be maintained under the laws of a state of the United States or the District of Columbia, and the administration of the trust must be governed by the laws of a particular state of the United States or the District of Columbia. For purposes of this paragraph (a), a trust is maintained under the laws of a state of the United States or the District of Columbia if the records of the trust (or copies thereof) are kept in that state (or the District of Columbia). The trust may be established pursuant to an instrument executed under either the laws of a state of the United States or the District of Columbia or pursuant to an instrument executed under the laws of a foreign jurisdiction, such as a foreign will or trust, provided that such foreign instrument designates the law of a particular state of the United States or the District of Columbia as governing the administration of the trust, and such designation is effective under the law of the designated jurisdiction. In addition, the trust must constitute an ordinary trust, as defined in § 301.7701–4(a) of this chapter, and not any other type of entity. For purposes of this paragraph, a trust will not fail to constitute an ordinary trust solely because of the nature of the assets transferred to that trust, regardless of its classification under §§ 301.7701–2 through 301.7701–4 of this chapter.

(b) *Qualified marital interest requirements*—(1) *Property passing to QDOT.* If property passes from a decedent to a QDOT, the trust must qualify for the federal estate tax marital deduction under section 2056(b)(5) (life estate with power of appointment), section 2056(b)(7) (qualified terminable interest property, including joint and survivor annuities under section 2056(b)(7)(C)), or section 2056(b)(8) (surviving spouse is the only noncharitable beneficiary of a charitable remainder trust), or meet the requirements of an estate trust as defined in § 20.2056(c)–2(b)(1)(i) through (iii).

(2) *Property passing outright to spouse.* If property does not pass from a decedent to a QDOT, but passes to a noncitizen surviving spouse in a form that meets the requirements for a marital deduction without regard to section 2056(d)(1)(A), and that is not described in paragraph (b)(1) of this section, the surviving spouse must either actually transfer the property, or irrevocably

assign the property, to a trust (whether created by the decedent, the decedent's executor or by the surviving spouse) that meets the requirements of paragraph (c) of this section and the requirements of § 20.2056A–2T(d) (pertaining, respectively, to statutory requirements and regulatory requirements imposed to ensure collection of tax) prior to the filing of the estate tax return for the decedent's estate and on or before the last date prescribed by law that the QDOT election may be made (see § 20.2056A–3(a)).

(3) *Property passing under a nontransferable plan or arrangement.* If property does not pass from a decedent to a QDOT, but passes under a plan or other arrangement that meets the requirements for a marital deduction without regard to section 2056(d)(1)(A) and whose payments are not assignable or transferable (see § 20.2056A–4(c)), the property is treated as meeting the requirements of this section, and the requirements of § 20.2056A–2T(d), if the requirements of § 20.2056A–4(c) are satisfied. In addition, where an annuity or similar arrangement is described above except that it is assignable or transferable, see § 20.2056A–4(b)(7).

(c) *Statutory requirements.* The requirements of section 2056A(a)(1)(A) and (B) must be satisfied. For purposes of that section, a domestic corporation is a corporation that is created or organized under the laws of the United States or under the laws of any state of the United States or the District of Columbia. The trustee required under that section is referred to herein as the ''U.S. Trustee''.

(d) *Additional requirements to ensure collection of the section 2056A estate tax*—(1) *Security and other arrangements for payment of estate tax imposed under section 2056A(b)(1)*—(i) *QDOTs with assets in excess of $2 million.* If the fair market value of the assets passing, treated, or deemed to have passed to the QDOT (or in the form of a QDOT), determined without reduction for any indebtedness with respect to the assets, as finally determined for federal estate tax purposes, exceeds $2 million as of the date of the decedent's death or, if applicable, the alternate valuation date (adjusted as provided in paragraph (d)(1)(iii) of this section), the trust instrument must meet the requirements of either paragraph (d)(1)(i) (A), (B), or (C) of this section at all times during the term of the QDOT. The QDOT may alternate between any of the arrangements provided in paragraphs (d)(1)(i) (A), (B), and (C) of this section provided that, at any given time, one of the arrangements must be operative. See paragraph (d)(1)(iii) of this section for the definition of finally determined. The QDOT may provide that the trustee has the discretion to use any one of the security arrangements or may provide that the trustee is limited to using only one or two of the arrangements specified in the trust instrument. A trust instrument that specifically states that the trust must be administered in compliance with paragraph (d)(1)(i) (A), (B), or (C) of this section is treated as meeting the requirements of paragraphs (d)(1)(i) (A), (B), or (C) of this section for purposes of paragraphs (d)(1)(i) and, if applicable, (d)(1)(ii) of this section.

(A) *Bank Trustee.* Except as otherwise provided in paragraph (d)(6) (ii) or (iii) of this section, the trust instrument must provide that whenever the Bank Trustee security alternative is used for the QDOT, at least one U.S. Trustee must be a bank as defined in section 581. Alternatively, except as otherwise provided in paragraph (d)(6) (ii) or (iii) of this section, at least one trustee must be a United States branch of a foreign bank, provided that, in such cases, during the entire term of the QDOT a U.S. Trustee must act as a trustee with the foreign bank trustee.

(B) *Bond.* Except as otherwise provided in paragraph (d)(6) (ii) or (iii) of this section, the trust instrument must provide that whenever the bond security arrangement alternative is used for the QDOT, the U.S. Trustee must furnish a bond in favor of the Internal Revenue Service in an amount equal to 65 percent of the fair market value of the trust assets (determined without regard to any indebtedness with respect to the assets) as of the date of

the decedent's death (or alternate valuation date, if applicable), as finally determined for federal estate tax purposes (and as further adjusted as provided in paragraph (d)(1)(iv) of this section). If, after examination of the estate tax return, the fair market value of the trust assets, as originally reported on the estate tax return, is adjusted (pursuant to a judicial proceeding or otherwise) resulting in a final determination of the value of the assets as reported on the return, the U.S. Trustee has a reasonable period of time (not exceeding sixty days after the conclusion of the proceeding or other action resulting in a final determination of the value of the assets) to adjust the amount of the bond accordingly. But see, paragraph (d)(1)(i)(D) of this section for a special rule in the case of a substantial undervaluation of QDOT assets. Unless an alternate arrangement under paragraph (d)(1)(i)(A), (B), or (C) of this section, or an arrangement prescribed under paragraph (d)(4) of this section, is provided, or the trust is otherwise no longer subject to the requirements of section 2056A pursuant to section 2056A(b)(12), the bond must remain in effect until the trust ceases to function as a QDOT and any tax liability finally determined to be due under section 2056A(b) is paid, or is finally determined to be zero.

(*1*) *Requirements for the bond.* The bond must be with a satisfactory surety, as prescribed under section 7101 and § 301.7101–1 of this chapter (Regulations on Procedure and Administration), and is subject to Internal Revenue Service review as may be prescribed by the Commissioner. The bond may not be cancelled. The bond must be for a term of at least one year and must be automatically renewable at the end of that term, on an annual basis thereafter, unless notice of failure to renew is mailed to the U.S. Trustee and the Internal Revenue Service at least 60 days prior to the end of the term, including periods of automatic extensions. Any notice of failure to renew required to be sent to the Internal Revenue Service must be sent to the Estate and Gift Tax Group in the District Office of the Internal Revenue Service that has examination jurisdiction over the decedent's estate (Internal Revenue Service, District Director, [*specify location*] District Office, Estate and Gift Tax Examination Group, [specify Street Address, City, State, Zip Code]) (or in the case of noncitizen decedents and United States citizens who die domiciled outside the United States, Estate Tax Group, Assistant Commissioner (International), 950 L'Enfant Plaza, CP:IN:D:C:EX:HQ:1114, Washington, DC 20024). The Internal Revenue Service will not draw on the bond if, within 30 days of receipt of the notice of failure to renew, the U.S. Trustee notifies the Internal Revenue Service (at the same address to which notice of failure to renew is to be sent) that an alternate arrangement under paragraph (d)(1)(i) (A), (B), or (C) or (d)(4) of this section, has been secured and that the arrangement will take effect immediately prior to or upon expiration of the bond.

(*2*) *Form of bond.* The bond must be in the following form (or in a form that is the same as the following form in all material respects), or in such alternative form as the Commissioner may prescribe by guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter):

Bond in Favor of the Internal Revenue Service To Secure Payment of Section 2056A Estate Tax Imposed Under Section 2056A(b) of the Internal Revenue Code.

KNOW ALL PERSONS BY THESE PRESENTS, That the undersigned, _____, the SURETY, and _____, the PRINCIPAL, are irrevocably held and firmly bound to pay the Internal Revenue Service upon written demand that amount of any tax up to *$[amount determined under paragraph (d)(1)(i)(B) of this section],* imposed under section 2056A(b)(1) of the Internal Revenue Code (including penalties and interest on said tax) determined by the Internal Revenue Service to be payable with respect to the principal as trustee for: *[Identify trust and governing instrument, name and address of trustee],* a qualified domestic trust as defined in section 2056A(a) of the Internal Revenue Code, for the payment of which the said Principal and said Surety, bind themselves, their heirs, executors, administrators, successors and assigns, jointly and severally, firmly by these presents.

WHEREAS, The Internal Revenue Service may demand payment under this bond at any time if the Internal Revenue Service in its sole discretion determines that a taxable event with respect to the trust has occurred; the trust no longer qualifies as a qualified domestic trust as described in section

2056A(a) of the Internal Revenue Code and the regulations promulgated thereunder, or a distribution subject to the tax imposed under section 2056A(b)(1) has been made. Demand by the Internal Revenue Service for payment may be made whether or not the tax and tax return (Form 706–QDT) with respect to the taxable event is due at the time of such demand, or an assessment has been made by the Internal Revenue Service with respect to the tax.

NOW THEREFORE, The condition of this obligation is such that it must not be cancelled and, if payment of all tax liability finally determined to be imposed under section 2056A(b) is made, then this obligation is null and void; otherwise, this obligation is to remain in full force and effect for one year from its effective date and is to be automatically renewable on an annual basis unless, at least 60 days prior to the expiration date, including periods of automatic renewals, the surety mails to the U.S. Trustee and the Internal Revenue Service by Registered or Certified Mail, return receipt requested, notice of the failure to renew. Receipt of this notice of failure to renew by the Internal Revenue Service may be considered a taxable event. The Internal Revenue Service will not draw upon the bond if, within 30 days of receipt of the notice of failure to renew, the trustee notifies the Internal Revenue Service that an alternate security arrangement has been secured and that the arrangement will take effect immediately prior to or upon expiration of the bond. The surety remains liable for all taxable events occurring prior to the date of expiration. All notices required to be sent to the Internal Revenue Service under this instrument should be sent to District Director, *[specify location]* District Office, Estate and Gift Tax Examination Group, Street Address, City, State, Zip Code. (In the case of nonresident noncitizen decedents and United States citizens who die domiciled outside the United States, all notices should be sent to Estate Tax Group, Assistant Commissioner (International), 950 L'Enfant Plaza, CP:IN:D:C:EX:HQ:1114, Washington, DC 20024).

This bond shall be effective as of _____. Principal _____ Date _____ Surety _____ Date _____

(*3*) *Additional governing instrument requirements.* The trust instrument must provide that in the event the Internal Revenue Service draws on the bond, in accordance with its terms, neither the U.S. Trustee nor any other person will seek a return of any part of the remittance until after April 15th of the calendar year following the year in which the bond is drawn upon. After that date, any such remittance will be treated as a deposit and returned (without interest) upon request of the U.S. Trustee, unless it is determined that assessment or collection of the tax imposed by section 2056A(b)(1) is in jeopardy, within the meaning of section 6861. If an assessment under section 6861 is made, the remittance will first be credited to any tax liability reported on the Form 706–QDT, then to any unpaid balance of a section 2056A(b)(1)(A) tax liability (plus interest and penalties) for any prior taxable years, and any balance will then be returned to the U.S. Trustee.

(*4*) *Procedure.* The bond is to be filed with the decedent's federal estate tax return, Form 706 or 706NA (unless an extension for filing the bond is granted under § 301.9100 of this chapter). The U.S. Trustee must provide a written statement with the bond that provides a list of the assets that will be used to fund the QDOT and the respective values of the assets. The written statement must also indicate whether any exclusions under paragraph (d)(1)(iv) of this section are claimed.

(C) *Letter of credit.* Except as otherwise provided in paragraph (d)(6) (ii) or (iii) of this section, the trust instrument must provide that whenever the letter of credit security arrangement is used for the QDOT, the U.S. Trustee must furnish an irrevocable letter of credit issued by a bank as defined in section 581, a United States branch of a foreign bank, or a foreign bank with a confirmation by a bank as defined in section 581. The letter of credit must be for an amount equal to 65 percent of the fair market value of the trust assets (determined without regard to any indebtedness with respect to the assets) as of the date of the decedent's death (or alternate valuation date, if applicable), as finally determined for federal estate tax purposes (and as further adjusted as provided in paragraph (d)(1)(iv) of this section). If, after examination of the estate tax return, the fair market value of the trust assets, as originally reported on the estate tax return, is adjusted (pursuant to a judicial proceeding or otherwise) resulting in a final determination of the value of the assets as reported on the return, the U.S. Trustee has a reasonable period of time (not exceeding 60 days after the conclusion of the proceeding

or other action resulting in a final determination of the value of the assets) to adjust the amount of the letter of credit accordingly. But see, paragraph (d)(1)(i)(D) of this section for a special rule in the case of a substantial undervaluation of QDOT assets. Unless an alternate arrangement under paragraph (d)(1)(i) (A), (B), or (C) of this section, or an arrangement prescribed under paragraph (d)(4) of this section, is provided, or the trust is otherwise no longer subject to the requirements of section 2056A pursuant to section 2056A(b)(12), the letter of credit must remain in effect until the trust ceases to function as a QDOT and any tax liability finally determined to be due under section 2056A(b) is paid or is finally determined to be zero.

(*1*) *Requirements for the letter of credit.* The letter of credit must be irrevocable and provide for sight payment. The letter of credit must have a term of at least one year and must be automatically renewable at the end of the term, at least on an annual basis, unless notice of failure to renew is mailed to the U.S. Trustee and the Internal Revenue Service at least sixty days prior to the end of the term, including periods of automatic renewals. If the letter of credit is issued by the U.S. branch of a foreign bank and the U.S. branch is closing, the branch (or foreign bank) must notify the U.S. Trustee and the Internal Revenue Service of the closure and the notice of closure must be mailed at least 60 days prior to the date of closure. Any notice of failure to renew or closure of a U.S. branch of a foreign bank required to be sent to the Internal Revenue Service must be sent to the Estate and Gift Tax Group in the District Office of the Internal Revenue Service that has examination jurisdiction over the decedent's estate (Internal Revenue Service, District Director, [*specify location*] District Office, Estate and Gift Tax Examination Group, [Street Address, City State, Zip Code]) (or in the case of noncitizen decedents and United States citizens who die domiciled outside the United States, Estate Tax, Assistant Commissioner (International), 950 L'Enfant Plaza, CP:IN:D:C:EX:HQ:1114, Washington, DC 20024). The Internal Revenue Service will not draw on the letter of credit if, within 30 days of receipt of the notice of failure to renew or closure of the U.S. branch of a foreign bank, the U.S. Trustee notifies the Internal Revenue Service (at the same address to which notice is to be sent) that an alternate arrangement under paragraph (d)(1)(i) (A), (B), or (C), or (d)(4) of this section, has been secured and that the arrangement will take effect immediately prior to or upon expiration of the letter of credit or closure of the U.S. branch of the foreign bank.

(*2*) *Form of letter of credit.* The letter of credit must be made in the following form (or in a form that is the same as the following form in all material respects), or an alternative form that the Commissioner prescribes by guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter):

[Issue Date]

To: Internal Revenue Service

Attention: District Director, *[specify location]* District Office

Estate and Gift Tax Examination Group [Street Address, City, State, ZIP Code]

[Or in the case of nonresident noncitizen decedents and United States citizens who die domiciled outside the United States,

To: Estate Tax Group, Assistant Commissioner (International) 950 L'Enfant Plaza CP:IN:D:C:EX:HQ:1114 Washington, DC 20024].

Dear Sirs: We hereby establish our irrevocable Letter of Credit No. ____ in your favor for drawings up to U.S. $ *[Applicant should provide bank with amount which Applicant determined under paragraph (d)(1)(i)(C)]* effective immediately. This Letter of Credit is issued, presentable and payable at our office at _____ and expires at 3:00 p.m. [EDT, EST, CDT, CST, MDT, MST, PDT, PST] on ____ at said office.

For information and reference only, we are informed that this Letter of Credit relates to [*Applicant should provide bank with the identity of qualified domestic trust and governing instrument*], and the name, address, and identifying number of the trustee is [*Applicant should provide bank with the trustee name, address and the QDOT's TIN number, if any*].

Drawings on this Letter of Credit are available upon presentation of the following documents:

1. Your draft drawn at sight on us bearing our Letter of Credit No. ____; and

2. Your signed statement as follows:

The amount of the accompanying draft is payable under *[identify bank]* irrevocable Letter of Credit No. _____ pursuant to section 2056A of the Internal Revenue Code and the regulations promulgated thereunder, because

the Internal Revenue Service in its sole discretion has determined that a ''taxable event'' with respect to the trust has occurred; e.g., the trust no longer qualifies as a qualified domestic trust as described in section 2056A of the Internal Revenue Code and regulations promulgated thereunder, or a distribution subject to the tax imposed under section 2056A(b)(1) of the Internal Revenue Code has been made.

Except as expressly stated herein, this undertaking is not subject to any agreement, requirement or qualification. The obligation of *[Name of Issuing Bank]* under this Letter of Credit is the individual obligation of [*Name of Issuing Bank*] and is in no way contingent upon reimbursement with respect thereto.

It is a condition of this Letter of Credit that it is deemed to be automatically extended without amendment for a period of one year from the expiration date hereof, or any future expiration date, unless at least 60 days prior to any expiration date, we mail to you and to the U.S. Trustee notice by Registered Mail or Certified Mail, return receipt requested, or by courier to your and the trustee's address indicated above, that we elect not to consider this Letter of Credit renewed for any such additional period. Upon receipt of this notice, you may draw hereunder on or before the then current expiration date, by presentation of your draft and statement as stipulated above.

[In the case of a letter of credit issued by a U.S. branch of a foreign bank the following language must be added]. It is a further condition of this Letter of Credit that if the U.S. branch of *[name of foreign bank]* is to be closed, that at least sixty days prior to closing, we mail to you and the U.S. Trustee notice by Registered Mail or Certified Mail, return receipt requested, or by courier to your and the U.S. Trustee's address indicated above, that this branch will be closing. This notice will specify the actual date of closing. Upon receipt of the notice, you may draw hereunder on or before the date of closure, by presentation of your draft and statement as stipulated above.

Except where otherwise stated herein, this Letter of Credit is subject to the Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500. If we notify you of our election not to consider this Letter of Credit renewed and the expiration date occurs during an interruption of business described in Article 17 of said Publication 500, unless you had consented to cancellation prior to the expiration date, the bank hereby specifically agrees to effect payment if this Letter of Credit is drawn against within 30 days after the resumption of business.

Except as stated herein, this Letter of Credit cannot be modified or revoked without your consent.

Authorized Signature _____ Date _____

(*3*) *Form of confirmation.* If the requirements of this paragraph (d)(1)(i)(C) are satisfied by the issuance of a letter of credit by a foreign bank with confirmation by a bank as defined in section 581, the confirmation must be made in the following form (or in a form that is the same as the following form in all material respects), or an alternative form as the Commissioner prescribes by guidance published in the Internal Revenue Bulletin (see § 602.101(d)(2) of this chapter):

[Issue Date]

To: Internal Revenue Service

Attention: District Director, [*specify location*] District Office Estate and Gift Tax Examination Group [State Address, City, State, ZIP Code]

[or in the case of nonresident noncitizen decedents and United States citizens who die domiciled outside the United States,

To: Estate Tax Group, Assistant Commissioner (International) 950 L'Enfant Plaza CP:IN:D:C:EX:HQ:1114, Washington, DC 20024].

Dear Sirs: We hereby confirm the enclosed irrevocable Letter of Credit No. _____, and amendments thereto, if any, in your favor by _____ [Issuing Bank] for drawings up to U.S. _____ [same amount as in initial Letter of Credit] effective immediately. This confirmation is issued, presentable and payable at our office at _____ and expires at 3:00 p.m. [EDT, EST, CDT, CST, MDT, MST, PDT, PST] on _____ at said office.

For information and reference only, we are informed that this Confirmation relates to [Applicant should provide bank with the identity of qualified domestic trust and governing instrument], and the name, address, and identifying number of the trustee is [Applicant should provide bank with the trustee name, address and the QDOT's TIN number, if any].

We hereby undertake to honor your sight draft(s) drawn as specified in the Letter of Credit.

Except as expressly stated herein, this undertaking is not subject to any agreement, condition or qualification. The obligation of [*Name of Confirming Bank*] under this Confirmation is the individual obligation of [*Name of Confirming Bank*] and is in no way contingent upon reimbursement with respect thereto.

It is a condition of this Confirmation that it is deemed to be automatically extended without amendment for a period of one year from the expiry date hereof, or any future expiration date, unless at least sixty days prior to the expiration date, we send to you and to the U.S. Trustee notice by Registered

Mail or Certified Mail, return receipt requested, or by courier to your and the trustee's addresses, respectively, indicated above, that we elect not to consider this Confirmation renewed for any additional period. Upon receipt of this notice by you, you may draw hereunder on or before the then current expiration date, by presentation of your draft and statement as stipulated above.

Except where otherwise stated herein, this Confirmation is subject to the Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500. If we notify you of our election not to consider this Confirmation renewed and the expiration date occurs during an interruption of business described in Article 17 of said Publication 500, unless you had consented to cancellation prior to the expiration date, the bank hereby specifically agrees to effect payment if this Confirmation is drawn against within 30 days after the resumption of business.

Except as stated herein, this Confirmation cannot be modified or revoked without your consent.

Authorized Signature _____ Date _____

(*4*) *Additional governing instrument requirements.* The trust instrument must provide that if the Internal Revenue Service draws on the letter of credit (or confirmation) in accordance with its terms, neither the U.S. Trustee nor any other person will seek a return of any part of the remittance until April 15th of the calendar year following the year in which the letter of credit (or confirmation) is drawn upon. After that date, any such remittance will be treated as a deposit and returned (without interest) upon request of the U.S. Trustee after the date specified above, unless it is determined that assessment or collection of the tax imposed by section 2056A(b)(1) is in jeopardy, within the meaning of section 6861. If an assessment under section 6861 is made, the remittance will first be credited to any tax liability reported on the Form 706–QDT, then to any unpaid balance of a section 2056A(b)(1)(A) tax liability (plus interest and penalties) for any prior taxable years, and any balance will then be returned to the U.S. Trustee.

(*5*) *Procedure.* The letter of credit (and confirmation, if applicable) is to be filed with the decedent's federal estate tax return, Form 706 or 706NA (unless an extension for filing the letter of credit is granted under § 301.9100 of this chapter). The U.S. Trustee must provide a written statement with the letter of credit that provides a list of the assets that will be used to fund the QDOT and the respective values of the assets. The written statement must also indicate whether any exclusions under paragraph (d)(1)(iv) of this section are claimed.

(D) *Disallowance of marital deduction for substantial undervaluation of QDOT property in certain situations.* (*1*) If either—

(*i*) The bond or letter of credit security arrangement under paragraph (d)(1)(i) (B) or (C) of this section is chosen by the U.S. Trustee; or

(*ii*) The QDOT property as originally reported on the decedent's estate tax return is valued at $2 million or less but, as finally determined for federal estate tax purposes, the QDOT property is determined to be in excess of $2 million, then the marital deduction will be disallowed in its entirety for failure to comply with the requirements of section 2056A if the value of the QDOT property reported on the estate tax return is 50 percent or less of the amount finally determined to be the correct value of the property for federal estate tax purposes.

(*2*) The preceding sentence does not apply if—

(*i*) There was reasonable cause for the undervaluation; and

(*ii*) The fiduciary of the estate acted in good faith with respect to the undervaluation. For this purpose, § 1.6664–4(b) of this chapter applies, to the extent applicable, with respect to the facts and circumstances to be taken into account in making this determination.

(ii) *QDOTs with assets of $2 million or less.* If the fair market value of the assets passing, treated, or deemed to have passed to the QDOT (or in the form of a QDOT), determined without reduction for any indebtedness with respect to the assets, as finally determined for federal estate tax purposes, is $2 million or less as of the date of the decedent's death or, if applicable, the alternate valuation date (adjusted as provided in paragraph (d)(1)(iv) of this section), the trust instrument must provide that either no more than 35 percent of the fair market value of the trust assets, determined annually on the last day of the taxable year of

the trust (or on the last day of the calendar year if the QDOT does not have a taxable year), will consist of real property located outside of the United States, or the trust will meet the requirements prescribed by paragraph (d)(1)(i)(A), (B), or (C) of this section. See paragraph (d)(1)(ii)(D) of this section for special rules in the case of principal distributions from a QDOT, fluctuations in the value of foreign real property held by a QDOT due to changes in value of foreign currency, and fluctuations in the fair market value of assets held by the QDOT. See paragraph (d)(1)(iv) of this section for a special rule for personal residences. If the fair market value, as originally reported on the decedent's estate tax return, of the assets passing or deemed to have passed to the QDOT (determined without reduction for any indebtedness with respect to the assets) is $2 million or less, but the fair market value of the assets as finally determined for federal estate tax purposes is more than $2 million, the U.S. Trustee has a reasonable period of time (not exceeding sixty days after the conclusion of the proceeding or other action resulting in a final determination of the value of the assets) to meet the requirements prescribed by paragraph (d)(1)(i) (A), (B), or (C) of this section. However, see paragraph (d)(1)(i)(D) of this section in the case of a substantial undervaluation of QDOT assets. See § 20.2056A–2(d)(1)(iii) for the definition of finally determined.

(A) *Multiple QDOTs.* For purposes of this paragraph (d)(1)(ii), if more than one QDOT is established for the benefit of the surviving spouse, the fair market value of all the QDOTs are aggregated in determining whether the $2 million threshold under this paragraph (d)(1)(ii) is exceeded.

(B) *Look-through rule.* For purposes of determining whether no more than 35 percent of the fair market value of the QDOT assets consists of foreign real property, if the QDOT owns more than 20% of the voting stock or value in a corporation with 15 or fewer shareholders, or more than 20% of the capital interest of a partnership with 15 or fewer partners, then all assets owned by the corporation or partnership are deemed to be owned directly by the QDOT to the extent of the QDOT's pro rata share of the assets of that corporation or partnership. For a partnership, the QDOT partner's pro rata share is based on the greater of its interest in the capital or profits of the partnership. For purposes of this paragraph, all stock in the corporation, or interests in the partnership, as the case may be, owned by or held for the benefit of the surviving spouse, or any members of the surviving spouse's family (within the meaning of section 267(c)(4)), are treated as owned by the QDOT solely for purposes of determining the number of partners or shareholders in the entity and the QDOT's percentage voting interest or value in the corporation or capital interest in the partnership, but not for the purpose of determining the QDOT's pro rata share of the assets of the entity.

(C) *Interests in other entities.* Interests owned by the QDOT in other entities (such as an interest in a trust) are accorded treatment consistent with that described in paragraph (d)(1)(ii)(B) of this section.

(D) *Special rule for foreign real property.* For purposes of this paragraph (d)(1)(ii), if, on the last day of any taxable year during the term of the QDOT (or the last day of the calendar year if the QDOT does not have a taxable year), the value of foreign real property owned by the QDOT exceeds 35 percent of the fair market value of the trust assets due to: distributions of QDOT principal during that year; fluctuations in the value of the foreign currency in the jurisdiction where the real estate is located; or fluctuations in the fair market value of any assets held in the QDOT, then the QDOT will not be treated as failing to meet the requirements of this paragraph (d)(1). Accordingly, the QDOT will not cease to be a QDOT within the meaning of § 20.2056A–5(b)(3) if, by the end of the taxable year (or the last day of the calendar year if the QDOT does not have a taxable year) of the QDOT immediately following the year in which the 35 percent limit was exceeded, the value of the foreign real property held by the QDOT does not exceed 35 percent of the fair market value of the trust assets or, alternatively, the QDOT meets the

requirements of either paragraph (d)(1)(i) (A), (B), or (C) of this section on or before the close of that succeeding year.

(iii) *Definition of finally determined.* For purposes of § 20.2056A–2(d)(1) (i) and (ii), the fair market value of assets will be treated as finally determined on the earliest to occur of—

(A) The entry of a decision, judgment, decree, or other order by any court of competent jurisdiction that has become final;

(B) The execution of a closing agreement made under section 7121;

(C) Any final disposition by the Internal Revenue Service of a claim for refund;

(D) The issuance of an estate tax closing letter (Form L–154 or equivalent) if no claim for refund is filed; or

(E) The expiration of the period of assessment.

(iv) *Special rules for personal residence and related personal effects*—(A) *Two million dollar threshold.* For purposes of determining whether the $2 million threshold under paragraphs (d)(1)(i) and (ii) of this section has been exceeded, the executor of the estate may elect to exclude up to $600,000 in value attributable to real property (and related furnishings) owned directly by the QDOT that is used by, or held for the use of the surviving spouse as a personal residence and that passes, or is treated as passing, to the QDOT under section 2056(d). The election may be made regardless of whether the real property is situated within or without the United States. The election is made by attaching to the estate tax return on which the QDOT election is made a written statement claiming the exclusion. The statement must clearly identify the property or properties (i.e. address and location) for which the election is being made.

(B) *Security requirement.* For purposes of determining the amount of the bond or letter of credit required when paragraph (d)(1)(i)(B) or (C) of this section applies, the executor of the estate may elect to exclude, during the term of the QDOT, up to $600,000 in value attributable to real property (and related furnishings) owned directly by the QDOT that is used by, or held for the use of the surviving spouse as a personal residence and that passes, or is treated as passing, to the QDOT under section 2056(d). The election may be made regardless of whether the real property is situated within or without the United States. The election is made by attaching to the estate tax return on which the QDOT election is made a written statement claiming the exclusion. If an election is not made on the decedent's estate tax return, the election may be made, prospectively, at any time, during the term of the QDOT, by attaching to the Form 706–QDT a written statement claiming the exclusion. A statement may also be attached to the Form 706–QDT that cancels a prior election of the personal residence exclusion that was made under this paragraph, either on the decedent's estate tax return or on a Form 706–QDT.

(C) *Foreign real property limitation.* The special rules of this paragraph (d)(1)(iv) do not apply for purposes of determining whether more than 35 percent of the QDOT assets consist of foreign real property under paragraph (d)(1)(ii) of this section.

(D) *Personal residence.* For purposes of this paragraph (d)(1)(iv), a *personal residence* is either the principal residence of the surviving spouse within the meaning of section 1034 or one other residence of the surviving spouse. In order to be used by or held for the use of the spouse as a personal residence, the residence must be available at all times for use by the surviving spouse. The residence may not be rented to another party, even when not occupied by the spouse. A personal residence may include appurtenant structures used by the surviving spouse for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location).

(E) *Related furnishings.* The term *related furnishings* means furniture and commonly included items such as appliances, fixtures, decorative items and china, that are not beyond the value associated with normal household and decorative use. Rare artwork, valuable antiques, and automobiles of any kind or class are not within the meaning of this term.

(F) *Required statement.* If one or both of the exclusions provided in paragraph (d)(1)(iv)(A) or (B) of this section are elected by the executor of the estate and the personal residence is later sold or ceases to be used, or held for use as a personal residence, the U.S. Trustee must file the statement that is required under paragraph (d)(3) of this section at the time and in the manner provided in paragraphs (d)(3)(ii) and (iii) of this section.

(G) *Cessation of use.* Except as provided in this paragraph (d)(1)(iv)(G), if the residence ceases to be used by, or held for the use of, the spouse as a personal residence of the spouse, or if the residence is sold during the term of the QDOT, the exclusions provided in paragraphs (d)(1)(iv)(A) and (B) of this section cease to apply. However, if the residence is sold, the exclusion continues to apply if, within 12 months of the date of sale, the amount of the adjusted sales price (as defined in section 1034(b)(1)) is reinvested to purchase a new personal residence for the spouse. If less than the amount of the adjusted sales price is reinvested, the amount of the exclusion equals the amount reinvested in the new residence plus any amount previously allocated to a residence that continues to qualify for the exclusion, up to a total of $600,000. If the QDOT ceases to qualify for all or any portion of the initially claimed exclusions, paragraph (d)(1)(i) of this section, if applicable (determined as if the portion of the exclusions disallowed had not been initially claimed by the QDOT), must be complied with no later than 120 days after the effective date of the cessation. In addition, if a residence ceases to be used by, or held for the use of the spouse as a personal residence of the spouse or if the personal residence is sold during the term of the QDOT, the personal residence exclusion may be allocated to another residence that is held in either the same QDOT or in another QDOT that is established for the surviving spouse, if the other residence qualifies as being used by, or held for the use of the spouse as a personal residence. The trustee may allocate up to $600,000 to the new personal residence (less the amount previously allocated to a residence that continues to qualify for the exclusion) even if the entire $600,000 exclusion was not previously utilized with respect to the original personal residence(s).

(v) *Anti-abuse rule.* Regardless of whether the QDOT designates a bank as the U.S. Trustee under paragraph (d)(1)(i)(A) of this section (or otherwise complies with paragraph (d)(1)(i)(A) of this section by naming a foreign bank with a United States branch as a trustee to serve with the U.S. Trustee), complies with paragraph (d)(1)(i)(B) or (C) of this section, or is subject to and complies with the foreign real property requirements of paragraph (d)(1)(ii) of this section, the trust immediately ceases to qualify as a QDOT if the trust utilizes any device or arrangement that has, as a principal purpose, the avoidance of liability for the estate tax imposed under section 2056A(b)(1), or the prevention of the collection of the tax. For example, the trust may become subject to this paragraph (d)(1)(v) if the U.S. Trustee that is selected is a domestic corporation established with insubstantial capitalization by the surviving spouse or members of the spouse's family.

(2) *Individual trustees.* If the U.S. Trustee is an individual United States citizen, the individual must have a tax home (as defined in section 911(d)(3)) in the United States.

(3) *Annual reporting requirements*—(i) *In general.* The U.S. Trustee must file a written statement described in paragraph (d)(3)(iii) of this section, if the QDOT satisfies any one of the following criteria for the applicable reporting years—

(A) The QDOT directly owns any foreign real property on the last day of its taxable year (or the last day of the calendar year if it has no taxable year), and the QDOT does not satisfy the requirements of paragraph (d)(1)(i) (A), (B), or (C) or (d)(4) of this section by employing a bank as trustee or providing security; or

(B) The personal residence previously subject to the exclusion under paragraph (d)(1)(iv) of this section is sold, or that personal residence ceases to be used, or held for use, as a personal residence, during the taxable year (or during the calendar year if the QDOT does not have a taxable year); or

(C) After the application of the look-through rule contained in paragraph (d)(1)(ii)(B) of this section, the QDOT is treated as owning any foreign real property on the last day of the taxable year (or the last day of the calendar year if the QDOT has no taxable year), and the QDOT does not satisfy the requirements of paragraph (d)(1) (A), (B), (C) or (d)(4) of this section by employing a bank as trustee or providing security.

(ii) *Time and manner of filing.* The written statement, containing the information described in paragraph (d)(3)(iii) of this section, is to be filed for the taxable year of the QDOT (calendar year if the QDOT does not have a taxable year) for which any of the events or conditions requiring the filing of a statement under paragraph (d)(3)(i) of this section have occurred or have been satisfied. The written statement is to be submitted to the Internal Revenue Service by filing a Form 706–QDT, with the statement attached, no later than April 15th of the calendar year following the calendar year in which or with which the taxable year of the QDOT ends (or by April 15th of the following year if the QDOT has no taxable year), unless an extension of time is obtained under § 20.2056A–11(a). The Form 706–QDT, with attached statement, must be filed regardless of whether the Form 706–QDT is otherwise required to be filed under the provisions of this chapter. Failure to file timely the statement may subject the QDOT to the rules of paragraph (d)(1)(v) of this section.

(iii) *Contents of statement.* The written statement must contain the following information—

(A) The name, address, and taxpayer identification number, if any, of the U.S. Trustee and the QDOT; and

(B) A list summarizing the assets held by the QDOT, together with the fair market value of each listed QDOT asset, determined as of the last day of the taxable year (December 31 if the QDOT does not have a taxable year) for which the written statement is filed. If the look-through rule contained in paragraph (d)(1)(ii)(B) of this section applies, then the partnership, corporation, trust or other entity must be identified and the QDOT's pro rata share of the foreign real property and other assets owned by that entity must be listed on the statement as if directly owned by the QDOT; and

(C) If a personal residence previously subject to the exclusion under paragraph (d)(1)(iv) of this section is sold during the taxable year (or during the calendar year if the QDOT does not have a taxable year), the statement must provide the date of sale, the adjusted sales price (as defined in section 1034(b)(1)), the extent to which the amount of the adjusted sales price has been or will be used to purchase a new personal residence and, if not timely reinvested, the steps that will or have been taken to comply with paragraph (d)(1)(i) of this section, if applicable; and

(D) If the personal residence ceases to be used, or held for use, as a personal residence by the surviving spouse during the taxable year (or during the calendar year if the QDOT does not have a taxable year), the written statement must describe the steps that will or have been taken to comply with paragraph (d)(1)(i) of this section, if applicable.

(4) *Request for alternate arrangement or waiver.* If the Commissioner provides guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) pursuant to which a testator, executor, or the U.S. Trustee may adopt an alternate plan or arrangement to assure collection of the section 2056A estate tax, and if the alternate plan or arrangement is adopted in accordance with the published guidance, then the QDOT will be treated, subject to paragraph (d)(1)(v) of this section, as meeting the requirements of paragraph (d)(1) of this section. Until this guidance is published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter), taxpayers may submit a request for a private letter ruling for the approval of an alternate plan or arrangement proposed to be adopted to assure collection of the section 2056A estate tax in lieu of the requirements prescribed in this paragraph (d)(4).

(5) *Adjustment of dollar threshold and exclusion.* The Commissioner may increase or decrease the dollar amounts referred to in paragraph (d)(1)(i), (ii) or (iv) of this section in accordance with

guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(6) *Effective date and special rules.* (i) This paragraph (d) is effective for estates of decedents dying after February 19, 1996.

(ii) *Special rule in the case of incompetency.* A revocable trust or a trust created under the terms of a will is deemed to meet the governing instrument requirements of this paragraph (d) notwithstanding that the requirements are not contained in the governing instrument (or otherwise incorporated by reference) if the trust instrument (or will) was executed on or before November 20, 1995, and—

(A) The testator or settlor dies after February 19, 1996;

(B) The testator or settlor is, on November 20, 1995, and at all times thereafter, under a legal disability to amend the will or trust instrument;

(C) The will or trust instrument does not provide the executor or the U.S. Trustee with a power to amend the instrument in order to meet the requirements of section 2056A; and

(D) The U.S. Trustee provides a written statement with the federal estate tax return (Form 706 or 706NA) that the trust is being administered (or will be administered) so as to be in actual compliance with the requirements of this paragraph (d) and will continue to be administered so as to be in actual compliance with this paragraph (d) for the duration of the trust. This statement must be binding on all successor trustees.

(iii) *Special rule in the case of certain irrevocable trusts.* An irrevocable trust is deemed to meet the governing instrument requirements of this paragraph (d) notwithstanding that the requirements are not contained in the governing instrument (or otherwise incorporated by reference) if the trust was executed on or before November 20, 1995, and:

(A) The settlor dies after February 19, 1996;

(B) The trust instrument does not provide the U.S. Trustee with a power to amend the trust instrument in order to meet the requirements of section 2056A; and

(C) The U.S. Trustee provides a written statement with the decedent's federal estate tax return (Form 706 or 706NA) that the trust is being administered in actual compliance with the requirements of this paragraph (d) and will continue to be administered so as to be in actual compliance with this paragraph (d) for the duration of the trust. This statement must be binding on all successor trustees.

[T.D. 8612, 60 FR 43540, Aug. 22, 1995, as amended by T.D. 8686, 61 FR 60553, Nov. 29, 1996]

### § 20.2056A–3 QDOT election.

(a) *General rule.* Subject to the time period prescribed in section 2056A(d), the election to treat a trust as a QDOT must be made on the last federal estate tax return filed before the due date (including extensions of time to file actually granted) or, if a timely return is not filed, on the first federal estate tax return filed after the due date. The election, once made, is irrevocable.

(b) *No partial elections.* An election to treat a trust as a QDOT may not be made with respect to a specific portion of an entire trust that would otherwise qualify for the marital deduction but for the application of section 2056(d). However, if the trust is actually severed in accordance with the applicable requirements of § 20.2056(b)–7(b)(2)(ii) prior to the due date for the election, a QDOT election may be made for any one or more of the severed trusts.

(c) *Protective elections.* A protective election may be made to treat a trust as a QDOT only if at the time the federal estate tax return is filed, the executor of the decedent's estate reasonably believes that there is a bona fide issue that concerns either the residency or citizenship of the decedent, the citizenship of the surviving spouse, whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive. For example, if at the time the federal estate tax return is filed either the estate is involved in a bona fide will contest, there is uncertainty regarding the inclusion in the gross estate of an asset which, if includible, would be eligible for the QDOT election, or there is uncertainty regarding the status of the decedent as

a resident alien or a nonresident alien for estate tax purposes, or a similar uncertainty regarding the citizenship status of the surviving spouse, a protective QDOT election may be made. The protective election is in addition to, and is not in lieu of, the requirements set forth in § 20.2056A–4. The protective QDOT election must be made on a written statement signed by the executor under penalties of perjury and must be attached to the return described in paragraph (a) of this section, and must identify the specific assets to which the protective election refers and the specific basis for the protective election. However, the protective election may otherwise be defined by means of a formula (such as the minimum amount necessary to reduce the estate tax to zero). Once made, the protective election is irrevocable. For example, if a protective election is made because a bona fide question exists as to the includibility of an asset in the decedent's gross estate and it is later finally determined that the asset is so includible, the protective election becomes effective with respect to the asset and cannot thereafter be revoked.

(d) *Manner of election.* The QDOT election under paragraph (a) of this section is made in the form and manner set forth in the decedent's estate tax return, including applicable instructions.

[T.D. 8612, 60 FR 43540, Aug. 22, 1995]

### § 20.2056A–4 Procedures for conforming marital trusts and nontrust marital transfers to the requirements of a qualified domestic trust.

(a) *Marital trusts*—(1) *In general.* If an interest in property passes from the decedent to a trust for the benefit of a noncitizen surviving spouse and if the trust otherwise qualifies for a marital deduction but for the provisions of section 2056(d)(1)(A), the property interest is treated as passing to the surviving spouse in a QDOT if the trust is reformed, either in accordance with the terms of the decedent's will or trust agreement or pursuant to a judicial proceeding, to meet the requirements of a QDOT. For this purpose, the requirements of a QDOT include all of the applicable requirements set forth in § 20.2056A–2, and the requirements of § 20.2056A–2T(d). A reformation pursuant to the terms of the decedent's will or trust instrument must be completed by the time prescribed (including extensions) for filing the decedent's estate tax return. For purposes of this paragraph (a), a return filed prior to the due date (including extensions) is considered filed on the last date that the return is required to be filed (including extensions), and a late return filed at any time after the due date is considered filed on the date that it is actually filed.

(2) *Judicial reformations.* In general, a reformation pursuant to a judicial proceeding is permitted under this section if the reformation is commenced on or before the due date (determined with regard to extensions actually granted) for filing the return of tax imposed by chapter 11 of the Internal Revenue Code, regardless of the date that the return is actually filed. The reformation (either pursuant to a judicial proceeding or otherwise) must result in a trust that is effective under local law. The reformed trust may be revocable by the spouse, or otherwise be subject to the spouse's general power of appointment, provided that no person (including the spouse) has the power to amend the trust during the continued existence of the trust such that it would no longer qualify as a QDOT. Prior to the time that the judicial reformation is completed, the trust must be treated as a QDOT. Thus, the trustee of the trust is responsible for filing the Form 706–QDT, paying any section 2056A estate tax that becomes due, and filing the annual statement required under § 20.2056A–2T(d)(3), if applicable. Failure to comply with these requirements may cause the trust to be subject to the anti-abuse rule under § 20.2056A–2T(d)(1)(iv). In addition, if the judicial reformation is terminated prior to the time that the reformation is completed, the estate of the decedent is required to pay the increased estate tax imposed on the decedent's estate (plus interest and any applicable penalties) that becomes due at the time of such termination as a result of the failure of the trust to comply with section 2056(d). See section 6511 as to applicable time periods for credit or refund of tax.

(3) *Tolling of statutory assessment period.* For the tolling of the statute of limitations in the case of a judicial reformation, see section 2056(d)(5)(B).

(b) *Nontrust marital transfers*—(1) *In general.* Under section 2056(d)(2)(B), if an interest in property passes outright from a decedent to a noncitizen surviving spouse either by testamentary bequest or devise, by operation of law, or pursuant to an annuity or other similar plan or arrangement, and such property interest otherwise qualifies for a marital deduction except that it does not pass in a QDOT, solely for purposes of section 2056(d)(2)(A), the property is treated as passing to the surviving spouse in a QDOT if the property interest is either actually transferred to a QDOT before the estate tax return is filed and on or before the last date prescribed by law that the QDOT election may be made, or is assigned to a QDOT under an enforceable and irrevocable written assignment made on or before the date on which the return is filed and on or before the last date prescribed by law that the QDOT election may be made. The transfer or assignment of property to a QDOT may be made by the surviving spouse, the surviving spouse's legal representative (if the surviving spouse is incompetent), or the personal representative of the surviving spouse's estate (if the surviving spouse has died). The QDOT to which the property is transferred may be created by the decedent (during life or by will), by the surviving spouse, or by the executor. For purposes of section 2056(d)(2)(B), if no property other than the property passing to the surviving spouse from the decedent is transferred to the QDOT, the transferee QDOT need not be in a form such that the property transferred to the QDOT would qualify for a marital deduction under section 2056(a). However, if other property is or has been transferred to the QDOT, 100 percent of the value of the transferee QDOT must qualify for the marital deduction under section 2056. For example, if the decedent, a U.S. citizen, bequeaths property to a trust that does not satisfy the requirements of section 2056(b)(5) or (7), or to a trust that does not qualify as an estate trust under § 20.2056(c)–2(b)(1)(i)–(iii), that trust cannot be used as a transferee QDOT by the surviving spouse, since after that trust is fully funded the portion of the value of the trust attributable to property bequeathed to the trust by the decedent will not qualify for a marital deduction under section 2056. Similarly, if the decedent, a nonresident not a citizen of the United States, bequeaths foreign situs assets to a trust created under his will, the surviving spouse may not transfer U.S. situs assets passing to the spouse outside of the will to that trust under this paragraph. See § 20.2056A–3(c) with respect to protective elections. See § 20.2056A–3(a) with respect to the time limitations for making the QDOT election.

(2) *Form of transfer or assignment.* A transfer or assignment of property to a QDOT must be in writing and otherwise be in accordance with all local law requirements for such assignment or transfer. The transfer or assignment may be of a specific asset or a group of assets, or a fractional share of either, or may be of a pecuniary amount. A transfer or assignment of less than an entire interest in an asset or a group of assets may be expressed by means of a formula (such as the minimum amount necessary to reduce the estate tax to zero). In the case of a transfer, a copy of the trust instrument evidencing the transfer must be submitted with the decedent's estate tax return. In the case of an assignment, a copy of the assignment must be submitted with the decedent's estate tax return.

(3) *Assets eligible for transfer or assignment.* If a transfer or assignment is of a specific asset or group of assets, only assets included in the decedent's gross estate and passing from the decedent to the spouse (or the proceeds from the sale, exchange or conversion of such assets) may be transferred or assigned to the QDOT. The noncitizen surviving spouse may not transfer or assign to the QDOT property owned by the surviving spouse at the time of the decedent's death in lieu of property included in the decedent's gross estate that passes to the spouse (or in lieu of the proceeds from the sale, exchange or conversion of such includible assets). In addition, if only a portion of an asset is includible in the decedent's gross estate, the spouse may only

transfer the portion that is so includible to the transferee trust under this paragraph (b)(3).

(4) *Pecuniary assignment—special rules.* If the assignment is expressed in the form of a pecuniary amount (such as a fixed dollar amount or a formula designed to reduce the decedent's estate tax to zero), the assignment must specify that—

(i) Assets actually transferred to the QDOT in satisfaction of the assignment have an aggregate fair market value on the date of actual transfer to the QDOT amounting to no less than the amount of the pecuniary transfer or assignment; or

(ii) The assets actually transferred to the QDOT be fairly representative of appreciation or depreciation in the value of all property available for transfer to the QDOT between the valuation date and the date of actual transfer to the QDOT, if the assignment is to be satisfied by accounting for the assets on the basis of their fair market value as of some date before the date of actual transfer to the QDOT.

(5) *Transfer tax treatment of transfer or assignment.* Property assigned or transferred to a QDOT pursuant to section 2056(d)(2)(B) is treated as passing from the decedent to a QDOT solely for purposes of section 2056(d)(2)(A). For all other purposes (e.g., income, gift, estate, generation-skipping transfer tax, and section 1491 excise tax), the surviving spouse is treated as the transferor of the property to the QDOT. However, the spouse is not considered the transferor of property to a QDOT if the transfer by the spouse constitutes a transfer that satisfies the requirements of section 2518(c)(3). For a special exception to the valuation rules of section 2702 in the case of a transfer by the surviving spouse to a QDOT, see § 25.2702–1(c)(8) of this chapter.

(6) *Period for completion of transfer.* Property irrevocably assigned but not actually transferred to the QDOT before the estate tax return is filed must actually be conveyed and transferred to the QDOT under applicable local law before the administration of the decedent's estate is completed. If there is no administration of the decedent's estate (because for example, none of the decedent's assets are subject to probate under local law), the conveyance must be made on or before the date that is one year after the due date (including extensions) for filing the decedent's estate tax return. If an actual transfer to the QDOT is not timely made, section 2056(d)(1)(A) applies and the marital deduction is not allowed. The executor of the decedent's estate (or other authorized legal representative) may request a private letter ruling from the Internal Revenue Service requesting an extension of the time for completing the conveyance or waiving the actual conveyance under specified circumstances under § 301.9100–1(a) of this chapter.

(7) *Retirement accounts and annuities*—(i) *In general.* An assignment otherwise in compliance with this paragraph (b) of rights under annuities or other similar arrangements that are assignable and thus, are not described in paragraph (c) of this section, is treated as a transfer of such property to the QDOT regardless of the method of payment actually elected under such annuity or plan.

(ii) *Individual retirement annuities.* Individual retirement annuities described in section 408(b) are not assignable pursuant to section 408(b)(1) and thus, do not come within the purview of this paragraph (b)(7). See the procedures provided in paragraph (c) of this section.

(iii) *Individual retirement accounts.* Unless the terms of the account provide otherwise, individual retirement accounts described in section 408(a) are assignable and subject to the provisions of this paragraph (b)(7). However, under paragraph (c) of this section, the surviving spouse may treat an individual retirement account as nonassignable and, therefore, eligible for the procedures in paragraph (c) of this section if the spouse timely complies with the requirements in paragraph (c) of this section.

(iv) *Other effects of assignment.* The provisions of this paragraph (b)(7) apply solely for purposes of qualifying the annuity or account under the rules of § 20.2056A–2 and this section. See, for example, section 408(d) and 4980A regarding the consequences of an assignment for purposes other than this paragraph (b)(7).

(8) *Protective assignment.* A protective assignment of property to a QDOT may be made only if, at the time the federal estate tax return is filed, the executor of the decedent's estate reasonably believes that there is a bona fide issue that concerns either the residency or citizenship of the decedent, the citizenship of the surviving spouse, whether all or a portion of an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive. For example, if at the time the federal estate tax return is filed, either the estate is involved in a bona fide will contest, there is uncertainty regarding the inclusion in the gross estate of an asset which, if includible, would be eligible for the QDOT election, or there is uncertainty regarding the status of the decedent as a resident alien or a nonresident alien for estate tax purposes, or a similar uncertainty regarding the citizenship status of the surviving spouse, a protective assignment may be made. The protective assignment must be made on a written statement signed by the assignor under penalties of perjury on or before the date prescribed under paragraph (b)(1) of this section, and must identify the specific assets to which the assignment refers and the specific basis for the protective assignment. However, the protective assignment may otherwise be defined by means of a formula (such as the minimum amount necessary to reduce the estate tax to zero). Once made, the protective assignment cannot be revoked. For example, if a protective assignment is made because a bona fide question exists as to the includibility of an asset in the decedent's gross estate and it is later finally determined that the asset is so includible, the protective assignment becomes effective with respect to the asset and cannot thereafter be revoked. Protective assignments are, in all events, subject to paragraph (b)(6) of this section. A copy of the protective assignment must be submitted with the decedent's estate tax return.

(c) *Nonassignable annuities and other arrangements*—(1) *Definition and general rule.* For purposes of this section, a *nonassignable annuity or other arrangement* means a plan, annuity, or other arrangement (whether qualified or not qualified under part I of subchapter D of chapter 1 of subtitle A of the Internal Revenue Code) that qualifies for the marital deduction but for section 2056(d)(1)(A), and whose payments are not assignable or transferable to the QDOT under either federal law (see, e.g., section 401(a)(13)), state law, foreign law, or the terms of the plan or arrangement itself. For purposes of this paragraph (c), a surviving spouse's interest as beneficiary of an individual retirement annuity described in section 408(b) is a nonassignable annuity or other arrangement. See section 408(b)(1). For purposes of this paragraph (c), a surviving spouse's interest as beneficiary of an individual retirement account described in section 408(a), although assignable under that section, is considered to be a nonassignable annuity or other arrangement eligible for the procedures contained in this paragraph (c), at the option of the surviving spouse, if the requirements of this paragraph are otherwise satisfied. See paragraph (b)(7) of this section if the spouse elects to treat the account as assignable. In the case of a plan, annuity, or other arrangement which is not assignable or transferable (or is treated as such), the property passing under the plan from the decedent is treated as meeting the requirements § 20.2056A–2, and the requirements of § 20.2056A–2T(d) (pertaining, respectively, to general requirements, qualified marital interest requirements, statutory requirements, and requirements to ensure collection of the tax) if the requirements of either paragraph (c)(2) or (3) of this section are satisfied. Thus, the property will be treated as passing in the form of a QDOT, notwithstanding that the spouse does not irrevocably transfer or assign the annuity or other payment to the QDOT as provided in paragraph (b) of this section. The Commissioner will prescribe by administrative guidance the extent, if any, to which the provisions of this paragraph (c) apply to a rollover from a qualified trust to an eligible retirement plan within the

meaning of section 402(c) or a distribution from an individual retirement account or an individual retirement annuity that is paid into an individual retirement account or an individual retirement annuity within the meaning of section 408(d)(3).

(2) *Agreement to remit section 2056A estate tax on corpus portion of each annuity payment.* The requirements of this paragraph (c)(2) are satisfied if—

(i) The noncitizen surviving spouse agrees to pay on an annual basis, as described in paragraph (c)(6)(i) of this section, the estate tax imposed under section 2056A(b)(1) due on the corpus portion, as defined in paragraph (c)(4) of this section, of each nonassignable annuity or other payment received under the plan or arrangement. However, for purposes of this paragraph (c)(2), if the financial circumstances of the spouse are such that an amount equal to all or a portion of the corpus portion of a nonassignable annuity payment received by the spouse would be subject to a hardship exemption (as defined in § 20.2056A–5(c)) if paid from a QDOT, then all or a corresponding part of the corpus portion will be exempt from the tax payment requirement under this paragraph (c)(2);

(ii) The executor of the decedent's estate files with the estate tax return the Information Statement described in paragraph (c)(5) of this section;

(iii) The executor files with the estate tax return the Agreement To Pay Section 2056A Estate Tax described in paragraph (c)(6) of this section; and

(iv) The executor makes the election under § 20.2056A–3 with respect to the nonassignable annuity or other payment.

(3) *Agreement to roll over corpus portion of annuity payment to QDOT.* The requirements of this paragraph (c)(3) are satisfied if—

(i) The noncitizen surviving spouse agrees to roll over and transfer, within the time prescribed under paragraph (c)(7)(i) of this section, the corpus portion of each annuity payment to a QDOT, whether the QDOT is created by the decedent's will, the executor of the decedent's estate, or the surviving spouse. However, for purposes of this section, if the financial circumstances of the spouse are such that an amount equal to all or a portion of the corpus portion of a nonassignable annuity payment received by the spouse would be subject to a hardship exemption (as defined in § 20.2056A–5(c)) if paid from a QDOT, then all or a corresponding part of the corpus portion will be exempt from the rollover requirement under this paragraph (c)(3);

(ii) A QDOT for the benefit of the surviving spouse is established prior to the date that the estate tax return is filed and on or prior to the last date prescribed by law that the QDOT election may be made;

(iii) The executor of the decedent's estate files with the estate tax return the Information Statement described in paragraph (c)(5) of this section;

(iv) The executor files with the estate tax return the Agreement To Roll Over Annuity Payments described in paragraph (c)(7) of this section; and

(v) The executor makes the election under § 20.2056A–3 with respect to the nonassignable annuity or other payment. See § 20.2056A–5(c)(3)(iv)(A), regarding distributions from the QDOT reimbursing the spouse for income taxes paid (either by actual payment or withholding) by the spouse with respect to amounts transferred to the QDOT pursuant to this paragraph (c)(3).

(4) *Determination of corpus portion*—(i) *Corpus portion.* For purposes of this paragraph (c), the corpus portion of each nonassignable annuity or other payment is the corpus amount of the annual payment divided by the total annual payment.

(ii) *Corpus amount.* (A) The corpus amount of the annual payment is determined in accordance with the following formula:

$$\text{Corpus Amount} = \frac{\text{Total present value of annuity or other payment}}{\text{Expected annuity term}}$$

(B) The total present value of the annuity or other payment is the present value of the nonassignable annuity or other payment as of the date of the decedent's death, determined in accordance with the interest rates and mortality data prescribed by section 7520. The expected annuity term is the number of years that would be required for the scheduled payments to exhaust a hypothetical fund equal to the present value of the scheduled payments. This is determined by first dividing the total present value of the payments by the annual payment. From the quotient so obtained, the expected annuity term is derived by identifying the term of years that corresponds to the annuity factor equal to the quotient. This is determined by using column 1 of Table B, for the applicable interest rate, contained in Publication 1457, *Alpha Volume*. A copy of this publication may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. If the quotient obtained falls between two terms, the longer term is used.

(5) *Information Statement*—(i) *In general*. In order for a nonassignable annuity or other payment described in this paragraph (c) to qualify under either paragraph (c) (2) or (3) of this section, the Information Statement described in paragraph (c)(5)(ii) of this section must be filed with the decedent's federal estate tax return. The Information Statement must be signed under penalties of perjury by both the executor of the decedent's estate and by the surviving spouse of the decedent (or by the legal representative of the surviving spouse if the surviving spouse is legally incompetent to sign the statement). The Statement must contain all of the information prescribed by this paragraph (c)(5).

(ii) *Annuity source information*—(A) *Employment-related annuity*. If the nonassignable annuity or other payment is employment-related, the following information must be provided—

(*1*) The name and address of the employer;

(*2*) The date of retirement or other separation from employment of the decedent;

(*3*) The name and address of the pension fund, insurance company, or other obligor that is paying the annuity (or similar payment); and

(*4*) The identification number, if any, that the obligor has assigned to the annuity or other payment.

(B) *Annuity not employment-related*. If the nonassignable annuity or other payment is not employment-related, the following information must be provided—

(*1*) The name and address of the person or entity paying the nonassignable annuity or other payment;

(*2*) The date of acquisition of the nonassignable annuity contract by the decedent or by the decedent and the surviving spouse; and

(*3*) The identification number, if any, that the obligor has assigned to the nonassignable annuity or other payment.

(iii) *The total annuity amount payable each year*. The total amount payable annually under the nonassignable annuity or other arrangement, including a description of whether the annuity is payable monthly, quarterly, or at some other interval, and a description of any scheduled changes in the annuity payout amount.

(iv) *The duration of the annuity*. A description of the term of the nonassignable annuity or other payment in years, if it is determined by a term certain, and the name, address, and birthdate of any measuring life if the nonassignable annuity or other payment is determined by one or more lives.

(v) *The market interest rate under section 7520*. The applicable interest rate as determined under section 7520.

(vi) *Determination of corpus portion of each payment (in accordance with paragraph (c)(4) of this section)*. The following items are required in order to determine the corpus portion of each payment—

(A) The present value of the nonassignable annuity or other payment as of the decedent's death;

(B) The expected annuity term;

(C) The corpus amount of the annual annuity payments (paragraph (c)(5)(vi)(A) of this section divided by paragraph (c)(5)(vi)(B) of this section); and

(D) The corpus portion of the annual payments (paragraph (c)(5)(vi)(C) of this section divided by the total amount payable annually).

(vii) *Recipient QDOT.* In the case of an agreement to rollover under paragraph (c)(3) of this section, the following must be provided—

(A) The name and address of the trustee of the QDOT who is the U.S. Trustee; and

(B) The name and taxpayer identification number of the QDOT.

(viii) *Certification statement.* The executor of the decedent's estate and the surviving spouse of the decedent (or the legal representative of the surviving spouse if the surviving spouse is legally incompetent to so certify) must each sign a Certification Statement as follows:

Under penalties of perjury, I hereby certify that, to the best of my knowledge and belief, the information reported in this Information Statement is true, correct and complete.

(6) *Agreement to pay section 2056A estate tax*—(i) *Payment of section 2056A estate tax.* The tax payable under paragraph (c)(2) of this section is payable on an annual basis, commencing in the calendar year following the calendar year of the receipt by the surviving spouse of the spouse's first annuity payment. Form 706QDT and the payment are due on April 15th of each year following the calendar year in which an annuity payment is received except that, in the year of the deceased spouse's death, the Form 706–QDT and the payment are not due prior to the due date, including extensions, for filing the deceased spouse's estate tax return, or if no return is filed, no later than 9 months from the date of the deceased spouse's death; and, in the year of the surviving spouse's death, the Form 706–QDT must be filed and the payment made no later than 9 months from the date of the surviving spouse's death. See § 20.2056A–11 for extensions of time for filing Form 706–QDT and paying the section 2056A estate tax.

(ii) *Agreement.* In order for a nonassignable annuity or other payment described in this paragraph (c) to qualify under paragraph (c)(2) of this section, the executor of the decedent's estate must file with the estate tax return the following Agreement To Pay Section 2056A Estate Tax, which must be signed by the surviving spouse of the decedent (or by the surviving spouse's legal representative if the surviving spouse is legally incompetent to sign the agreement):

I [ *name* ] hereby agree that I will report all annuity payments received under the [*name of plan or arrangement*] on Form 706–QDT for the calendar year and remit, on an annual basis, to the Internal Revenue Service the estate tax that is imposed under section 2056A(b)(1) of the Internal Revenue Code on the corpus portion of each annuity payment (as defined in § 20.2056A–4(c)(4) of the Estate Tax Regulations) received under the plan during the calendar year. I also agree that Form 706–QDT is to be filed no later than April 15th of the year following the calendar year in which any annuity payments are received except that: in the case of annuity payments received in the year of my spouse's death, Form 706–QDT and the payment shall not be due prior to the due date, including extensions, for filing my spouse's estate tax return or, if no return is filed, no later than 9 months from the date of my spouse's death (except if I am granted an extension of time to file Form 706–QDT under the provisions of § 20.2056A–11); and in the year of my death, the Form 706–QDT must be filed and the payment made no later than the date my estate tax return is filed (or if no return is filed, no later than 9 months from the date of my death). I further agree that if I fail to timely file Form 706–QDT or to timely pay the tax imposed on the corpus portion of any annuity payment (determined after any extensions of time to pay granted to me under the provisions of § 20.2056A- 11), I may become immediately liable to pay the amount of the tax determined by application of section 2056A(b)(1) on the entire remaining present value of the annuity, calculated as of the beginning of the year in which the payment was received with respect to which I failed to timely pay the tax or failed to timely file the return. However, I may make an application for relief under § 301.9100–1 of the Procedure and Administration Regulations, from the consequences of failing to timely file the Form 706–QDT or failing to timely pay the tax on the corpus portion. [The following sentence is applicable only in cases where the plan or arrangement is established and administered by a person or an entity that is located outside of the United States.] I agree, at the request of the District Director, [or the Assistant Commissioner (International) in the case of a surviving spouse of a nonresident noncitizen decedent or a surviving spouse of a United States citizen who died domiciled outside the United States] to enter into a security

agreement to secure my undertakings under this agreement.

(7) *Agreement to roll over annuity payments*—(i) *Roll over of corpus portion.* Beginning in the calendar year of the receipt by the surviving spouse of the spouse's first annuity payment, the corpus portion of each annuity payment, as determined under paragraph (c)(4) of this section, must, within 60 days of receipt, be transferred to a QDOT. In addition, all annuity payments received during the calendar year must be reported on Form 706–QDT no later than April 15th of the year following the year in which the annuity payments are received, except that in the year of the surviving spouse's death, the Form 706–QDT must be filed no later than the date the estate tax return is filed (or if no return is filed, no later than 9 months from the date of the surviving spouse's death). See § 20.2056A–11 for extensions of time for filing Form 706–QDT.

(ii) *Agreement.* In order for a nonassignable annuity or other payment described in this paragraph (c) to qualify under paragraph (c)(3) of this section, the executor of the decedent's estate must file with the estate tax return the following Agreement To Roll Over Annuity Payments, which must be signed by the surviving spouse of the decedent (or by the legal representative of the surviving spouse if the surviving spouse is legally incompetent to sign the agreement):

I [ *name* ] hereby agree that within 60 days of receipt of each annuity payment paid under the [*name of plan or arrangement*], I will transfer an amount equal to _____ percent (the corpus portion determined under § 20.2056A–4(c)(4) of the Estate Tax Regulations) of each annuity payment to [*identify the QDOT*]. Further, I will report all annuity payments received during the calendar year under the [*name of plan or arrangement*] on Form 706–QDT including a schedule of transfers to the [identify the QDOT]. I also agree that Form 706–QDT is to be filed no later than April 15th of the year following the year in which any annuity payments are received except that: in the case of annuity payments received in the year of my spouse's death, Form 706–QDT shall not be due prior to the due date, including extensions, for filing my spouse's estate tax return, or, if no return is filed, no later than 9 months from the date of my spouse's death (except if I am granted an extension of time to file Form 706–QDT under the provisions of § 20.2056A–11); and in the year of my death, the Form 706–QDT must be filed no later than the date my estate tax return is filed (or if no return is filed, no later than 9 months from the date of my death), and except if I am granted an extension of time to file Form 706–QDT under the provisions of § 20.2056A–11. I further agree that if I fail to timely transfer any required amount with respect to any annuity payment, or fail to timely file Form 706–QDT reporting the transfers for any year, I may become immediately liable to pay the amount of the tax determined by application of section 2056A(b)(1) on the entire remaining present value of the annuity, calculated as of the beginning of the year in which the payment was received with respect to which I failed to make the timely transfer or timely file a return. However, I may make an application for relief under § 301.9100–1 of the Procedure and Administration Regulations, from the consequences of failing to timely file Form 706–QDT or failing to timely transfer the corpus portion of any annuity payment to the QDOT. [The following sentence is applicable only in cases where the plan or arrangement is established and administered by a person or an entity that is located outside of the United States.] I agree, at the request of the District Director [or the Assistant Commissioner (International) in the case of a surviving spouse of a nonresident noncitizen decedent or a surviving spouse of a United States citizen who died domiciled outside the United States] to enter into a security agreement to secure my undertakings under this agreement.

(d) *Examples.* The provisions of this section are illustrated by the following examples. In each of the following examples the decedent, *D*, a citizen of the United States, died after August 22, 1995, and *D*'s surviving spouse, *S*, is not a United States citizen at the time of *D*'s death.

*Example 1. Transfer and assignment of probate and nonprobate property to QDOT.* (i) *S* is the beneficiary of the following probate and nonprobate assets included in *D*'s gross estate:

| | |
|---|---|
| Pecuniary bequest under will ..... | $400,000 |
| Proceeds of life insurance ..... | 200,000 |
| *D*'s interest in property owned jointly with *S* includible in the gross estate under § 2040(a) ..... | 300,000 |
| Devise of real property under will | 100,000 |
| Total ..... | $1,000,000 |

(ii) Before the estate tax return for *D*'s estate is filed and before the date that the QDOT election must be made, *S* creates a

QDOT pursuant to which all income is payable to *S* for life and the remainder is distributable to *S*'s children. *S* retains a power of appointment over the disposition of the remainder to ensure that *S* does not make an immediate gift of the remainder of the trust. Also, before the estate tax return is filed and before the date that the QDOT election must be made, *S* transfers the life insurance proceeds and the specifically devised real property to the QDOT. *S* decides not to transfer the property that had been jointly owned to the QDOT. Because S has not received distribution of the pecuniary bequest before *D*'s estate tax return is filed and before the date that the QDOT election must be made, *S* irrevocably assigns the interest in the pecuniary bequest to the QDOT. Assume that the pecuniary bequest is in fact transferred by *S* to the QDOT before the estate administration is concluded. *D*'s executor makes a QDOT election on the estate tax return for the $700,000 in property that *S* has transferred and assigned to the QDOT. A marital deduction of $700,000 is allowed to *D*'s estate assuming the estate tax return is filed and the QDOT election is made within the time limitation prescribed in § 20.2056A–3(a). No marital deduction is allowed for the $300,000 interest in jointly-owned property not transferred to the QDOT.

*Example 2. Formula assignment.* Under the terms of *D*'s will, the entire probate estate passes outright to *S*. Prior to the date *D*'s estate tax return is filed and before the date that the QDOT election must be made, *S* establishes a QDOT and *S* executes an irrevocable assignment in which *S* assigns to the QDOT, ''that portion of the gross estate necessary to reduce the estate tax to zero, taking into account all available credits and deductions.'' The assignment meets the requirements of paragraph (b) of this section, assuming that the QDOT is funded by the time that administration of *D*'s estate is completed.

*Example 3. Jointly owned property.* At the time of *D*'s death, *D* and *S* hold real property as joint tenants with right of survivorship. In accordance with section 2056(d)(1)(B), section 2040(a), and § 20.2056A–8(a), 60 percent of the value of the property is included in *D*'s gross estate. *S* establishes a QDOT and, prior to the date the estate tax return is filed and before the date that the QDOT election must be made, *S* transfers a 60 percent interest in the real property to the QDOT. The transfer satisfies the requirements of paragraph (b) of this section.

*Example 4. Computation of corpus portion of annuity payment.* (i) At the time of *D*'s death, *D* is a participant in an employees' pension plan described in section 401(a). On *D*'s death, *D*'s spouse *S*, a resident of the United States, becomes entitled to receive a survivor's annuity of $72,000 per year, payable monthly, for life. At the time of *D*'s death, *S* is age 60. Assume that under section 7520, the appropriate discount rate to be used for valuing annuities in the case of this decedent is 9 percent. The annuity factor at 9 percent for a person age 60 is 8.3031. The adjustment factor at 9 percent for monthly payments is 1.0406. Accordingly, the right to receive $72,000 a year on a monthly basis is equal to the right to receive $74,923 ($72,000 × 1.0406) on an annual basis.

(ii) The corpus portion of each annuity payment received by *S* is determined as follows. The first step is to determine the annuity factor for the number of years that would be required to exhaust a hypothetical fund that has a present value and a payout corresponding to *S*'s interest in the payments under the plan, determined as follows:

(A) Present value of *S*'s annuity: $74,923 x 8.3031 = $622,093

(B) Annuity Factor for Expected Annuity Term: $622,093/$74,923 = 8.3031

(iii) The second step is to determine the number of years that would be required for *S*'s annuity to exhaust a hypothetical fund of $622,093. The term certain annuity factor of 8.3031 falls between the annuity factors for 15 and 16 years in a 9 percent term certain annuity table (Column 1 of Table B, Publication 1457 *Alpha Volume* which may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402). Accordingly, the expected annuity term is 16 years.

(iv) The third step is to determine the corpus amount by dividing the expected term of 16 years into the present value of the hypothetical fund as follows:

Corpus amount of annual payment: $622,093/16 = $38,881

(v) In the fourth step, the corpus portion of each annuity payment is determined by dividing the corpus amount of each annual payment by the annual annuity payment as follows:

Corpus portion of each annuity payment: $38,881/$74,923 = .52

(vi) Accordingly, 52 percent of each payment to *S* is deemed to be a distribution of corpus. A marital deduction is allowed for $622,093, the present value of the annuity as of *D*'s date of death, if either: *S* agrees to roll over the corpus portion of each payment to a QDOT and the executor files the Information Statement described in paragraph (c)(5) of this section and the Roll Over Agreement described in paragraph (c)(7) of this section; or *S* agrees to pay the tax due on the corpus portion of each payment and the executor files the Information Statement described in paragraph (c)(5) of this section and the Payment Agreement described in paragraph (c)(6) of this section.

*Example 5. Transfer to QDOT subject to gift tax.* *D*'s will bequeaths $700,000 outright to *S*.

The bequest qualifies for a marital deduction under section 2056(a) except that it does not pass in a QDOT. *S* creates an irrevocable trust that meets the requirements for a QDOT and transfers the $700,000 to the QDOT. The QDOT instrument provides that *S* is entitled to all the income from the QDOT payable at least annually and that, upon the death of *S*, the property remaining in the QDOT is to be distributed to the grandchildren of *D* and *S* in equal shares. The trust instrument contains all other provisions required to qualify as a QDOT. On *D*'s estate tax return, *D*'s executor makes a QDOT election under section 2056A(a)(3). Solely for purposes of the marital deduction, the property is deemed to pass from *D* to the QDOT. *D*'s estate is entitled to a marital deduction for the $700,000 value of the property passing from *D* to *S*. *S*'s transfer of property to the QDOT is treated as a gift of the remainder interest for gift tax purposes because *S*'s transfer creates a vested remainder interest in the grandchildren of *D* and *S*. Accordingly, as of the date that *S* transfers the property to the QDOT, a gift tax is imposed on the present value of the remainder interest. See § 25.2702–1(c)(8) of this chapter exempting *S*'s transfer from the special valuation rules contained in section 2702. At *S*'s death, *S* is treated as the transferor of the property into the trust for estate tax and generation-skipping transfer tax purposes. See, e.g., sections 2036 and 2652(a)(1). The trust is not eligible for a reverse QTIP election by *D*'s estate under section 2652(a)(3) because a QTIP election cannot be made for the QDOT. This is so because the marital deduction is allowed under section 2056(a) for the outright bequest to the spouse and the spouse is then separately treated as the transferor of the property to the QDOT.

[T.D. 8612, 60 FR 43541, Aug. 22, 1995]

### § 20.2056A–5 Imposition of section 2056A estate tax.

(a) *In general.* An estate tax is imposed under section 2056A(b)(1) on the occurrence of a taxable event, as defined in section 2056A(b)(9). The tax is generally equal to the amount of estate tax that would have been imposed if the amount involved in the taxable event had been included in the decedent's taxable estate and had not been deductible under section 2056. See section 2056A(b)(3) and paragraph (c) of this section for certain exceptions from taxable events.

(b) *Amounts subject to tax*—(1) *Distribution of principal during the spouse's lifetime.* If a taxable event occurs during the noncitizen surviving spouse's lifetime, the amount on which the section 2056A estate tax is imposed is the amount of money and the fair market value of the property that is the subject of the distribution (including property distributed from the trust pursuant to the exercise of a power of appointment), including any amount withheld from the distribution by the U.S. Trustee to pay the tax. If, however, the tax is not withheld by the U.S. Trustee but is paid by the U.S. Trustee out of other assets of the QDOT, an amount equal to the tax so paid is treated as an additional distribution to the spouse in the year that the tax is paid.

(2) *Death of surviving spouse.* If a taxable event occurs as a result of the death of the surviving spouse, the amount subject to tax is the fair market value of the trust assets on the date of the spouse's death (or alternate valuation date if applicable). See also section 2032A. Any corpus portion amounts, within the meaning of § 20.2056A–4(c)(4)(i), remaining in a QDOT upon the surviving spouse's death, are subject to tax under section 2056A(b)(1)(B), as well as any residual payments resulting from a nonassignable plan or arrangement that, upon the surviving spouse's death, are payable to the spouse's estate or to successor beneficiaries.

(3) *Trust ceases to qualify as QDOT.* If a taxable event occurs as a result of the trust ceasing to qualify as a QDOT (for example, the trust ceases to have at least one U.S. Trustee), the amount subject to tax is the fair market value of the trust assets on the date of disqualification.

(c) *Distributions and dispositions not subject to tax*—(1) *Distributions of principal on account of hardship.* Section 2056A(b)(3)(B) provides an exemption from the section 2056A estate tax for distributions to the surviving spouse on account of hardship. A distribution of principal is treated as made on account of hardship if the distribution is made to the spouse from the QDOT in response to an immediate and substantial financial need relating to the spouse's health, maintenance, education, or support, or the health, maintenance, education, or support of any

person that the surviving spouse is legally obligated to support. A distribution is not treated as made on account of hardship if the amount distributed may be obtained from other sources that are reasonably available to the surviving spouse; e.g., the sale by the surviving spouse of personally owned, publicly traded stock or the cashing in of a certificate of deposit owned by the surviving spouse. Assets such as closely held business interests, real estate and tangible personalty are not considered sources that are reasonably available to the surviving spouse. Although a hardship distribution of principal is exempt from the section 2056A estate tax, it must be reported on Form 706–QDT even if it is the only distribution that occurred during the filing period. See § 20.2056A–11 regarding filing requirements for Form 706–QDT.

(2) *Distributions of income to the surviving spouse.* Section 2056A(b)(3)(A) provides an exemption from the section 2056A estate tax for distributions of income to the surviving spouse. In general, for purposes of section 2056A(b)(3)(A), the term *income* has the same meaning as is provided in section 643(b), except that income does not include capital gains. In addition, income does not include any other item that would be allocated to corpus under applicable local law governing the administration of trusts irrespective of any specific trust provision to the contrary. In cases where there is no specific statutory or case law regarding the allocation of such items under the law governing the administration of the QDOT, the allocation under this paragraph (c)(2) will be governed by general principles of law (including but not limited to any uniform state acts, such as the Uniform Principal and Income Act, or any Restatements of applicable law). Further, except as provided in this paragraph (c)(2) or in administrative guidance published by the Internal Revenue Service, income does not include items constituting income in respect of a decedent (IRD) under section 691. However, in cases where a QDOT is designated by the decedent as a beneficiary of a pension or profit sharing plan described in section 401(a) or an individual retirement account or annuity described in section 408, the proceeds of which are payable to the QDOT in the form of an annuity, any payments received by the QDOT may be allocated between income and corpus using the method prescribed under § 20.2056A–4(c) for determining the corpus and income portion of an annuity payment.

(3) *Certain miscellaneous distributions and dispositions.* Certain miscellaneous distributions and dispositions of trust assets are exempt from the section 2056A estate tax, including but not limited to the following—

(i) Payments for ordinary and necessary expenses of the QDOT (including bond premiums and letter of credit fees);

(ii) Payments to applicable governmental authorities for income tax or any other applicable tax imposed on the QDOT (other than a payment of the section 2056A estate tax due on the occurrence of a taxable event as described in paragraph (b) of this section);

(iii) Dispositions of trust assets by the trustees (such as sales, exchanges, or pledging as collateral) for full and adequate consideration in money or money's worth; and

(iv) Pursuant to section 2056A(b)(15), amounts paid from the QDOT to reimburse the surviving spouse for any tax imposed on the spouse under Subtitle A of the Internal Revenue Code on any item of income of the QDOT to which the surviving spouse is not entitled under the terms of the trust. Such distributions include (but are not limited to) amounts paid from the QDOT to reimburse the spouse for income taxes paid by the spouse (either by actual payment or through withholding) with respect to amounts received from a nonassignable annuity or other arrangement that are transferred by the spouse to a QDOT pursuant to § 20.2056A– 4(c)(3); and income taxes paid by the spouse (either by actual payment or through withholding) with respect to amounts received in a lump sum distribution from a qualified plan if the lump sum distribution is assigned by the surviving spouse to a QDOT. For purposes of this paragraph (c)(3)(iv), the amount of attributable tax eligible for reimbursement is the difference between the actual income

tax liability of the spouse and the spouse's income tax liability determined as if the item had not been included in the spouse's gross income in the applicable taxable year.

[T.D. 8612, 60 FR 43546, Aug. 22, 1995]

**§ 20.2056A–6 Amount of tax.**

(a) *Definition of tax.* Section 2056A(b)(2) provides for the computation of the section 2056A estate tax. For purposes of sections 2056A(b)(2)(A)(i) and (ii), in determining the tax that would have been imposed under section 2001 on the estate of the first decedent, the rates in effect on the date of the first decedent's death are used. For this purpose, the provisions of section 2001(c)(2) (pertaining to phaseout of graduated rates and unified credit) apply. In addition, for purposes of sections 2056A(b)(2)(A) (i) and (ii), *the tax which would have been imposed by section 2001 on the estate of the decedent* means the net tax determined under section 2001 or 2101, as the case may be, after allowance of any allowable credits, including the unified credit allowable under section 2010, the credit for state death taxes under section 2011, the credit for tax on prior transfers under section 2013, and the credit for foreign death taxes under section 2014. See paragraph (b)(4) of this section regarding the application of the credits under sections 2011 and 2014. In the case of a decedent nonresident not a citizen of the United States, the applicable credits are determined under section 2102. The estate tax (net of any applicable credits) imposed under section 2056A(b)(1) constitutes an estate tax for purposes of section 691(c)(2)(A).

(b) *Benefits allowed in determining amount of section 2056A estate tax*—(1) *General rule.* Section 2056A(b)(10) provides for the allowance of certain benefits in computing the section 2056A estate tax. Except as provided in this section, the rules of each of the credit, deduction and deferral provisions, as provided in the Internal Revenue Code must be complied with.

(2) *Treatment as resident.* For purposes of section 2056A(b)(10)(A), a noncitizen spouse is treated as a resident of the United States for purposes of determining whether the QDOT property is includible in the spouse's gross estate under chapter 11 of the Internal Revenue Code, and for purposes of determining whether any of the credits, deductions or deferral provisions are allowable with respect to the QDOT property to the estate of the spouse.

(3) *Special rule in the case of trusts described in section 2056(b)(8).* In the case of a QDOT in which the spouse's interest qualifies for a marital deduction under section 2056(b)(8), the provisions of section 2056A(b)(10)(A) apply in determining the allowance of a charitable deduction in computing the section 2056A estate tax, notwithstanding that the QDOT is not includible in the spouse's gross estate.

(4) *Credit for state and foreign death taxes.* If the assets of the QDOT are included in the surviving spouse's gross estate for federal estate tax purposes, or would have been so includible if the spouse had been a United States resident, and state or foreign death taxes are paid by the spouse's estate with respect to the QDOT, the taxes paid by the spouse's estate with respect to the QDOT are creditable, to the extent allowable under section 2011 or 2014, as applicable, in computing the section 2056A estate tax. In addition, state or foreign death taxes previously paid by the decedent/transferor's estate are also creditable in computing the section 2056A estate tax to the extent allowable under sections 2011 and 2014. Specifically, the tax that would have been imposed on the decedent's estate if the taxable estate had been increased by the value of the QDOT assets on the spouse's death plus the amount involved in prior taxable events (section 2056A(b)(2)(A)(i)), is determined after allowance of a credit equal to the lesser of the state or foreign death tax previously paid by the decedent's estate, or the amount prescribed under section 2011(b) or 2014(b) computed based on a taxable estate increased by such amounts. Similarly, the tax that would have been imposed on the decedent's estate if the taxable estate had been increased only by the amount involved in prior taxable events (section 2056A(b)(2)(A)(ii)) is determined after allowance of a credit equal to the lesser of the state or foreign death tax previously paid by the decedent's estate, or the amount prescribed under section

2011(b) or 2014(b) computed based on a taxable estate increased by the amount involved in such prior taxable events. See paragraph (d), *Example 2*, of this section.

(5) *Alternate valuation and special use valuation*—(i) *In general.* In order to claim the benefits of alternate valuation under section 2032, or special use valuation under section 2032A, for purposes of computing the section 2056A estate tax, an election must be made on the Form 706–QDT that is filed with respect to the balance remaining in the QDOT upon the death of the surviving spouse. In addition, the separate requirements for making the section 2032 and/or section 2032A elections under those sections and the regulations thereunder must be complied with except that, for this purpose, the surviving spouse is treated as a resident of the United States regardless of the surviving spouse's actual residency status. Solely for purposes of this paragraph (b)(5), the citizenship of the first decedent is immaterial.

(ii) *Alternate valuation.* For purposes of the alternate valuation election under section 2032, the election may not be made unless the election decreases both the value of the property remaining in the QDOT upon the death of the surviving spouse and the net amount of section 2056A estate tax due. Once made, the election is irrevocable.

(iii) *Special use valuation.* For purposes of section 2032A, the Designated Filer (in the case of multiple QDOTs) or the U.S. Trustee may elect to value certain farm and closely held business real property at its farm or business use value, rather than its fair market value, if all of the requirements under section 2032A and the applicable regulations are met, except that, for this purpose, the surviving spouse is treated as a resident of the United States regardless of the spouse's actual residency status. The total value of property valued under section 2032A in the QDOT cannot be decreased from fair market value by more than $750,000.

(c) *Miscellaneous rules.* See sections 2056A(b)(2)(B)(i) and 2056A(b)(2)(C) for special rules regarding the appropriate rate of tax. See section 2056A(b)(2)(B)(ii) for provisions regarding a credit or refund with respect to the section 2056A estate tax.

(d) *Examples.* The rules of this section are illustrated by the following examples.

*Example 1.* (i) *D*, a United States citizen, dies in 1995 a resident of State X, with a gross estate of $1,200,000. Under *D*'s will, a pecuniary bequest of $700,000 passes to a QDOT for the benefit of *D*'s spouse S, who is a resident but not a citizen of the United States. *D*'s estate tax is computed as follows:

| | | |
|---|---|---|
| Gross estate | $1,200,000 | |
| Marital Deduction | (700,000) | |
| Taxable Estate | $500,000 | |
| Gross Tax | | $155,800 |
| Less: Unified Credit | | (155,800) |
| Net Tax | | 0 |

(ii) *S* dies in 1997 at which time *S* is still a resident of the United States and the value of the assets of the QDOT is $700,000. Assuming there were no taxable events during *S*'s lifetime with respect to the QDOT, the estate tax imposed under section 2056A(b)(1)(B) is $235,000, computed as follows:

| | | |
|---|---|---|
| *D*'s actual taxable estate | $500,000 | |
| QDOT property | 700,000 | |
| Total | $1,200,000 | |
| Gross Tax | | $427,800 |
| Less: Unified Credit | | (192,800) |
| Net Tax | | $235,000 |
| Less: Tax that would have been imposed on *D*'s actual taxable estate of $500,000 | | 0 |
| Section 2056A Estate Tax | | $235,000 |

*Example 2.* (i) The facts are the same as in *Example 1*, except that *D*'s gross estate was $2,000,000 and *D*'s estate paid $70,000 in state death taxes to State X. *D*'s estate tax is computed as follows:

| | | | |
|---|---|---|---|
| Gross Estate | $2,000,000 | | |

| | | | |
|---|---|---|---|
| Marital Deduction | (700,000) | ..... | ..... |
| Taxable Estate | $1,300,000 | ..... | ..... |
| Gross Tax | ..... | ..... | $469,800 |
| Less: Unified Credit | ..... | 192,800 | ..... |
| State Death Tax Credit Limitation (lesser of $51,600 or $70,000 tax paid) | ..... | 51,600 | (244,400) |
| Estate Tax | ..... | ..... | $225,400 |

(ii) *S* dies in 1997 at which time *S* is still a resident of the United States and the value of the assets of the QDOT is $800,000. *S*'s estate pays $40,000 in State X death taxes with respect to the inclusion of the QDOT in *S*'s gross estate for state death tax purposes. Assuming there were no taxable events during *S*'s lifetime with respect to the QDOT, the estate tax imposed under section 2056A(b)(1)(B) is $304,800 computed as follows:

| | | |
|---|---|---|
| *D*'s Actual Taxable Estate | $1,300,000 | ..... |
| QDOT Property | 800,000 | ..... |
| Total | $2,100,000 | ..... |
| Gross Tax | ..... | $829,800 |
| Less: Unified Credit | ..... | (192,800) |
| Pre-2011 section 2056A estate tax | ..... | $637,000 |
| (A) State Death Tax Credit Computation: | | |
| (1) State death tax paid by *S*'s estate with respect to the QDOT [$40,000] plus state death tax previously paid by *D*'s estate [$70,000] = $110,000. | ..... | ..... |
| (2) Credit limit under section 2011(b) (based on *D*'s adjusted taxable estate of $2,040,000 under sections 2056A(b)(2)(A) and 2011(b)) = $106,800. | ..... | ..... |
| (B) State death tax credit allowable against section 2056A estate tax (lesser of paragraph (ii)(A)(1) or (2) of this Example 2 | ..... | (106,800) |
| Net Tax | ..... | $530,200 |
| Less: Tax that would have been imposed on *D*'s taxable estate of $1,300,000 | ..... | 225,400 |
| Section 2056A Estate Tax | ..... | $304,800 |

[T.D. 8612, 60 FR 43547, Aug. 22, 1995]

### §20.2056A–7 Allowance of prior transfer credit under section 2013.

(a) *Property subject to QDOT election.* Section 2056(d)(3) provides special rules for computing the section 2013 credit allowed with respect to property subject to a QDOT election. In computing the credit under section 2013, the amount of the credit is determined under section 2013 and the regulations thereunder, except that—

(1) The first limitation as described in section 2013(b) and §20.2013–2 is the amount of the estate tax imposed under section 2056A(b)(1)(A), with respect to distributions during the spouse's life, and under section 2056A(b)(1)(B), with respect to the value of the QDOT assets on the spouse's death;

(2) In computing the second limitation as described in section 2013(c) and §20.2013–3, the value of the property transferred to the decedent (as defined in section 2013(d) and §20.2013–4) is deemed to be the value of the QDOT assets on the date of death of the surviving spouse. The value as so determined is not reduced by the section 2056A estate tax imposed at the time of the spouse's death; and

(3) The amount of the credit is determined without regard to the percentage limitations contained in section 2013(a).

(b) *Property not subject to QDOT election.* If property includible in a decedent's gross estate passes to a noncitizen surviving spouse (the transferee) and no deduction is allowed to the decedent's estate for that interest in property under section 2056(a) solely because the requirements of section 2056(d)(2) are not satisfied, and the transferee spouse dies with an estate that is subject to tax under section 2001 or 2101, as the case may be, any credit for tax on prior transfers allowable to the estate of the transferee spouse under section 2013 with respect to such interest in property is determined in accordance with the rules of section 2013 and the regulations thereunder, except that the amount of the credit is determined without regard to the percentage limitations contained in section 2013(a).

(c) *Example.* The application of this section may be illustrated by the following example:

*Example.* The facts are the same as in § 20.2056A–6, *Example 2*(ii). *D*, a United States citizen, dies in 1994, a resident of State X, with a gross estate of $2,000,000. Under *D*'s will, a pecuniary bequest of $700,000 passes to a QDOT for the benefit of *D*'s spouse *S*, who is a resident but not a citizen of the United States. *S* dies in 1997 at which time *S* is still a resident of the United States and the value of the assets of the QDOT is $800,000. There were no taxable events during *S*'s lifetime. An estate tax of $304,800 is imposed under section 2056A(b)(1)(B). *S*'s taxable estate, including the value of the QDOT ($800,000), is $1,500,000.

(i) Under paragraph (a)(1) of this section, the first limitation for purposes of section 2013(b) is $304,800, the amount of the section 2056A estate tax.

(ii) Under paragraph (a)(2) of this section, the second limitation for purposes of section 2013(c) is computed as follows:

(A) *S*'s net estate tax payable under § 20.2013–3(a)(1), as modified under paragraph (a)(2) of this section, is computed as follows:

| | | |
|---|---|---|
| Taxable estate | ..... | $1,500,000 |
| Gross estate tax | ..... | 555,800 |
| Less: Unified credit | $192,800 | ..... |
| Credit for state death taxes | 64,400 | 257,200 |
| Pre-2013 net estate tax payable | ..... | $298,600 |

(B) *S*'s net estate tax payable under § 20.2013–3(a)(2), as modified under paragraph (a)(2) of this section, is computed as follows:

| | | |
|---|---|---|
| Taxable estate | ..... | $700,000 |
| Gross estate tax | ..... | 229,800 |
| Less: Unified credit | $192,800 | ..... |
| Credit for state death taxes | 18,000 | 210,800 |
| Net tax payable | ..... | $19,000 |
| (C) *Second Limitation:* | | |
| Paragraph (ii)(A) of this *Example* | $298,600 | ..... |
| Less: Paragraph (ii)(B) of this *Example* | 19,000 | |
| | | $279,600 |

(iii) Credit for tax on prior transfers = $279,600 (lesser of paragraphs (i) or (ii) of this *Example.*

[T.D. 8612, 60 FR 43549, Aug. 22, 1995]

## § 20.2056A–8 Special rules for joint property.

(a) *Inclusion in gross estate*—(1) *General rule.* If property is held by the decedent and the surviving spouse of the decedent as joint tenants with right of survivorship, or as tenants by the entirety, and the surviving spouse is not a United States citizen (or treated as a United States citizen) at the time of the decedent's death, the property is subject to inclusion in the decedent's gross estate in accordance with the rules of section 2040(a) (general rule for includibility of joint interests), and section 2040(b) (special rule for includibility of certain joint interests of husbands and wives) does not apply. Accordingly, the rules contained in section 2040(a) and § 20.2040–1 govern the extent to which such joint interests are includible in the gross estate of a decedent who was a citizen or resident of the United States. Under § 20.2040–1(a)(2), the entire value of jointly held property is included in the decedent's gross estate unless the executor submits facts sufficient to show that property was not entirely acquired with consideration furnished by the decedent, or was acquired by the decedent and the other joint owner by

gift, bequest, devise or inheritance. If the decedent is a nonresident not a citizen of the United States, the rules of this paragraph (a)(1) apply pursuant to sections 2103, 2031, 2040(a), and 2056(d)(1)(B).

(2) *Consideration furnished by surviving spouse.* For purposes of applying section 2040(a), in determining the amount of consideration furnished by the surviving spouse, any consideration furnished by the decedent with respect to the property before July 14, 1988, is treated as consideration furnished by the surviving spouse to the extent that the consideration was treated as a gift to the spouse under section 2511, or to the extent that the decedent elected to treat the transfer as a gift to the spouse under section 2515 (to the extent applicable). For purposes of determining whether the consideration was a gift by the decedent under section 2511, it is presumed that the decedent was a citizen of the United States at the time the consideration was so furnished to the spouse. The special rule of this paragraph (a)(2) is applicable only if the donor spouse predeceases the donee spouse and not if the donee spouse predeceases the donor spouse. In cases where the donee spouse predeceases the donor spouse, any portion of the consideration treated as a gift to the donee spouse/decedent on the creation of the tenancy (or subsequently thereafter), regardless of the date the tenancy was created, is not treated as consideration furnished by the donee spouse/decedent for purposes of section 2040(a).

(3) *Amount allowed to be transferred to QDOT.* If, as a result of the application of the rules described above, only a portion of the value of a jointly-held property interest is includible in a decedent's gross estate, only that portion that is so includible may be transferred to a QDOT under section 2056(d)(2). See § 20.2056A–4(b)(1) and (d), *Example 3.*

(b) *Surviving spouse becomes citizen.* Paragraph (a) of this section does not apply if the surviving spouse meets the requirements of section 2056(d)(4). For the definition of resident in applying section 2056(d)(4), see § 20.0–1(b).

(c) *Examples.* The provisions of this section are illustrated by the following examples:

*Example 1.* In 1987, *D*, a United States citizen, purchases real property and takes title in the names of *D* and *S*, *D*'s spouse (a noncitizen, but a United States resident), as joint tenants with right of survivorship. In accordance with § 25.2511–1(h)(5) of this chapter, one-half of the value of the property is a gift to *S*. *D* dies in 1995. Because *S* is not a United States citizen, the provisions of section 2040(a) are determinative of the extent to which the real property is includible in *D*'s gross estate. Because the joint tenancy was established before July 14, 1988, and under the applicable provisions of the Internal Revenue Code and regulations the transfer was treated as a gift of one-half of the property, one-half of the value of the property is deemed attributable to consideration furnished by *S* for purposes of section 2040(a). Accordingly, only one-half of the value of the property is includible in *D*'s gross estate under section 2040(a).

*Example 2.* The facts are the same as in *Example 1*, except that *S* dies in 1995 survived by *D* who is not a citizen of the United States. For purposes of applying section 2040(a), *D*'s gift to *S* on the creation of the tenancy is not treated as consideration furnished by *S* toward the acquisition of the property. Accordingly, since *S* made no other contributions with respect to the property, no portion of the property is includible in *S*'s gross estate.

*Example 3.* The facts are the same as in *Example 1*, except that *D* and *S* purchase real property in 1990 making the down payment with funds from a joint bank account. All subsequent mortgage payments and improvements are paid from the joint bank account. The only funds deposited in the joint bank account are the earnings of *D* and *S*. It is established that *D* earned approximately 60% of the funds and *S* earned approximately 40% of the funds. *D* dies in 1995. The establishment of *S*'s contribution to the joint bank account is sufficient to show that *S* contributed 40% of the consideration for the property. Thus, under paragraph § 20.2040–1(a)(2), 60% of the value of the property is includible in *D*'s gross estate.

[T.D. 8612, 60 FR 43549, Aug. 22, 1995]

### § 20.2056A–9 Designated Filer.

Section 2056A(b)(2)(C) provides special rules where more than one QDOT is established with respect to a decedent. The designation of a person responsible for filing a return under section 2056A(b)(2)(C)(i) (the Designated Filer) must be made on the decedent's federal estate tax return, or on the first Form 706–QDT that is due and is filed by its prescribed date, including extensions. The Designated Filer must be a U.S. Trustee. If the U.S. Trustee is

an individual, that individual must have a tax home (as defined in section 911(d)(3)) in the United States. At least sixty days before the due date for filing the tax returns for all of the QDOTs, the U.S. Trustee(s) of each of the QDOTs must provide to the Designated Filer all of the necessary information relating to distributions from their respective QDOTs. The section 2056A estate tax due from each QDOT is allocated on a pro rata basis (based on the ratio of the amount of each respective distribution constituting a taxable event to the amount of all such distributions), unless a different allocation is required under the terms of the governing instrument or under local law. Unless the decedent has provided for a successor Designated Filer, if the Designated Filer ceases to qualify as a U.S. Trustee, or otherwise becomes unable to serve as the Designated Filer, the remaining trustees of each QDOT must select a qualifying successor Designated Filer (who is also a U.S. Trustee) prior to the due date for the filing of Form 706–QDT (including extensions). The selection is to be indicated on the Form 706–QDT. Failure to select a successor Designated Filer will result in the application of section 2056A(b)(2)(C).

[T.D. 8612, 60 FR 43550, Aug. 22, 1995]

### § 20.2056A–10 Surviving spouse becomes citizen after QDOT established.

(a) *Section 2056A estate tax no longer imposed under certain circumstances.* Section 2056A(b)(12) provides that a QDOT is no longer subject to the imposition of the section 2056A estate tax if the surviving spouse becomes a citizen of the United States and the following conditions are satisfied—

(1) The spouse either was a United States resident (for the definition of resident for this purpose, see § 20.2056A–1(b)) at all times after the death of the decedent and before becoming a United States citizen, or no taxable distributions are made from the QDOT before the spouse becomes a United States citizen (regardless of the residency status of the spouse); and

(2) The U.S. Trustee(s) of the QDOT notifies the Internal Revenue Service and certifies in writing that the surviving spouse has become a United States citizen. Notice is to be made by filing a final Form 706–QDT on or before April 15th of the calendar year following the year in which the surviving spouse becomes a United States citizen, unless an extension of time for filing is granted under section 6081.

(b) *Special election by spouse.* If the surviving spouse becomes a United States citizen and the spouse is not a United States resident at all times after the death of the decedent and before becoming a United States citizen, and a tax was previously imposed under section 2056A(b)(1)(A) with respect to any distribution from the QDOT before the surviving spouse becomes a United States citizen, the estate tax imposed under section 2056A(b)(1) does not apply to distributions after the spouse becomes a citizen if—

(1) The spouse elects to treat any taxable distribution from the QDOT prior to the spouse's election as a taxable gift made by the spouse for purposes of section 2001(b)(1)(B) (referring to adjusted taxable gifts), and for purposes of determining the amount of the tax imposed by section 2501 on actual taxable gifts made by the spouse during the year in which the spouse becomes a citizen or in any subsequent year;

(2) The spouse elects to treat any previous reduction in the section 2056A estate tax by reason of the decedent's unified credit (under either section 2010 or section 2102(c)) as a reduction in the spouse's unified credit under section 2505 for purposes of determining the amount of the credit allowable with respect to taxable gifts made by the surviving spouse during the taxable year in which the spouse becomes a citizen, or in any subsequent year; and

(3) The elections referred to in this paragraph (b) are made by timely filing a Form 706–QDT on or before April 15th of the year following the year in which the surviving spouse becomes a citizen (unless an extension of time for filing is granted under section 6081) and attaching notification of the election to the return.

[T.D. 8612, 60 FR 43550, Aug. 22, 1995]

**§ 20.2056A–11 Filing requirements and payment of the section 2056A estate tax.**

(a) *Distributions during surviving spouse's life.* Section 2056A(b)(5)(A) provides the due date for payment of the section 2056A estate tax imposed on distributions during the spouse's lifetime. An extension of not more than 6 months may be obtained for the filing of Form 706–QDT under section 6081(a) if the conditions specified therein are satisfied. See also § 20.2056A- 5(c)(1) regarding the requirements for filing a Form 706–QDT in the case of a distribution to the surviving spouse on account of hardship, and § 20.2056A–2T(d)(3) regarding the requirements for filing Form 706–QDT in the case of the required annual statement.

(b) *Tax at death of surviving spouse.* Section 2056A(b)(5)(B) provides the due date for payment of the section 2056A estate tax imposed on the death of the spouse under section 2056A(b)(1)(B). An extension of not more than 6 months may be obtained for the filing of the Form 706–QDT under section 6081(a), if the conditions specified therein are satisfied. The obtaining of an extension of time to file under section 6081(a) does not extend the time to pay the section 2056A estate tax as prescribed under section 2056A(b)(5)(B).

(c) *Extension of time for paying section 2056A estate tax*—(1) *Extension of time for paying tax under section 6161(a)(2).* Pursuant to sections 2056A(b)(10)(C) and 6161(a)(2), upon a showing of reasonable cause, an extension of time for a reasonable period beyond the due date may be granted to pay any part of the estate tax that is imposed upon the surviving spouse's death under section 2056A(b)(1)(B) and shown on the final Form 706–QDT, or any part of any installments of such tax payable under section 6166 (including any part of a deficiency prorated to any installment under such section). The extension may not exceed 10 years from the date prescribed for payment of the tax (or in the case of an installment or part of a deficiency prorated to an installment, if later, not beyond the date that is 12 months after the due date for the last installment). Such extension may be granted by the district director or the director of the service center where the Form 706–QDT is filed.

(2) *Extension of time for paying tax under section 6161(a)(1).* An extension of time beyond the due date to pay any part of the estate tax imposed on lifetime distributions under section 2056A(b)(1)(A), or imposed at the death of the surviving spouse under section 2056A(b)(1)(B), may be granted for a reasonable period of time, not to exceed 6 months (12 months in the case of the estate tax imposed under section 2056A(b)(1)(B) at the surviving spouse's death), by the district director or the director of the service center where the Form 706–QDT is filed.

(d) *Liability for tax.* Under section 2056A(b)(6), each trustee (and not solely the U.S. Trustee(s)) of a QDOT is personally liable for the amount of the estate tax imposed in the case of any taxable event under section 2056A(b)(1). In the case of multiple QDOTs with respect to the same decedent, each trustee of a QDOT is personally liable for the amount of the section 2056A estate tax imposed on any taxable event with respect to that trustee's QDOT, but is not personally liable for tax imposed with respect to taxable events involving QDOTs of which that person is not a trustee. However, the assets of any QDOT are subject to collection by the Internal Revenue Service for any tax resulting from a taxable event with respect to any other QDOT established with respect to the same decedent. The trustee may also be personally liable as a withholding agent under section 1461 or other applicable provisions of the Internal Revenue Code.

[T.D. 8612, 60 FR 43551, Aug. 22, 1995]

**§ 20.2056A–12 Increased basis for section 2056A estate tax paid with respect to distribution from a QDOT.**

Under section 2056A(b)(13), in the case of any distribution from a QDOT on which an estate tax is imposed under section 2056A(b)(1)(A), the distribution is treated as a transfer by gift for purposes of section 1015, and any estate tax paid under section 2056A(b)(1)(A) is treated as a gift tax. See § 1.1015–5(c)(4) and (5) of this chapter for rules for determining the

amount by which the basis of the distributed property is increased.

[T.D. 8612, 60 FR 43551, Aug. 22, 1995]

### § 20.2056A–13 Effective date.

The provisions of §§ 20.2056A–1 through 20.2056A–12 are effective with respect to estates of decedents dying after August 22, 1995.

[T.D. 8612, 60 FR 43551, Aug. 22, 1995]

## ESTATES OF NONRESIDENTS NOT CITIZENS

### § 20.2101–1 Estates of nonresidents not citizens; tax imposed.

(a) *Imposition of tax.* Section 2101 imposes a tax on the transfer of the taxable estate of a nonresident who is not a citizen of the United States at the time of death. In the case of estates of decedents dying after November 10, 1988, the tax is computed at the same rates as the tax that is imposed on the transfer of the taxable estate of a citizen or resident of the United States in accordance with the provisions of sections 2101(b) and (c). For the meaning of the terms *resident, nonresident,* and *United States,* as applied to a decedent for purposes of the estate tax, see § 20.0–1(b)(1) and (2). For the liability of the executor for the payment of the tax, see section 2002. For special rules as to the phaseout of the graduated rates and unified credit, see sections 2001(c)(2) and 2101(b).

(b) *Special rates in the case of certain decedents.* In the case of an estate of a nonresident who was not a citizen of the United States and who died after December 31, 1976, and on or before November 10, 1988, the tax on the nonresident's taxable estate is computed using the formula provided under section 2101(b), except that the rate schedule in paragraph (c) of this section is to be used in lieu of the rate schedule in section 2001(c).

(c) *Rate schedule for decedents dying after December 31, 1976 and on or before November 10, 1988.*

| If the amount for which the tentative tax to be computed is: | The tentative tax is: |
|---|---|
| Not over $100,000 | 6% of such amount. |
| Over $100,000 but not over $500,000 | $6,000, plus 12% of excess over $100,000. |
| Over $500,000 but not over $1,000,000 | $54,000, plus 18% of excess over $500,000. |
| Over $1,000,000 but not over $2,000,000 | $144,000, plus 24% of excess over $1,000,000. |
| Over $2,000,000 | $384,000, plus 30% of excess over $2,000,000. |

[T.D. 8612, 60 FR 43551, Aug. 22, 1995]

### § 20.2102–1 Estates of nonresidents not citizens; credits against tax.

(a) *In general.* In arriving at the net estate tax payable with respect to the transfer of an estate of a nonresident who was not a citizen of the United States at the time of his death, the following credits are subtracted from the tax imposed by section 2101:

(1) The State death tax credit under section 2011, to the extent permitted by section 2102(b) and paragraph (b) of this section;

(2) The gift tax credit under section 2012; and

(3) The credit under section 2013 for tax on prior transfers.

Except as provided in section 2102(b) and paragraph (b) of this section (relating to a special limitation on the amount of the credit for State death taxes), the amount of each of these credits is determined in the same manner as that prescribed for its determination in the case of estates of citizens or residents of the United States. See §§ 20.2011–1 through 20.2013–6. Subject to the additional special limitation contained in section 2102(b) in the case of section 2015, the provisions of sections 2015 and 2016, relating respectively to the credit for death taxes on remainders and the recovery of taxes claimed as a credit, are applicable with respect to the credit for State death taxes in the case of the estates of nonresidents not citizens. However, no credit is allowed under section 2014 for foreign death taxes.

(b) *Special limitation*—(1) *In general.* In the case of estates of decedents dying on or after November 14, 1966, other than estates the estate tax treatment of which is subject to a Presidential

proclamation made pursuant to section 2108(a), the maximum credit allowable under section 2011 for State death taxes against the tax imposed by section 2101 on the transfer of estates of nonresidents not citizens of the United States is an amount which bears the same ratio to the maximum credit computed as provided in section 2011(b) (and without regard to this special limitation) as the value of the property (determined in the same manner as that prescribed in paragraph (b) of § 20.2031–1 for the estates of citizens or residents of the United States) in respect of which a State death tax was actually paid and which is included in the gross estate under section 2103 or, if applicable, section 2107(b) bears to the value (as so determined) of the total gross estate under section 2103 or 2107(b). For purposes of this special limitation, the term ''State death taxes'' means the taxes described in section 2011(a) and paragraph (a) of § 20.2011–1.

(2) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

*Example (1).* A, a nonresident not a citizen of the United States, died on February 15, 1967, owning real property in State Z valued at $50,000 and stock in various domestic corporations valued at $100,000 and not subject to death taxes in any State. State Z's inheritance tax actually paid with respect to the real property in State Z is $2,000. A's taxable estate for Federal estate tax purposes is $110,000, in respect of which the maximum credit under section 2011 would be $720 in the absence of the special limitation contained in section 2102(b). However, under section 2102(b) and this paragraph the amount of the maximum credit allowable in respect to A's estate for State death taxes is limited to the amount which bears the same ratio to $720 (the maximum credit computed as provided in section 2011(b)) as $50,000 (the value of the property in respect of which a State death tax was actually paid and which is included in A's gross estate under section 2103) bears to $150,000 (the value of A's total gross estate under section 2103). Accordingly, the maximum credit allowable under section 2102 and this section for all State death taxes actually paid is $240 ($720×$50,000/$150,000).

*Example (2).* B, a nonresident not a citizen of the United States, died on January 15, 1967, owning real property in State X valued at $100,000, real property in State Y valued at $200,000, and stock in various domestic corporations valued at $300,000 and not subject to death taxes in any State. States X and Y both imposed inheritance taxes. State X has, in addition to its inheritance tax, an estate tax equal to the amount by which the maximum State death tax credit allowable to an estate against its Federal estate tax exceeds the amount of the inheritance tax imposed by State X plus the amount of death taxes paid to other States. State Y has no estate tax. The amount of the inheritance tax actually paid to State X with respect to the real property situated in State X is $4,000; the amount of the inheritance tax actually paid to State Y with respect to the real property situated in State Y is $9,000. B's taxable estate for Federal estate tax purposes is $550,000, in respect of which the maximum credit under section 2011 would be $14,400 in the absence of the special limitation contained in section 2102(b). However, under section 2102(b) and this paragraph the amount of the maximum credit allowable in respect of B's estate for State death taxes is limited to the amount which bears the same ratio to $14,400 (the maximum credit computed as provided in section 2011(b)) as $300,000 (the value of the property in respect of which a State death tax was actually paid and which is included in B's gross estate under section 2103) bears to $600,000 (the value of B's total gross estate under section 2103). Accordingly, the maximum credit allowable under section 2102 and this section for all State death taxes actually paid is $7,200 ($14,400×$300,000/$600,000), and the estate tax of State X is not applicable to B's estate.

(c) *Unified credit*—(1) *In general.* Subject to paragraph (c)(2) of this section, in the case of estates of decedents dying after November 10, 1988, a unified credit of $13,000 is allowed against the tax imposed by section 2101 subject to the limitations of section 2102(c).

(2) *When treaty is applicable.* To the extent required under any treaty obligation of the United States, the estate of a nonresident not a citizen of the United States is allowed the unified credit permitted to a United States citizen or resident of $192,800, multiplied by the proportion that the total gross estate of the decedent situated in the United States bears to the decedent's total gross estate wherever situated.

(3) *Certain residents of possessions.* In the case of a decedent who is considered to be a nonresident not a citizen of the United States under section 2209, there is allowed a unified credit equal to the greater of $13,000, or $46,800 multiplied by the proportion that the decedent's gross estate situated in the United States bears to the total gross

estate of the decedent wherever situated.

[T.D. 7296, 38 FR 34194, Dec. 12, 1973, as amended at T.D. 8612, 60 FR 43552, Aug. 22, 1995]

### § 20.2103–1 Estates of nonresidents not citizens; "entire gross estate".

The ''entire gross estate'' wherever situated of a nonresident who was not a citizen of the United States at the time of his death is made up in the same way as the ''gross estate'' of a citizen or resident of the United States. See §§ 20.2031–1 through 20.2044–1. See paragraphs (a) and (c) of § 20.2031–1 for the circumstances under which real property situated outside the United States is excluded from the gross estate of a citizen or resident of the United States. However, except as provided in section 2107(b) with respect to the estates of certain expatriates, in the case of a nonresident not a citizen, only that part of the entire gross estate which on the date of the decedent's death is situated in the United States is included in his taxable estate. In fact, property situated outside the United States need not be disclosed on the return unless section 2107 is applicable, certain deductions are claimed, or information is specifically requested. See §§ 20.2106–1, 20.2106–2, and 20.2107–1. For a description of property considered to be situated in the United States, see § 20.2104–1. For a description of property considered to be situated outside the United States, see § 20.2105–1.

[T.D. 7296, 38 FR 34195, Dec. 12, 1973]

### § 20.2104–1 Estates of nonresidents not citizens; property within the United States.

(a) *In general.* Property of a nonresident who was not a citizen of the United States at the time of his death is considered to be situated in the United States if it is—

(1) Real property located in the United States.

(2) Tangible personal property located in the United States, except certain works of art on loan for exhibition (see paragraph (b) of § 20.2105–1).

(3) In the case of an estate of a decedent dying before November 14, 1966, written evidence of intangible personal property which is treated as being the property itself, such as a bond for the payment of money, if it is physically located in the United States; except that this subparagraph shall not apply to obligations of the United States (but not its instrumentalities) issued before March 1, 1941, if the decedent was not engaged in business in the United States at the time of his death. See section 2106(c).

(4) Except as specifically provided otherwise in this section or in § 20.2105–1 (which specific exceptions, in the case of estates of decedents dying on or after November 14, 1966, cause this subparagraph to have relatively limited applicability), intangible personal property the written evidence of which is not treated as being the property itself, if it is issued by or enforceable against a resident of the United States or a domestic corporation or governmental unit.

(5) Shares of stock issued by a domestic corporation, irrespective of the location of the certificates (see, however, paragraph (i) of § 20.2105–1 for a special rule with respect to certain withdrawable accounts in savings and loan or similar associations).

(6) In the case of an estate of a decedent dying before November 14, 1966, moneys deposited in the United States by or for the decedent with any person carrying on the banking business, if the decedent was engaged in business in the United States at the time of his death.

(7) In the case of an estate of a decedent dying on or after November 14, 1966, except as specifically provided otherwise in paragraph (d), (i), (j), (l), or (m) of § 20.2105–1, any debt obligation, including a bank deposit, the primary obligor of which is—

(i) A United States person (as defined in section 7701(a)(30)), or

(ii) The United States, a State or any political subdivision thereof, the District of Columbia, or any agency or instrumentality of any such government.

This paragraph applies irrespective of whether the written evidence of the debt obligation is treated as being the property itself or whether the decedent was engaged in business in the United States at the time of his death. For purposes of this subparagraph and

paragraphs (k), (l), and (m) of § 20.2105–1, a debt obligation on which there are two or more primary obligors shall be apportioned among such obligors, taking into account to the extent appropriate under all the facts and circumstances any choate or inchoate rights of contribution existing among such obligors with respect to the indebtedness. The term ''agency or instrumentality,'' as used in paragraph (a)(7)(ii) of this section does not include a possession of the United States or an agency or instrumentality of a possession. Currency is not a debt obligation for purposes of this subparagraph.

(8) In the case of an estate of a decedent dying on or after January 1, 1970, except as specifically provided otherwise in paragraph (i) or (l) of § 20.2105–1, deposits with a branch in the United States of a foreign corporation, if the branch is engaged in the commercial banking business, whether or not the decedent was engaged in business in the United States at the time of his death.

(b) *Transfers.* Property of which the decedent has made a transfer taxable under sections 2035 through 2038 is deemed to be situated in the United States if it is determined, under the provisions of paragraph (a) of this section, to be so situated either at the time of the transfer or at the time of the decedent's death. See §§ 20.2035–1 through 20.2038–1.

(c) *Death tax convention.* It should be noted that the situs rules described in this section may be modified for various purposes under the provisions of an applicable death tax convention with a foreign country.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7296, 38 FR 34195, Dec. 12, 1973; T.D. 7321, 39 FR 29597, Aug. 16, 1974]

### § 20.2105–1 Estates of nonresidents not citizens; property without the United States.

Property of a nonresident who was not a citizen of the United States at the time of his death is considered to be situated outside the United States if it is—

(a)(1) Real property located outside the United States, except to the extent excludable from the entire gross estate wherever situated under § 20.2103–1.

(2) Tangible personal property located outside the United States.

(b) Works of art owned by the decedent if they were—

(1) Imported into the United States solely for exhibition purposes,

(2) Loaned for those purposes to a public gallery or museum, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and

(3) At the time of the death of the owner, on exhibition, or en route to or from exhibition, in such a public gallery or museum.

(c) In the case of an estate of a decedent dying before November 14, 1966, written evidence of intangible personal property which is treated as being the property itself, such as a bond for the payment of money, if it is not physically located in the United States.

(d) Obligations of the United States issued before March 1, 1941, even though physically located in the United States, if the decedent was not engaged in business in the United States at the time of his death.

(e) Except as specifically provided otherwise in this section or in § 20.2104–1, intangible personal property the written evidence of which is not treated as being the property itself, if it is not issued by or enforceable against a resident of the United States or a domestic corporation or governmental unit.

(f) Shares of stock issued by a corporation which is not a domestic corporation, regardless of the location of the certificates.

(g) Amounts receivable as insurance on the decedent's life.

(h) In the case of an estate of a decedent dying before November 14, 1966, moneys deposited in the United States by or for the decedent with any person carrying on the banking business, if the decedent was not engaged in business in the United States at the time of his death.

(i) In the case of an estate of a decedent dying on or after November 14, 1966, and before January 1, 1976, any amount deposited in the United States which is described in section 861(c) (relating to certain bank deposits,

withdrawable accounts, and amounts held by an insurance company under an agreement to pay interest), if any interest thereon, were such interest received by the decedent at the time of his death, would be treated under section 862(a)(1) as income from sources without the United States by reason of section 861(a)(1)(A) (relating to interest on amounts described in section 861(c) which is not effectively connected with the conduct of a trade or business within the United States) and the regulations thereunder. If such interest would be treated by reason of those provisions as income from sources without the United States only in part, the amount described in section 861(c) shall be considered situated outside the United States in the same proportion as the part of the interest which would be treated as income from sources without the United States bears to the total amount of the interest. This paragraph applies whether or not the decedent was engaged in business in the United States at the time of his death, and, except with respect to amounts described in section 861(c)(3) (relating to amounts held by an insurance company under an agreement to pay interest), whether or not the deposit or other amount is in fact interest bearing.

(j) In the case of an estate of a decedent dying on or after November 14, 1966, deposits with a branch outside of the United States of a domestic corporation or domestic partnership, if the branch is engaged in the commercial banking business. This paragraph applies whether or not the decedent was engaged in business in the United States at the time of his death, and whether or not the deposits, upon withdrawal, are payable in currency of the United States.

(k) In the case of an estate of a decedent dying on or after November 14, 1966, except as specifically provided otherwise in paragraph (a)(8) of § 20.2104–1 with respect to estates of decedents dying on or after January 1, 1970, any debt obligation, including a bank deposit, the primary obligor of which is neither—

(1) A United States person (as defined in section 7701(a)(30)), nor

(2) The United States, a State or any political subdivision thereof, the District of Columbia, or any agency or instrumentality of any such government.

This paragraph applies irrespective of whether the written evidence of the debt obligation is treated as being the property itself or whether the decedent was engaged in business in the United States at the time of his death. See paragraph (a)(7) of § 20.2104–1 for the treatment of a debt obligation on which there are two or more primary obligors. The term ''agency or instrumentality,'' as used in subparagraph (2) of this paragraph, does not include a possession of the United States or an agency or instrumentality of a possession. Currency is not a debt obligation for purposes of this paragraph.

(l) In the case of an estate of a decedent dying on or after November 14, 1966, any debt obligation to the extent that the primary obligor on the debt obligation is a domestic corporation, if any interest thereon, were the interest received from such obligor by the decedent at the time of his death, would be treated under section 862(a)(1) as income from sources without the United States by reason of section 861(a)(1)(B) (relating to interest received from a domestic corporation less than 20 percent of whose gross income for a 3-year period was derived from sources within the United States) and the regulations thereunder. For such purposes the 3-year period referred to in section 861(a)(1)(B) is the period of 3 years ending with the close of the domestic corporation's last taxable year terminating before the decedent's death. This paragraph applies whether or not (1) the obligation is in fact interest bearing, (2) the written evidence of the debt obligation is treated as being the property itself, or (3) the decedent was engaged in business in the United States at the time of his death. See paragraph (a)(7) of § 20.2104–1 for the treatment of a debt obligation on which there are two or more primary obligors.

(m)(1) In the case of an estate of a decedent dying after December 31, 1972, except as otherwise provided in paragraph (m)(2) of this section any debt obligation to the extent that the primary obligor on the debt obligation is

a domestic corporation or domestic partnership, if any interest thereon, were the interest received from such obligor by the decedent at the time of his death, would be treated under section 862(a)(1) as income from sources without the United States by reason of section 861(a)(1)(G) (relating to interest received on certain debt obligations with respect to which elections have been made under section 4912(c)) and the regulations thereunder. This paragraph applies whether or not (i) the obligation is in fact interest bearing, (ii) the written evidence of the debt obligation is treated as being the property itself, or (iii) the decedent was engaged in business in the United States at the time of his death. See paragraph (a)(7) of § 20.2104–1 for the treatment of a debt obligation on which there are two or more primary obligors.

(2) In the case of an estate of a decedent dying before January 1, 1974, this paragraph does not apply to any debt obligation of a foreign corporation assumed by a domestic corporation which is treated under section 4912(c)(2) as issued by such domestic corporation during 1973.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6684, 28 FR 11410, Oct. 24, 1963; T.D. 7296, 38 FR 34196, Dec. 12, 1973; T.D. 7321, 39 FR 29597, Aug. 16, 1974]

### § 20.2106–1 Estates of nonresidents not citizens; taxable estate; deductions in general.

(a) The taxable estate of a nonresident who was not a citizen of the United States at the time of his death is determined by adding the value of that part of his gross estate which, at the time of his death, is situated in the United States and, in the case of an estate to which section 2107 (relating to expatriation to avoid tax) applies, any amounts includible in his gross estate under section 2107(b), and then subtracting from the sum thereof the total amount of the following deductions:

(1) The deductions allowed in the case of estates of decedents who were citizens or residents of the United States under sections 2053 and 2054 (see §§ 20.2053–1 through 20.2053–9 and § 20.2054–1) for expenses, indebtedness and taxes, and for losses, to the extent provided in § 20.2106–2.

(2) A deduction computed in the same manner as the one allowed under section 2055 (see §§ 20.2055–1 through 20.2055–5) for charitable, etc., transfers, except—

(i) That the deduction is allowed only for transfers to corporations and associations created or organized in the United States, and to trustees for use within the United States, and

(ii) That the provisions contained in paragraph (c)(2) of § 20.2055–2 relating to termination of a power to consume are not applicable.

(3) Subject to the special rules set forth at § 20.2056A–1(c), the amount which would be deductible with respect to property situated in the United States at the time of the decedent's death under the principles of section 2056. Thus, if the surviving spouse of the decedent is a citizen of the United States at the time of the decedent's death, a marital deduction is allowed with respect to the estate of the decedent if all other applicable requirements of section 2056 are satisfied. If the surviving spouse of the decedent is not a citizen of the United States at the time of the decedent's death, the provisions of section 2056, including specifically the provisions of section 2056(d) and (unless section 2056(d)(4) applies) the provisions of section 2056A (QDOTs) must be satisfied.

(b) Section 2106(b) provides that no deduction is allowed under paragraph (a) (1) or (2) of this section unless the executor discloses in the estate tax return the value of that part of the gross estate not situated in the United States. See § 20.2105–1. Such part must be valued as of the date of the decedent's death, or if the alternate valuation method under section 2032 is elected, as of the applicable valuation date.

[T.D. 6296, 23 FR 5429, June 24, 1958, as amended by T.D. 6526, 26 FR 417, Jan. 19, 1961; T.D. 7296, 38 FR 34197, Dec. 12, 1973; T.D. 7318, 39 FR 25457, July 11, 1974; T.D. 8612, 60 FR 43552, Aug. 22, 1995]

### § 20.2106–2 Estates of nonresidents not citizens; deductions for expenses, losses, etc.

(a) In computing the taxable estate of a nonresident who was not a citizen of the United States at the time of his

death, deductions are allowed under sections 2053 and 2054 for expenses, indebtedness and taxes, and for losses, to the following extent:

(1) A pledge or subscription is deductible if it is an enforceable claim against the estate and if it would constitute an allowable deduction under paragraph (a)(2) of § 20.2106–1, relating to charitable, etc., transfers, if it had been a bequest.

(2) That proportion of other deductions under sections 2053 and 2054 is allowed which the value of that part of the decedent's gross estate situated in the United States at the time of his death bears to the value of the decedent's entire gross estate wherever situated. It is immaterial whether the amounts to be deducted were incurred or expended within or without the United States. For purposes of this subparagraph, an amount which is includible in the decedent's gross estate under section 2107(b) with respect to stock in a foreign corporation shall be included in the value of the decedent's gross estate situated in the United States.

No deduction is allowed under this paragraph unless the value of the decedent's entire gross estate is disclosed in the estate tax return. See paragraph (b) of § 20.2106–1.

(b) In order that the Internal Revenue Service may properly pass upon the items claimed as deductions, the executor should submit a certified copy of the schedule of liabilities, claims against the estate, and expenses of administration filed under any applicable foreign death duty act. If no such schedule was filed, the executor should submit a certified copy of the schedule of these liabilities, claims and expenses filed with the foreign court in which administration was had. If the items of deduction allowable under section 2106(a)(1) were not included in either such schedule, or if no such schedules were filed, then there should be submitted a written statement of the foreign executor containing a declaration that it is made under the penalties of perjury setting forth the facts relied upon as entitling the estate to the benefit of the particular deduction or deductions.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7296, 38 FR 34197, Dec. 12, 1973; T.D. 8612, 60 FR 43552, Aug. 22, 1995]

### § 20.2107–1 Expatriation to avoid tax.

(a) *Rate of tax.* The tax imposed by section 2107(a) on the transfer of the taxable estates of certain nonresident expatriate decedents who were formerly citizens of the United States is computed in accordance with the table contained in section 2001, relating to the rate of the tax imposed on the transfer of the taxable estates of decedents who were citizens or residents of the United States. Except for any amounts included in the gross estate solely by reason of section 2107(b) and paragraph (b)(1) (ii) and (iii) of this section, the value of the taxable estate to be used in this computation is determined as provided in section 2106 and § 20.2106–1. The decedents to which section 2107(a) and this section apply are described in paragraph (d) of this section.

(b) *Gross estate*—(1) *Determination of value*—(i) *General rule.* Except as provided in subdivision (ii) of this subparagraph with respect to stock in certain foreign corporations, for purposes of the tax imposed by section 2107(a) the value of the gross estate of every estate the transfer of which is subject to the tax imposed by that section is determined as provided in section 2103 and § 20.2103–1.

(ii) *Amount includible with respect to stock in certain foreign corporations.* If at the time of his death a nonresident expatriate decedent the transfer of whose estate is subject to the tax imposed by section 2107(a)—

*(a)* Owned (within the meaning of section 958(a) and the regulations thereunder) 10 percent or more of the total combined voting power of all classes of stock entitled to vote in a foreign corporation, and

*(b)* Owned (within the meaning of section 958(a) and the regulations thereunder), or is considered to have owned (by applying the ownership rules of section 958(b) and the regulations thereunder), more than 50 percent of the total combined voting power of all

classes of stock entitled to vote in such foreign corporation,

then section 2107(b) requires the inclusion in the decedent's gross estate, in addition to amounts otherwise includible therein under subdivision (i) of this subparagraph, of an amount equal to that proportion of the fair market value (determined at the time of the decedent's death or, if so elected by the executor of the decedent's estate, on the alternate valuation date as provided in section 2032) of the stock in such foreign corporation owned (within the meaning of section 958(a) and the regulations thereunder) by the decedent at the time of his death, which the fair market value of any assets owned by such foreign corporation and situated in the United States, at the time of his death, bears to the total fair market value of all assets owned by such foreign corporation at the time of his death.

(iii) *Rules of application. (a)* In determining the proportion of the fair market value of the stock which is includible in the gross estate under subdivision (ii) of this subparagraph, the fair market value of the foreign corporation's assets situated in the United States and of its total assets shall be determined without reduction for any outstanding liabilities of the corporation.

(*b*) For purposes of subdivision (ii) of this subparagraph, the foreign corporation's assets which are situated in the United States shall be all its property which, by applying the provisions of sections 2104, 2105, and §§ 20.2104–1 and 20.2105–1, would be considered to be situated in the United States if such property were property of a nonresident who was not a citizen of the United States.

(*c*) For purposes of subdivision (ii)(*a*) of this subparagraph, a decedent is treated as owning stock in a foreign corporation at the time of his death to the extent he owned (within the meaning of section 958(a) and the regulations thereunder) the stock at the time he made a transfer of the stock in a transfer described in sections 2035 to 2038, inclusive (relating respectively to transfers made in contemplation of death, transfers with a retained life estate, transfers taking effect at death, and revocable transfers). For purposes of subdivision (ii)*(b)* of this subparagraph, a decedent is treated as owning stock in a foreign corporation at the time of his death to the extent he owned (within the meaning of section 958(a) and the regulations thereunder), or is considered to have owned (by applying the ownership rules of section 958(b) and the regulations thereunder), the stock at the time he made a transfer of the stock in a transfer described in sections 2035 to 2038, inclusive. In applying the proportion rule of section 2107(b) and subdivision (ii) of this subparagraph where a decedent is treated as owning stock in a foreign corporation at the time of his death by reason of having transferred his interest in such stock in a transfer described in sections 2035 to 2038, inclusive, the proportionate value of the interest includible in his gross estate is based upon the value as of the applicable valuation date described in section 2031 or 2032 of the amount, determined as of the date of transfer, of his interest in the stock. See example (2) in subparagraph (2) of this paragraph.

(*d*) For purposes of applying subdivision (ii)*(b)* of this subparagraph, the same shares of stock may not be counted more than once. See example (2) in subparagraph (2) of this paragraph.

(*e*) The principles applied in paragraph (b) of § 1.957–1 of this chapter (Income Tax Regulations) for determining what constitutes total combined voting power of all classes of stock entitled to vote in a foreign corporation for purposes of section 957(a) shall be applied in determining what constitutes total combined voting power of all classes of stock entitled to vote in a foreign corporation for purposes of section 2107(b) and subdivision (ii) of this subparagraph. In applying such principles under this paragraph changes in language shall be made, where necessary, in order to treat the nonresident expatriate decedent, rather than U.S. shareholders, as owning such total combined voting power.

(2) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

*Example (1).* (a) At the time of his death, H, a nonresident expatriate decedent the transfer of whose estate is subject to the tax imposed by section 2107(a), owned a 60-percent interest in M Company, a foreign partnership, which in turn owned stock issued by N Corporation, a foreign corporation. The stock in N Corporation held by M Company, which constituted 50 percent of the total combined voting power of all classes of stock entitled to vote in N Corporation, was valued at $50,000 at the time of H's death. In addition, W, H's wife, also a nonresident not a citizen of the United States, owned at the time of H's death stock in N Corporation constituting 25 percent of the total combined voting power of all classes of stock entitled to vote in that corporation. The fair market value of the assets of N Corporation which, at the time of H's death, were situated in the United States constituted 40 percent of the fair market value of all assets of that corporation. It is assumed for purposes of this example that the executor of H's estate has not elected to value the estate on the alternate valuation date provided in section 2032.

(b) The test contained in subparagraph (1)(ii)*(a)* of this paragraph is met since at the time of his death H indirectly owned (within the meaning of section 958(a) and the regulations thereunder) 30 percent (60 percent of 50 percent) of the total combined voting power of all classes of stock entitled to vote in N Corporation; and the test contained in subparagraph (1)(ii)*(b)* of this paragraph is met since at such time H owned or is considered to have owned (within the meaning of section 958 (a) and (b) and the regulations thereunder) 55 percent of the total combined voting power of all classes of stock entitled to vote in N Corporation (having constructive ownership of his wife's 25 percent, in addition to his own indirect ownership of 30 percent, of the total combined voting power). Accordingly, $12,000 is included in H's gross estate by reason of section 2107(b) and this paragraph. This $12,000 is the amount which is equal to 40 percent (the percentage of the fair market value of N Corporation's asset which were situated within the United States at H's death) of $30,000 (the fair market value of the stock then owned by H within the meaning of section 958(a) and the regulations thereunder, *i.e.,* H's 60-percent interest in the $50,000 fair market value of stock held by M Company).

*Example (2).* (a) Assume the same facts as those given in example (1) except that H made a transfer to W in contemplation of his death (within the meaning of section 2035) of his 60-percent interest in M Company, that on the date of the transfer M Company held stock in N Corporation constituting 80 percent of the total combined voting power of all classes of stock entitled to vote in that corporation (rather than the 50 percent of total combined voting power held by M Company on the date of H's death), and that the 80 percent of total combined voting power owned by M Company on the date of the transfer is valued at $70,000 on that date and at $85,000 at the time of H's death. It is assumed for purposes of this example that the 60-percent interest in M Company was held by W at the time of H's death.

(b) The test contained in subparagraph (1)(ii)*(a)* of this paragraph is met since, under subparagraph (1)(iii)*(c)* of this paragraph, H is treated as owning (within the meaning of section 958(a) and the regulations thereunder), at the time of his death, the 48 percent (60 percent of 80 percent) of the total combined voting power of all classes of stock entitled to vote in N Corporation represented by his transferred interest in M Company; and the test contained in subparagraph (1)(ii)*(b)* of this paragraph is met since, under that subparagraph and subparagraph (1)(iii)*(c)* of this paragraph, H is treated as owning (within the meaning of section 958 (a) or (b)), at the time of his death, 73 percent (48 percent plus 25 percent) of the total combined voting power of all classes of stock entitled to vote in N Corporation. Accordingly, $20,400 is included in H's gross estate by reason of section 2107(b) and this paragraph. This $20,400 is the amount which is equal to 40 percent (the percentage of the fair market value of N Corporation's assets which were situated within the United States at H's death) of $51,000 (the fair market value at the time of H's death of the transferred interest which under subparagraph (1)(iii)*(c)* of this paragraph H is considered to own within the meaning of section 958(a) and the regulations thereunder at that time, *i.e.,* the 60-percent interest in the $85,000 fair market value at that time of the 80-percent total combined voting power held by M Company on the date of transfer).

(c) The fact that the stock in N Corporation owned by M Company is considered under subparagraph (1)(ii)*(b)* of this paragraph to be owned by H for two independent reasons (*i.e.,* under section 958(a) and the regulations thereunder, because H transferred his 60-percent interest in M Company to W in contemplation of death, and under section 958(b) and the regulations thereunder, because H is considered to own the stock in N Corporation indirectly owned by his wife, W, by reason of her ownership of such transferred interest) does not cause the shares of stock represented by the transferred interest in M Company to be counted twice in determining whether the test contained in that subparagraph is met. See subparagraph (1)(iii)*(d)* of this paragraph.

*Example (3).* (a) At the time of his death, H, a nonresident expatriate decedent the transfer of whose estate is subject to the tax imposed by section 2107(a), owned a 40-percent beneficial interest in a domestic trust; at that time he also directly owned stock in P

Corporation, a foreign corporation, constituting 15 percent of the total combined voting power of all classes of stock entitled to vote in that corporation. The trust owned stock in P Corporation constituting 51 percent of the total combined voting power of all classes of stock entitled to vote in that corporation. The stock in P Corporation owned directly by H was valued at $20,000 on the alternate valuation date determined pursuant to an election under section 2032. The fair market value of the assets of P Corporation which, at the time of H's death, were situated in the United States constituted 20 percent of the fair market value of all assets of that corporation.

(b) By reason of section 958(b)(2) and the regulations thereunder, the trust is considered to own all the stock entitled to vote in P Corporation since it owns more than 50 percent of the total combined voting power of all classes of stock entitled to vote in that corporation. The test contained in subparagraph (1)(ii)*(a)* of this paragraph is met since at the time of his death H owned (within the meaning of section 958(a) and the regulations thereunder) 15 percent of the total combined voting power of all classes of stock entitled to vote in P Corporation; the stock in P Corporation owned by the trust is not considered to have been owned by H under section 958(a)(2) since the trust is not a foreign trust. In addition, the test contained in subparagraph (1)(ii)*(b)* of this paragraph is met since at the time of his death H owned or is considered to have owned (within the meaning of section 958 (a) and (b) and the regulations thereunder) 55 percent of the total combined voting power of all classes of stock entitled to vote in that corporation (his 15 percent directly owned plus his 40 percent (40 percent of 100 percent) considered to be owned). Accordingly, $4,000 is included in H's gross estate by reason of section 2107(b) and this paragraph. This $4,000 is the amount which is equal to 20 percent (the percentage of the fair market value of P Corporation's assets which were situated within the United States at H's death) of $20,000 (the fair market value of the stock then owned by H within the meaning of section 958(a) and the regulations thereunder). In addition, the value of H's interest in the domestic trust is included in his gross estate under section 2103 to the extent it constitutes property having a situs in the United States.

(c) *Credits.* Credits against the tax imposed by section 2107(a) are allowed for any amounts determined in accordance with section 2102 and § 20.2102–1 (relating to credits against the estate tax for State death taxes, gift tax, and tax on prior transfers). In computing the special limitation on the credit for State death taxes contained in section 2102(b) and paragraph (b) of § 20.2102–1, amounts included in the gross estate under section 2107(b) and paragraph (b)(1) of this section are to be taken into account.

(d) *Decedents to whom the tax imposed by section 2107(a) applies*—(1) *General rule.* The tax imposed by section 2107(a) applies to the transfer of the taxable estate of every decedent nonresident not a citizen of the United States dying on or after November 14, 1966, who lost his U.S. citizenship after March 8, 1965, and within the 10-year period ending with the date of his death, except in the case of the estate of a decedent whose loss of U.S. citizenship either—

(i) Resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b), 1482, or 1487); or

(ii) Did not have for one of its principal purposes (but not necessarily its only principal purpose) the avoidance of Federal income, estate, or gift tax.

Section 301(b) of the Immigration and Nationality Act provides generally that a U.S. citizen, who is born outside the United States of parents one of whom is an alien and the other is a U.S. citizen who was physically present in the United States for a specified period, shall lose his U.S. citizenship if, within a specified period preceding the age of 28 years, he fails to be continuously physically present in the United States for at least 5 years. Section 350 of that Act provides that under certain circumstances a person, who at birth acquired the nationality of the United States and of a foreign country and who has voluntarily sought or claimed benefits of the nationality of any foreign country, shall lose his U.S. nationality if, after attaining the age of 22 years, he has a continuous residence for 3 years in the foreign country of which he is a national by birth. Section 355 of that Act provides that a person having U.S. nationality, who is under 21 years of age and whose residence is in a foreign country with or under the legal custody of a parent who loses his U.S. nationality under specified circumstances, shall lose his U.S. nationality if he has or acquires the nationality of that foreign country and attains the age of 25 years without having established his residence in the

United States. Section 2107 and this section do not apply to the transfer of any estate the estate tax treatment of which is subject to a Presidential proclamation made pursuant to section 2108(a) (relating to the application of pre-1967 estate tax provisions in the case of a foreign country which imposes a more burdensome tax than the United States).

(2) *Burden of proof*—(i) *General rule.* In determining for purposes of subparagraph (1)(ii) of this paragraph whether a principal purpose for the loss of U.S. citizenship by a decedent was the avoidance of Federal income, estate, or gift tax, the Commissioner must first establish that it is reasonable to believe that the decedent's loss of U.S. citizenship would, but for section 2107 and this section, result in a substantial reduction in the sum of *(a)* the Federal estate tax and *(b)* all estate, inheritance, legacy, and succession taxes imposed by foreign countries and political subdivisions thereof, in respect of the transfer of the decedent's estate. Once the Commissioner has so established, the burden of proving that the loss of citizenship by the decedent did not have for one of its principal purposes the avoidance of Federal income, estate, or gift tax shall be on the executor of the decedent's estate.

(ii) *Tentative determination of substantial reduction in Federal and foreign death taxes.* In the absence of complete factual information, the Commissioner may make a tentative determination, based on the information available, that the decedent's loss of U.S. citizenship would, but for section 2107 and this section, result in a substantial reduction in the sum of the Federal and foreign death taxes described in subdivision (i) *(a)* and *(b)* of this subparagraph. This tentative determination may be based upon the fact that the laws of the foreign country of which the decedent became a citizen and the laws of the foreign country of which the decedent was a resident at the time of his death, including the laws of any political subdivisions of those foreign countries, would ordinarily result, in the case of an estate of a nonexpatriate decedent having the same citizenship and residence as the decedent, in liability for total death taxes under such laws substantially lower than the amount of the Federal estate tax which would be imposed on the transfer of a comparable estate of a citizen of the United States. In the absence of a preponderance of evidence to the contrary, this tentative determination shall be sufficient to establish that it is reasonable to believe that the decedent's loss of U.S. citizenship would, but for section 2107 and this section, result in a substantial reduction in the sum of the Federal and foreign death taxes described in subdivision (i) *(a)* and *(b)* of this subparagraph.

[T.D. 7296, 38 FR 34197, Dec. 12, 1973]

MISCELLANEOUS

### § 20.2201–1 Members of the Armed Forces dying during an induction period.

(a) The additional estate tax as defined in section 2011(d) does not apply to the transfer of the taxable estate of a citizen or resident of the United States dying during an induction period as defined in section 112(c)(5) (see paragraph (b) of this section) and while in active service as a member of the Armed Forces of the United States, if the decedent—

(1) Was killed in action while serving in a combat zone, as determined under section 112(c) (2) and (3) (see paragraph (c) of this section), or

(2) Died as a result of wounds, disease, or injury suffered while serving in such a combat zone and while in line of duty, by reason of a hazard to which he was subject as an incident of such service.

(b) Section 112(c)(5) defines the term ''induction period'' as meaning any period during which individuals are liable for induction, for reasons other than prior deferment, for training and service in the Armed Forces of the United States.

(c) Section 112(c) (2) and (3) provides that service is performed in a combat zone only—

(1) If it is performed in an area which the President of the United States has designated by Executive order for purposes of section 112(c) as an area in which the Armed Forces of the United States are, or have, engaged in combat, and

(2) If it is performed on or after the date designated by the President by Executive order as the date of the commencing of combatant activities in such zone and on or before the date designated by the President by Executive order as the date of termination of combatant activities in such zone.

(d) If the official record of the branch of the Armed Forces of which the decedent was a member at the time of his death states that the decedent was killed in action while serving in a combat zone, or that death resulted from wounds or injuries received or disease contracted while in line of duty in a combat zone, this fact shall, in the absence of evidence establishing to the contrary, be presumed to be established for the purposes of the exemption. Moreover, wounds, injuries or disease suffered while in line of duty will be considered to have been caused by a hazard to which the decedent was subjected as an incident of service as a member of the Armed Forces, unless the hazard which caused the wounds, injuries, or disease was clearly unrelated to such service.

(e) A person was in active service as a member of the Armed Forces of the United States if he was at the time of his death actually serving in such forces. A member of the Armed Forces in active service in a combat zone who thereafter becomes a prisoner of war or missing in action, and occupies such status at death or when the wounds, disease, or injury resulting in death were incurred, is considered for purposes of this section as serving in a combat zone.

(f) The exemption from tax granted by section 2201 does not apply to the basic estate tax as defined in section 2011(d).

### § 20.2202–1 Missionaries in foreign service.

Section 2202 provides that a duly commissioned missionary, dying while in foreign missionary service under a board of foreign missions of a religious denomination in the United States, is presumed to have retained a United States residence (see paragraph (b)(1) of § 20.0–1) held at the time of his commission and departure for foreign service, in the absence of relevant facts other than his intention to remain permanently in such foreign service.

### § 20.2203–1 Definition of executor.

The term *executor* means the executor or administrator of the decedent's estate. However, if there is no executor or administrator appointed, qualified and acting within the United States, the term means any person in actual or constructive possession of any property of the decedent. The term ''person in actual or constructive possession of any property of the decedent'' includes, among others, the decedent's agents and representatives; safe-deposit companies, warehouse companies, and other custodians of property in this country; brokers holding, as collateral, securities belonging to the decedent; and debtors of the decedent in this country.

### § 20.2204–1 Discharge of executor from personal liability.

(a) *General rule.* The executor of a decedent's estate may make written application to the applicable internal revenue officer with whom the estate tax return is required to be filed, as provided in § 20.6091–1, for a determination of the Federal estate tax and for a discharge of personal liability therefrom. Within 9 months after receipt of the application, or if the application is made before the return is filed then within 9 months after the return is filed, the executor will be notified of the amount of the tax and, upon payment thereof, he will be discharged from personal liability for any deficiency in the tax thereafter found to be due. If no such notification is received, the executor is discharged at the end of such 9 month period from personal liability for any deficiency thereafter found to be due. The discharge of the executor from personal liability under this section applies only to him in his personal capacity and to his personal assets. The discharge is not applicable to his liability as executor to the extent of the assets of the estate in his possession or control. Further, the discharge is not to operate as a release of any part of the gross estate from the lien for estate tax for any deficiency that may thereafter be determined to be due.

(b) *Special rule in the case of extension of time for payment of tax.* In addition to the provisions of paragraph (a) of this section, an executor of the estate of a decedent dying after December 31, 1970, may make written application to be discharged from personal liability for the amount of Federal estate tax for which the time for payment has been extended under section 6161, 6163, or 6166. In such a case, the executor will be notified of the amount of bond, if any, to be furnished within 9 months after receipt of the application, or, if the application is made before the return is filed, within 9 months after the return is filed. The amount of any bond required under the provisions of this paragraph shall not exceed the amount of tax the payment of which has been extended. Upon furnishing the bond in the form required under § 301.7101–1 of this chapter (Regulations on Procedure and Administration), or upon receipt of the notification that no bond is required, the executor will be discharged from personal liability for the tax the payment of which has been extended. If no notification is received, the executor is discharged at the end of such 9 month period from personal liability for the tax the payment of which has been extended.

[T.D. 7238, 37 FR 28720, Dec. 29, 1972, as amended by T.D. 7941, 49 FR 4468, Feb. 7, 1984]

### § 20.2204–2 Discharge of fiduciary other than executor from personal liability.

(a) A fiduciary (not including a fiduciary of the estate of a nonresident decedent, other than the executor, who as a fiduciary holds, or has held at any time since the decedent's death, property transferred to the fiduciary from a decedent dying after December 31, 1970, or his estate, may make written application to the applicable internal revenue officer with whom the estate tax return is required to be filed, as provided in § 20.6091–1, for a determination of the Federal estate tax liability with respect to such property and for a discharge of personal liability therefrom. The application must be accompanied by a copy of the instrument, if any, under which the fiduciary is acting, a description of all the property transferred to the fiduciary from the decedent or his estate, and any other information that would be relevant to a determination of the fiduciary's tax liability.

(b) Upon the discharge of the executor from personal liability under § 20.2204–1, or, if later, within 6 months after the receipt of the application filed by a fiduciary pursuant to the provisions of paragraph (a) of this section, such fiduciary will be notified either (1) of the amount of tax for which it has been determined the fiduciary is liable, or (2) that it has been determined that the fiduciary is not liable for any such tax. The fiduciary will also be notified of the amount of bond, if any, to be furnished for any Federal estate tax for which the time for payment has been extended under section 6161, 6163, or 6166. The amount of any bond required under the provisions of this paragraph shall not exceed the amount of tax the payment of which has been so extended. Upon payment of the amount for which it has been determined the fiduciary is liable, and upon furnishing any bond required under this paragraph in the form specified under § 301.7101–1 of this chapter (Regulations on Procedure and Administration), or upon receipt by the fiduciary of notification of a determination that he is not liable for such tax or that a bond is not required, the fiduciary will be discharged from personal liability for any deficiency in the tax thereafter found to be due. If no such notification is received, the fiduciary is discharged at the end of such 6 months (or upon discharge of the executor, if later) from personal liability for any deficiency thereafter found to be due. The discharge of the fiduciary from personal liability under this section applies only to him in his personal capacity and to his personal assets. The discharge is not applicable to his liability as a fiduciary (such as a trustee) to the extent of the assets of the estate in his possession or control. Further, the discharge is not to operate as a release of any part of the gross estate from the lien for estate tax for any deficiency that may thereafter be determined to be due.

[T.D. 7238, 37 FR 28720, Dec. 29, 1972]

**§ 20.2204–3 Special rules for estates of decedents dying after December 31, 1976; special lien under section 6324A.**

For purposes of §§ 20.2204–1(b) and 20.2204–2(b), in the case of a decedent dying after December 31, 1976, if the executor elects a special lien in favor of the United States under section 6324A, relating to special lien for estate taxes deferred under sections 6166 or 6166A (as in effect prior to its repeal by the Economic Recovery Tax Act of 1981), such lien shall be treated as the furnishing of a bond with respect to the amount for which the time for payment has been extended under section 6166. If an election has been made under section 6324A, the executor may not thereafter substitute a bond pursuant to section 2204 in lieu of that lien. If a bond has been supplied under section 2204, however,the executor may, by filing a proper notice of election and agreement, substitute a lien under section 6324A for any part or all of such bond. See §§ 20.6324A–1 and 301.6324A–1 for rules relating to a special lien under section 6324A.

[T.D. 7941, 49 FR 4468, Feb. 7, 1984]

**§ 20.2205–1 Reimbursement out of estate.**

If any portion of the tax is paid by or collected out of that part of the estate passing to, or in the possession of, any person other than the duly qualified executor or administrator, that person may be entitled to reimbursement, either out of the undistributed estate or by contribution from other beneficiaries whose shares or interests in the estate would have been reduced had the tax been paid before distribution of the estate, or whose shares or interests are subject either to an equal or prior liability for the payment of taxes, debts, or other charges against the estate. For specific provisions giving the executor the right to reimbursement from life insurance beneficiaries and from recipients of property over which the decedent had a power of appointment, see sections 2206 and 2207. These provisions, however, are not designed to curtail the right of the district director to collect the tax from any person, or out of any property, liable for its payment. The district director cannot be required to apportion the tax among the persons liable nor to enforce any right of reimbursement or contribution.

**§ 20.2206–1 Liability of life insurance beneficiaries.**

With respect to the right of the district director to collect the tax without regard to the provisions of section 2206, see § 20.2205–1.

**§ 20.2207–1 Liability of recipient of property over which decedent had power of appointment.**

With respect to the right of the district director to collect the tax without regard to the provisions of section 2207, see § 20.2205–1.

**§ 20.2207A–1 Right of recovery of estate taxes in the case of certain marital deduction property.**

(a) *In general*—(1) *Right of recovery from person receiving the property*. If the gross estate includes the value of property that is includible by reason of section 2044 (relating to certain property in which the decedent had a qualifying income interest for life under sections 2056(b)(7) or 2523(f)), the estate of the surviving spouse is entitled to recover from the *person receiving the property* (as defined in paragraph (d) of this section) the amount of Federal estate tax attributable to that property. The right of recovery arises when the Federal estate tax with respect to the property includible in the gross estate by reason of section 2044 is paid by the estate. There is no right of recovery from any person for the property received by that person for which a deduction was allowed from the gross estate if no tax is attributable to that property.

(2) *Failure to exercise right of recovery*. Failure of an estate to exercise a right of recovery under this section upon a transfer subject to section 2044 is treated as a transfer for Federal gift tax purposes of the unrecovered amounts from the persons who would benefit from the recovery to the persons from whom the recovery could have been obtained. See § 25.2511–1 of this chapter. The transfer is considered made when the right of recovery is no longer enforceable under applicable local law. A

delay in the exercise of the right of recovery may be treated as an interest-free loan with appropriate gift tax consequences under section 7872 depending on the facts of the particular case.

(3) *Waiver of right of recovery*. The provisions of § 20.2207A–1(a)(2) do not apply to the extent that the surviving spouse's will provides that a recovery shall not be made or to the extent that the beneficiaries cannot otherwise compel recovery. Thus, e.g., if the surviving spouse gives the executor of the estate discretion to waive the right of recovery and the executor waives the right, no gift occurs under § 25.2511–1 of this chapter if the persons who would benefit from the recovery cannot compel the executor to exercise the right of recovery.

(b) *Amount of estate tax attributable to property includible under section 2044.* The amount of Federal estate tax attributable to property includible in the gross estate under section 2044 is the amount by which the total Federal estate tax (including penalties and interest attributable to the tax) under chapter 11 of the Internal Revenue Code that has been paid, exceeds the total Federal estate tax (including penalties and interest attributable to the tax) under chapter 11 of the Internal Revenue Code that would have been paid if the value of the property includible in the gross estate by reason of section 2044 had not been so included.

(c) *Amount of estate tax attributable to a particular property*. An estate's right of recovery with respect to a particular property is an amount equal to the amount determined in paragraph (b) of this section multiplied by a fraction. The numerator of the fraction is the value for Federal estate tax purposes of the particular property included in the gross estate by reason of section 2044, less any deduction allowed with respect to the property. The denominator of the fraction is the total value of all properties included in the gross estate by reason of section 2044, less any deductions allowed with respect to those properties.

(d) *Person receiving the property*. If the property is in a trust at the time of the decedent's death, the *person receiving the property* is the trustee and any person who has received a distribution of the property prior to the expiration of the right of recovery if the property does not remain in trust. This paragraph (d) does not affect the right, if any, under local law, of any person with an interest in property to reimbursement or contribution from another person with an interest in the property.

(e) *Example.* The following example illustrates the application of paragraphs (a) through (d) of this section.

*Example.* D died in 1994. D's will created a trust funded with certain income producing assets included in D's gross estate at $1,000,000. The trust provides that all the income is payable to D's wife, S, for life, remainder to be divided equally among their four children. In computing D's taxable estate, D's executor deducted, pursuant to section 2056(b)(7), $1,000,000. Assume that S received no other property from D and that S died in 1996. Assume further that S made no section 2519 disposition of the property, that the property was included in S's gross estate at a value of $1,080,000, and that S's will contained no provision regarding section 2207A(a). The tax attributable to the property is equal to the amount by which the total Federal estate tax (including penalties and interest) paid by S's estate exceeds the Federal estate tax (including penalties and interest) that would have been paid if S's gross estate had been reduced by $1,080,000. That amount of tax may be recovered by S's estate from the trust. If, at the time S's estate seeks reimbursement, the trust has been distributed to the four children, S's estate is also entitled to recover the tax from the children.

[T.D. 8522, 59 FR 9654, Mar. 1, 1994]

### § 20.2207A–2 Effective date.

The provisions of § 20.2207A–1 are effective with respect to estates of decedents dying after March 1, 1994. With respect to estates of decedent dying on or before such date, the executor of the decedent's estate may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of § 20.2207A–1 (as well as project LR–211–76, 1984–1 C.B., page 598, see § 601.601(d)(2)(ii)(*b*) of this chapter), are considered a reasonable interpretation of the statutory provisions.

[T.D. 8522, 59 FR 9655, Mar. 1, 1994]

### § 20.2208–1 Certain residents of possessions considered citizens of the United States.

As used in this part, the term ''citizen of the United States'' is considered to include a decedent dying after September 2, 1958, who, at the time of his death, was domiciled in a possession of the United States and was a United States citizen, and who did not acquire his United States citizenship solely by reason of his being a citizen of such possession or by reason of his birth or residence within such possession. The estate of such a decedent is, therefore, subject to the tax imposed by section 2001. See paragraph (a)(2) of § 20.0–1 and § 20.2209–1 for further information relating to the application of the Federal estate tax to the estates of decedents who were residents of possessions of the United States. The application of this section may be illustrated by the following example and the examples set forth in § 20.2209–1:

*Example.* A, a citizen of the United States by reason of his birth in the United States at San Francisco, established residence in Puerto Rico and acquired a Puerto Rican citizenship. A died on September 4, 1958, while a citizen and domiciliary of Puerto Rico. A's estate is, by reason of the provisions of section 2208, subject to the tax imposed by section 2001 inasmuch as his United States citizenship is based on birth in the United States and is not based solely on being a citizen of a possession or solely on birth or residence in a possession.

[T.D. 6526, 26 FR 417, Jan. 19, 1961]

### § 20.2209–1 Certain residents of possessions considered nonresidents not citizens of the United States.

As used in this part, the term ''nonresident not a citizen of the United States'' is considered to include a decedent dying after September 14, 1960, who, at the time of his death, was domiciled in a possession of the United States and was a United States citizen, and who acquired his United States citizenship solely by reason of his being a citizen of such possession or by reason of his birth or residence within such possession. The estate of such a decedent is, therefore, subject to the tax imposed by section 2101 which is the tax applicable in the case of a ''nonresident not a citizen of the United States.'' See paragraph (a)(2) of § 20.0–1 and § 20.2208–1 for further information relating to the application of the Federal estate tax to the estates of decedents who were residents of possessions of the United States. The application of this section may be illustrated by the following examples and the example set forth in § 20.2208–1. In each of the following examples the decedent is deemed a ''nonresident not a citizen of the United States'' and his estate is subject to the tax imposed by section 2101 since the decedent died after September 14, 1960, but would not have been so deemed and subject to such tax if the decedent had died on or before September 14, 1960.

*Example (1).* C, who acquired his United States citizenship under section 5 of the Act of March 2, 1917 (39 Stat. 953), by reason of being a citizen of Puerto Rico, died in Puerto Rico on October 1, 1960, while domiciled therein. C is considered to have acquired his United States citizenship solely by reason of his being a citizen of Puerto Rico.

*Example (2).* E, whose parents were United States citizens by reason of their birth in Boston, was born in the Virgin Islands on March 1, 1927. On September 30, 1960, he died in the Virgin Islands while domiciled therein. E is considered to have acquired his United States citizenship solely by reason of his birth in the Virgin Islands (section 306 of the Immigration and Nationality Act (66 Stat. 237, 8 U.S.C. 1406)).

*Example (3).* N, who acquired United States citizenship by reason of being a native of the Virgin Islands and a resident thereof on June 28, 1932 (section 306 of the Immigration and Nationality Act (66 Stat. 237, 8 U.S.C. 1406)), died on October 1, 1960, while domiciled in the Virgin Islands. N is considered to have acquired his United States citizenship solely by reason of his birth or residence in the Virgin Islands.

*Example (4).* P, a former Danish citizen, who on January 17, 1917, resided in the Virgin Islands, made the declaration to preserve his Danish citizenship required by Article 6 of the treaty entered into on August 4, 1916, between the United States and Denmark. Subsequently P acquired United States citizenship when he renounced such declaration before a court of record (section 306 of the Immigration and Nationality Act (66 Stat. 237, 8 U.S.C. 1406)). P died on October 1, 1960, while domiciled in the Virgin Islands. P is considered to have acquired his United States citizenship solely by reason of his birth or residence in the Virgin Islands.

*Example (5).* R, a former French citizen, acquired his United States citizenship through naturalization proceedings in a court located in the Virgin Islands after having qualified

for citizenship by residing in the Virgin Islands for 5 years. R died on October 1, 1960, while domiciled in the Virgin Islands. R is considered to have acquired his United States citizenship solely by reason of his birth or residence within the Virgin Islands.

[T.D. 6526, 26 FR 418, Jan. 19, 1961]

PROCEDURE AND ADMINISTRATION

### § 20.6001–1 Persons required to keep records and render statements.

(a) It is the duty of the executor to keep such complete and detailed records of the affairs of the estate for which he acts as will enable the district director to determine accurately the amount of the estate tax liability. All documents and vouchers used in preparing the estate tax return (§ 20.6018–1) shall be retained by the executor so as to be available for inspection whenever required.

(b) In addition to filing an estate tax return (see § 20.6018–1) and, if applicable, a preliminary notice (see § 20.6036–1), the executor shall furnish such supplemental data as may be necessary to establish the correct estate tax. It is therefore the duty of the executor (1) to furnish, upon request, copies of any documents in his possession (or on file in any court having jurisdiction over the estate) relating to the estate, appraisal lists of any items included in the gross estate, copies of balance sheets or other financial statements obtainable by him relating to the value of stock, and any other information obtainable by him that may be found necessary in the determination of the tax, and (2) to render any written statement, containing a declaration that it is made under penalties of perjury, of facts within his knowledge which the district director may require for the purpose of determining whether a tax liability exists and, if so, the extent thereof. Failure to comply with such a request will render the executor liable to penalties (see section 7269), and proceedings may be instituted in the proper court of the United States to secure compliance therewith (see section 7604).

(c) Persons having possession or control of any records or documents containing or supposed to contain any information concerning the estate, or having knowledge of or information about any fact or facts which have a material bearing upon the liability, or the extent of liability, of the estate for the estate tax, shall, upon request of the district director, make disclosure thereof. Failure on the part of any person to comply with such request will render him liable to penalties (section 7269), and compliance with the request may be enforced in the proper court of the United States (section 7604).

(d) Upon notification from the Internal Revenue Service, a corporation (organized or created in the United States) or its transfer agent is required to furnish the following information pertaining to stocks or bonds registered in the name of a nonresident decedent (regardless of citizenship): (1) The name of the decedent as registered; (2) the date of the decedent's death; (3) the decedent's residence and his place of death; (4) the names and addresses of executors, attorneys, or other representatives of the estate, within and without the United States; and (5) a description of the securities, the number of shares or bonds and the par values thereof.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 7238, 37 FR 28720, Dec. 29, 1972]

### § 20.6011–1 General requirement of return, statement, or list.

(a) *General rule.* Every person made liable for any tax imposed by subtitle B of the Code shall make such returns or statements as are required by the regulations in this part. The return or statement shall include therein the information required by the applicable regulations or forms.

(b) *Use of prescribed forms.* Copies of the forms prescribed by §§ 20.6018–1 and 20.6036–1 may be obtained from district directors. The fact that an executor has not been furnished with copies of these forms will not excuse him from making a return or, if applicable, from filing a preliminary notice. Application for a form shall be made to the district director in ample time for the executor to have the form prepared, verified, and filed with the appropriate internal revenue office on or before the date prescribed for the filing thereof (see §§ 20.6071–1 and 20.6075–1). The executor shall carefully prepare the return and,

if applicable, the preliminary notice so as to set forth fully and clearly the data called for therein. A return or, if applicable, a preliminary notice which has not been so prepared will not be accepted as meeting the requirements of §§ 20.6018–1 through 20.6018–4, and § 20.6036–1.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 7238, 37 FR 28720, Dec. 29, 1972]

### § 20.6018–1 Returns.

(a) *Estates of citizens or residents.* A return must be filed on Form 706 for the estate of every citizen or resident of the United States whose gross estate exceeded $60,000 in value on the date of his death. The value of the gross estate at the date of death governs with respect to the filing of the return regardless of whether the value of the gross estate is, at the executor's election, finally determined as of a date subsequent to the date of death pursuant to the provisions of section 2032. Duplicate copies of the return are not required to be filed. For the contents of the return, see § 20.6018–3.

(b) *Estates of nonresidents not citizens*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, a return must be filed on Form 706 or Form 706NA for the estate of every nonresident not a citizen of the United States if the value of that part of the gross estate situated in the United States on the date of his death exceeded $30,000 in the case of a decedent dying on or after November 14, 1966, or $2,000 in the case of a decedent dying before November 14, 1966. Under certain conditions the return may be made only on Form 706. See the instructions on Form 706NA for circumstances under which that form may not be used. Duplicate copies of the return are not required to be filed. For the contents of the return, see § 20.6018–3. For the determination of the gross estate situated in the United States, see §§ 20.2103–1 and 20.2104–1.

(2) *Certain estates of decedents dying on or after November 14, 1966.* In the case of an estate of a nonresident not a citizen of the United States dying on or after November 14, 1966—

(i) *Transfers subject to the tax imposed by section 2107(a).* If the transfer of the estate is subject to the tax imposed by section 2107(a) (relating to expatriation to avoid tax), any amounts includible in the decedent's gross estate under section 2107(b) are to be added to the value on the date of his death of that part of his gross estate situated in the United States, for purposes of determining under subparagraph (1) of this paragraph whether his gross estate exceeded $30,000 on the date of his death.

(ii) *Transfers subject to a Presidential proclamation.* If the transfer of the estate is subject to tax pursuant to a Presidential proclamation made under section 2108(a) (relating to Presidential proclamations of the application of pre-1967 estate tax provisions), the return must be filed on Form 706 or Form 706NA if the value on the date of the decedent's death of that part of his gross estate situated in the United States exceeded $2,000.

(c) *Place for filing.* See § 20.6091–1 for the place where the return shall be filed.

(d) *Time for filing.* See § 20.6075–1 for the time for filing the return.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7296, 38 FR 34200, Dec. 12, 1973]

### § 20.6018–2 Returns; person required to file return.

It is required that the duly qualified executor or administrator shall file the return. If there is more than one executor or administrator, the return must be made jointly by all. If there is no executor or administrator appointed, qualified and acting within the United States, every person in actual or constructive possession of any property of the decedent situated in the United States is constituted an executor for purposes of the tax (see § 20.2203–1), and is required to make and file a return. If in any case the executor is unable to make a complete return as to any part of the gross estate, he is required to give all the information he has as to such property, including a full description, and the name of every person holding a legal or beneficial interest in the property. If the executor is unable to make a return as to any property, every person holding a legal or beneficial interest therein shall, upon notice from the district director, make a

return as to that part of the gross estate. For delinquency penalty for failure to file return, see section 6651 and § 301.6651–1 of this chapter (Regulations on Procedure and Administration). For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, 7207, and 7269.

**§ 20.6018–3 Returns; contents of returns.**

(a) *Citizens or residents.* The return of an estate of a decedent who was a citizen or resident of the United States at the time of his death must contain an itemized inventory by schedule of the property constituting the gross estate and lists of the deductions under the proper schedules. The return shall set forth (1) the value of the gross estate (see §§ 20.2031–1 through 20.2044–1), (2) the deduction claimed (see §§ 20.2052–1 through 20.2056(e)–3), (3) the taxable estate (see § 20.2051–1), and (4) the gross estate tax, reduced by any credits (see §§ 20.2011–1 through 20.2014–6) against the tax. In listing upon the return the property constituting the gross estate (other than household and personal effects for which see § 20.2031–6), the description of it shall be such that the property may be readily identified for the purpose of verifying the value placed on it by the executor.

(b) *Nonresidents not citizens.* The return of an estate of a decedent who was not a citizen or resident of the United States at the time of his death must contain the following information:

(1) An itemized list of that part of the gross estate situated in the United States (see §§ 20.2103–1 and 20.2104–1);

(2) In the case of an estate the transfer of which is subject to the tax imposed by section 2107(a) (relating to expatriation to avoid tax), a list of any amounts with respect to stock in a foreign corporation which are includible in the gross estate under section 2107(b), together with an explanation of how the amounts were determined;

(3) An itemized list of any deductions claimed (see §§ 20.2106–1 and 20.2106–2);

(4) The amount of the taxable estate (see § 20.2106–1); and

(5) The gross estate tax, reduced by any credits against the tax (see § 20.2102–1).

For the disallowance of certain deductions if the return does not disclose that part of the gross estate not situated in the United States, see §§ 20.2106–1 and 20.2106–2.

(c) *Provisions applicable to returns described in paragraphs (a) and (b) of this section.* (1) A legal description shall be given of each parcel of real estate, and, if located in a city, the name of the street and number, its area, and, if improved, a short statement of the character of the improvements.

(2) A description of bonds shall include the number held, principal amount, name of obligor, date of maturity, rate of interest, date or dates on which interest is payable, series number if there is more than one issue, and the principal exchange upon which listed, or the principal business office of the obligor, if unlisted. A description of stocks shall include number of shares, whether common or preferred, and, if preferred, what issue, par value, quotation at which returned, exact name of corporation, and, if the stock is unlisted, the location of the principal business office and State in which incorporated and the date of incorporation, or if the stock is listed, the principal exchange upon which sold. A description of notes shall include name of maker, date on which given, date of maturity, amount of principal, amount of principal unpaid, rate of interest and whether simple or compound, date to which interest has been paid and amount of unpaid interest. A description of the seller's interest in land contracts shall include name of buyer, date of contract, description of property, sale price, initial payment, amounts of installment payments, unpaid balance of principal and accrued interest, interest rate and date prior to decedent's death to which interest had been paid.

(3) A description of bank accounts shall disclose the name and address of depository, amount on deposit, whether a checking, savings, or a time-deposit account, rate of interest, if any payable, amount of interest accrued and payable, and serial number. A description of life insurance shall give the name of the insurer, number of policy, name of the beneficiary, and the amount of the proceeds.

(4) In describing an annuity, the name and address of the grantor of the annuity shall be given, or, if the annuity is payable out of a trust or other funds, such a description as will fully identify it. If the annuity is payable for a term of years, the duration of the term and the date on which it began shall be given, and if payable for the life of a person other than the decedent, the date of birth of such person shall be stated. If the executor has not included in the gross estate the full value of an annuity or other payment described in section 2039, he shall nevertheless fully describe the annuity and state its total purchase price and the amount of the contribution made by each person (including the decedent's employer) toward the purchase price. If the executor believes that any part of the annuity or other payment is excludable from the gross estate under the provisions of section 2039, or for any other reason, he shall state in the return the reason for his belief.

(5) Judgments should be described by giving the title of the cause and the name of the court in which rendered, date of judgment, name and address of the judgment debtor, amount of judgment, and rate of interest to which subject, and by stating whether any payments have been made thereon, and, if so, when and in what amounts.

(6) If, pursuant to section 2032, the executor elects to have the estate valued at a date or dates subsequent to the time of the decedent's death, there must be set forth on the return: (i) An itemized description of all property included in the gross estate on the date of the decedent's death, together with the value of each item as of that date; (ii) an itemized disclosure of all distributions, sales, exchanges, and other dispositions of any property during the 6 month (1 year, if the decedent died on or before December 31, 1970) period after the date of the decedent's death, together with the dates thereof; and (iii) the value of each item of property in accordance with the provisions of section 2032 (see § 20.2032–1). Interest and rents accrued at the date of the decedent's death and dividends declared to stockholders of record on or before the date of the decedent's death and not collected at that date are to be shown separately. (See also paragraph (e) of § 20.6018–4 with respect to documents required to be filed with the return.)

(7) All transfers made by the decedent within 3 years before the date of his death of a value of $1,000 or more and all transfers (other than outright transfers not in trust) made by the decedent at any time during his life of a value of $5,000 or more, except bona fide sales for an adequate and full consideration in money or money's worth, must be disclosed in the return, whether or not the executor regards the transfers as subject to the tax. If the executor believes that such a transfer is not subject to the tax, a brief statement of the pertinent facts shall be made.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 7238, 37 FR 28721, Dec. 29, 1972; T.D. 7296, 38 FR 34200, Dec. 12, 1973]

### § 20.6018–4 Returns; documents to accompany the return.

(a) A certified copy of the will, if the decedent died testate, must be submitted with the return, together with copies of such other documents as are required in Form 706 and in the applicable sections of these regulations. There may also be filed copies of any documents which the executor may desire to submit in explanation of the return.

(b) In the case of an estate of a nonresident citizen, the executor shall also file the following documents with the return:

(1) A copy of any inventory of property and schedule of liabilities, claims against the estate and expenses of administration filed with the foreign court of probate jurisdiction, certified by a proper official of the court; and

(2) A copy of any return filed under any applicable foreign inheritance, estate, legacy, or succession tax act, certified by a proper official of the foreign tax department.

(c) In the case of an estate of a nonresident not a citizen of the United States, the executor must also file with the return, but only if deductions are claimed or the transfer of the estate is subject to the tax imposed by section 2107(a) (relating to expatriation to avoid tax), a copy of the inventory of

property filed under the foreign death duty act; or, if no such inventory was filed, a certified copy of the inventory filed with the foreign court of probate jurisdiction.

(d) For every policy of life insurance listed on the return, the executor must procure a statement, on Form 712, by the company issuing the policy and file it with the return.

(e) If, pursuant to section 2032, the executor elects to have the estate valued at a date or dates subsequent to the time of the decedent's death, the executor shall file with the return evidence in support of any statements made by him in the return as to distributions, sales, exchanges, or other dispositions of property during the 6 month (1 year, if the decedent died on or before December 31, 1970) period which followed the decedent's death. If the court having jurisdiction over the estate makes an order or decree of distribution during that period, a certified copy thereof must be submitted as part of the evidence. The district director, or the director of a service center, may require the submission of such additional evidence as is deemed necessary.

(f) In any case where a transfer, by trust or otherwise, was made by a written instrument, a copy thereof shall be filed with the return if (1) the property is included in the gross estate, or (2) the executor pursuant to the provisions of paragraph (c)(7) of § 20.6018–3 has made a disclosure of the transfer on the return but has not included its value in the gross estate in the belief that it is not so includible. If the written instrument is of public record, the copy shall be certified, or if it is not of record, the copy shall be verified. If the decedent was a nonresident, not a citizen at the time of his death, the copy may be either certified or verified.

(g) If the executor contends that the value of property transferred by the decedent within a period of three years ending with the date of the decedent's death should not be included in the gross estate because he considers that the transfer was not made in contemplation of death, he shall file with the return (1) a copy of the death certificate, and (2) a statement, continuing a declaration that it is made under the penalties of perjury, of all the material facts and circumstances, including those directly or indirectly indicating the decedent's motive in making the transfer and his mental and physical condition at that time. However, this data need not be furnished with respect to transfers of less than $1,000 in value unless requested by the district director.

[T.D. 6996, 23 FR 4529, June 24, 1958, as amended by T.D. 7238, 37 FR 28721, Dec. 29, 1972; T.D. 7296, 38 FR 34200, Dec. 12, 1973]

### § 20.6036–1 Notice of qualification as executor of estate of decedent dying before 1971.

(a) *Preliminary notice for estates of decedents dying before January 1, 1971.* (1) A preliminary notice must be filed on Form 704 for the estate of every citizen or resident of the United States whose gross estate exceeded $60,000 in value on the date of his death.

(2) In the case of a nonresident not a citizen of the United States dying on or after November 14, 1966—

(i) Subject to the provisions of subdivisions (ii) and (iii) of this subparagraph, a preliminary notice must be filed on Form 705 if that part of the decedent's gross estate situated in the United States exceeded $30,000 in value on the date of his death (see §§ 20.2103–1 and 20.2104–1).

(ii) If the transfer of the estate is subject to the tax imposed by section 2107(a) (relating to expatriation to avoid tax), any amounts includible in the decedent's gross estate under section 2107(b) are to be added to the value on the date of his death of that part of his gross estate situated in the United States, for purposes of determining under subdivision (i) of this subparagraph whether his gross estate exceeded $30,000 in value on the date of his death.

(iii) If the transfer of the estate is subject to tax pursuant to a Presidential proclamation made under section 2108(a) (relating to Presidential proclamations of the application of pre-1967 estate tax provisions), a preliminary notice must be filed on Form 705 if the value on the date of the decedent's death of that part of his gross estate situated in the United States exceeded $2,000.

(3) A preliminary notice must be filed on Form 705 for the estate of every nonresident not a citizen of the United States dying before November 14, 1966, if the value on the date of his death of that part of his gross estate situated in the United States exceeded $2,000.

(4) The value of the gross estate on the date of death governs with respect to the requirement for filing the preliminary notice irrespective of whether the value of the gross estate is, at the executor's election, finally determined pursuant to the provisions of section 2032 as of a date subsequent to the date of death. If there is doubt as to whether the gross estate exceeds $60,000, $30,000, or $2,000, as the case may be, the notice shall be filed as a matter of precaution in order to avoid the possibility of penalties attaching.

(5) The primary purpose of the preliminary notice is to advise the Internal Revenue Service of the existence of taxable estates, and filing shall not be delayed beyond the period provided for in § 20.6071–1 merely because of uncertainty as to the exact value of the assets. The estimate of the gross estate called for by the notice shall be the best approximation of value which can be made within the time allowed. Duplicate copies of the preliminary notice are not required to be filed.

(6) For criminal penalties for failure to file a notice and filing a false or fraudulent notice, see sections 7203, 7207, and 7269. See § 20.6091–1 for the place for filing the notice. See § 20.6071–1 for the time for filing the notice.

(b) *Persons required to file.* In the case of an estate of a citizen or resident of the United States described in paragraph (a) of this section, the preliminary notice must be filed by the duly qualified executor or administrator, or if none qualifies within two months after the decedent's death, by every person in actual or constructive possession of any property of the decedent at or after the time of the decedent's death. The signature of one executor or administrator on the preliminary notice is sufficient. In the case of a nonresident not a citizen, the notice must be filed by every duly qualified executor or administrator within the United States, or if none qualifies within two months after the decedent's death, by every person in actual or constructive possession of any property of the decedent at or after the time of the decedent's death.

[T.D. 7238, 37 FR 28721, Dec. 29, 1972, as amended by T.D. 7296, 38 FR 34200, Dec. 12, 1973]

### § 20.6036–2 Notice of qualification as executor of estate of decedent dying after 1970.

In the case of the estate of a decedent dying after December 31, 1970, no special notice of qualification as executor of an estate is required to be filed. The requirement of section 6036 for notification of qualification as executor of an estate shall be satisfied by the filing of the estate tax return required by section 6018 and the regulations thereunder.

[T.D. 7238, 37 FR 28721, Dec. 29, 1972]

### § 20.6061–1 Signing of returns and other documents.

Any return, statement, or other document required to be made under any provision of Chapter 11 or Subtitle F of the Code or regulations prescribed thereunder with respect to any tax imposed by Chapter 11 of the Code shall be signed by the executor, administrator or other person required or duly authorized to sign in accordance with the regulations, forms or instructions prescribed with respect to such return, statement, or other document. See section 2203 for definition of executor, administrator, etc. The person required or duly authorized to make the return may incur liability for the penalties provided for erroneous, false, or fraudulent returns. For criminal penalties see sections 7201, 7203, 7206, 7207, and 7269.

[T.D. 6600, 27 FR 4986, May 29, 1962]

### § 20.6065–1 Verification of returns.

(a) *Penalties of perjury.* If a return, statement, or other document made under the provisions of Chapter 11 or Subtitle F of the Code or the regulations thereunder with respect to any tax imposed by Chapter 11 of the Code, or the form and instructions issued with respect to such return, statement, or other document, requires that it shall contain or be verified by a written declaration that it is made under

the penalties of perjury, it must be so verified by the person or persons required to sign such return, statement or other document. In addition, any other statement or document submitted under any provision of Chapter 11 or Subtitle F of the Code or regulations thereunder with respect to any tax imposed by Chapter 11 of the Code may be required to contain or be verified by a written declaration that it is made under the penalties of perjury.

(b) *Oath.* Any return, statement, or other document required to be submitted under Chapter 11 or Subtitle F of the Code or regulations prescribed thereunder with respect to any tax imposed by Chapter 11 of the Code may be required to be verified by an oath.

[T.D. 6600, 27 FR 4986, May 29, 1962]

### § 20.6071–1 Time for filing preliminary notice required by § 20.6036–1.

In the case of the estate of a decedent dying before January 1, 1971, if a duly qualified executor or administrator of the estate of such a decedent who was a resident or a citizen of the United States qualifies within 2 months after a decedent's death, or if a duly qualified executor or administrator of the estate of such a decedent who was a nonresident not a citizen qualifies within the United States within 2 months after the decedent's death, the preliminary notice required by § 20.6036–1 must be filed within 2 months after his qualification. If no such executor or administrator qualifies within that period, the preliminary notice must be filed within 2 months of the decedent's death.

[T.D. 7238, 37 FR 28721, Dec. 29, 1972]

### § 20.6075–1 Returns; time for filing estate tax return.

The estate tax return required by section 6018 must be filed on or before the due date. The due date is the date on or before which the return is required to be filed in accordance with the provisions of section 6075(a) or the last day of the period covered by an extension of time granted by the district director or the director of a service center as provided in § 20.6081–1. The due date, with respect to a decedent dying after December 31, 1970, is, unless an extension of time for filing has been granted, the day of the 9th calendar month after the decedent's death numerically corresponding to the day of the calendar month on which death occurred, except that, if there is no numerically corresponding day in such ninth month, the last day of the ninth month is the due date. For example, if the decedent dies on July 31, 1972, the estate tax return and tax payment must be made on or before April 30, 1973. The due date, with respect to a decedent dying before January 1, 1971, is, unless an extension of time for filing has been granted, the day of the 15th calendar month after the decedent's death numerically corresponding to the day of the calendar month on which death occurred, except that, if there is no numerically corresponding day in such 15th month, the last day of the 15th month is the due date. When the due date falls on Saturday, Sunday, or a legal holiday, the due date for filing the return is the next succeeding day which is not Saturday, Sunday, or a legal holiday. For definition of a legal holiday, see section 7503 and § 301.7503–1 of this chapter (Regulations on Procedure and Administration). As to additions to the tax in the case of failure to file the return or pay the tax within the prescribed time, see section 6651 and § 301.6651–1 of this chapter (Regulations on Procedure and Administration). For rules with respect to the right to elect to have the property valued as of a date or dates subsequent to the decedent's death, see § 20.2032–1, and section 7502 and § 301.7502–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 7238, 37 FR 28721, Dec. 29, 1972]

### § 20.6081–1 Extension of time for filing the return.

(a) In case it is impossible or impracticable for the executor to file a reasonably complete return within 9 months (15 months in the case of a decedent dying before January 1, 1971) from the date of death, the district director or the director of a service center may, upon a showing of good and

sufficient cause, grant a reasonable extension of time for filing the return required by section 6018. Unless the executor is abroad, the extension may not be for more than 6 months from the date for filing provided by section 6075(a). Therefore, unless the executor is abroad, the due date for filing the return under any extension granted by a district director or a director of a service center may not be later than 15 months (21 months in the case of a decedent dying before January 1, 1971) from the date of the decedent's death. The extension may, of course, be for a lesser period of time.

(b) Except as provided in paragraph (b) of § 301.6091–1 of this chapter (Regulations on Procedure and Administration), relating to hand-carried documents, such application shall be made to the internal revenue officer with whom the estate tax return is required to be filed and must contain a full recital of the causes for the delay. It should be made before the expiration of the time within which the return otherwise must be filed and failure to do so may indicate negligence and constitute sufficient cause for denial. It should, where possible, be made sufficiently early to permit the internal revenue officer to consider the matter and reply before what otherwise would be the due date of the return.

(c) A return as complete as possible must be filed before the expiration of the extension period granted. The return thus filed will be the return required by section 6018(a) and any tax shown thereon will be the ''amount determined by the executor as the tax'' referred to in section 6161(a)(2), or the ''amount shown as the tax by the taxpayer upon his return'' referred to in section 6211(a)(1)(A). Except as provided in §§ 20.2032A–8(d) and 20.6166–1(h), the return cannot be amended after the expiration of the extension period although supplemental information may subsequently be filed that may result in a finally determined tax different from the amount shown as the tax by the executor on the return. An extension of time for filing the return does not operate to extend the time for payment of the tax. See § 20.6151–1 for the time for payment of the tax, and §§ 20.6161–1 and 20.6163–1 for extensions of time for payment of the tax.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6711, 29 FR 3656, Mar. 24, 1964; T.D. 7238, 37 FR 28722, Dec. 29, 1972; T.D. 7710, 45 FR 50745, July 31, 1980]

### § 20.6091–1 Place for filing returns or other documents.

(a) *General rule.* If the decedent was domiciled in the United States at the time of his death, the preliminary notice required by § 20.6036–1 in the case of the estate of a decedent dying before January 1, 1971, and the estate tax return required by § 20.6018–1 shall be filed with:

(1) The service center serving the district in which the decedent was domiciled at the time of his death, if the instructions applicable to the estate tax return provide that the return shall be filed with a service center, or

(2) The district director (or with any person assigned the administrative supervision of an area, zone or local office constituting a permanent post of duty within the internal revenue district of such director) in whose district the decedent was domiciled at the time of his death, if paragraph (a)(1) of this section does not apply.

Paragraph (a)(1) of this section does not apply if the return is made by hand-carrying or if the instructions applicable to the preliminary notice or to the return do not provide that it shall be filed with a service center.

(b) *Non-U.S. domiciliaries.* If the decedent was not domiciled in the United States at the time of his death, the preliminary notice required by § 20.6036–1 in the case of the estate of a decedent dying before January 1, 1971, and the estate tax return required by § 20.6018–1 shall be filed with the Internal Revenue Service Center, Philadelphia, Pa. or the Director of International Operations, Washington, DC, depending upon the place designated on the return form or in the instructions issued with respect to such form. This paragraph applies whether or not the decedent was a citizen of the United States and whether or not the return is made by hand-carrying.

[T.D. 7238, 37 FR 28722, Dec. 29, 1972, as amended by T.D. 7302, 39 FR 796, Jan. 3, 1974; T.D. 7495, 42 FR 33726, July 1, 1977]

### § 20.6091–2 Exceptional cases.

Notwithstanding the provisions of § 20.6091–1 the Commissioner may permit the filing of the preliminary notice required by § 20.6036–1 and the estate tax return required by § 20.6018–1 in any internal revenue district.

[T.D. 6600, 27 FR 4986, May 29, 1962]

### § 20.6151–1 Time and place for paying tax shown on the return.

(a) *General rule.* The tax shown on the estate tax return is to be paid at the time and place fixed for filing the return (determined without regard to any extension of time for filing the return). For provisions relating to the time and place for filing the return, see §§ 20.6075–1 and 20.6091–1. For the duty of the executor to pay the tax, see § 20.2002–1.

(b) *Extension of time for paying*—(1) *In general.* For general provisions relating to extension of time for paying the tax, see § 20.6161–1.

(2) *Reversionary or remainder interests.* For provisions relating to extension of time for payment of estate tax on the value of a reversionary or remainder interest in property, see § 20.6163–1.

(3) *Interest in a closely held business.* For provisions relating to payment in installments of the estate tax attributable to inclusion in the gross estate of an interest in a closely held business, see §§ 20.6166–1 through 20.6166–4.

(c) *Payment with obligations of the United States.* Treasury bonds of certain issues which were owned by the decedent at the time of his death or which were treated as part of his gross estate under the rules contained in § 306.28 of Treasury Department Circular No. 300, Revised (31 CFR part 306), may be redeemed at par plus accrued interest for the purpose of payment of the estate tax, as provided in said section. Whether bonds of particular issues may be redeemed for this purpose will depend on the terms of the offering circulars cited on the face of the bonds. A current list of eligible issues may be obtained from any Federal reserve bank or branch, or from the Bureau of Public Debt, Washington, DC. See section 6312 and §§ 301.6312–1 and 301.6312–2 of this chapter (Regulations on Procedure and Administration) for provisions relating to the payment of taxes with United States Treasury obligations.

(d) *Receipt for payment.* For provisions relating to duplicate receipts for payment of the tax, see § 20.6314–1.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6522, 25 FR 13885, Dec. 29, 1960]

### § 20.6161–1 Extension of time for paying tax shown on the return.

(a) *Basis for granting an extension of time*—(1) *Reasonable cause.* With respect to the estate of a decedent dying after December 31, 1970, an extension of time beyond the due date to pay any part of the tax shown on the estate tax return may be granted for a reasonable period of time, not to exceed 12 months, 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. (See paragraph (b) of this section for rules relating to application for extension.) The following examples illustrate cases involving reasonable cause for granting an extension of time pursuant to this paragraph:

*Example (1).* An estate includes sufficient liquid assets to pay the estate tax when otherwise due. The liquid assets, however, are located in several jurisdictions and are not immediately subject to the control of the executor. Consequently, such assets cannot readily be marshaled by the executor, even with the exercise of due diligence.

*Example (2).* An estate is comprised in substantial part of assets consisting of rights to receive payments in the future (i.e., annuities, copyright royalties, contingent fees, or accounts receivable). These assets provide insufficient present cash with which to pay the estate tax when otherwise due and the estate cannot borrow against these assets except upon terms which would inflict loss upon the estate.

*Example (3).* An estate includes a claim to substantial assets which cannot be collected without litigation. Consequently, the size of the gross estate is unascertainable as of the time the tax is otherwise due.

*Example (4).* An estate does not have sufficient funds (without borrowing at a rate of interest higher than that generally available) with which to pay the entire estate tax when otherwise due, to provide a reasonable allowance during the remaining period of administration of the estate for the decedent's widow and dependent children, and to satisfy claims against the estate that are due and

payable. Furthermore, the executor has made a reasonable effort to convert assets in his possession (other than an interest in a closely held business to which section 6166 applies) into cash.

(2) *Undue hardship*—(i) *General rule.* In any case where the district director finds that payment on the due date of any part of the tax shown on the return, or payment of any part of an installment under section 6166 (including any part of a deficiency prorated to an installment the date for payment of which had not arrived) on the date fixed for payment thereof, would impose undue hardship upon the estate, he may extend the time for payment for a period or periods not to exceed one year for any one period and for all periods not to exceed 10 years from the date prescribed in section 6151(a) for payment of the tax. See paragraph (a) of § 20.6151–1. In addition, if the district director finds that payment upon notice and demand of any part of a deficiency prorated under the provisions of section 6166 to installments the date for payment of which had arrived would impose undue hardship upon the estate, he may extend the time for payment for a similar period or periods.

(ii) *Definition of ''undue hardship''.* The extension provided under this subparagraph on the basis of undue hardship to the estate will not be granted upon a general statement of hardship or merely upon a showing of reasonable cause. The term ''undue hardship'' means more than an inconvenience to the estate. A sale of property at a price equal to its current fair market value, where a market exists, is not ordinarily considered as resulting in an undue hardship to the estate. The following examples illustrate cases in which an extension of time will be granted based on undue hardship pursuant to this paragraph:

*Example (1).* A farm (or other closely held business) comprises a significant portion of an estate, but the percentage requirements of section 6166(a) (relating to an extension where the estate includes a closely held business) are not satisfied and, therefore, that section does not apply. Sufficient funds for the payment of the estate tax when otherwise due are not readily available. The farm (or closely held business) could be sold to unrelated persons at a price equal to its fair market value, but the executor seeks an extension of time to facilitate the raising of funds from other sources for the payment of the estate tax.

*Example (2).* The assets in the gross estate which must be liquidated to pay the estate tax can only be sold at a sacrifice price or in a depressed market if the tax is to be paid when otherwise due.

(b) *Application for extension.* An application containing a request for an extension of time for paying the tax shown on the return shall be in writing, shall state the period of the extension requested, and shall include a declaration that it is made under penalties of perjury. If the application is based upon reasonable cause (see paragraph (a)(1) of this section), a statement of such reasonable cause shall be included in the application. If the application is based upon undue hardship to the estate (see paragraph (a)(2) of this section), the application shall include a statement explaining in detail the undue hardship to the estate that would result if the requested extension were refused. At the option of the executor, an application for an extension of time based upon undue hardship may contain an alternative request for an extension based upon reasonable cause if the application for an extension based upon undue hardship is denied. However, an application for an extension of time based solely upon reasonable cause will be treated as such even though an examination of all the facts and circumstances discloses that an application for an extension of time based upon undue hardship might have been granted had such an application therefor been made. If the application is based solely on reasonable cause, it shall be filed with the internal revenue officer with whom the estate tax return is required to be filed under the provisions of § 20.6091–1(a). If the application is based on undue hardship (including an application in which the executor makes an alternative request for an extension based on reasonable cause), it shall be filed with the appropriate district director referred to in paragraph (a)(2) of § 20.6091–1 whether or not the return is to be filed with, orthe tax is to be paid to, such district director. An application, for an extension of time, relating to the estate of a decedent who was not domiciled in the United States at the time of death,

shall be filed with the Director of International Operations, Internal Revenue Service, Washington, DC. 20225. When received, the application will be examined, and, if possible, within 30 days will be denied, granted, or tentatively granted subject to certain conditions of which the executor will be notified. An application for an extension of time for payment of the tax, or of an installment under section 6166 (including any part of a deficiency prorated to an installment the date for payment of which had not arrived), will not be considered unless the extension is applied for on or before the date fixed for payment of the tax or installment. Similarly, an application for such an extension of time for payment of any part of a deficiency prorated under the provisions of section 6166 to installments the date for payment of which had arrived, will not be considered unless the extension is applied for on or before the date prescribed for payment of the deficiency as shown by the notice and demand from the district director. If the executor desires to obtain an additional extension of time for payment of any part of the tax shown on the return, or any part of an installment under section 6166 (including any part of a deficiency prorated to installment), it must be applied for on or before the date of the expiration of the previous extension. The granting of the extension of time for paying the tax is discretionary with the appropriate internal revenue officer and his authority will be exercised under such conditions as he may deem advisable. However, if a request for an extension of time for payment of estate tax under this section is denied by a district director or a director of a service center, a written appeal may be made, by registered or certified mail or hand delivery, to the regional commissioner with authority over such district director or service center director within 10 days after the denial is mailed to the executor. The provisions of sections 7502 (relating to timely mailing treated as timely filing) and 7503 (relating to time for performance of acts where the last day falls on Saturday, Sunday, or a legal holiday) apply in the case of appeals filed under this paragraph. When received, the appeal will be examined, and if possible, within 30 days will be denied, granted, or tentatively granted subject to certain conditions of which the executor will be notified. If, in the mistaken belief that an estate satisfies the requirements of section 6166, the executor, within the time prescribed in paragraph (e) of § 20.6166–1, files a notification of election to pay estate tax in installments, the notification of election to pay tax in installments will be treated as a timely filed application for an extension, under section 6161, of time for payment of the tax if the executor so requests, in writing, within a reasonable time after being notified by the district director that the estate does not satisfy the requirements of section 6166. A request that the election under section 6166 be treated as a timely filed application for an extension under section 6161 must contain, or be supported by the same information required by this paragraph with respect to an application for such an extension.

(c) *Special rules*—(1) *Payment pursuant to extension.* The amount of the tax for which an extension is granted, with the additions thereto, shall be paid on or before the expiration of the period of extension without the necessity of notice and demand from the district director.

(2) *Interest.* The granting of an extension of the time for payment of the tax will not relieve the estate from liability for the payment of interest thereon during the period of the extension. See section 6601.

(3) *Duty to file timely return.* The granting of an extension of time for paying the tax will not relieve the executor from the duty of filing the return on or before the date provided for in § 20.6075–1.

(4) *Credit for taxes.* An extension of time to pay the tax may extend the period within which State and foreign death taxes allowed as a credit under sections 2011 and 2014 are required to be paid and the credit therefor claimed. See paragraph (c) of § 20.2011–1 and § 20.2014–6.

(d) *Cross references.* For provisions requiring the furnishing of security for the payment of the tax for which an extension is granted, see paragraph (a) of § 20.6165–1. For provisions relating to

extensions of time for payment of tax on the value of a reversionary or remainder interest in property, see § 20.6163–1.

[T.D. 7238, 37 FR 28722, Dec. 29, 1972, as amended by T.D. 7384, 40 FR 49323, Oct. 22, 1975]

### § 20.6161–2 Extension of time for paying deficiency in tax.

(a) In any case in which the district director finds that payment, on the date prescribed therefor, of any part of a deficiency would impose undue hardship upon the estate, he may extend the time for payment for a period or periods not to exceed one year for any one period and for all periods not to exceed four years from the date prescribed for payment thereof. However, see § 20.6161–1 for extensions of time for payment of the part of a deficiency which is prorated to installments under the provisions of section 6166.

(b) The extension will not be granted upon a general statement of hardship. The term ''undue hardship'' means more than an inconvenience to the estate. It must appear that a substantial financial loss, for example, due to the sale of property at a sacrifice price, will result to the estate from making payment of the deficiency at the date prescribed therefor. If a market exists, a sale of property at the current market price is not ordinarily considered as resulting in an undue hardship. No extension will be granted if the deficiency is due to negligence or intentional disregard of rules and regulations or to fraud with intent to evade the tax.

(c) An application for such an extension must be in writing and must contain, or be supported by, information in a written statement declaring that it is made under penalties of perjury showing the undue hardship that would result to the estate if the extension were refused. The application, with the supporting information, must be filed with the district director. When received, it will be examined, and, if possible, within thirty days will be denied, granted, or tentatively granted subject to certain conditions of which the executor will be notified. The district director will not consider an application for such an extension unless it is applied for on or before the date prescribed for payment of the deficiency, as shown by the notice and demand from the district director. If the executor desires to obtain an additional extension, it must be applied for on or before the date of the expiration of the previous extension. The granting of the extension of time for paying the deficiency is discretionary with the district director.

(d) The amount of the deficiency for which an extension is granted, with the additions thereto, shall be paid on or before the expiration of the period of extension without the necessity of notice and demand from the district director.

(e) The granting of an extension of time for paying the deficiency will not operate to prevent the running of interest. See section 6601. An extension of time to pay the deficiency may extend the period within which State and foreign death taxes allowed as a credit under sections 2011 and 2014 are required to be paid and the credit therefor claimed. See paragraph (c) of § 20.2011–1 and § 20.2014–6.

(f) For provisions requiring the furnishing of security for the payment of the deficiency for which an extension is granted, see § 20.6165–1.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6522, 25 FR 13885, Dec. 29, 1960]

### § 20.6163–1 Extension of time for payment of estate tax on value of reversionary or remainder interest in property.

(a)(1) In case there is included in the gross estate a reversionary or remainder interest in property, the payment of the part of the tax attributable to that interest may, at the election of the executor, be postponed until six months after the termination of the precedent interest or interests in the property. The provisions of this section are limited to cases in which the reversionary or remainder interest is included in the decedent's gross estate as such and do not extend to cases in which the decedent creates future interests by his own testamentary act.

(2) If the district director finds that the payment of the tax at the expiration of the period of postponement described in subparagraph (1) of this paragraph would result in undue hardship to the estate, he may—

(i) After September 2, 1958, and before February 27, 1964, extend the time for payment for a reasonable period or periods not to exceed in all 2 years from the expiration of the period of postponement, but only if the precedent interest or interests in the property terminated after March 2, 1958, or

(ii) After February 26, 1964, extend the time for payment for a reasonable period or periods not to exceed in all 3 years from the expiration of the period of postponement, but only if the time for payment of the tax, including any extensions thereof, did not expire before February 26, 1964.

See paragraph (a)(2)(ii) of § 20.6161–1 for the meaning of the term ''undue hardship''. An example of undue hardship is a case where, by reason of the time required to settle the complex issues involved in a trust, the decedent's heirs or beneficiaries cannot reasonably expect to receive the decedent's remainder interest in the trust before the expiration of the period of postponement. The extension will be granted only in the manner provided in paragraph (b) of § 20.6161–1, and the amount of the tax for which the extension is granted, with the additions thereto, shall be paid on or before the expiration of the period of extension without the necessity of notice and demand from the district director.

(b) Notice of the exercise of the election to postpone the payment of the tax attributable to a reversionary or remainder interest should be filed with the district director before the date prescribed for payment of the tax. The notice of election may be made in the form of a letter addressed to the district director. There shall be filed with the notice of election a certified copy of the will or other instrument under which the reversionary or remainder interest, was created, or a copy verified by the executor if the instrument is not filed of record. The district director may require the submission of such additional proof as he deems necessary to disclose the complete facts. If the duration of the precedent interest is dependent upon the life of any person, the notice of election must show the date of birth of that person.

(c) If the decedent's gross estate consists of both a reversionary or remainder interest in property and other property, the tax attributable to the reversionary or remainder interest, within the meaning of this section, is an amount which bears the same ratio to the total tax as the value of the reversionary or remainder interest (reduced as provided in the following sentence) bears to the entire gross estate (reduced as provided in the last sentence of this paragraph). In applying this ratio, the value of the reversionary or remainder interest is reduced by (1) the amount of claims, mortgages, and indebtedness which is a lien upon such interest; (2) losses in respect of such interest during the settlement of the estate which are deductible under the provisions of section 2054 or section 2106(a)(1); (3) any amount deductible in respect of such interest under section 2055 or 2106(a)(2) for charitable, etc., transfers; and (4) the portion of the marital deduction allowed under the provisions of section 2056 on account of bequests, etc., of such interests to the decedent's surviving spouse. Likewise, in applying the ratio, the value of the gross estate is reduced by such deductions having similar relationship to the items comprising the gross estate.

(d) For provisions requiring the payment of interest during the period of the extension occurring before July 1, 1975, see section 6601(b) prior to its amendment by section 7(d)(1) of the Act of Jan. 3, 1975 (Pub. L. 93–625, 88 Stat. 2115). For provisions requiring the furnishing of security for the payment of the tax for which the extension is granted, see paragraph (b) of § 20.6165–1. For provisions concerning the time within which credit for State and foreign death taxes on such a reversionary or remainder interest may be taken, see section 2015 and the regulations thereunder.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6716, 29 FR 3757, Mar. 26, 1964; T.D. 7238, 37 FR 28724, Dec. 29, 1972; T.D. 7384, 40 FR 49323, Oct. 22, 1975]

**§ 20.6165–1 Bonds where time to pay tax or deficiency has been extended.**

(a) *Extensions under sections 6161 and 6163(b) of time to pay tax or deficiency.* If an extension of time for payment of tax or deficiency is granted under section 6161 or 6163(b), the district director may, if he deems it necessary, require the executor to furnish a bond for the payment of the amount in respect of which the extension is granted in accordance with the terms of the extension. However, such bond shall not exceed double the amount with respect to which the extension is granted. For other provisions relating to bonds required where extensions of time to pay estate taxes or deficiencies are granted under sections 6161 and 6163(b), see the regulations under section 7101 contained in part 301 of this chapter (Regulations on Procedure and Administration).

(b) *Extensions under section 6163 of time to pay estate tax attributable to reversionary or remainder interests.* As a prerequisite to the postponement of the payment of the tax attributable to a reversionary or remainder interest as provided in § 20.6163–1, a bond equal to double the amount of the tax and interest for the estimated duration of the precedent interest must be furnished conditioned upon the payment of the tax and interest accrued thereon within six months after the termination of the precedent interest. If after the acceptance of a bond it is determined that the amount of the tax attributable to the reversionary or remainder interest was understated in the bond, a new bond or a supplemental bond may be required, or the tax, to the extent of the understatement, may be collected. The bond must be conditioned upon the principal or surety promptly notifying the district director when the precedent interest terminates and upon the principal or surety notifying the district director during the month of September of each year as to the continuance of the precedent interest, if the duration of the precedent interest is dependent upon the life or lives of any person or persons, or is otherwise indefinite. For other provisions relating to bonds where an extension of time has been granted for paying the tax, see the regulations under section 7101 contained in part 301 of this chapter (Regulations on Procedure and Administration).

[T.D. 6526, 26 FR 418, Jan. 19, 1961, as amended by T.D. 6600, 27 FR 4986, May 29, 1962]

**§ 20.6166–1 Election of alternate extension of time for payment of estate tax where estate consists largely of interest in closely held business.**

(a) *In general.* Section 6166 allows an executor to elect to extend payment of part or all of the portion of the estate tax which is attributable to a closely held business interest (as defined in section 6166(b)(1)). If it is made at the time the estate tax return is filed, the election is applicable both to the tax originally determined to be due and to certain deficiencies. If no election is made when the estate tax return is filed, up to the full amount of certain later deficiencies (but not any tax originally determined to be due) may be paid in installments.

(b) *Time and manner of election.* The election provided under section 6166(a) is made by attaching to a timely filed estate tax return a notice of election containing the following information:

(1) The decedent's name and taxpayer identification number as they appear on the estate tax return;

(2) The amount of tax which is to be paid in installments;

(3) The date selected for payment of the first installment;

(4) The number of annual installments, including the first installment, in which the tax is to be paid;

(5) The properties shown on the estate tax return which constitute the closely held business interest (identified by schedule and item number); and

(6) The facts which formed the basis for the executor's conclusion that the estate qualifies for payment of the estate tax in installments.

In the absence of a statement in the notice of election as to the amount of tax to be paid in installments, the date selected for payment of the first installment, or the number of installments, the election is presumed to be for the maximum amount so payable and for payment thereof in 10 equal installments, the first of which is due on the date which is 5 years after the date

prescribed in section 6151(a) for payment of estate tax.

(c) *Treatment of certain deficiencies*—(1) *No election before assessment of deficiency.* Where a deficiency is assessed and no election, including a protective election, has been made under section 6166(a) to pay any tax in installments, the executor may elect under section 6166(h) to pay the portion of the deficiency attributable to the closely held business interest in installments. However, this is true only if the estate qualifies under section 6166 based upon values as finally determined (or agreed to following examination of a return). Such an election is exercised by filing a notice of election with the Internal Revenue Service office where the estate tax return was filed. The notice of election must be filed within 60 days after issuance of notice and demand for payment of the deficiency, and it must contain the same information as is required under paragraph (b) of this section. The notice of election is to be accompanied by payment of the amount of tax and interest, the date for payment of which has arrived as determined under paragraphs (e) and (f) of this section, plus any amount of unpaid tax and interest which is not attributable to the closely held business interest and which is not eligible for further extension (or currently extended) under another section (other than section 6166A).

(2) *Election made with estate tax return.* If the executor makes an election under section 6166(a) (other than a protective election) at the time the estate tax return is filed and a deficiency is later assessed, the portion of the deficiency which is attributable to the closely held business interest (but not any accrued interest thereon) will be prorated to the installments payable pursuant to the original section 6166(a) election. Any part of the deficiency prorated to an installment, the date for payment of which has arrived, is due upon notice and demand. Interest for any such period, including the deferral period, is payable upon notice and demand.

(3) *Portion of deficiency attributable to closely held business interest.* Only that portion of any deficiency which is attributable to a closely held business interest may be paid in installments under section 6166. The amount of any deficiency which is so attributable is the difference between the amount of tax which the executor has previously elected to pay in installments under section 6166 and the maximum amount of tax which the executor could have elected to pay in installments on the basis of a return which reflects the adjustments that resulted in the deficiency.

(d) *Protective election.* A protective election may be made to defer payment of any portion of tax remaining unpaid at the time values are finally determined (or agreed to following examination of a return) and any deficiencies attributable to the closely held business interest (within the meaning of paragraph (c)(3) of this section). Extension of tax payments pursuant to this election is contingent upon final values meeting the requirements of section 6166. A protective election does not, however, extend the time for payment of any amount of tax. Rules for such extensions are contained in sections 6161, 6163, and 6166A. A protective election is made by filing a notice of election with a timely filed estate tax return stating that the election is being made. Within 60 days after values are finally determined (or agreed to following examination of a return), a final notice of election which sets forth the information required under paragraph (b) of this section must be filed with the Internal Revenue Service office where the original estate tax return was filed. That notice of final election is to be accompanied by payment of any amount of previously unpaid tax and interest, the date for payment of which has arrived as determined under paragraphs (e) and (f) of this section, plus any amount of unpaid tax and interest which is not attributable to the closely held business interest and which is not eligible for further extension (or currently extended) under another section (other than section 6166A).

(e) *Special rules*—(1) *Effect of deficiencies and protective elections upon payment.* Upon election to extend the time for payment of a deficiency or

upon final determination of values following a protective election, the executor must prorate the tax or deficiency attributable to the closely held business interest among all installments. All amounts attributed to installments which would have been due had the election been made at the time the tax was due to be paid under section 6151(a) and all accrued interest must be paid at the time the election is made.

(2) *Determination of date for payment of first installment.* The executor may defer payment of tax (but not interest) for any period up to 5 years from the date determined under section 6151(a) for payment of the estate tax. The date chosen for payment of the first installment of tax is not required to be on an annual anniversary of the original due date of the tax; however, it must be the date within any month which corresponds to the day of the month determined under section 6151(a).

(f) *Rule for computing interest.* Section 6601(j) provides a special 4 percent interest rate for the amount of tax (including deficiencies) which is to be paid in installments under section 6166. This special interest rate applies only to that amount of tax which is to be paid in installments and which does not exceed the limitation of section 6601(j)(2). Where payment of a greater amount of tax than is subject to section 6601(j)(2) is extended under section 6166, each installment is deemed to be comprised of both tax subject to the 4 percent interest rate and tax subject to the rate otherwise prescribed by section 6621. The percentage of any installment subject to the special 4 percent rate is equal to the percentage of the total tax payable in installments which is subject to the 4 percent rate. Where an election is made under the provisions of paragraphs (b) or (c) (1) of this section, the 4 percent rate applies from the date on which the estate tax was originally due to be paid. If only a protective election is made, section 6601(j) applies to the amount which is to be paid in installments, limited to the amount of any deficiency, from the due date for payment of estate tax. After the date upon which the section 6166 election is made final, section 6601(j) applies to the entire amount to be paid in installments.

(g) *Relation of sections 6166 and 6166A.* No election may be made under section 6166 if an election under section 6166A applies with respect to an estate. For example, no election can be made under section 6166(h) where an executor has made an election under section 6166A. If an election is timely made under either section 6166 or section 6166A, however, a protective election can be made under the other section at the same time. If the executor then files a timely notice of final election under the section protectively elected and pays any amounts determined to be due currently following final determination of (or agreement as to) estate tax values, the original election under the other provision will be deemed never to have applied to the estate.

(h) *Special rule for estates for which elections under section 6166 are made on or before August 30, 1980.* An election to extend payment of estate tax under section 6166 that is made on or before August 30, 1980, may be revoked. To revoke an election, the executor must file a notice of revocation with the Internal Revenue Service office where the original estate tax return was filed on or before January 31, 1981 (or if earlier, the date on which the period of limitation on assessment expires). This notice of revocation must contain the decedent's name, date of death, and taxpayer identification number, and is to be accompanied by remittance of any additional amount of estate tax and interest determined to be due.

(i) *Examples.* The provisions of this section may be illustrated by the following examples:

*Example (1).* (i) Based upon values shown on decedent A's timely filed estate tax return, 60 percent of the value of A's adjusted gross estate consisted of a farm which was a closely held business within the meaning of section 6166. A's executor, B, made a protective election under section 6166 when he filed A's estate tax return. B also applied for an extension of time under section 6161 to pay $15,000 of the $30,000 of estate tax shown due on the return. The requested extension was granted and was renewed at the end of 1 year. Eighteen months after the return was filed and after examination of A's estate tax return, the value of the farm was found to constitute 67 percent of the adjusted gross estate. B entered into an agreement consenting to the values as established on examination and to a deficiency of $5,000. B then

filed a final notice of election under section 6166, choosing a 5-year deferral followed by 10 annual installment payments and thereby terminated his extension under section 6161 because that amount of tax was then included under the section 6166 election. B could have extended payment of 67 percent of the total estate tax, or $23,450. $23,450 is eligible for installment payments under section 6166 and the section section 6166 election is considered to be for that amount. B is considered to have prepaid $3,450 of tax since only $20,000 of tax remained unpaid. The $3,450 is attributed to the first installment of $2,345 and to $1,105 of the second installment which would have been payable under the section 6166 election.

(ii) Had B been granted an extension of time under section 6161 to pay $20,000 of tax, $25,000 would remain upaid when the final section 6166 election is made. Payment of the full $23,450 (67 percent) of tax which is attributable to the closely held business interest is included under the section 6166 election. The balance of unpaid tax ($1,550) is due upon expiration of the estate's section 6161 extension.

(iii) Assume the facts under example (1) (i). B must pay all unpaid accrued interest with his notice of final election. Since only 18 months have passed, no installments of tax are due. Interest on the $5,000 deficiency is computed at 4 percent per annum for the entire 18 months, and interest for 12 months of that period is currently due to be paid. Interest for the remaining 6 months is due at the next succeeding date for payment of interest. Interest on the $15,000 of tax extended under section 6161 is computed at the rate determined under section 6621 until the date of the final section 6166 election and is due upon termination of the section 6161 extension. After that date, the interest on the $15,000 will also accrue at 4 percent per annum.

*Example (2).* Assume the facts as in example (1), except B initially made an election under section 6166A and made no protective election under section 6166. Following final determination of values, B is not permitted to make any election under section 6166; however, had B protectively elected section 6166 at the time he made the section 6166A election, he could have terminated the section 6166A election and finally elected under section 6166. In such a case, the full $23,450 of tax attributable to the farm would have been eligible for extension under section 6166. The 4 percent interest rate would apply to the $5,000 deficiency from the original due date of the tax, and, as with the extension under section 6161, it would apply to the amounts extended under section 6166A only from the date on which the election under section 6166 was finalized.

*Example (3).* C died in 1977. His estate owes Federal estate taxes of $750,000, $500,000 of which is attributable to a closely held business interest. Payment of the $500,000 was extended under section 6166. A 5-year deferral followed by 10 annual installment payments was chosen by C's executor. Under paragraph (f) of this section, only 63.16 percent of each installment will be subject to the special 4 percent interest rate and the remainder will be subject to the rate determined under section 6621. The same rule applies in computing interest for the 5 years during which payment of tax is deferred. (This is so because the 4 percent interest rate applies only to a maximum of $345,800 of tax less the $30,000 of credit allowable under section 2010(a) rather than to the entire $500,000 extended amount).

[T.D. 7710, 45 FR 50745, July 31, 1980]

### § 20.6166A–1 Extension of time for payment of estate tax where estate consists largely of interest in closely held business.

(a) *In general.* Section 6166 provides that where the value of an interest in a closely held business, which is included in the gross estate of a decedent who was a citizen or resident of the United States at the time of his death, exceeds either (1) 35 percent of the value of the gross estate, or (2) 50 percent of the taxable estate, the executor may elect to pay part or all of the Federal estate tax in installments. The election to pay the tax in installments applies to deficiencies in tax as well as to the tax shown on the return, unless the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax. Except as otherwise provided in section 6166(i) and § 20.6166–4, the provisions of section 6166 and this section apply only if the due date of the return is after September 2, 1958. See § 20.6166–4 for special rules applicable where the decedent died after August 16, 1954, and the due date of the return was on or before September 2, 1958. See also § 20.6075–1 for the due date of the return, and § 20.6166–2 for definition of the term ''interest in a closely held business.'' Since the election must be made on or before the due date of the return, the provisions of section 6166 will not apply to a deficiency in a case where, for whatever reason, no election was made to pay in installments the tax shown on the return. However, see

paragraph (e)(3) of this section concerning a protective election. The general administrative provisions of Subtitle F of the Code are applicable in connection with an election by the executor to pay the estate tax in installments in the same manner in which they are applied in a case where an extension of time under section 6161 is granted for payment of the tax. See paragraph (a) of § 20.6165–1 for provisions requiring the furnishing of security for the payment of the tax in cases where an extension is granted under section 6161.

(b) *Limitation on amount of tax payable in installments.* The amount of estate tax which the executor may elect to pay in installments is limited to an amount A, which bears the same ratio to B (the gross Federal estate tax, reduced by the credits authorized by sections 2011 through 2014 and any death tax convention) as C (the value of the interest in a closely held business which is included in the gross estate) bears to D (the value of the gross estate). Stated algebraically, the limitation (A) equals:

Value of interest in a closely held business which is included in the gross estate (C) ÷ Value of gross estate (D) × Gross Federal estate tax reduced by the credits authorized by sections 2011 through 2014 and any death tax convention (B).

The executor may elect to pay in installments an amount less than the amount computed under the limitation in this paragraph. For example, if the total estate tax payable is $100,000 and the amount computed under the limitation in this paragraph is $60,000, the executor may elect to pay in installments some lesser sum such as $30,000, in which event the executor must pay $73,000 to the district director on or before the date prescribed by section 6151(a) for payment of the tax. Of such payment, $70,000 represents tax which the executor either could not elect to pay in installments or did not choose to so elect, and $3,000 represents a payment of the first installment of the tax which the executor elected to pay in installments.

(c) *Number of installments and dates for payment.* The executor may elect to pay part or all of the tax (determined after application of the limitation contained in paragraph (b) of this section) in two or more, but not exceeding 10, equal annual installments. The first installment shall be paid on or before the date prescribed by section 6151(a) for payment of the tax (see paragraph (a) of § 20.6151–1), and each succeeding installment shall be paid on or before the date which is one year after the date prescribed for the payment of the preceding installment. See § 20.6166–3 for the circumstances under which the privilege of paying the tax in installments will terminate.

(d) *Deficiencies.* The amount of a deficiency which may be paid in installments shall not exceed the difference between the amount of tax which the executor elected to pay in installments and the maximum amount of tax (determined under paragraph (b) of this section) which the executor could have elected to pay in installments on the basis of a return which reflects in adjustments which resulted in the deficiency. This amount is then prorated to the installments in which the executor elected to pay the tax. The part of the deficiency prorated to installments not yet due shall be paid at the same time as, and as a part of, such installments. The part of the deficiency prorated to installments already paid or due shall be paid upon notice and demand from the district director. At the time the executor receives such notice and demand he may, of course, prepay the portions of the deficiency which have been prorated to installments not yet due. See paragraph (h) of this section.

(e) *Notice of election*—(1) *Filing of notice.* The notice of election to pay the estate tax in installments shall be filed with the district director on or before the due date of the return. However, if the due date of the return is after September 2, 1958, but before November 3, 1958, the election will be considered as timely made if the notice is filed with the district director on or before November 3, 1958. See § 20.6075–1 for the due date of the return.

(2) *Form of notice.* The notice of election to pay the estate tax in installments may be in the form of a letter addressed to the district director. The executor shall state in the notice the

amount of tax which he elects to pay in installments, and the total number of installments (including the installment due 9 months (15 months, in the case of a decedent dying before January 1, 1971) after the date of the decedent's death, in which he elects to pay the tax. The properties in the gross estate which constitute the decedent's interest in a closely held business should be listed in the notice, and identified by the schedule and item number at which they appear on the estate tax return. The notice should set forth the facts which formed the basis for the executor's conclusion that the estate qualifies for the payment of the estate tax in installments.

(3) *Protective election.* In a case where the estate does not qualify under section 6166(a) on the basis of the values as returned, or where the return shows no tax as due, an election may be made, contingent upon the values as finally determined meeting the percentage requirements set forth in section 6166(a), to pay in installments any portion of the estate tax, including a deficiency, which may be unpaid at the time of such final determination and which does not exceed the limitation provided in section 6166(b). The protective election must be made on or before the due date of the return and should state that it is a protective election. In the absence of a statement in the protective election as to the amount of tax to be paid in installments and the number of installments, the election will be presumed to be made for the maximum amount so payable and for the payment thereof in 10 equal annual installments, the first of which would have been due on the date prescribed in section 6151(a) for payment of the tax. The unpaid portion of the tax which may be paid in installments is prorated to the installments which would have been due if the provisions of section 6166(a) had applied to the tax, if any, shown on the return. The part of the unpaid portion of the tax so prorated to installments the date for payment of which would not have arrived before the deficiency is assessed shall be paid at the time such installments would have been due. The part of the unpaid portion of the tax so prorated to any installment the date for payment of which would have arrived before the deficiency is assessed shall be paid upon receipt of notice and demand from the district director. At the time the executor receives such notice and demand he may, of course, prepay the unpaid portions of the tax which have been prorated to installments not yet due. See paragraph (h) of this section.

(f) *Time for paying interest.* Under the provisions of section 6601, interest at the annual rate referred to in the regulations under section 6621 shall be paid on the unpaid balance of the estate tax which the executor has elected to pay in installments, and on the unpaid balance of any deficiency prorated to the installments. Interest on such unpaid balance of estate tax shall be paid annually at the same time as, and as a part of, each installment of the tax. Accordingly, interest is computed on the entire unpaid balance for the period from the preceding installment date to the current installment date, and is paid with the current installment. In making such a computation, proper adjustment shall be made for any advance payments made during the period, whether the advance payments are voluntary or are brought about by the operation of section 6166(h)(2). In computing the annual interest payment, the portion of any deficiency which is prorated to installments the date for payment of which has not arrived shall be added to the unpaid balance at the beginning of the annual period during which the assessment of the deficiency occurs. Interest on such portion of the deficiency for the period from the original due date of the tax to the date fixed for the payment of the last installment preceding the date of assessment of a deficiency shall be paid upon notice and demand from the district director. Any extension of time under section 6161(a)(2) (on account of undue hardship to the estate) for payment of an installment will not extend the time for payment of the interest which is due on the installment date.

(g) *Extensions of time for payment in hardship cases.* The provisions of section 6161, under which extensions of time may be granted for payment of estate tax in cases involving undue hardship, apply to both the portion of the tax which may be paid in installments

under section 6166 and the portion of the tax which is not so payable. Therefore, in a case involving undue hardship, the executor may elect under section 6166 to pay in installments the portion of the tax which is attributable to the interest in the closely held business and, in addition, may file an application under section 6161 for an extension of time to pay both the portion of the tax which is not attributable to the interest in the closely held business and such of the installments as are payable within the period of the requested extension. If an executor files a notice of election to pay the tax in installments and thereafter it is determined that the estate does not qualify for the privilege of paying the tax in installments, the executor is not deprived of the right to request an extension under section 6161 of time for payment of the tax to which the purported election applied. See § 20.6161–1 for the circumstances under which a timely filed election to pay the tax in installments will be treated as a timely filed application for an extension of time to pay the tax on account of undue hardship to the estate.

(h) *Prepayments.* Voluntary prepayment may be made at any time of all, or of any part, of the unpaid portion of the tax (including deficiencies) payable in installments. Voluntary prepayments shall be applied in payment of such installments, installment, or part of an installment as the person making the prepayment shall designate. For purposes of this paragraph, a payment described in paragraph (d) (2) of § 20.6166–3 of tax in an amount not less than the amount of money or other property distributed in a section 303 redemption is considered to be a voluntary prepayment to the extent paid before the date prescribed for payment of the first installment after the redemption or, if paid on the date prescribed for payment of such installment, to the extent it exceeds the amount due on the installment. See paragraph (b)(3) of § 20.6166–3 for the application to be made of the prepayment required by section 6166(h)(2).

[T.D. 6522, 25 FR 13886, Dec. 29, 1960, as amended by T.D. 7238, 37 FR 28724, Dec. 29, 1972; T.D. 7384, 40 FR 49323, Oct. 22, 1975. Redesignated by T.D. 7710, 45 FR 50745, July 31, 1980]

### § 20.6166A–2 Definition of an interest in a closely held business.

(a) *In general.* For purposes of §§ 20.6166–1, 20.6166–3, and 20.6166–4, the term ''interest in a closely held business'' means:

(1) An interest as a proprietor in a trade or business carried on as a proprietorship.

(2) An interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest in the partnership is included in determining the decedent's gross estate or if the partnership had 10 or less partners.

(3) Stock in a corporation carrying on a trade or business if 20 percent or more in value of the voting stock of the corporation is included in determining the decedent's gross estate or if the corporation had 10 or less shareholders.

(b) *Number of partners or shareholders.* The number of partners of the partnership or shareholders of the corporation is determined as of the time immediately before the decedent's death. Where an interest in a partnership, or stock in a corporation, is the community property of husband and wife, both the husband and the wife are counted as partners or shareholders in arriving at the number of partners or shareholders. Similarly, if stock is held by co-owners, tenants in common, tenants by the entirety, or joint tenants, each co-owner, tenant in common, tenant by the entirety, or joint tenant is counted as a shareholder.

(c) *Carrying on a trade or business.* (1) In order for the interest in a partnership or the stock of a corporation to qualify as an interest in a closely held business it is necessary that the partnership or the corporation be engaged in carrying on a trade or business at

the time of the decedent's death. However, it is not necessary that all the assets of the partnership or the corporation be utilized in the carrying on of the trade or business.

(2) In the case of a trade or business carried on as a proprietorship, the interest in the closely held business includes only those assets of the decedent which were actually utilized by him in the trade or business. Thus, if a building was used by the decedent in part as a personal residence and in part for the carrying on of a mercantile business, the part of the building used as a residence does not form any part of the interest in the closely held business. Whether an asset will be considered as used in the trade or business will depend on the facts and circumstances of the particular case, for example, if a bank account was held by the decedent in his individual name (as distinguished from the trade or business name) and it can be clearly shown that the amount on deposit represents working capital of the business as well as nonbusiness funds (e.g., receipts from investments, such as dividends and interest), then that part of the amount on deposit which represents working capital of the business will constitute a part of the interest in the closely held business. On the other hand, if a bank account is held by the decedent in the trade or business name and it can be shown that the amount represents nonbusiness funds as well as working capital, then only that part of the amount on deposit which represents working capital of the business will constitute a part of the interest in the closely held business. In a case where an interest in a partnership or stock of a corporation qualifies as an interest in a closely held business, the decedent's entire interest in the partnership, or the decedent's entire holding of stock in the corporation, constitutes an interest in a closely held business even though a portion of the partnership or corporate assets is used for a purpose other than the carrying on of a trade or business.

(d) *Interests in two or more closely held businesses.* For purpose of paragraphs (a) and (b) of § 20.6166–1 and paragraphs (d) and (e) of § 20.6166–3, interests in two or more closely held businesses shall be treated as an interest in a single closely held business if more than 50 percent of the total value of each such business is included in determining the value of the decedent's gross estate. For the purpose of the 50 percent requirement set forth in the preceding sentence, an interest in a closely held business which represents the surviving spouse's interest in community property shall be considered as having been included in determining the value of the decedent's gross estate.

[T.D. 6522, 25 FR 13888, Dec. 29, 1960. Redesignated by T.D. 7710, 45 FR 50745, July 31, 1980]

### § 20.6166A–3 Acceleration of payment.

(a) *In general.* Under the circumstances described in this section all or a part of the tax which the executor has elected to pay in installments shall be paid before the dates fixed for payment of the installments. Upon an estate's having undistributed net income described in paragraph (b) of this section for any taxable year after its fourth taxable year, the executor shall pay an amount equal to such undistributed net income in liquidation of the unpaid portion of the tax payable in installments. Upon the happening of any of the events described in paragraphs (c), (d), and (e) of this section, any unpaid portion of the tax payable in installments shall be paid upon notice and demand from the district director.

(b) *Undistributed net income of estate.* (1) If an estate has undistributed net income for any taxable year after its fourth taxable year, the executor shall pay an amount equal to such undistributed net income in liquidation of the unpaid portion of the tax payable in installments. The amount shall be paid to the district director on or before the time prescribed for the filing of the estate's income tax return for such taxable year. For this purpose extensions of time granted for the filing of the income tax return are taken into consideration in determining the time prescribed for filing the return and making such payment. In determining the number of taxable years, a short taxable year is counted as if it were a full taxable year.

(2) The term ''undistributed net income'' of the estate for any taxable

year for purposes of this section is the amount by which the distributable net income of the estate, as defined in section 643, exceeds the sum of—

(i) The amount for such year specified in section 661(a) (1) and (2),

(ii) The amount of the Federal income tax imposed on the estate for such taxable year under Chapter I of the Code, and

(iii) The amount of the Federal estate tax, including interest thereon, paid for the estate during such taxable year (other than any amount paid by reason of the application of this acceleration rule).

(3) The payment described in subparagraph (1) of this paragraph shall be applied against the total unpaid portion of the tax which the executor elected to pay in installments, and shall be divided equally among the installments due after the date of such payment. The application of this subparagraph may be illustrated by the following example:

*Example.* The decedent died on January 1, 1959. The executor elects under section 6166 to pay tax in the amount of $100,000 in 10 installments of $10,000. The first installment is due on April 1, 1960. The estate files its income tax returns on a calendar year basis. For its fifth taxable year (calendar year 1963) it has undistributed net income of $6,000. If the prepayment of $6,000 required by section 6166(h)(2)(A), and due on or before April 15, 1964, is paid before the fifth installment (due April 1, 1964), the $6,000 is apportioned equally among installments 5 through 10, leaving $9,000 as the amount due on each of such installments. However, if the prepayment of $6,000 is paid after the fifth installment, it is apportioned equally among installments 6 through 10, leaving $8,800 as the amount due on each of such installments.

(c) *Failure to pay installment on or before due date.* If any installment of tax is not paid on or before the date fixed for its payment (including any extension of time for the payment thereof), the whole of the unpaid portion of the tax which is payable in installments becomes due and shall be paid upon notice and demand from the district director. See paragraph (c) of § 20.6166–1 for the dates fixed for the payment of installments. See also § 20.6161–1 for the circumstances under which an extension of time for the payment of an installment will be granted.

(d) *Withdrawal of funds from business.* (1) In any case where money or other property is withdrawn from the trade or business and the aggregate withdrawals of money or other property equal or exceed 50 percent of the value of the trade or business, the privilege of paying the tax in installments terminates and the whole of the unpaid portion of the tax which is payable in installments becomes due and shall be paid upon notice and demand from the district director. The withdrawals of money or other property from the trade or business must be in connection with the interest therein included in the gross estate, and must equal or exceed 50 percent of the value of the entire trade or business (and not just 50 percent of the value of the interest therein included in the gross estate). The withdrawal must be a withdrawal of money or other property which constitutes ''included property'' within the meaning of that term as used in paragraph (d) of § 20.2032–1. The provisions of this section do not apply to the withdrawal of money or other property which constitutes ''excluded property'' within the meaning of that term as used in such paragraph (d).

(2) If a distribution in redemption of stock is (by reason of the provisions of section 303 or so much of section 304 as relates to section 303) treated for income tax purposes as a distribution in full payment in exchange for the stock so redeemed, the amount of such distribution is not counted as a withdrawal of money or other property made with respect to the decedent's interest in the trade or business for purposes of determining whether the withdrawals of money or other property made with respect to the decedent's interest in the trade or business equal or exceed 50 percent of the value of the trade or business. However, in the case described in the preceding sentence the value of the trade or business for purposes of applying the rule set forth in subparagraph (1) of this paragraph is the value thereof reduced by the proportionate part thereof which such distribution represents. The proportionate part of the value of the trade or business which the distribution represents is determined at the time of the distribution, but the reduction in the

value of the trade or business represented by it relates back to the time of the decedent's death, or the alternate valuation date if an election is made under section 2032, for purposes of determining whether other withdrawals with respect to the decedent's interest in the trade or business constitute withdrawals equaling or exceeding 50 percent of the value of the trade or business. See example (3) of paragraph (e)(6) of this section for illustration of this principle. The rule stated in the first sentence of this subparagraph does not apply unless after the redemption, but on or before the date prescribed for payment of the first installment which becomes due after the redemption, there is paid an amount of estate tax not less than the amount of money or other property distributed. Where there are a series of section 303 redemptions, each redemption is treated separately and the failure of one redemption to qualify under the rule stated in the first sentence of this subparagraph does not necessarily mean that another redemption will not qualify.

(3) The application of this paragraph may be illustrated by the following examples, in each of which the executor elected to pay the estate tax in installments:

*Example (1).* A, who died on July 1, 1957, owned an 80 percent interest in a partnership which qualified as an interest in a closely held business. B owned the other 20 percent interest in the partnership. On the date of A's death the value of the business was $200,000 and the value of A's interest therein was included in his gross estate at $160,000. On October 1, 1958, when the value of the business was the same as at A's death, the executor withdrew $80,000 from the business. On December 1, 1958, when the value of the remaining portion of the business was $160,000, the executor withdrew $20,000 from the business and B withdrew $10,000. On February 1, 1959, when the value of the then remaining portion of the business was $150,000 the executor withdrew $15,000. The withdrawals of money or other property from the trade or business with respect to the interest therein included in the gross estate are considered as not having equaled or exceeded 50 percent of the value of the trade or business until February 1, 1959. The executor is considered as having withdrawn 40 percent of the value of the trade or business on October 1, 1958, computed as follows:

$80,000 (withdrawal) ÷ $200,000 (value of trade or business at time of withdrawal) × 100 percent = 40 percent

Immediately following the October withdrawal the remaining portion of the business represents 60 percent of the value of the trade or business in existence at the time of A's death (100 percent less 40 percent withdrawn). The executor is considered as having withdrawn 7.5 percent of the value of the trade or business on December 1, 1958, and B as having withdrawn 3.75 percent of the value thereof at that time, computed as follows:

Executor's withdrawal—

$20,000 (withdrawal) ÷ $160,000 (value of trade or business at time of withdrawal) × 60 percent = 7.5 percent

B's withdrawal—

$10,000 (withdrawal) ÷ $160,000 (value of trade or business at time of withdrawal) × 60 percent = 3.75 percent

Immediately following the December withdrawal the then remaining portion of the business represented 48.75 percent of the value of the trade or business in existence at the time of A's death (100 percent less 40 percent withdrawn by executor in October, 7.5 percent withdrawn by executor in December, and 3.75 percent withdrawn by B in December). It should be noted that while at this point the total withdrawals by the executor and B from the trade or business exceed 50 percent of the value thereof, the aggregate of the withdrawals by the executor were less than 50 percent of the value of the trade or business. Also it should be noted that while the total withdrawals by the executor exceeded 50 percent of the value of A's interest in the trade or business, they did not exceed 50 percent of the value of the entire trade or business. The executor is considered as having withdrawn 4.875 percent of the value of the trade or business on February 1, 1959, computed as follows:

$15,000 (withdrawal) ÷ $150,000 (value of trade or business at time of withdrawal) × 48.75 percent = 4.875 percent

As of February 1, 1959, the total withdrawals from the trade or business made with respect to A's interest therein was 52.375 percent of the value of the trade or business.

*Example (2).* The decedent's 40-percent interest in the XYZ partnership constituted an interest in a closely held business. Since the decedent's interest in the closely held business amounted to less than 50 percent of the value of the business, money or other property equaling or exceeding 50 percent of the value of the business could not be withdrawn from the decedent's interest in the business. Therefore, withdrawals of money or other property from this trade or business never would accelerate the payment of the tax under the provisions of this paragraph.

*Example (3).* The decedent died on September 1, 1957. He owned 100 shares of B Corporation (the total number of shares outstanding at the time of his death) and a 75 percent interest in a partnership of which C was the other partner. The B Corporation stock and the interest in the partnership together make up the interest in the closely held business which was included in the decedent's gross estate. The B Corporation stock was included in the gross estate at a value of $400,000 and the interest in the partnership was included at a value of $300,000. On November 1, 1957, at which time the value of the corporation's assets had not changed, in a section 303 redemption the executor surrendered 26 shares of B Corporation stock for $104,000. On December 1, 1957, at which time the value of the partnership's assets had not changed, the partners withdrew 90 percent of the assets of the partnership, with the executor receiving $270,000 and C receiving $90,000. The estate tax amounts to $240,000, of which the executor elected under section 6166 to pay $140,000 in 10 installments of $14,000 each. On December 1, 1958, the due date for paying the estate tax which was not payable in installments and for paying the first installment under section 6166, the executor paid estate tax of $114,000, of which $100,000 represented the tax not payable in installments and $14,000 represented the first installment. Inasmuch as after the section 303 distribution and on or before the due date of the first installment (December 1, 1958) after the section 303 distribution the executor paid as estate tax an amount not less than the amount of the distribution, the section 303 distribution does not constitute a withdrawal of money or other property from the business for purposes of section 6166(h)(1). Therefore, the value of the trade or business is reduced by the amount of the section 303 distribution. Accordingly, the value of the entire trade or business is $696,000, of which $400,000 represents the value of the partnership and $296,000 represents the value of the B Corporation stock. Since the executor is considered as having withdrawn only $270,000 (the withdrawal from the partnership) from the trade or business, the withdrawal of money or other property from the trade or business made with respect to the decedent's interest therein was 270,000/696,000 of the value of the entire trade or business, or less than 50 percent thereof.

(e) *Disposition of interest in business.* (1) In any case where in the aggregate 50 percent or more of the decedent's interest in a closely held business has been distributed, sold, exchanged, or otherwise disposed of, the privilege of paying the tax in installments terminates and the whole of the unpaid portion of the tax which is payable in installments becomes due and shall be paid upon notice and demand from the district director. A transfer by the executor of an interest in the closely held business to a beneficiary or trustee named in the decedent's will or to an heir who is entitled to receive it under the applicable intestacy law does not constitute a distribution thereof for purposes of determining whether 50 percent or more of an interest in a closely held business has been distributed, sold, exchanged, or otherwise disposed of. However, a subsequent transfer of the interest by the beneficiary, trustee, or heir will constitute a distribution, sale, exchange, or other disposition thereof for such purposes. The disposition must be a disposition of an interest which constitutes ''included property'' within the meaning of that term as used in paragraph (d) of § 20.2032–1. The provisions of this section do not apply to the disposition of an interest which constitutes ''excluded property'' within the meaning of that term as used in such paragraph (d).

(2) The phrase ''distributed, sold, exchanged, or otherwise disposed of'' comprehends all possible ways by which an interest in a closely held business ceases to form a part of the gross estate. The term includes the surrender of a stock certificate for corporate assets in complete or partial liquidation of a corporation pursuant to section 331. The term also includes the surrender of stock for stock pursuant to a transaction described in subparagraphs (A), (B), or (C) of section 368(a)(1). In general the term does not, however, extend to transactions which are mere changes in form. It does not include a transfer of assets to a corporation in exchange for its stock in a transaction with respect to which no gain or loss would be recognizable for income tax purposes under section 351. It does not include an exchange of stock in a corporation for stock in the same corporation or another corporation pursuant to a plan of reorganization described in subparagraph (D), (E), or (F) of section 368(a)(1), nor to an exchange to which section 355 (or so much of section 356 as relates to section 355) applies. However, any stock received in an exchange to which the

two preceding sentences apply shall for purposes of this paragraph be treated as an interest in a closely held business.

(3) An interest in a closely held business may be ''distributed'' by either a trustee who received it from the executor, or a trustee of an interest which is included in the gross estate under sections 2035 through 2038, or section 2041. See subparagraph (1) of this paragraph relative to the distribution of an interest by the executor to the person entitled to receive it under the decedent's will or an intestacy law.

(4) An interest in a closely held business may be ''sold, exchanged, or otherwise disposed of'' by (i) the executor; (ii) a trustee or other donee to whom the decedent in his lifetime transferred the interest included in his gross estate under section 2035 through 2038, or section 2041; (iii) a beneficiary, trustee, or heir entitled to receive the property from the executor under the decedent's will or under the applicable law of descent and distribution, or to whom title to the interest passed directly under local law; (iv) a surviving joint tenant or tenant by the entirety; or (v) any other person.

(5) If a distribution in redemption of stock is (by reason of the provisions of section 303 or so much of section 304 as relates to section 303) treated for income tax purposes as a distribution in full payment in exchange for the stock redeemed, the stock so redeemed is not counted as distributed, sold, exchanged, or otherwise disposed of for purposes of determining whether 50 percent or more of the decedent's interest in a closely held business has been distributed, sold, exchanged, or otherwise disposed of. However, in the case described in the preceding sentence the interest in the closely held business for purposes of applying the rule set forth in subparagraph (1) of this paragraph is such interest reduced by the proportionate part thereof which the redeemed stock represents. The proportionate part of the interest which the redeemed stock represents is determined at the time of the redemption, but the reduction in the interest represented by it relates back to the time of the decedent's death, or the alternate valuation date if an election is made under section 2032, for purposes of determining whether other distributions, sales, exchanges, and dispositions of the decedent's interest in the closely held business equal or exceed in the aggregate 50 percent of such interest. See example (3) of subparagraph (6) of this paragraph for illustration of this principle. The rule stated in the first sentence of this subparagraph does not apply unless after the redemption, but on or before the date prescribed for payment of the first installment which becomes due after the redemption, there is paid an amount of estate tax not less than the amount of money or other property distributed. Where there are a series of section 303 redemptions, each redemption is treated separately and the failure of one redemption to qualify under the rule stated in the first sentence of this subparagraph does not necessarily mean that another redemption will not qualify.

(6) The application of this paragraph may be illustrated by the following examples, in each of which the executor elected to pay the tax in installments:

*Example (1).* The decedent died on October 1, 1957. He owned 8,000 of the 12,000 shares of D Corporation outstanding at the time of his death and 3,000 of the 5,000 shares of E Corporation outstanding at that time. The D Corporation stock was included in the gross estate at $50 per share, or a total of $400,000. The E Corporation stock was included in the gross estate at $100 per share, or a total of $300,000. On November 1, 1958, the executor sold the 3,000 shares of E Corporation and on February 1, 1959, he sold 1,000 shares of D Corporation. Since the decedent's shares of D Corporation and E Corporation together constituted the interest in a closely held business, the value of such interest was $700,000 ($400,000 plus $300,000) and the D Corporation stock represented 400,000/700,000 thereof and the E Corporation stock represented 300,000/700,000 thereof. While the sale of 3,000 shares of E Corporation on November 1, 1958, was a sale of the decedent's entire interest in E Corporation and a sale of more than 50 percent of the outstanding stock of E Corporation, nevertheless it constituted a sale of only 300,000/700,000 of the interest in the closely held business. The sale of 1,000 shares of D Corporation stock on February 1, 1959, represented a sale of 50,000/700,000 of the interest in the closely held business. The numerator of $50,000 is determined as follows:

1,000 (shares sold) ÷ 8,000 (shares owned) × $400,000 (value of shares owned, as included in gross estate)

Taken together the two sales represented a sale of 50 percent (350,000/700,000) of the interest in the closely held business. Therefore, as of February 1, 1959 (the date of the sale of 1,000 shares of E Corporation), 50 percent or more in value of the interest in the closely held business is considered as distributed, sold, exchanged, or otherwise disposed of.

*Example (2).* The decedent died on September 1, 1958. The interest owned by him in a closely held business consisted of 100 shares of the M Corporation. On February 1, 1959, in a section 303 redemption, 20 shares were redeemed for cash and an amount equivalent to the proceeds was paid on the Federal estate tax before the date of the next installment. On July 1, 1959, the executor sold 40 of the remaining shares of the stock. The section 303 redemption is not considered to be a distribution, sale, exchange, or other disposition of the portion of the interest represented by the 20 shares redeemed. As a result of the section 303 redemption the remaining 80 shares represent the decedent's entire interest in the closely held business for purposes of determining whether in the aggregate 50 percent or more of the interest in the closely held business has been distributed, sold, exchanged, or otherwise disposed of. The sale on July 1, 1959, of the 40 shares represents a sale of 50 percent of the interest in the closely held business.

*Example (3).* The facts are the same as in example (2) except that the 40 shares were sold on December 1, 1958 (before the section 303 redemption was made) instead of on July 1, 1959 (after the section 303 redemption was made). The sale of the 40 shares in December represents, as of that date, a sale of 40 percent of the interest in the closely held business. However, the section 303 redemption of 20 shares does not count as a distribution, sale, exchange, or other disposition of the interest, but it does reduce the interest to 80 shares (100 shares less 20 shares redeemed) for purposes of determining whether other distributions, sales, exchanges, and dispositions in the aggregate equal or exceed 50 percent of the interest in the closely held business. Since the reduction of the interest to 80 shares relates back to the time of the decedent's death, or the alternate valuation date if an election is made under section 2032, the sale of the 40 shares, as recomputed represents a sale of 50 percent of the interest. However, since the sale of the 40 shares did not represent a sale of 50 percent of the interest until the section 303 distribution was made, February 1, 1959 (the date of the section 303 distribution) is considered the date on which 50 percent of the interest was distributed, sold, exchanged, or otherwise disposed of.

(f) *Information to be furnished by executor.* (1) If the executor acquires knowledge of the happening of any transaction described in paragraph (d) or (e) of this section which, in his opinion, standing alone or when taken together with other transactions of which he has knowledge, would result in—

(i) Aggregate withdrawals of money or other property from the trade or business equal to or exceeding 50 percent of the value of the entire trade or business, or

(ii) Aggregate distributions, sales, exchanges, and other dispositions equal to or exceeding 50 percent of the interest in the closely held business which was included in the gross estate, the executor shall so notify the district director, in writing, within 30 days of acquiring such knowledge.

(2) On the date fixed for payment of each installment of tax (determined without regard to any extension of time for the payment thereof), other than the final installment, the executor shall furnish the district director, in writing, with either—

(i) A complete disclosure of all transactions described in paragraphs (d) and (e) of this section of which he has knowledge and which have not previously been made known by him to the district director, or

(ii) A statement that to the best knowledge of the executor all transactions described in paragraphs (d) and (e) of this section which have occurred have not produced a result described in subparagraph (1) (i) or (ii) of this paragraph.

(3) The district director may require the submission of such additional information as is deemed necessary to establish the estate's right to continue payment of the tax in installments.

[T.D. 6522, 25 FR 13888, Dec. 29, 1960. Redesignated by T.D. 7710, 45 FR 50745, July 31, 1980]

### § 20.6166A–4 Special rules applicable where due date of return was before September 3, 1958.

(a) *In general.* Section 206(f) of the Small Business Tax Revision Act of 1958 (72 Stat. 1685) provides that section 6166(i) of the Code shall apply in cases where the decedent died after August 16, 1954, but only if the date for filing

the estate tax return (including extensions thereof) expired before September 3, 1958. Therefore, the privilege of paying the estate tax in installments as described in §§ 20.6166–1 through 20.6166–3 is available also in cases where the due date of the return is before September 3, 1958, but under somewhat different circumstances. These differences are explained in paragraphs (b) through (e) of this section. Therefore except as otherwise provided in paragraphs (b) through (e) of this section, the regulations contained in §§ 20.6166–1 through 20.6166–3 apply also in cases where the due date of the return is before September 3, 1958. See § 20–6075–1 for the due date of the return. The value of the gross estate as determined for purposes of a deficiency in tax assessed after September 2, 1958, and the value at which the interest in the closely held business, to which the election applies, is included in such value of the gross estate are used in ascertaining whether an estate coming within the purview of section 6166(i) and this section satisfies the percentage requirements as to qualification set forth in section 6166(a).

(b) *Tax to which election applies.* In a case where the due date of the return was before September 3, 1958, an election to pay estate tax in installments does not apply to the tax shown on the return nor to a deficiency in tax assessed before that date. It does apply to a deficiency in tax assessed after September 2, 1958, unless the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax. The amount of the deficiency which may be paid in installments shall not exceed that proportion of the total tax (including the deficiency) which is determined by applying thereto the ratio set forth in paragraph (b) of § 20.6166–1. See paragraph (c) of this section for the method of prorating the deficiency to the installments.

(c) *Proration of deficiency to installments.* The deficiency in tax which may be paid in installments is prorated to the installments which would have been due if the provisions of section 6166(a) had applied to the tax shown on the return and if an election had been timely made at the time the estate tax return was filed. The part of the deficiency so prorated to any installment the date for payment of which would have arrived before the election is made shall be paid at the time the election is made. The portion of the deficiency so prorated to installments the date for payment of which would not have arrived before the election is made shall be paid at the time such installments would have been due if such an election had been made.

(d) *Notice of election.* The notice of election to pay the deficiency in installments shall be filed with the district director not later than 60 days after issuance of notice and demand by the district director for payment of the deficiency. The number of installments in which the executor elects to pay the deficiency includes those installments the dates for payment of which would have arrived within the meaning of paragraph (c) of this section. See paragraph (e)(2) of § 20.6166–1 for further information relative to the notice of election.

(e) *Undistributed income of estate.* In any case where the due date of the estate tax return was before September 3, 1958, the provisions of paragraph (b) of § 20.6166–3 (providing for acceleration of payment of estate tax by amount of estate's undistributed net income for any taxable year after its fourth taxable year) shall not apply with respect to the estate's undistributed net income for any taxable year ending before January 1, 1960.

[T.D. 6522, 25 FR 13891, Dec. 29, 1960. Redesignated by T.D. 7710, 45 FR 50745, July 31, 1980]

### § 20.6314–1 Duplicate receipts for payment of estate taxes.

The internal revenue officer with whom the estate tax return is filed will, upon request, give to the person paying the tax duplicate receipts, either of which will be sufficient evidence of such payment and entitle the executor to be credited with the amount by any court having jurisdiction to audit or settle his accounts.

[T.D. 7238, 37 FR 28724, Dec. 29, 1972]

### § 20.6321 Statutory provisions; lien for taxes.

SEC. 6321. *Lien for taxes.* If any person liable to pay any tax neglects or refuses to pay the

same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

### § 20.6321–1 Lien for taxes.

For regulations concerning the lien for taxes, see § 301.6321–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 7710, 45 FR 50747, July 31, 1980]

### § 20.6323–1 Validity and priority against certain persons.

For regulations concerning the validity of the lien imposed by section 6321 against certain persons, see §§ 301.6323(a)–1 through 301.6323(i)–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 7429, 41 FR 35495, Aug. 23, 1976]

### § 20.6324–1 Special lien for estate tax.

For regulations concerning the special lien for the estate tax, see § 301.6324–1 of this chapter (Regulations on Procedure and Administration).

### § 20.6324A–1 Special lien for estate tax deferred under section 6166 or 6166A.

(a) *In general.* If the executor of an estate of a decedent dying after December 31, 1976, makes an election under section 6166 or 6166A (as in effect prior to its repeal by the Economic Recovery Tax Act of 1981) to defer the payment of estate tax, the executor may make an election under section 6324A. An election under section 6324A will cause a lien in favor of the United States to attach to the estate's section 6166 lien property, as defined in paragraph (b)(1) of this section. This lien is in lieu of the bonds required by sections 2204 and 6165 and in lieu of any lien under section 6324 on the same property with respect to the same estate. The value of the property which the district director may require under section 6324A as section 6166 lien property may not exceed the sum of the deferred amount (as defined in paragraph (e)(1) of this section) and the required interest amount (as defined in paragraph (e)(2) of this section). The unpaid portion of the deferred amount (plus any unpaid interest, additional amount, addition to tax, assessable penalty, and cost attributable to the deferred amount) shall be a lien in favor of the United States on the section 6166 lien property. See § 301.6324A–1 of this chapter (Regulations on Procedure and Administration) for provisions relating to the election of and agreement to the special lien for estate tax deferred under section 6166 or 6166A (as in effect prior to its repeal by the Economic Recovery Tax Act of 1981).

(b) *Section 6166 lien property*—(1) *In general.* Section 6166 lien property consists of those interests in real and personal property designated in the agreement referred to in section 6324A (c) (see paragraph (b) of § 301.6324A–1 of this chapter). An interest in property may be designated as section 6166 lien property only to the extent such interest can be expected to survive the deferral period (as defined in paragraph (e)(3) of this section). Property designated, however, need not be property included in the decedent's estate.

(2) *Maximum value of required property.* The fair market value of the property required by the district director to be designated as section 6166 lien property with respect to any estate shall not be greater than the sum of the deferred amount and the required interest amount, as these terms are defined in paragraphs (e) (1) and (2) of this section. However, the parties to the agreement referred to in section 6324A (c) may voluntarily designate property having a fair market value in excess of that sum. The fair market value of the section 6166 lien property shall be determined as of the date prescribed in section 6151(a) (without regard to any extension) for payment of the estate tax. Such value must take into account any encumbrance on the property (such as a mortgage or a lien under section 6324B).

(3) *Additional lien property may be required.* If, at any time, the unpaid portion of the deferred amount and the required interest amount exceeds the fair market value of the section 6166 lien property, the district director may require the addition of property to the

agreement in an amount up to such excess. When additional property is required, the district director shall make notice and demand upon the agent designated in the agreement setting forth the amount of additional property required. Property having the required value (or other security equal to the required value must be added to the agreement within 90 days after notice and demand from the district director. Failure to comply with the demand within the 90-day period shall be treated as an act accelerating payment of installments under section 6166(g) or 6166A(h) (as in effect prior to its repeal by the Economic Recovery Tax Act of 1981).

(4) *Partial substitution of bond.* See paragraph (c) of § 301.6324A–1 of this chapter for rules relating to the partial substitution of a bond for the lien where the value of property designated as section 6166 lien property is less than the amount of unpaid estate tax plus interest.

(c) *Special rules*—(1) *Period of lien.* The lien under section 6324A arises at the earlier of the date—

(i) The executor is discharged from liability under section 2204; or

(ii) Notice of lien is filed in accordance with § 301.6323(f)–1 of this chapter.

The section 6324A lien continues until the liability for the deterred amount is satisfied or becomes unenforceable by reason of lapse of time. The provisions of § 301.6325–1(c), relating to release of lien or discharge of property, shall apply to this paragraph (c)(1).

(2) *Requirement that lien be filed.* The lien imposed by section 6324A is not valid against a purchaser (as defined in paragraph (f) of § 301.6323(h)–1), holder of a security interest (as defined in paragraph (a) of § 301.6323(h)–1), mechanic's lienor (as defined in paragraph (b) of § 301.6323(h)–1), or judgment lien creditor (as defined in paragraph (g) of § 301.6323(h)–1) until notice of the lien is filed. Once filed, the notice of lien remains effective without being refiled.

(3) *Priorities.* Although a notice of lien under section 6324A had been properly filed, that lien is not valid—

(i) To the extent provided in section 6323(b)(6), relating to real property tax and special assessment liens, regardless of whether such liens came into existence before or after the filing of the notice of Federal tax lien;

(ii) In the case of any real property subject to a lien for repair or improvement, as against a mechanic's lienor, whether or not such lien came into existence before or after the notice of tax lien was filed; and

(iii) As against any security interest set forth in section 6323(c)(3), relating to real property construction or improvement financing agreements, regardless whether such security interest came into existence before or after filing of the notice of tax lien.

However, paragraphs (c)(3) (ii) and (iii) of this section shall not apply to any security interest that came into existence after the date of filing of notice (in a manner similar to a notice filed under section 6323(f)) that payment of the deferred amount has been accelerated under section 6166(g) or 6166A(h) (as in effect prior to its repeal by the Economic Recovery Tax Act of 1981).

(d) *Release or discharge of lien.* For rules relating to release of the lien imposed by section 6324A or discharge of the section 6166 lien property, see section 6325 and § 301.6325–1 of this chapter.

(e) *Definitions.* For purposes of section 6324A of this section—

(1) *Deferred amount.* The deferred amount is the aggregate amount of estate tax deferred under section 6166 or 6166A (as in effect prior to its repeal by the Economic Recovery Tax Act of 1981) determined as of the date prescribed by section 6151(a) for payment of the estate tax.

(2) *Required interest amount.* The required interest amount is the aggregate amount of interest payable over the first four years of the deferral period. For purposes of computing the required interest amount, the interest rate prescribed by section 6621 in effect on the date prescribed by section 6151(a) for payment of the estate tax shall be used for computing the interest for the first four years of the deferral period. The 4-percent interest rate prescribed by section 6601(j) shall apply to the extent provided in that section. For purposes of computing interest during deferral periods beginning after December 31, 1982, interest shall be compounded daily.

(3) *Deferral period.* The deferral period is the period for which the payment of tax is deferred pursuant to the election under section 6166 or 6166A (as in effect prior to its repeal by the Economic Recovery Tax Act of 1981).

(4) *Application of definitions.* In the case of a deficiency, a separate deferred amount, required interest amount, and deferral period shall be determined as of the due date of the first installment after the deficiency is prorated to installments under section 6166 or 6166A (as in effect prior to its repeal by the Economic Recovery Tax Act of 1981).

[T.D. 7941, 49 FR 4468, Feb. 7, 1984]

### § 20.6324B–1 Special lien for additional estate tax attributable to farm, etc., valuation.

(a) *General rule.* In the case of an estate of a decedent dying after December 31, 1976, which includes any interest in qualified real property, if the executor elects to value part or all of such property pursuant to section 2032A, a lien arises in favor of the United States on the property to which the election applies. The lien is in the amount equal to the adjusted tax difference attributable to such interest (as defined by section 2032A(c)(2)(B)). The term ''qualified real property'' means qualified real property as defined in section 2032A(b), qualified replacement property within the meaning of section 2032A(h)(3)(B), and qualified exchange property within the meaning of section 2032A(i)(3). The rules set forth in the regulations under section 2032A shall apply in determining whether this section is applicable to otherwise qualified real property held by a partnership, corporation or trust.

(b) *Period of lien.* The lien shall arise at the time the executor files an election under section 2032A. It shall remain in effect until one of the following occurs:

(1) The liability for the additional estate tax under section 2032A(c) with respect to such interest has been satisfied; or

(2) Such liability has become unenforceable by reason of lapse of time; or

(3) The district director is satisfied that no further liability for additional estate tax with respect to such interest may arise under section 2032A(c), i.e., the required time period has elapsed since the decedent's death without the occurrence of an event described in section 2032A(c)(1), or the qualified heir (as defined in section 2032A(e)(1)) had died.

For procedures regarding the release or subordination of liens or discharge of property from liens, see § 301.6325–1 of this chapter (Regulations on Procedure and Administration).

(c) *Substitution of security for lien.* The district director may, upon written application of the qualified heir (as defined in section 2032A(e) (1)) acquiring any interest in qualified real property to which a lien imposed by section 6324B attaches, issue a certificate of discharge of any or all property subject to such lien, after receiving a bond or other security in an amount or value determined by the district director as sufficient security for the maximum potential liability for additional estate tax with respect to such interest. Any bond shall be in the form and with the security prescribed in § 301.7101–1 of this chapter.

(d) *Special rules.* The rules set forth in section 6324A(d) (1), (3), and (4), and the regulations thereunder, shall apply with respect to a lien imposed by section 6324B as if it were a lien imposed by section 6324A.

[T.D. 7847, 47 FR 50856, Nov. 10, 1982]

### § 20.6325–1 Release of lien or partial discharge of property; transfer certificates in nonresident estates.

(a) A transfer certificate is a certificate permitting the transfer of property of a nonresident decedent without liability. Except as provided in paragraph (b) of this section, no domestic corporation or its transfer agent should transfer stock registered in the name of a non-resident decedent (regardless of citizenship) except such shares which have been submitted for transfer by a duly qualified executor or administrator who has been appointed and is acting in the United States, without first requiring a transfer certificate covering all of the decedent's stock of the corporation and showing that the transfer may be made without liability. Corporations, transfer agents of domestic corporations, transfer agents of foreign corporations (except

as to shares held in the name of a nonresident decedent not a citizen of the United States), banks, trust companies, or other custodians in actual or constructive possession of property, of such a decedent can insure avoidance of liability for taxes and penalties only by demanding and receiving transfer certificates before transfer of property of nonresident decedents.

(b)(1) Subject to the provisions of paragraph (b)(2) of this section—

(i) In the case of a nonresident not a citizen of the United States dying on or after January 1, 1977, a transfer certificate is not required with respect to the transfer of any property of the decedent if the value on the date of death of that part of the decedent's gross estate situated in the United States did not exceed the lesser of $60,000 or $60,000 reduced by the adjustments, if any, required by section 6018(a)(4) for certain taxable gifts made by the decedent and for the aggregate amount of certain specific exemptions.

(ii) In the case of a nonresident not a citizen of the United States dying on or after November 14, 1966, a transfer certificate is not required with respect to the transfer before June 24, 1981 of any property of the decedent if the value on the date of death of that part of the decedent's gross estate situated in the United States did not exceed $30,000.

(2)(i) If the transfer of the estate is subject to the tax imposed by section 2107(a) (relating to expatriation to avoid tax), any amounts which are includible in the decedent's gross estate under section 2107(b) must be added to the date of death value of the decedent's gross estate situated in the United States to determine the value on the date of death of the decedent's gross estate for purposes of paragraph (b)(1) of this section.

(ii) If the transfer of the estate is subject to tax pursuant to a Presidential proclamation made under section 2108(a) (relating to Presidential proclamations of the application of pre-1967 estate tax provisions), a transfer certificate is not required with respect to the transfer of any property of the decedent if the value on the date of death of that part of the decedent's gross estate situated in the United States did not exceed $2,000.

(3) A corporation, transfer agent, bank, trust company, or other custodian will not incur liability for a transfer of the decedent's property without a transfer certificate if the corporation or other person, having no information to the contrary, first receives from the executor or other responsible person, who may be reasonably regarded as in possession of the pertinent facts, a statement of the facts relating to the estate showing that the sum of the value on the date of the decedent's death of that part of his gross estate situated in the United States, and, if applicable, any amounts includible in his gross estate under section 2107(b), is such an amount that, pursuant to the provisions of paragraph (b) (1) and (2) of this section, a transfer certificate is not required.

(4) For the determination of the gross estate situated in the United States, see §§ 20.2103–1 and 20.2104–1.

(c) A transfer certificate will be issued by the service center director or the district director when he is satisfied that the tax imposed upon the estate, if any, has been fully discharged or provided for. The tax will be considered fully discharged for purposes of the issuance of a transfer certificate only when investigation has been completed and payment of the tax, including any deficiency finally determined, has been made. If the tax liability has not been fully discharged, transfer certificates may be issued permitting the transfer of particular items of property without liability upon the filing with the district director of such security as he may require. No transfer certificate is required in an estate of a resident decedent. Further, in the case of an estate of a nonresident decedent (regardless of citizenship) a transfer certificate is not required with respect to property which is being administered by an executor or administrator appointed, qualified, and acting within the United States. For additional regulations under section 6325, see § 301.6325–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7296, 38 FR 34201, Dec. 12, 1973; T.D. 7302, 39 FR 796, Jan. 3, 1974; T.D. 7825, 47 FR 35189, Aug. 13, 1982]

### § 20.6601–1 Interest on underpayment, nonpayment, or extensions of time for payment, of tax.

For regulations concerning interest on underpayments, etc., see § 301.6601–1 of this chapter (Regulations on Procedure and Administration).

### § 20.6905–1 Discharge of executor from personal liability for decedent's income and gift taxes.

For regulations concerning the discharge of an executor from personal liability for a decedent's income and gift taxes, see § 301.6905–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 7238, 37 FR 28725, Dec. 29, 1972]

### § 20.7101–1 Form of bonds.

See paragraph (b) of § 20.6165–1 for provisions relating to the bond required in any case in which the payment of the tax attributable to a reversionary or remainder interest has been postponed under the provisions of § 20.6163–1. For further provisions relating to bonds, see § 20.6165–1 of these regulations and the regulations under section 7101 contained in part 301 of this chapter (Regulations on Procedure and Administration).

[T.D. 6600, 27 FR 4987, May 29, 1962]

## GENERAL ACTUARIAL VALUATIONS

SOURCE: Sections 20.7520–1 through 20.7520–4 appear at T.D. 8540, 59 FR 30170, June 10, 1994, unless otherwise noted.

### § 20.7520–1 Valuation of annuities, unitrust interests, interests for life or term of years, and remainder or reversionary interests.

(a) *General actuarial valuations.* (1) Except as otherwise provided in this section and in § 20.7520–3 (relating to exceptions to the use of prescribed tables under certain circumstances), in the case of estates of decedents with valuation dates after April 30, 1989, the fair market value of annuities, interests for life or for a term of years (including unitrust interests), remainders, and reversions is their present value determined under this section. See § 20.2031–7(d) (and, for certain prior periods, § 20.2031–7A) of this chapter for the computation of the value of annuities, unitrust interests, life estates, terms of years, remainders, and reversions, other than interests described in paragraphs (a)(2) and (a)(3) of this section.

(2) In the case of a transfer to a pooled income fund with a valuation date after April 30, 1989, see § 1.642(c)–6(e) (or, for certain prior periods, § 1.642(c)–6A) of this chapter (Income Tax Regulations) with respect to the valuation of the remainder interest.

(3) In the case of a transfer to a charitable remainder annuity trust with a valuation date after April 30, 1989, see § 1.664–2 of this chapter with respect to the valuation of the remainder interest. See § 1.664–4 (or, for certain prior periods, § 1.664–4A) of this chapter with respect to the valuation of the remainder interest in property transferred to a charitable remainder unitrust.

(b) *Components of valuation*—(1) *Interest rate component*—(i) *Section 7520 Interest rate.* The section 7520 interest rate is the rate of return, rounded to the nearest two-tenths of one percent, that is equal to 120 percent of the applicable Federal mid-term rate, compounded annually, for purposes of section 1274(d)(1), for the month in which the valuation date falls. In rounding the rate to the nearest two-tenths of a percent, any rate that is midway between one two-tenths of a percent and another is rounded up to the higher of those two rates. For example, if 120 percent of the applicable Federal mid-term rate is 10.30, the section 7520 interest rate component is 10.4. The section 7520 interest rate is published monthly by the Internal Revenue Service in the Internal Revenue Bulletin (See § 601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Valuation date.* Generally, the valuation date is the date on which the transfer takes place. For estate tax purposes, the valuation date is the date of the decedent's death, unless the executor elects the alternate valuation date in accordance with section 2032, in which event, and under the limitations prescribed in section 2032 and the regulations thereunder, the valuation date is the alternate valuation date. For special rules in the case of charitable transfers, see § 20.7520–2.

(2) *Mortality component.* The mortality component reflects the mortality data most recently available from the United States census. As new mortality data becomes available after each decennial census, the mortality component described in this section will be revised periodically and the revised mortality component tables will be published in the regulations at that time. For decedents' estates with valuation dates after April 30, 1989, the mortality component table (Table 80CNSMT) is included in § 20.2031–7(d)(6). See § 20.2031–7A for mortality component tables applicable to decedent's estates with valuation dates before May 1, 1989.

(c) *Tables.* The present value on the valuation date of an annuity, life estate, term of years, remainder, or reversion is computed by using the section 7520 interest rate component that is described in paragraph (b)(1) of this section and the mortality component that is described in paragraph (b)(2) of this section. Actuarial factors for determining these present values are included in tables in these regulations and in publications by the Internal Revenue Service. If a special factor is required in order to value an interest, the Internal Revenue Service will furnish the factor upon a request for a ruling. The request for a ruling must be accompanied by a recitation of the facts, including the date of birth for each measuring life and copies of relevant instruments. A request for a ruling must comply with the instructions for requesting a ruling published periodically in the Internal Revenue Bulletin (see Rev. Proc. 94–1, 1994–1 I.R.B. 10, and the first Rev. Proc. published each year, and §§ 601.201 and 601.601(d)(2)(ii)(*b*) of this chapter) and include payment of the required user fee.

(1) *Regulation sections containing tables with interest rates between 4.2 and 14 percent.* Section 1.642(c)–6(e)(4) of this chapter contains Table S used for determining the present value of a single life remainder interest in a pooled income fund as defined in § 1.642(c)–5 of this chapter (Income Tax Regulations). Section 1.664–4(e)(6) of this chapter contains Table D (actuarial factors used in determining the present value of a remainder interest postponed for a term of years), Table U(1) (actuarial factors for one life), and Table F (payout factors) used in determining the present value of a remainder interest in a charitable remainder unitrust as defined in § 1.664–3 of this chapter. Section 20.2031–7(d)(6) contains Table S (actuarial factors for one life), Table B (actuarial factors used in determining the present value of an interest for a term of years), Table K (annuity end-of-interval adjustment factors), Table J (term certain annuity beginning-of-interval adjustment factors), and Table 80CNSMT (mortality components) used in determining the present value of annuities, life estates, remainders, and reversions. The regulations will be revised periodically to include new mortality component tables and new tables of factors.

(2) *Internal Revenue Service publications containing tables with interest rates between 2.2 and 26 percent.* The following documents (except for Publication 1459) have been published for sale by the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402:

(i) Internal Revenue Service Publication 1457, ''Actuarial Values, Alpha Volume,'' (8/89). This publication includes tables of valuation factors, as well as examples that show how to compute other valuation factors, for determining the present value of annuities, life estates, terms of years, remainders, and reversions, measured by one or two lives. These factors may also be used in the valuation of interests in a charitable remainder annuity trust as defined in § 1.664–2 of this chapter (Income Tax Regulations) and a pooled income fund as defined in § 1.642(c)–5 of this chapter.

(ii) Internal Revenue Service Publication 1458, ''Actuarial Values, Beta Volume,'' (8/89). This publication includes term certain tables and tables of one and two life valuation factors for determining the present value of remainder interests in a charitable remainder unitrust as defined in § 1.664–3 of this chapter.

(iii) Internal Revenue Service Publication 1459, ''Actuarial Values, Gamma Volume,'' (8–89) is no longer available for purchase from the Superintendent

of Documents. However, it may be obtained by requesting a copy from: CC:DOM:CORP:T:R (IRS Publication 1459), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. This publication includes tables for computing depreciation adjustment factors. See § 1.170A–12 of this chapter (Income Tax Regulations).

(d) *Effective date.* This section is effective as of May 1, 1989.

**§ 20.7520–2 Valuation of charitable interests.**

(a) *In general*—(1) *Valuation.* Except as otherwise provided in this section and in § 20.7520–3 (relating to exceptions to the use of prescribed tables under certain circumstances), the fair market value of annuities, interests for life or for a term of years, remainders, and reversions for which an estate tax charitable deduction is allowable is the present value of such interests determined under § 20.7520–1.

(2) *Prior-month election rule.* If any part of the property interest transferred qualifies for an estate tax charitable deduction under section 2055 or 2106, the executor may compute the present value of the transferred interest by use of the section 7520 interest rate for the month during which the interest is transferred or the section 7520 interest rate for either of the 2 months preceding the month during which the interest is transferred. Paragraph (b) of this section explains how a prior-month election is made. The interest rate for the month so elected is the applicable section 7520 interest rate. If the executor elects the alternate valuation date under section 2032 and also elects to use the section 7520 interest rate for either of the 2 months preceding the month in which the interest is transferred, the month so elected (either of the 2 months preceding the month in which the alternate valuation date falls) is the valuation date. If the actuarial factor for either or both of the 2 months preceding the month during which the interest is transferred is based on a mortality experience that is different from the mortality experience at the date of the transfer and if the executor elects to use the section 7520 rate for a prior month with the different mortality experience, the executor must use the actuarial factor derived from the mortality experience in effect during the month of the section 7520 rate elected. All actuarial computations relating to the transfer must be made by applying the interest rate component and the mortality component of the month elected by the executor.

(3) *Transfers of more than one interest in the same property.* If a decedent's estate includes the transfer of more than one interest in the same property, the executor must, for purposes of valuing the transferred interests, use the same interest rate and mortality components for each interest in the property transferred.

(4) *Information required with tax return.* The following information must be attached to the estate tax return (or be filed subsequently as supplemental information to the return) if the estate claims a charitable deduction for the present value of a temporary or remainder interest in property—

(i) A complete description of the interest that is transferred, including a copy of the instrument of transfer;

(ii) The valuation date of the transfer;

(iii) The names and identification numbers of the beneficiaries of the transferred interest;

(iv) The names and birthdates of any measuring lives, a description of any relevant terminal illness condition of any measuring life, and (if applicable) an explanation of how any terminal illness condition was taken into account in valuing the interest; and

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

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

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

election information within 24 months after the later of the date the original estate tax return was filed or the due date for filing the return.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(C) An *ordinary remainder or reversionary interest* is the right to receive an interest in property at the end of one or more measuring lives or some

other defined period. A standard section 7520 remainder factor for an ordinary remainder or reversionary interest represents the present worth of the right to receive $1.00 at the end of a defined period, using the interest rate prescribed under section 7520 for the appropriate month.

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

(iii) *Other beneficial interests.* If, under the provisions of this paragraph (b), the interest rate and mortality components prescribed under section 7520 are not applicable in determining the value of any annuity, income, remainder, or reversionary interest, the actual fair market value of the interest (determined without regard to section 7520) is based on all of the facts and circumstances if and to the extent permitted by the Internal Revenue Code provision applicable to the property interest.

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

(ii) *Income and similar interests*—(A) *Beneficial enjoyment.* A standard section 7520 income factor for an ordinary income interest may not be used to determine the present value of an income or similar interest in trust for a term of years, or for the life of one or more individuals, unless the effect of the trust, will, or other governing instrument is to provide the income beneficiary with that degree of beneficial enjoyment of the property during the term of the income interest that the principles of the law of trusts accord to

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

(B) *Diversions of income and corpus.* A standard section 7520 income factor for an ordinary income interest may not be used to value an income interest or similar interest in property for a term of years, or for one or more measuring lives, if—

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

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

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

(iv) *Pooled income fund interests.* In general, pooled income funds are created and administered to achieve a special rate of return. A beneficial interest in a pooled income fund is not ordinarily valued using a standard section 7520 income or remainder interest factor. The present value of a beneficial interest in a pooled income fund is determined according to rules and special remainder factors prescribed in § 1.642(c)–6 of this chapter and, when applicable, the rules set forth under paragraph (b)(3) of this section if the individual who is the measuring life is terminally ill at the time of the transfer.

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

*Example 1. Unproductive property.* A died, survived by B and C. B died two years after A. A's will provided for a bequest of corporation stock in trust under the terms of which all of the trust income was paid to B for life. After the death of B, the trust terminated and the trust property was distributed to C. The trust specifically authorized, but did not require, the trustee to retain the shares of

stock. The corporation paid no dividends on this stock during the 5 years before A's death and the 2 years before B's death. There was no indication that this policy would change after A's death. Under applicable state law, the corporation is considered to be a sound investment that satisfies fiduciary standards. The facts and circumstances, including applicable state law, indicate that B did not have the legal right to compel the trustee to make the trust corpus productive in conformity with the requirements for a lifetime trust income interest under applicable local law. Therefore, B's life income interest in this case is considered nonproductive. Consequently, B's income interest may not be valued actuarially under this section.

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

*Example 3. Discretionary invasion of corpus.* The decedent, A, transferred property to a trust under the terms of which all of the trust income is to be paid to A's child for life and the remainder of the trust is to be distributed to a grandchild. The trust authorizes the trustee without restriction to distribute corpus to A's surviving spouse for the spouse's comfort and happiness. In this case, because the trustee's power to invade trust corpus is unrestricted, the exercise of the power could result in the termination of the income interest at any time. Consequently, the income interest is not considered an ordinary income interest for purposes of this paragraph, and may not be valued actuarially under this section.

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

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

(3) *Mortality component*—(i) *Terminal illness.* Except as provided in paragraph (b)(3)(ii) of this section, the mortality component prescribed under section 7520 may not be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life is terminally ill at the time of the decedent's death. For purposes of this paragraph (b)(3), an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die

within 1 year. However, if the individual survives for eighteen months or longer after the date of the decedent's death, that individual shall be presumed to have not been terminally ill at the date of death unless the contrary is established by clear and convincing evidence.

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

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

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

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

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

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

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

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

### § 20.7520–4 Transitional rules.

(a) *Reliance.* If the valuation date is after April 30, 1989, and before June 10, 1994, an executor can rely on Notice 89–24, 1989–1 C.B. 660, or Notice 89–60, 1989–1 C.B. 700 (See § 601.601(d)(2)(ii)(*b*) of this chapter), in valuing the transferred interest.

(b) *Effective date.* This section is effective as of May 1, 1989.

## PART 22—TEMPORARY ESTATE TAX REGULATIONS UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981

AUTHORITY: 26 U.S.C. 7805.

**§ 22.0 Certain elections under the Economic Recovery Tax Act of 1981.**

(a) *Election of special rules for woodlands*—(1) *In general.* This paragraph applies to the election of special rules for woodlands under section 2032A(e)(13) of the Code, as added by section 421(h) of the Economic Recovery Tax Act of 1981. The executor shall make this election for an estate by attaching to the estate tax return a statement that—

(i) Contains the decedent's name and taxpayer identification number as they appear on the estate tax return,

(ii) Identifies the election as an election under section 2032A(e)(13) of the Code,

(iii) Specifies the property with respect to which the election is made, and

(iv) Provides all information necessary to show that the executor is entitled to make the election.

(2) *Additional information required.* If later regulations issued under section 2032A(e)(13) require the executor to furnish information in addition to that required under paragraph (a)(1) of this section and an office of the Internal Revenue Service requests the executor to furnish the additional information, the executor shall furnish the additional information in a statement filed with that office of the Internal Revenue Service within 60 days after the request is made. The statement shall also contain the information required by paragraphs (a)(1) (i), (ii), and (iii) of this section. If the additional information is not provided within 60 days after the request is made, the election may, at the discretion of the Commissioner, be held invalid.

(b) *Election of special use valuation for qualified real property.* This paragraph applies to the election of special use valuation for qualified real property under section 2032A(d)(1) of the Code, as amended by section 421(j)(3) of the Economic Recovery Tax Act of 1981. This election shall be made in the manner prescribed in § 20.2032A–8(a)(3), except that the election shall be valid even if the estate tax return is not timely filed.

(c) *Elections irrevocable.* Elections to which this section applies may not be revoked.

(d) *Effective date.* The elections described in this section are available with respect to the estates of decedents dying after 1981.

[T.D. 7793, 46 FR 54540, Nov. 3, 1981]

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

GIFT TAX

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Section 25.2512–5 also issued under 26 U.S.C. 7520(c)(2).

Section 25.2512–5A also issued under 26 U.S.C. 7520(c)(2).

Section 25.2518–2 is also issued under 26 U.S.C. 2518(b).

Section 25.7520–1 also issued under 26 U.S.C. 7520(c)(2).

Section 25.7520–2 also issued under 26 U.S.C. 7520(c)(2).

Section 25.7520–3 also issued under 26 U.S.C. 7520(c)(2).

Section 25.7520–4 also issued under 26 U.S.C. 7520(c)(2).

SOURCE: T.D. 6334, 23 FR 8904, Nov. 15, 1958; 25 FR 14021, Dec. 31, 1960, unless otherwise noted.

GIFT TAX

## § 25.0–1 Introduction.

(a) *In general.* (1) The regulations in this part are designated ''Gift Tax Regulations.'' These regulations pertain to (i) the gift tax imposed by Chapter 12 of Subtitle B of the Internal Revenue Code on the transfer of property by gift by individuals in the calendar year 1955, in subsequent calendar years beginning before the calendar year 1971, in calendar quarters beginning with the first calendar quarter of calendar year 1971 through the last calendar quarter of the calendar year 1981, and in calendar years beginning with the calendar year 1982, and (ii) certain related administrative provisions of Subtitle F of the Code. It should be noted that the application of some of the provisions of these regulations may be affected by the provisions of an applicable gift tax convention with a foreign country. Unless otherwise indicated, references in these regulations to the ''Internal Revenue Code'' or the ''Code'' are references to the Internal Revenue Code of 1954, as amended, and references to a section or other provision of law are references to a section or other provision of the Internal Revenue Code of 1954, as amended. The Gift Tax Regulations are applicable to the transfer of property by gift by individuals in calendar years 1955 through 1970, in calendar quarters beginning with the first calendar quarter of calendar year 1971 through the last calendar quarter of the calendar year 1981, and in calendar years beginning with the calendar year 1982, and supersede the regulations contained in part 86, subchapter B, Chapter 1, Title 26, Code of Federal Regulations (1939) (Regulations 108, Gift Tax (8 FR 10858)), as prescribed and made applicable to the Internal Revenue Code of 1954 by Treasury Decision 6091, signed August 16, 1954 (19 FR 5167, Aug. 17, 1954).

(2) Section 2501(b) makes the provisions of Chapter 12 of the Code apply in the case of gifts made after September 2, 1958, by certain citizens of the United States who were residents of a possession thereof at the time the gifts were made. Section 2501(c) makes the provisions of Chapter 12 apply in the case of gifts made after September 14, 1960, by

certain other citizens of the United States who were residents of a possession thereof at the time the gifts were made. See paragraphs (c) and (d) of § 25.2501–1. Except as otherwise provided in paragraphs (c) and (d) of § 25.2501–1, the provisions of these regulations do not apply to the making of gifts by such citizens.

(b) *Nature of tax.* The gift tax is not a property tax. It is a tax imposed upon the transfer of property by individuals. It is not applicable to transfers by corporations or persons other than individuals. However, see paragraph (h)(1) of § 25.2511–1 with respect to the extent to which a transfer by or to a corporation is considered a transfer by or to its shareholders.

(c) *Scope of regulations*—(1) *Determination of tax liability.* subchapter A of Chapter 12 of the Code pertains to the determination of tax liability. The regulations pursuant to subchapter A are set forth in §§ 25.2501–1 through 25.2504–2. Sections 25.2701–5 and 25.2702–6 contain rules that provide additional adjustments to mitigate double taxation where the amount of the transferor's property was previously determined under the special valuation provisions of sections 2701 and 2702.

(2) *Transfer.* Subchapter B of chapter 12 and chapter 14 of the Internal Revenue Code pertain to the transfers which constitute the making of gifts and the valuation of those transfers. The regulations pursuant to subchapter B are set forth in §§ 25.2511–1 through 25.2518–3. The regulations pursuant to chapter 14 are set forth in §§ 25.2701–1 through 25.2704–3.

(3) *Deductions.* Subchapter C of Chapter 12 of the Code pertains to the deductions which are allowed in determining the amount of taxable gifts. The regulations pursuant to Subchapter C are set forth in §§ 25.2521–1 through 25.2524–1.

(4) *Procedure and administration provisions.* Subtitle F of the Internal Revenue Code contains some sections which are applicable to the gift tax. The regulations pursuant to those sections are set forth in §§ 25.6001–1 through 25.7101–1. Such regulations do not purport to be all the regulations on procedure and administration which are pertinent to gift tax matters. For the remainder of the regulations on procedure and administration which are pertinent to gift tax matters, see part 301 of this chapter (Regulations on Procedure and Administration).

(d) *Arrangement and numbering.* Each section of the regulations in this part (other than this section) is designated by a number composed of the part number followed by a decimal point (25.); the section of the Internal Revenue Code which it interprets; a hyphen (-); and a number identifying this section. By use of these designations one can ascertain the sections of the regulations relating to a provision of the Code. For example, the regulations pertaining to section 2521 of the Code are designated § 25.2521–1.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 6542, 26 FR 548, Jan. 20, 1961; 45 FR 6089, Jan. 25, 1980; T.D. 7910, 48 FR 40372, Sept. 7, 1983; T.D. 8395, 57 FR 4254, Feb. 4, 1992]

DETERMINATION OF TAX LIABILITY

### § 25.2207A–1 Right of recovery of gift taxes in the case of certain marital deduction property.

(a) *In general.* If an individual is treated as transferring an interest in property by reason of section 2519, the individual or the individual's estate is entitled to recover from the *person receiving the property* (as defined in paragraph (e) of this section) the amount of gift tax attributable to that property. The value of property to which this paragraph (a) applies is the value of all interests in the property other than the qualifying income interest. There is no right of recovery from any person for the property received by that person for which a deduction was allowed from the total amount of gifts, if no Federal gift tax is attributable to the property. The right of recovery arises at the time the Federal gift tax is actually paid by the transferor subject to section 2519.

(b) *Failure of a person to exercise the right of recovery.* [Reserved].

(c) *Amount of gift tax attributable to all properties.* The amount of Federal gift tax attributable to all properties includible in the total amount of gifts under section 2519 made during the calendar year is the amount by which the total Federal gift tax for the calendar

year (including penalties and interest attributable to the tax) under chapter 12 of the Internal Revenue Code which has been paid, exceeds the total Federal gift tax for the calendar year (including penalties and interest attributable to the tax) under chapter 12 of the Internal Revenue Code which would have been paid if the value of the properties includible in the total amount of gifts by reason of section 2519 had not been included.

(d) *Amount of gift tax attributable to a particular property.* A person's right of recovery with respect to a particular property is an amount equal to the amount determined in paragraph (c) of this section multiplied by a fraction. The numerator of the fraction is the value of the particular property included in the total amount of gifts made during the calendar year by reason of section 2519, less any deduction allowed with respect to the property. The denominator of the fraction is the total value of all properties included in the total amount of gifts made during the calendar year by reason of section 2519, less any deductions allowed with respect to those properties.

(e) *Person receiving the property.* If the property is in a trust at the time of the transfer, the *person receiving the property* is the trustee, and any person who has received a distribution of the property prior to the expiration of the right of recovery if the property does not remain in trust. This paragraph (e) does not affect the right, if any, under local law, of any person with an interest in property to reimbursement or contribution from another person with an interest in the property.

(f) *Example.* The following example illustrates the application of paragraphs (a) through (e) of this section.

*Example.* D created an inter vivos trust during 1994 with certain income producing assets valued at $1,000,000. The trust provides that all income is payable to D's wife, S, for S's life, with the remainder at S's death to be divided equally among their four children. In computing taxable gifts during calendar year 1994, D deducted, pursuant to section 2523(f), $1,000,000 from the total amount of gifts made. In addition, assume that S received no other transfers from D and that S made a gift during 1996 of the entire life interest to one of the children, at which time the value of trust assets was $1,080,000 and the value of S's life interest was $400,000. Although the entire value of the trust assets ($1,080,000) is, pursuant to sections 2511 and 2519, included in the total amount of S's gifts for calendar year 1996, S is only entitled to reimbursement for the Federal gift tax attributable to the value of the remainder interest, that is, the Federal gift tax attributable to $680,000 ($1,080,000 less $400,000). The Federal gift tax attributable to $680,000 is equal to the amount by which the total Federal gift tax (including penalties and interest) paid for the calendar year exceeds the federal gift tax (including penalties and interest) that would have been paid if the total amount of gifts during 1996 had been reduced by $680,000. That amount of tax may be recovered by S from the trust.

[T.D. 8522, 59 FR 9655, Mar. 1, 1994]

### § 25.2207A–2 Effective date.

The provisions of § 25.2207A–1 are effective with respect to dispositions made after March 1, 1994. With respect to gifts made on or before such date, the donor may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of § 25.2207A–1 (as well as project LR–211–76, 1984–1 C.B., page 598, see § 601.601(d)(2)(ii)(*b*) of this chapter), are considered a reasonable interpretation of the statutory provisions.

[T.D. 8522, 59 FR 9656, Mar. 1, 1994]

### § 25.2501–1 Imposition of tax.

(a) *In general.* (1) The tax applies to all transfers by gift of property, wherever situated, by an individual who is a citizen or resident of the United States, to the extent the value of the transfers exceeds the amount of the exclusions authorized by section 2503 and the deductions authorized by sections 2521 (as in effect prior to its repeal by the Tax Reform Act of 1976), 2522, and 2523. For each ''calendar period'' (as defined in § 25.2502–1(c)(1)), the tax described in this paragraph (a) is imposed on the transfer of property by gift during such calendar period.

(2) The tax does not apply to a transfer by gift of intangible property before January 1, 1967, by a nonresident not a citizen of the United States, unless the donor was engaged in business in the United States during the calendar year in which the transfer was made.

(3)(i) The tax does not apply to any transfer by gift of intangible property

on or after January 1, 1967, by a nonresident not a citizen of the United States (whether or not he was engaged in business in the United States), unless the donor is an expatriate who lost his U.S. citizenship after March 8, 1965, and within the 10-year period ending with the date of transfer, and the loss of citizenship—

*(a)* Did not result from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b), 1482, or 1487) (For a summary of these sections, see paragraph (d)(1) of § 20.2107–1 of this chapter (estate tax regulations)), and

*(b)* Had for one of its principal purposes (but not necessarily its only principal purpose) the avoidance of Federal income, estate, or gift tax.

(ii) In determining for purposes of subdivision (i)*(b)* of this subparagraph whether a principal purpose for the loss of U.S. citizenship by a donor was the avoidance of Federal income, estate, or gift tax, the Commissioner must first establish that it is reasonable to believe that the donor's loss of U.S. citizenship would, but for section 2501(a)(3) and this subparagraph, result in a substantial reduction for the calendar period (as defined in § 25.2502–1(c)(1)) in the sum of *(a)* the Federal gift tax and *(b)* all gift taxes imposed by foreign countries and political subdivisions thereof, in respect of the transfer of property by gift. Once the Commissioner has so established, the burden of proving that the loss of citizenship by the donor did not have for one of its principal purposes the avoidance of Federal income, estate, or gift tax shall be on the donor. In the absence of complete factual information, the Commissioner may make a tentative determination, based on the information available, that the donor's loss of U.S. citizenship would, but for section 250(a)(3) and this subparagraph, result in a substantial reduction for the calendar period in the sum of the Federal and foreign gift taxes described in *(a)* and *(b)* of this subdivision on the transfer of property by gift. This tentative determination may be based upon the fact that the laws of the foreign country of which the donor became a citizen and the laws of the foreign country of which the donor was a resident at the time of the transfer, including the laws of any political subdivision of those foreign countries, would ordinarily result, in the case of a nonexpatriate donor having the same citizenship and residence as the donor, in liability for total gift taxes under such laws for the calendar period substantially lower than the amount of the Federal gift tax which would be imposed for such period on an amount of comparable gifts by a citizen of the United States. In the absence of a preponderance of evidence to the contrary, this tentative determination shall be sufficient to establish that it is reasonable to believe that the donor's loss of U.S. citizenship would, but for section 2501(a)(3) and this subparagraph, result in a substantial reduction for the calendar period in the sum of the Federal and foreign gift taxes described in *(a)* and *(b)* of this subdivision on the transfer of property by gift.

(4) For additional rules relating to the application of the tax to transfers by nonresidents not citizens of the United States, see section 2511 and § 25.2511–3.

(5) The general rule of this paragraph (a) shall not apply to a transfer after May 7, 1974, of money or other property to a political organization for the use of that organization. However, this exception to the general rule applies solely to a transfer to a political organization as defined in section 527(e)(1) and including a newsletter fund to the extent provided under section 527(g). The general rule governs a transfer of property to an organization other than a political organization as so defined.

(b) *Resident.* A resident is an individual who has his domicile in the United States at the time of the gift. For this purpose the United States includes the States and the District of Columbia. The term also includes the Territories of Alaska and Hawaii prior to admission as a State. See section 7701(a)(9). All other individuals are nonresidents. A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of moving therefrom. Residence without the requisite intention to remain indefinitely will not constitute domicile, nor will intention to change domicile effect

such a change unless accompanied by actual removal.

(c) *Certain residents of possessions considered citizens of the United States.* As used in this part, the term ''citizen of the United States'' includes a person who makes a gift after September 2, 1958 and who, at the time of making the gift, was domiciled in a possession of the United States and was a United States citizen, and who did not acquire his United States citizenship solely by reason of his being a citizen of such possession or by reason of his birth or residence within such possession. The gift of such a person is, therefore, subject to the tax imposed by section 2501 in the same manner in which a gift made by a resident of the United States is subject to the tax. See paragraph (a) of § 25.01 and paragraph (d) of this section for further information relating to the application of the Federal gift tax to gifts made by persons who were residents of possessions of the United States. The application of this paragraph may be illustrated by the following example and the examples set forth in paragraph (d) of this section:

*Example.* A, a citizen of the United States by reason of his birth in the United States at San Francisco, established residence in Puerto Rico and acquired Puerto Rican citizenship. A makes a gift of stock of a Spanish corporation on September 4, 1958, while a citizen and domiciliary of Puerto Rico. A's gift is, by reason of the provisions of section 2501(b) subject to the tax imposed by section 2501 inasmuch as his United States citizenship is based on birth in the United States and is not based solely on being a citizen of a possession or solely on birth or residence in a possession.

(d) *Certain residents of possessions considered nonresidents not citizens of the United States.* As used in this part, the term ''nonresident not a citizen of the United States'' includes a person who makes a gift after September 14, 1960, and who at the time of making the gift, was domiciled in a possession of the United States and was a United States citizen, and who acquired his United States citizenship solely by reason of his being a citizen of such possession or by reason of his birth or residence within such possession. The gift of such a person, is, therefore, subject to the tax imposed by section 2501 in the same manner in which a gift is subject to the tax when made by a donor who is a ''nonresident not a citizen of the United States.'' See paragraph (a) of § 25.01 and paragraph (c) of this section for further information relating to the application of the Federal gift tax to gifts made by persons who were residents of possessions of the United States. The application of this paragraph may be illustrated by the following examples and the example set forth in paragraph (c) of this section. In each of the following examples the person who makes the gift is deemed a ''nonresident not a citizen of the United States'' and his gift is subject to the tax imposed by section 2501 in the same manner in which a gift is subject to the tax when made by a donor who is a nonresident not a citizen of the United States, since he made the gift after September 14, 1960, but would not have been so deemed and subject to such tax if the person who made the gift had made it on or before September 14, 1960.

*Example (1).* C, who acquired his United States citizenship under section 5 of the Act of March 2, 1917 (39 Stat. 953), by reason of being a citizen of Puerto Rico, while domiciled in Puerto Rico makes a gift on October 1, 1960, of real estate located in New York. C is considered to have acquired his United States citizenship solely by reason of his being a citizen of Puerto Rico.

*Example (2).* E, whose parents were United States citizens by reason of their birth in Boston, was born in the Virgin Islands on March 1, 1927. On September 30, 1960, while domiciled in the Virgin Islands, he made a gift of tangible personal property situated in Kansas. E is considered to have acquired his United States citizenship solely by reason of his birth in the Virgin Islands (section 306 of the Immigration and Nationality Act (66 Stat. 237, 8 U.S.C. 1406)).

*Example (3).* N, who acquired United States citizenship by reason of being a native of the Virgin Islands and a resident thereof on June 28, 1932 (section 306 of the Immigration and Nationality Act (66 Stat. 237, 8 U.S.C. 1406)), made a gift on October 1, 1960, at which time he was domiciled in the Virgin Islands, of tangible personal property situated in Wisconsin. N is considered to have acquired his United States citizenship solely by reason of his birth or residence in the Virgin Islands.

*Example (4).* P, a former Danish citizen, who on January 17, 1917, resided in the Virgin Islands, made the declaration to preserve his Danish citizenship required by Article 6 of the treaty entered into on August 4, 1916,

between the United States and Denmark. Subsequently P acquired United States citizenship when he renounced such declaration before a court of record (section 306 of the Immigration and Nationality Act (66 Stat. 237, 8 U.S.C. 1406)). P, while domiciled in the Virgin Islands, made a gift on October 1, 1960, of tangible personal property situated in California, P is considered to have acquired his United States citizenship solely by reason of his birth of residence in the Virgin Islands.

*Example (5).* R, a former French citizen, acquired his United States citizenship through naturalization proceedings in a court located in the Virgin Islands after having qualified for citizenship by residing in the Virgin Islands for 5 years. R, while domiciled in the Virgin Islands, made a gift of tangible personal property situated in Hawaii on October 1, 1960. R is considered to have acquired his United States citizenship solely by reason of his birth or residence within the Virgin Islands.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 6542, 26 FR 549 Jan. 20 1961; T.D. 7296, 38 FR 34201, Dec. 12, 1973; T.D. 7871, 45 FR 8004, Feb. 6, 1980; T.D. 7910, 48 FR 40372, Sept. 7, 1983]

### § 25.2502–1 Rate of tax.

(a) *Computation of tax.* The rate of tax is determined by the total of all gifts made by the donor during the calendar period and all the preceding calendar periods since June 6, 1932. See § 25.2502–1(c)(1) for the definition of ''calendar period'' and § 25.2502–1(c)(2) for the definition of ''preceding calendar periods.'' The following six steps are to be followed in computing the tax:

(1) *First step.* Ascertain the amount of the ''taxable gifts'' (as defined in § 25.2503–1) for the calendar period for which the return is being prepared.

(2) *Second step.* Ascertain ''the aggregate sum of the taxable gifts for each of the preceding calendar periods'' (as defined in § 25.2504–1), considering only those gifts made after June 6, 1932.

(3) *Third step.* Ascertain the total amount of the taxable gifts, which is the sum of the amounts determined in the first and second steps.See § 25.2702–6 for an adjustment to the total amount of an individual's taxable gifts where the individual's current taxable gifts include the transfer of certain interests in trust that were previously valued under the provisions of section 2702.

(4) *Fourth step.* Compute the tentative tax on the total amount of taxable gifts (as determined in the third step) using the rate schedule in effect at the time the gift (for which the return is being filed) is made.

(5) *Fifth step.* Compute the tentative tax on the aggregate sum of the taxable gifts for each of the preceding calendar periods (as determined in the second step), using the same rate schedule set forth in the fourth step of this paragraph (a).

(6) *Sixth step.* Subtract the amount determined in the fifth step from the amount determined in the fourth step. The amount remaining is the gift tax for the calendar period for which the return is being prepared.

(b) *Rate of tax.* The tax is computed in accordance with the rate schedule in effect at the time the gift was made as set forth in section 2001(c) or corresponding provisions of prior law.

(c) *Definitions.* (1) The term ''calendar period'' means:

(i) Each calendar year for the calendar years 1932 (but only that portion of such year after June 6, 1932) through 1970;

(ii) Each calendar quarter for the first calendar quarter of the calendar year 1971 through the last calendar quarter of calendar year 1981; or

(iii) Each calendar year for the calendar year 1982 and each succeeding calendar year.

(2) The term ''preceding calendar periods'' means all calendar periods ending prior to the calendar period for which the tax is being computed.

(d) *Examples.* The following examples illustrate the application of this section with respect to gifts made by citizens or residents of the United States:

*Example (1).* Assume that in 1955 the donor made taxable gifts, as ascertained under the first step (paragraph (a)(2) of this section), of $62,500 and that there were no taxable gifts for prior years, with the result that the amount ascertainable under the third step is $62,500. Under the fourth step a tax is computed on this amount. Reference to the tax rate schedule in effect in the year 1955 discloses that the tax on this amount is $7,650.

*Example (2).* A donor makes gifts (other than gifts of future interests in property) during the calendar year 1955 of $30,000 to A and $33,000 to B. Two exclusions of $3,000 each are allowable, in accordance with the provisions of section 2503(b), which results in

included gifts for 1955 of $57,000. Specific exemption was claimed and allowed in a total amount of $50,000 in the donor's gift tax returns for the calendar years 1934 and 1935 so there remains no specific exemption available for the donor to claim for 1955. The total amount of gifts made by the donor during preceding years, after excluding $5,000 for each donee for each calendar year in accordance with the provisions of section 1003(b)(1) of the 1939 Code, is computed as follows:

| | |
|---|---|
| Calendar year 1934 | $120,000 |
| Calendar year 1935 | 25,000 |
| Total amount of included gifts for preceding calendar years | 145,000 |

The aggregate sum of the taxable gifts for preceding calendar years is $115,000, which is determined by deducting a specific exemption of $30,000 from $145,000, the total amount of included gifts for preceding calendar years. The deduction from the 1934 and 1935 gifts for the specific exemption cannot exceed $30,000 for purposes of computing the tax on the 1955 gifts even though a specific exemption in a total amount of $50,000 was allowed in computing the donor's gift tax liability for 1934 and 1935. (See paragraph (b) of § 25.2504–1.) The computation of the tax for the calendar year 1955 (following the steps set forth in paragraph (a) of this section) is shown below:

| | |
|---|---|
| (1) Amount of taxable gifts for year | $57,000 |
| (2) Total amount of taxable gifts for preceding years | 115,000 |
| (3) Total taxable gifts | 172,000 |
| (4) Tax computed on item 3 (in accordance with the rate schedule in effect for the year 1955) | 31,725 |
| (5) Tax computed on item 2 (using same rate schedule) | 18,900 |
| (6) Tax for year 1955 (item 4 minus item 5) | 12,825 |

*Example (3)* (i) *Facts.* During the calendar year 1955, H makes the following gifts of present interests:

| | |
|---|---|
| To his daughter | $40,000 |
| To his son | 5,000 |
| To W, his wife | 5,000 |
| To a charitable organization | 10,000 |

The gifts to W qualify for the marital deduction, and, pursuant to the provisions of section 2513 (see § 25.2513–1), H and W consent to treat the gifts to third parties as having been made one-half by each spouse. The amount of H's taxable gifts for preceding years is $50,000. Only $25,000 of H's specific exemption provided under section 2521, which was in effect at the time, was claimed and allowed in preceding years. H's remaining specific exemption of $5,000 is claimed for the calendar year of 1955. See § 25.2521–1. W made no gifts during the calendar year 1955 nor during any preceding calendar year. W claims sufficient specific exemption on her return to eliminate tax liability.

(ii) *Computation of H's tax for the calendar year 1955—(a) H's taxable gifts for year.*

| | | |
|---|---|---|
| Total gifts of H | | $60,000 |
| Less: Portion of items to be reported by spouse (one-half of total gifts to daughter, son and charity) | | 27,500 |
| Balance | | 32,500 |
| Less: Exclusions (three of $3,000 each for daughter, wife and charity and one of $2,500 for son) | | 11,500 |
| Total included amount of gifts for year | | 21,000 |
| Less: Deductions: | | |
| Charity | $2,000 | |
| Marital | 2,000 | |
| Specific exemption | 5,000 | |
| Total deductions | | 9,000 |
| Amount of taxable gifts for year | | 12,000 |

*(b) Computation of tax.* The steps set forth in paragraph (a) of this section are followed.

| | |
|---|---|
| *(1)* Amount of taxable gifts for year | $12,000 |
| *(2)* Total taxable gifts for preceding years | 50,000 |
| *(3)* Total taxable gifts (item *(1)* plus item *(2))* | 62,000 |
| *(4)* Tax computed on item *(3)* (in accordance with the rate schedule in effect for the year 1955) | 7,545 |
| *(5)* Tax computed in item *(2)* (in accordance with the rate schedule in effect for the year 1955) | 5,250 |
| *(6)* Tax for the calendar year (item *(4)* minus item *(5))* | 2,295 |

(iii) *Computation of W's tax for calendar year 1955—(a) W's taxable gifts for year.*

| | | |
|---|---|---|
| Total gifts of W | | 0 |
| Less: Portion of items to be reported by spouse | | 0 |
| Balance | | 0 |
| Gifts of spouse to be included | | $27,500 |
| Total gifts for year | | 27,500 |
| Less: Exclusions (two of $3,000 each for daughter and charity and one of $2,500 for son) | | $8,500 |
| Balance | | 19,000 |
| Less—Deductions: | | |
| Charity | $2,000 | |
| Marital | 0 | |
| Specific exemption | 17,000 | |
| Total deductions | | $19,000 |
| Amount of taxable gifts for year | | 0 |

*(b) Computation of tax.* Since W had no ''taxable gifts'' during the year, there is no tax.

*Example (4)* (i) *Facts.* The facts are the same as in example (3) except that W made outright gifts of $10,000 to her niece and $20,000 to H at various times during the year. The amount of taxable gifts made by W in preceding calendar years is $75,000, and only $20,000 of her specific exemption provided under section 2521, which was in effect at the time, was claimed and allowed for preceding years. See § 25.2521–1. The remaining specific exemption of $10,000 is claimed for the calendar year 1955.

(ii) *Computation of H's tax for the calendar year 1955—(a) H's taxable gifts for year.*

| | | |
|---|---|---|
| Total gifts of H | | $60,000 |
| Less: Portion of items to be reported by spouse | | 27,500 |
| Balance | | 32,500 |
| Gifts of spouse to be included | | 5,000 |
| Total gifts for year | | 37,500 |
| Less: Exclusions ($11,500 as shown in example (3) plus $3,000 exclusion for gift to niece) | | 14,500 |
| Total included amount of gifts for year | | 23,000 |
| Deductions: | | |
| Charity | $2,000 | |
| Marital | 2,000 | |
| Specific exemption | 5,000 | |
| Total deductions | | 9,000 |
| Amount of taxable gifts for year | | 14,000 |

*(b) Computation of tax.*

| | |
|---|---|
| *(1)* Amount of taxable gifts for year | $14,000 |
| *(2)* Total taxable gifts for preceding years | 50,000 |
| *(3)* Total taxable gifts (item *(1)* plus item *(2))* | 64,000 |
| *(4)* Tax computed on item *(3)* | 7,965 |
| *(5)* Tax computed on item *(2)* | 5,250 |
| *(6)* Tax for year (item *(4)* minus item *(5))* | 2,715 |

(iii) *Computation of W's tax for the calendar year 1955—(a) W's taxable gifts for year.*

| | | |
|---|---|---|
| Total gifts of W | | $30,000 |
| Less: Portion of item—to be reported by spouse (one-half of gift to niece) | | 5,000 |
| Balance | | 25,000 |
| Gifts of spouse to be included | | 27,500 |
| Total gifts for year | | 52,500 |
| Less: Exclusions (four of $3,000 each for daughter, husband, niece and charity, and one of $2,500 for son) | | $14,500 |
| Total included amount of gifts for year | | 38,000 |
| Deductions: | | |
| Charity | $2,000 | |
| Marital | 10,000 | |
| Specific exemption | 10,000 | |
| Total deductions | | 22,000 |
| Amount of taxable gifts for year | | $16,000 |

*(b) Computation of tax.*

| | |
|---|---|
| *(1)* Amount of taxable gifts for year | 16,000 |
| *(2)* Total taxable gifts for preceding years | 75,000 |
| *(3)* Total taxable gifts | 91,000 |
| *(4)* Tax computed on item *(3)* | 13,635 |
| *(5)* Tax computed on item *(2)* | 10,275 |
| *(6)* Tax for year (item *(4)* minus item *(5))* | 3,360 |

*Example (5).* A makes gifts (other than gifts of future interests in property) to B in the first quarter of 1971 of $43,000 and in the second quarter of 1971 of $60,000. A gave to C in the second quarter of 1971 land valued at $11,000. The full amount of A's specific exemption provided under section 2521 was claimed and allowed in 1956. In 1966, A made taxable gifts totaling $21,000 on which gift tax was timely paid and no other taxable gifts were made by A in any other year preceding 1971. The gift tax return due for the first calendar quarter of 1971 was timely filed and the tax paid. With respect to the gifts made to B in 1971, the $3,000 annual gift tax exclusion provided by section 2503(b) is applied in its entirety against the $43,000 gift made to B in the first quarter and therefore is not available to offset the $60,000 gift made to B in the second quarter (See § 25.2503–2(b)). A further $3,000 annual gift tax exclusion is available, however, to offset the $11,000 gift made to C in the second quarter of 1971. The computation of the gift tax for the second calendar quarter of 1971 due on August 15, 1971 (following the steps set forth in paragraph (a) of this section) is shown below:

| | |
|---|---|
| (1) Amount of taxable gifts for the second calendar quarter of 1971 ($60,000+$11,000 − $3,000) | $68,000 |
| (2) Total amount of taxable gifts for preceding calendar periods ($43,000 − $3,000+$21,000) | 61,000 |
| (3) Total taxable gifts | 129,000 |
| (4) Tax computed on item 3 (in accordance with rate schedule in effect for the year 1971 | 22,050 |
| (5) Tax computed on item 2 (using same rate schedule) | 7,335 |
| (6) Tax for second calendar quarter of 1971 (item 4 minus item 5) | 14,715 |

*Example (6).* A makes gifts (other than gifts of future interests in property) during the calendar year 1982 of $160,000 to B and $100,000 to C. Two exclusions of $10,000 each are allowable, in accordance with the provisions of section 2503(b), which results in taxable gifts for 1982 of $240,000. In the first calendar quarter of 1978, A made taxable gifts totaling $100,000 on which gift tax was paid. For the calendar year 1969, A made taxable gifts totaling $50,000. The full amount of A's specific exemption provided under section 2521, which was in effect at the time, was claimed and allowed in 1968. The computation of the gift tax for the calendar period 1982 (following the steps set forth in paragraph (a) of this section) is shown below.

(1) Amount of taxable gifts for the calendar year 1982, $240,000.

(2) Total amount of taxable gifts for preceding calendar periods ($100,000+$50,000), $150,000.

(3) Total taxable gifts, $390,000.

(4) Tax computed on item 3 (in accordance with the rate schedule in effect for the year 1982), $118,400.

(5) Tax computed on item 2 (using same rate schedule), $38,800.

(6) Tax for year 1982 (item 4 minus item 5), $79,600.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7238, 37 FR 28725, Dec. 29, 1972; T.D. 7910, 48 FR 40372, Sept. 7, 1983; T.D. 8395, 57 FR 4255, Feb. 4, 1992]

**§ 25.2502–2 Donor primarily liable for tax.**

Section 2502(d) provides that the donor shall pay the tax. If the donor dies before the tax is paid the amount of the tax is a debt due the United States from the decedent's estate and his executor or administrator is responsible for its payment out of the estate. (See § 25.6151–1 for the time and place for paying the tax.) If there is no duly qualified executor or administrator, the heirs, legatees, devisees, and distributees are liable for and required to pay the tax to the extent of the value of their inheritances, bequests, devises, or distributive shares of the donor's estate. If a husband and wife effectively signify consent, under section 2513, to have gifts made to a third party during any ''calendar period'' (as defined in § 25.2502–1(c)(1)) considered as made one-half by each, the liability with respect to the gift tax of each spouse for that calendar period is joint and several (see § 25.2513–4). As to the personal liability of the donee, see paragraph (b) of § 301.6324–1 of this chapter (Regulations on Procedure and Administration). As to the personal liability of the executor or administrator, see section 3467 of the Revised Statutes (31 U.S.C. 192), which reads as follows:

> Every executor, administrator, or assignee, or other person, who pays, in whole or in part, any debt due by the person or estate for whom or for which he acts before he satisfies and pays the debts due to the United States from such person or estate, shall become answerable in his own person and estate to the extent of such payments for the debts so due to the United States, or for so much thereof as may remain due and unpaid.

As used in such section 3467, the word ''debt'' includes a beneficiary's distributive share of an estate. Thus if an executor pays a debt due by the estate which is being administered by him or distributes any portion of the estate before there is paid all of the gift tax which he has a duty to pay, the executor is personally liable, to the extent of the payment or distribution, for so much of the gift tax as remains due and unpaid.

[T.D. 7238, 37 FR 28726, Dec. 29, 1972, as amended by T.D. 7910, 48 FR 40373, Sept. 7, 1983]

**§ 25.2503–1 General definitions of "taxable gifts" and of "total amount of gifts."**

The term *taxable gifts* means the ''total amount of gifts'' made by the donor during the ''calendar period'' (as defined in § 25.2502–1(c)(1)) less the deductions provided for in sections 2521 (as in effect before its repeal by the Tax Reform Act of 1976), 2522, and 2523 (specific exemption, charitable, etc., gifts and the marital deduction, respectively). The term ''total amount of gifts'' means the sum of the values of the gifts made during the calendar period less the amounts excludable under section 2503(b). See § 25.2503–2. The entire value of any gift of a future interest in property must be included in the total amount of gifts for the calendar period in which the gift is made. See § 25.2503–3.

[T.D. 7910, 48 FR 40373, Sept. 7, 1983]

**§ 25.2503–2 Exclusions from gifts.**

(a) Except as provided in paragraph (f) of this section (involving gifts to a noncitizen spouse), the first $10,000 of gifts made to any one donee during the calendar year 1982 or any calendar year thereafter, except gifts of future interests in property as defined in §§ 25.2503–3 and 25.2503–4, is excluded in determining the total amount of gifts for the calendar year. In the case of a gift in trust the beneficiary of the trust is the donee.

(b) *Gifts made after December 31, 1970 and before January 1, 1982.* In computing taxable gifts for the calendar quarter, in the case of gifts (other than gifts of future interests in property) made to any person by the donor during any calendar quarter of the calendar year 1971 or any subsequent calendar year, $3,000 of such gifts to such person less the aggregate of the amounts of such gifts to such person during all preceding calendar quarters of any such calendar year shall not be included in the total amount of gifts made during such quarter. Thus, the first $3,000 of gifts made to any one donee during the calendar year 1971 or any calendar year thereafter, except gifts of future interests in property as defined in §§ 25.2503–3 and 25.2503–4, is excluded in determining the total amount of gifts for a

calendar quarter. In the case of a gift in trust the beneficiary of the trust is the donee. The application of this paragraph may be illustrated by the following examples:

*Example (1).* A made a gift of $3,000 to B on January 8, 1971, and on April 20, 1971, gave B an additional gift of $10,000. A made no other gifts in 1971. The total amount of gifts made by A during the second quarter of 1971 is $10,000 because the $3,000 exclusion provided by section 2503(b) is first applied to the January 8th gift.

*Example (2).* A gave $2,000 to B on January 8, 1971, and on April 20, 1971, gave him $10,000. The total amount of gifts made by A during the second quarter of 1971 is $9,000 because only $2,000 of the $3,000 exclusion provided by section 2503(b) was applied against the January 8th gift; $1,000 was available to offset other gifts (except gifts of a future interest) made to B during 1971.

(c) *Gifts made before January 1, 1971.* The first $3,000 of gifts made to any one donee during the calendar year 1955, or 1970, or any calendar year intervening between calendar year 1955 and calendar year 1970, except gifts of future interests in property as defined in §§ 25.2503–3 and 25.2503–4, is excluded in determining the total amount of gifts for the calendar year. In the case of a gift in trust the beneficiary of the trust is the donee.

(d) *Transitional rule.* The increased annual gift tax exclusion as defined in section 2503(b) shall not apply to any gift subject to a power of appointment granted under an instrument executed before September 12, 1981, and not amended on or after that date, provided that: (1) The power is exercisable after December 31, 1981, (2) the power is expressly defined in terms of, or by reference to, the amount of the gift tax exclusion under section 2503(b) (or the corresponding provision of prior law), and (3) there is not enacted a State law applicable to such instrument which construes the power of appointment as referring to the increased annual gift tax exclusion provided by the Economic Recovery Tax Act of 1981.

(e) *Examples.* The provisions of paragraph (d) of this section may be illustrated by the following examples:

*Example (1).* A executed an instrument to create a trust for the benefit of B on July 2, 1981. The trust granted to B the power, for a period of 90 days after any transfer of cash to the trust, to withdraw from the trust the lesser of the amount of the transferred cash or the amount equal to the section 2503(b) annual gift tax exclusion. The trust was not amended on or after September 12, 1981. No state statute has been enacted which construes the power of appointment as referring to the increased annual gift tax exclusion provided by the Economic Recovery Tax Act of 1981. Accordingly, the maximum annual gift tax exclusion applicable to any gift subject to the exercise of the power of appointment is $3,000.

*Example (2).* Assume the same facts as in example (1) except that the power of appointment granted in the trust refers to section 2503(b) as amended at any time. The maximum annual gift tax exclusion applicable to any gift subject to the exercise of the power of appointment is $10,000.

(f) *Special rule in the case of gifts made on or after July 14, 1988, to a spouse who is not a United States citizen*—(1) *In general.* Subject to the special rules set forth at § 20.2056A–1(c) of this chapter, in the case of gifts made on or after July 14, 1988, if the donee of the gift is the donor's spouse and the donee spouse is not a citizen of the United States at the time of the gift, the first $100,000 of gifts made during the calendar year to the donee spouse (except gifts of future interests) is excluded in determining the total amount of gifts for the calendar year. The rule of this paragraph (f) applies regardless of whether the donor is a citizen or resident of the United States for purposes of chapter 12 of the Internal Revenue Code.

(2) *Gifts made after June 29, 1989.* In the case of gifts made after June 29, 1989, the $100,000 exclusion provided in paragraph (f)(1) of this section applies only if the gift in excess of the otherwise applicable annual exclusion is in a form that qualifies for the gift tax marital deduction under section 2523(a) but for the provisions of section 2523(i)(1) (disallowing the marital deduction if the donee spouse is not a United States citizen.) See § 25.2523(i)–1(d), *Example 4.*

(3) *Effective date.* This paragraph (f) is effective with respect to gifts made after August 22, 1995.

[T.D. 7238, 37 FR 28727, Dec. 29, 1972, as amended by T.D. 7910, 48 FR 40373, Sept. 7, 1983; T.D. 7978, 49 FR 38541, Oct. 1, 1984; T.D. 8612, 60 FR 43552, Aug. 22, 1995]

### § 25.2503–3 Future interests in property.

(a) No part of the value of a gift of a future interest may be excluded in determining the total amount of gifts made during the ''calendar period'' (as defined in § 25.2502–1(c)(1)). ''Future interest'' is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. The term has no reference to such contractual rights as exist in a bond, note (though bearing no interest until maturity), or in a policy of life insurance, the obligations of which are to be discharged by payments in the future. But a future interest or interests in such contractual obligations may be created by the limitations contained in a trust or other instrument of transfer used in effecting a gift.

(b) An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property. An exclusion is allowable with respect to a gift of such an interest (but not in excess of the value of the interest). If a donee has received a present interest in property, the possibility that such interest may be diminished by the transfer of a greater interest in the same property to the donee through the exercise of a power is disregarded in computing the value of the present interest, to the extent that no part of such interest will at any time pass to any other person (see example (4) of paragraph (c) of this section). For an exception to the rule disallowing an exclusion for gifts of future interests in the case of certain gifts to minors, see § 25.2503–4.

(c) The operation of this section may be illustrated by the following examples:

*Example (1).* Under the terms of a trust created by A the trustee is directed to pay the net income to B, so long as B shall live. The trustee is authorized in his discretion to withhold payments of income during any period he deems advisable and add such income to the trust corpus. Since B's right to receive the income payments is subject to the trustee's discretion, it is not a present interest and no exclusion is allowable with respect to the transfer in trust.

*Example (2).* C transfers certain insurance policies on his own life to a trust created for the benefit of D. Upon C's death the proceeds of the policies are to be invested and the net income therefrom paid to D during his lifetime. Since the income payments to D will not begin until after C's death the transfer in trust represents a gift of a future interest in property against which no exclusion is allowable.

*Example (3).* Under the terms of a trust created by E the net income is to be distributed to E's three children in such shares as the trustee, in his uncontrolled discretion deems advisable. While the terms of the trust provide that all of the net income is to be distributed, the amount of income any one of the three beneficiaries will receive rests entirely within the trustee's discretion and cannot be presently ascertained. Accordingly, no exclusions are allowable with respect to the transfers to the trust.

*Example (4).* Under the terms of a trust the net income is to be paid to F for life, with the remainder payable to G on F's death. The trustee has the uncontrolled power to pay over the corpus to F at any time. Although F's present right to receive the income may be terminated, no other person has the right to such income interest. Accordingly, the power in the trustee is disregarded in determining the value of F's present interest. The power would not be disregarded to the extent that the trustee during F's life could distribute corpus to persons other than F.

*Example (5).* The corpus of a trust created by J consists of certain real property, subject to a mortgage. The terms of the trust provide that the net income from the property is to be used to pay the mortgage. After the mortgage is paid in full the net income is to be paid to K during his lifetime. Since K's right to receive the income payments will not begin until after the mortgage is paid in full the transfer in trust represents a gift of a future interest in property against which no exclusion is allowable.

*Example (6).* L pays premiums on a policy of insurance on his life, all the incidents of ownership in the policy (including the right to surrender the policy) are vested in M. The payment of premiums by L constitutes a gift of a present interest in property.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7238, 37 FR 28727, Dec. 29, 1972; T.D. 7910, 48 FR 40373, Sept. 7, 1983]

### § 25.2503–4 Transfer for the benefit of a minor.

(a) Section 2503(c) provides that no part of a transfer for the benefit of a

donee who has not attained the age of 21 years on the date of the gift will be considered a gift of a future interest in property if the terms of the transfer satisfy all of 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 subparagraph (1) of this paragraph 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 subparagraph (1) of this paragraph will be payable either to the estate of the donee or as he may appoint under a general power of appointment as defined in section 2514(c) if he dies before attaining the age of 21 years.

(b) Either a power of appointment exercisable by the donee by will or a power of appointment exercisable by the donee during his lifetime will satisfy the conditions set forth in paragraph (a)(3) of this section. However, if the transfer is to qualify for the exclusion under this section, there must be no restrictions of substance (as distinguished from formal restrictions of the type described in paragraph (g)(4) of § 25.2523(e)–1 by the terms of the instrument of transfer on the exercise of the power by the donee. However, if the minor is given a power of appointment exercisable during lifetime or is given a power of appointment exercisable by will, the fact that under the local law a minor is under a disability to exercise an intervivos power or to execute a will does not cause the transfer to fail to satisfy the conditions of section 2503(c). Further, a transfer does not fail to satisfy the conditions of section 2503(c) by reason of the mere fact that—

(1) There is left to the discretion of a trustee the determination of the amounts, if any, of the income or property to be expended for the benefit of the minor and the purpose for which the expenditure is to be made, provided there are no substantial restrictions under the terms of the trust instrument on the exercise of such discretion;

(2) The donee, upon reaching age 21, has the right to extend the term of the trust; or

(3) The governing instrument contains a disposition of the property or income not expended during the donee's minority to persons other than the donee's estate in the event of the default of appointment by the donee.

(c) A gift to a minor which does not satisfy the requirements of section 2503(c) may be either a present or a future interest under the general rules of § 25.2503–3. Thus, for example, a transfer of property in trust with income required to be paid annually to a minor beneficiary and corpus to be distributed to him upon his attaining the age of 25 is a gift of a present interest with respect to the right to income but is a gift of a future interest with respect to the right to corpus.

### § 25.2503–6 Exclusion for certain qualified transfer for tuition or medical expenses.

(a) *In general.* Section 2503(e) provides that any qualified transfer after December 31, 1981, shall not be treated as a transfer of property by gift for purposes of Chapter 12 of Subtitle B of the Code. Thus, a qualified transfer on behalf of any individual is excluded in determining the total amount of gifts in calendar year 1982 and subsequent years. This exclusion is available in addition to the $10,000 annual gift tax exclusion. Furthermore, an exclusion for a qualified transfer is permitted without regard to the relationship between the donor and the donee.

(b) *Qualified transfers*—(1) *Definition.* For purposes of this paragraph, the term ''qualified transfer'' means any amount paid on behalf of an individual—

(i) As tuition to a qualifying educational organization for the education or training of that individual, or

(ii) To any person who provides medical care with respect to that individual as payment for the qualifying medical expenses arising from such medical care.

(2) *Tuition expenses.* For purposes of paragraph (b)(1)(i) of this section, a qualifying educational organization is

one which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. See section 170(b)(1)(A)(ii) and the regulations thereunder. The unlimited exclusion is permitted for tuition expenses of full-time or part-time students paid directly to the qualifying educational organization providing the education. No unlimited exclusion is permitted for amounts paid for books, supplies, dormitory fees, board, or other similar expenses which do not constitute direct tuition costs.

(3) *Medical expenses.* For purposes of paragraph (b)(1)(ii) of this section, qualifying medical expenses are limited to those expenses defined in section 213(d) (section 213(e) prior to January 1, 1984) and include expenses incurred for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body or for transportation primarily for and essential to medical care. In addition, the unlimited exclusion from the gift tax includes amounts paid for medical insurance on behalf of any individual. The unlimited exclusion from the gift tax does not apply to amounts paid for medical care that are reimbursed by the donee's insurance. Thus, if payment for a medical expense is reimbursed by the donee's insurance company, the donor's payment for that expense, to the extent of the reimbursed amount, is not eligible for the unlimited exclusion from the gift tax and the gift is treated as having been made on the date the reimbursement is received by the donee.

(c) *Examples.* The provisions of paragraph (b) of this section may be illustrated by the following examples.

*Example (1).* In 1982, A made a tuition payment directly to a foreign university on behalf of B. A had no legal obligation to make this payment. The foreign university is described in section 170(b)(1)(A)(ii) of the Code. A's tuition payment is exempt from the gift tax under section 2503(e) of the Code.

*Example (2).* A transfers $100,000 to a trust the provisions of which state that the funds are to be used for tuition expenses incurred by A's grandchildren. A's transfer to the trust is a completed gift for Federal gift tax purposes and is not a direct transfer to an educational organization as provided in paragraph (b)(2) of this section and does not qualify for the unlimited exclusion from gift tax under section 2503(e).

*Example (3).* C was seriously injured in an automobile accident in 1982. D, who is unrelated to C, paid C's various medical expenses by checks made payable to the physician. D also paid the hospital for C's hospital bills. These medical and hospital expenses were types described in section 213 of the Code and were not reimbursed by insurance or otherwise. Because the medical and hospital bills paid in 1982 for C were medical expenses within the meaning of section 213 of the Code, and since they were paid directly by D to the person rendering the medical care, they are not treated as transfers subject to the gift tax.

*Example (4).* Assume the same facts as in example (2) except that instead of making the payments directly to the medical service provider, D reimbursed C for the medical expenses which C had previously paid. The payments made by D to C do not qualify for the exclusion under section 2503(e) of the Code and are subject to the gift tax on the date the reimbursement is received by C to the extent the reimbursement and all other gifts from D to C during the year of the reimbursement exceed the $10,000 annual exclusion provided in section 2503(b).

[T.D. 7978, 49 FR 38541, Oct. 1, 1984; 49 FR 39843, Oct. 11, 1984]

### § 25.2504–1 Taxable gifts for preceding calendar periods.

(a) In order to determine the correct gift tax liability for any calendar period it is necessary to ascertain the correct amount, if any, of the aggregate sum of the taxable gifts for each of the ''preceding calendar periods'' (as defined in § 25.2502–1(c)(2)). See paragraph (a) of § 25.2502–1. The term ''aggregate sum of the taxable gifts for each of the preceding calendar periods'' means the correct aggregate of such gifts, not necessarily that returned for those calendar periods and in respect of which tax was paid. All transfers that constituted gifts in prior calendar periods under the laws, including the provisions of law relating to exclusions from gifts, in effect at the time the transfers were made are included in determining the amount of taxable gifts for preceding calendar periods. The deductions other than for the specific exemption (see paragraph (b) of this section) allowed by the laws in effect at the time the transfers were made also are

taken into account in determining the aggregate sum of the taxable gifts for preceding calendar periods. (The allowable exclusion from a gift is $5,000 for years before 1939, $4,000 for the calendar years 1939 through 1942, $3,000 for the calendar years 1943 through 1981, and $10,000 thereafter.)

(b) In determining the aggregate sum of the taxable gifts for the ''preceding calendar periods'' (as defined in § 25.2502–1(c)(2)), the total of the amounts allowed as deductions for the specific exemption, under section 2521 (as in effect prior to its repeal by the Tax Reform Act of 1976) and the corresponding provisions of prior laws, shall not exceed $30,000. Thus, if the only prior gifts by a donor were made in 1940 and 1941 (at which time the specific exemption allowable was $40,000), and if in the donor's returns for those years the donor claimed deductions totaling $40,000 for the specific exemption and reported taxable gifts totaling $110,000, then in determining the aggregate sum of the taxable gifts for the preceding calendar periods, the deductions for the specific exemption cannot exceed $30,000, and the donor's taxable gifts for such periods will be $120,000 (instead of the $110,000 reported on the donor's returns). (The allowable deduction for the specific exemption was $50,000 for calendar years before 1936, $40,000 for calendar years 1936 through 1942, and $30,000 for 1943 through 1976.)

(c) If the donor and the donor's spouse consented to have gifts made to third parties considered as made one-half by each spouse, pursuant to the provisions of section 2513 or section 1000(f) of the Internal Revenue Code of 1939 (which corresponds to section 2513), these provisions shall be taken into account in determining the aggregate sum of the taxable gifts for the preceding calendar periods (under paragraph (a) of this section).

(d) If interpretations of the gift tax law in preceding calendar periods resulted in the erroneous inclusion of property for gift tax purposes that should have been excluded, or the erroneous exclusion of property that should have been included, adjustments must be made in order to arrive at the correct aggregate of taxable gifts for the preceding calendar periods (under paragraph (a) of this section). However, see section 1000 (e) and (g) of the 1939 Code relating to certain discretionary trusts and reciprocal trusts.

[T.D. 7238, 37 FR 28727, Dec. 29, 1972, as amended by T.D. 7910, 48 FR 40373, Sept. 7, 1983]

### § 25.2504–2 Valuation of certain gifts for preceding calendar periods.

Section 2504(c) provides that if the valuation of a transfer for gift tax purposes with respect to a gift made in a ''preceding calendar period,'' as defined in § 25.2502–1(c)(2), is at issue, and if the statutory period within which an assessment may be made with respect to the gift has expired and a tax has been actually assessed or paid for such prior calendar period, then the value of the gift, for purposes of arriving at the correct amount of the taxable gifts for the preceding calendar periods (under § 25.2504–1(a)), is the value that was used in computing the tax for the last preceding calendar period for which a tax was assessed or paid under Chapter 12 of the Internal Revenue Code of 1954 or the corresponding provisions of prior laws. However, this rule will not prevent an adjustment in value where no tax was paid or assessed for the prior calendar period. Furthermore, this rule does not apply to adjustments involving issues other than valuation. See paragraph (d) of § 25.2504–1.

[T.D. 7910, 48 FR 40374, Sept. 7, 1983]

## TRANSFERS

### § 25.2511–1 Transfers in general.

(a) 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 effected by the creation of a trust, the forgiving of a debt, the assignment of a judgment, the assignment of the benefits of an insurance policy, or the transfer of cash, certificates of deposit, or Federal, State or municipal bonds. Statutory provisions which exempt bonds, notes, bills and certificates of indebtedness of the Federal Government or its agencies and the interest thereon from taxation are not applicable to the gift tax, since

the gift tax is an excise tax on the transfer, and is not a tax on the subject of the gift.

(b) In the case of a gift by a nonresident not a citizen of the United States—

(1) If the gift was made on or after January 1, 1967, by a donor who was not an expatriate to whom section 2501(a)(2) was inapplicable on the date of the gift by reason of section 2501(a)(3) and paragraph (a)(3) of § 25.2501–1, or

(2) If the gift was made before January 1, 1967, by a donor who was not engaged in business in the United States during the calendar year in which the gift was made,

the gift tax applies only if the gift consisted of real property or tangible personal property situated within the United States at the time of the transfer. See §§ 25.2501–1 and 25.2511–3.

(c)(1) The gift tax also applies to gifts indirectly made. Thus, any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax. See further § 25.2512–8 relating to transfers for insufficient consideration. However, in the case of a transfer creating an interest in property (within the meaning of § 25.2518–2(c)(3) and (c)(4)) made after December 31, 1976, this paragraph (c)(1) shall not apply to the donee if, as a result of a qualified disclaimer by the donee, the interest passes to a different donee. Nor shall it apply to a donor if, as a result of a qualified disclaimer by the donee, a completed transfer of an interest in property is not effected. See section 2518 and the corresponding regulations for rules relating to a qualified disclaimer.

(2) In the case of taxable transfers creating an interest in the person disclaiming made before January 1, 1977, where the law governing the administration of the decedent's estate gives a beneficiary, heir, or next-of-kin a right completely and unqualifiedly to refuse to accept ownership of property transferred from a decedent (whether the transfer is effected by the decedent's will or by the law of descent and distribution), a refusal to accept ownership does not constitute the making of a gift if the refusal is made within a reasonable time after knowledge of the existence of the transfer. The refusal must be unequivocal and effective under the local law. There can be no refusal of ownership of property after its acceptance. In the absence of the facts to the contrary, if a person fails to refuse to accept a transfer to him of ownership of a decedent's property within a reasonable time after learning of the existence of the transfer, he will be presumed to have accepted the property. Where the local law does not permit such a refusal, any disposition by the beneficiary, heir, or next-of-kin whereby ownership is transferred gratuitously to another constitutes the making of a gift by the beneficiary, heir, or next-of-kin. In any case where a refusal is purported to relate to only a part of the property, the determination of whether or not there has been a complete and unqualified refusal to accept ownership will depend on all of the facts and circumstances in each particular case, taking into account the recognition and effectiveness of such a purported refusal under the local law. In illustration, if Blackacre was devised to A under the decedent's will (which also provided that all lapsed legacies and devises shall go to B, the residuary beneficiary), and under the local law A could refuse to accept ownership in which case title would be considered as never having passed to A, A's refusal to accept Blackacre within a reasonable time of learning of the devise will not constitute the making of a gift by A to B. However, if a decedent who owned Greenacre died intestate with C and D as his only heirs, and under local law the heir of a decedent cannot, by refusal to accept, prevent himself from becoming an owner of intestate property, any gratuitous disposition by C (by whatever term it is known) whereby he gives up his ownership of a portion of Greenacre and D acquires the whole thereof constitutes the making of a gift by C to D.

(3) The fourth sentence of paragraph (c)(1) of this section is applicable for transfers creating an interest to be disclaimed made on or after December 31, 1997.

(d) If a joint income tax return is filed by a husband and wife for a taxable year, the payment by one spouse of all or part of the income tax liability for such year is not treated as resulting in a transfer that is subject to gift tax. The same rule is applicable to the payment of gift tax for a ''calendar period'' (as defined in § 25.2502–1(c)(1)) in the case of a husband and wife who have consented to have the gifts made considered as made half by each of them in accordance with the provisions of section 2513.

(e) If a donor transfers by gift less than his entire interest in property, the gift tax is applicable to the interest transferred. The tax is applicable, for example, to the transfer of an undivided half interest in property, or to the transfer of a life estate when the grantor retains the remainder interest, or vice versa. However, if the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift. Thus if a donor, aged 65 years, transfers a life estate in property to A, aged 25 years, with remainder to A's issue, or in default of issue, with reversion to the donor, the gift tax will normally be applicable to the entire value of the property.

(f) If a donor is the owner of only a limited interest in property, and transfers his entire interest, the interest is in every case to be valued by the rules set forth in §§ 25.2512–1 through 25.2512–7. If the interest is a remainder or reversion or other future interest, it is to be valued on the basis of actuarial principles set forth in § 25.2512–5, or if it is not susceptible of valuation in that manner, in accordance with the principles set forth in § 25.2512–1.

(g)(1) 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. However, there are certain types of transfers to which the tax is not applicable. It is applicable only to a transfer of a beneficial interest in property. It is not applicable to a transfer of bare legal title to a trustee. A transfer by a trustee of trust property in which he has no beneficial interest does not constitute a gift by the trustee (but such a transfer may constitute a gift by the creator of the trust, if until the transfer he had the power to change the beneficiaries by amending or revoking the trust). 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, described in § 25.2512–8.

(2) If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. A clearly measurable standard under which the holder of a power is legally accountable is such a standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or to meet an emergency, would be such a standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not such a standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no such standard exists.

(h) The following are examples of transactions resulting in taxable gifts and in each case it is assumed that the transfers were not made for an adequate and full consideration in money or money's worth:

(1) A transfer of property by a corporation to B is a gift to B from the stockholders of the corporation. If B

himself is a stockholder, the transfer is a gift to him from the other stockholders but only to the extent it exceeds B's own interest in such amount as a shareholder. A transfer of property by B to a corporation generally represents gifts by B to the other individual shareholders of the corporation to the extent of their proportionate interests in the corporation. However, there may be an exception to this rule, such as a transfer made by an individual to a charitable, public, political or similar organization which may constitute a gift to the organization as a single entity, depending upon the facts and circumstances in the particular case.

(2) The transfer of property to B if there is imposed upon B the obligation of paying a commensurate annuity to C is a gift to C.

(3) The payment of money or the transfer of property to B in consideration of B's promise to render a service to C is a gift to C, or to both B and C, depending on whether the service to be rendered to C is or is not an adequate and full consideration in money or money's worth for that which is received by B. See section 2512(b) and the regulations thereunder.

(4) 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.

(5) 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 example (4) 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. However, see § 25.2515–1 relative to the creation of a joint tenancy (or tenancy by the entirety) between husband and wife in real property with rights of survivorship which, unless the donor elects otherwise is not considered as a transfer includible for Federal gift tax purposes at the time of the creation of the joint tenancy. See § 25.2515–2 with respect to determining the extent to which the creation of a tenancy by the entirety constitutes a taxable gift if the donor elects to have the creation of the tenancy so treated. See also § 25.2523(d)–1 with respect to the marital deduction allowed in the case of the creation of a joint tenancy or a tenancy by the entirety.

(6) If A is possessed of a vested remainder interest in property, subject to being divested only in the event he should fail to survive one or more individuals or the happening of some other event, an irrevocable assignment of all or any part of his interest would result in a transfer includible for Federal gift tax purposes. See especially § 25.2512–5 for the valuation of an interest of this type.

(7) If A, without retaining a power to revoke the trust or to change the beneficial interests therein, transfers property in trust whereby B is to receive the income for life and at his death the trust is to terminate and the corpus is to be returned to A, provided A survives, but if A predeceases B the corpus is to pass to C, A has made a gift equal to the total value of the property less the value of his retained interest. See § 25.2512–5 for the valuation of the donor's retained interest.

(8) If the insured purchases a life insurance policy, or pays a premium on a previously issued policy, the proceeds of which are payable to a beneficiary or beneficiaries other than his estate, and with respect to which the insured retains no reversionary interest in himself or his estate and no power to revest the economic benefits in himself or his estate or to change the beneficiaries or their proportionate benefits (or if the insured relinquishes by assignment, by designation of a new beneficiary or otherwise, every such power that was retained in a previously issued policy), the insured has made a gift of the value of the policy, or to the extent of the premium paid, even

though the right of the assignee or beneficiary to receive the benefits is conditioned upon his surviving the insured. For the valuation of life insurance policies see § 25.2512–6.

(9) Where property held by a husband and wife as community property is used to purchase insurance upon the husband's life and a third person is revocably designated as beneficiary and under the State law the husband's death is considered to make absolute the transfer by the wife, there is a gift by the wife at the time of the husband's death of half the amount of the proceeds of such insurance.

(10) If under a pension plan (pursuant to which he has an unqualified right to an annuity) an employee has an option to take either a retirement annuity for himself alone or a smaller annuity for himself with a survivorship annuity payable to his wife, an irrevocable election by the employee to take the reduced annuity in order that an annuity may be paid, after the employee's death, to his wife results in the making of a gift. However, see section 2517 and the regulations thereunder for the exemption from gift tax of amounts attributable to employers' contributions under qualified plans and certain other contracts.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7150, 36 FR 22900, Dec. 2, 1971; T.D. 7238, 37 FR 28728, Dec. 29, 1972; T.D. 7296, 38 FR 34202, Dec. 12, 1973; T.D. 7910, 48 FR 40374, Sept. 7, 1983; T.D. 8095, 51 FR 28369, Aug. 7, 1986; T.D. 8540, 59 FR 30103, June 10, 1994; T.D. 8744, 62 FR 68185, Dec. 31, 1997]

### § 25.2511–2 Cessation of donor's dominion and control.

(a) The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

(b) As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined. For example, if a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or his heirs, the entire transfer would be a completed gift. However, if the exercise of the trustee's power in favor of the grantor is limited by a fixed or ascertainable standard (see paragraph (g)(2) of § 25.2511–1), enforceable by or on behalf of the grantor, then the gift is incomplete to the extent of the ascertainable value of any rights thus retained by the grantor.

(c) A gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself. A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. Thus, if an estate for life is transferred but, by an exercise of a power, the estate may be terminated or cut down by the donor to one of less value, and without restriction upon the extent to which the estate may be so cut down, the transfer constitutes an incomplete gift. If in this example the power was confined to the right to cut down the

estate for life to one for a term of five years, the certainty of an estate for not less than that term results in a gift to that extent complete.

(d) A gift is not considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment. Thus, the creation of a trust the income of which is to be paid annually to the donee for a period of years, the corpus being distributable to him at the end of the period, and the power reserved by the donor being limited to a right to require that, instead of the income being so payable, it should be accumulated and distributed with the corpus to the donee at the termination of the period, constitutes a completed gift.

(e) A donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. A trustee, as such, is not a person having an adverse interest in the disposition of the trust property or its income.

(f) The relinquishment or termination of a power to change the beneficiaries of transferred property, occurring otherwise than by the death of the donor (the statute being confined to transfers by living donors), is regarded as the event that completes the gift and causes the tax to apply. For example, if A transfers property in trust for the benefit of B and C but reserves the power as trustee to change the proportionate interests of B and C, and if A thereafter has another person appointed trustee in place of himself, such later relinquishment of the power by A to the new trustee completes the gift of the transferred property, whether or not the new trustee has a substantial adverse interest. The receipt of income or of other enjoyment of the transferred property by the transferee or by the beneficiary (other than by the donor himself) during the interim between the making of the initial transfer and the relinquishment or termination of the power operates to free such income or other enjoyment from the power, and constitutes a gift of such income or of such other enjoyment taxable as of the ''calendar period'' (as defined in § 25.2502–1(c)(1)) of its receipt. If property is transferred in trust to pay the income to A for life with remainder to B, powers to distribute corpus to A, and to withhold income from A for future distribution to B, are powers to change the beneficiaries of the transferred property.

(g) If a donor transfers property to himself as trustee (or to himself and some other person, not possessing a substantial adverse interest, as trustees), and retains no beneficial interest in the trust property and no power over it except fiduciary powers, the exercise or nonexercise of which is limited by a fixed or ascertainable standard, to change the beneficiaries of the transferred property, the donor has made a completed gift and the entire value of the transferred property is subject to the gift tax.

(h) If a donor delivers a properly indorsed 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.

(i) [Reserved]

(j) If the donor contends that a power is of such nature as to render the gift incomplete, and hence not subject to the tax as of the ''calendar period'' (as defined in § 25.2502–1(c)(1)) of the initial transfer, the transaction shall be disclosed in the return and evidence showing all relevant facts, including a copy of the instrument of transfer, should be submitted.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7238, 37 FR 28728, Dec. 29, 1972; T.D. 7910, 48 FR 40374, Sept. 7, 1983]

### § 25.2511–3 Transfers by nonresidents not citizens.

(a) *In general.* Sections 2501 and 2511 contain rules relating to the taxation of transfers of property by gift by a donor who is a nonresident not a citizen of the United States. (See paragraph (b) of § 25.2501–1 for the definition of the term ''resident'' for purposes of the gift tax.) As combined these rules are:

(1) The gift tax applies only to the transfer of real property and tangible personal property situated in the United States at the time of the transfer if either—

(i) The gift was made on or after January 1, 1967, by a nonresident not a citizen of the United States who was not an expatriate to whom section 2501(a)(2) was inapplicable on the date of the gift by reason of section 2501(a)(3) and paragraph (a)(3) of § 25.2501–1, or

(ii) The gift was made before January 1, 1967, by a nonresident not a citizen of the United States who was not engaged in business in the United States during the calendar year in which the gift was made.

(2) The gift tax applies to the transfer of all property (whether real or personal, tangible or intangible) situated in the United States at the time of the transfer if either—

(i) The gift was made on or after January 1, 1967, by a nonresident not a citizen of the United States who was an expatriate to whom section 2501(a)(2) was inapplicable on the date of the gift by reason of section 2501(a)(3) and paragraph (a)(3) of § 25.2501–1, or

(ii) The gift was made before January 1, 1967, by a nonresident not a citizen of the United States who was engaged in business in the United States during the calendar year in which the gift was made.

(b) *Situs of property*. For purposes of applying the gift tax to the transfer of property owned and held by a nonresident not a citizen of the United States at the time of the transfer—

(1) *Real property and tangible personal property*. Real property and tangible personal property constitute property within the United States only if they are physically situated therein.

(2) *Intangible personal property*. Except as provided otherwise in subparagraphs (3) and (4) of this paragraph, intangible personal property constitutes property within the United States if it consists of a property right issued by or enforceable against a resident of the United States or a domestic corporation (public or private), irrespective of where the written evidence of the property is physically located at the time of the transfer.

(3) *Shares of stock*. Irrespective of where the stock certificates are physically located at the time of the transfer—

(i) Shares of stock issued by a domestic corporation constitute property within the United States, and

(ii) Shares of stock issued by a corporation which is not a domestic corporation constitute property situated outside the United States.

(4) *Debt obligations*. (i) In the case of gifts made on or after January 1, 1967, a debt obligation, including a bank deposit, the primary obligor of which is a United States person (as defined in section 7701(a)(30)), the United States, a State, or any political subdivision thereof, the District of Columbia, or any agency or instumentality of any such government constitutes property situated within the United States. This subdivision applies—

*(a)* In the case of a debt obligation of a domestic corporation, whether or not any interest on the obligation would be treated under section 862(a)(1) as income from sources without the United States by reason of section 861(a)(1)(B) (relating to interest received from a domestic corporation less than 20 percent of whose gross income for a 3–year period was derived from sources within the United States) and the regulations thereunder;

*(b)* In the case of an amount described in section 861(c) (relating to certain bank deposits, withdrawable accounts, and amounts held by an insurance company under an agreement to pay interest), whether or not any interest thereon would be treated under section 862(a)(1) as income from sources without the United States by reason of section 861(a)(1)(A) (relating to interest on amounts described in section 861(c) which is not effectively connected with the conduct of a trade or business within the United States) and the regulations thereunder;

*(c)* In the case of a deposit with a domestic corporation or domestic partnership, whether or not the deposit is with a foreign branch thereof engaged in the commercial banking business; and

*(d)* Irrespective of where the written evidence of the debt obligation is physically located at the time of the transfer.

For purposes of this subdivision, a debt obligation on which there are two or more primary obligors shall be apportioned among such obligors, taking into account to the extent appropriate under all the facts and circumstances any choate or inchoate rights of contribution existing among such obligors with respect to the indebtedness. The term ''agency or instrumentality'', as used in this subdivision, does not include a possession of the United States or an agency or instrumentality of a possession.

(ii) In the case of gifts made on or after January 1, 1967, a debt obligation, including a bank deposit, not deemed under subdivision (i) of this subparagraph to be situated within the United States, constitutes property situated outside the United States.

(iii) In the case of gifts made before January 1, 1967, a debt obligation the written evidence of which is treated as being the property itself constitutes property situated within the United States if the written evidence of the obligation is physically located in the United States at the time of the transfer, irrespective of who is the primary obligor on the debt. If the written evidence of the obligation is physically located outside the United States, the debt obligation constitutes property situated outside the United States.

(iv) Currency is not a debt obligation for purposes of this subparagraph.

[T.D. 7296, 38 FR 34202, Dec. 12, 1973]

### § 25.2512–0 Table of contents.

This section lists the section headings that appear in the regulations under section 2512.

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*§ 25.2512–3 Valuation of interests in businesses.*
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*§ 25.2512–5 Valuation of annuities, unitrust interests, interests for life or term of years, and remainder or reversionary interests transferred after April 30, 1989.*
*§ 25.2512–6 Valuation of certain life insurance and annuity contracts; valuation of shares in an open-end investment company.*
*§ 25.2512–7 Effect of excise tax.*
*§ 25.2512–8 Transfers for insufficient consideration.*

ACTUARIAL TABLES APPLICABLE BEFORE MAY 1, 1989

*§ 25.2512–5A Valuation of annuities, unitrust interests, interests for life or term of years, and remainder or reversionary interests transferred before May 1, 1989.*

[T.D. 8540, 59 FR 30173, June 10, 1994]

### § 25.2512–1 Valuation of property; in general.

Section 2512 provides that if a gift is made in property, its value at the date of the gift shall be considered the amount of the gift. The value of the property is the price at which such 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. The value of a particular item of property is not the price that a forced sale of the property would produce. Nor is the fair market value of an item of property the sale price in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property made the subject of a gift, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the value of an automobile (an article generally obtained by the public in the retail market) which is the subject of a gift, is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the donor would be purchased by a dealer in used automobiles. Examples of items of property which are generally sold to the public at retail may be found in § 25.2512–6. The value is generally to be determined by ascertaining as a basis the fair market value at the time of the gift of each unit of the property. For example, in the case of shares of stocks or bonds, such unit of property is generally a share or a bond. Property shall not be returned at the

value at which it is assessed for local tax purposes unless that value represents the fair market value thereof on the date of the gift. All relevant facts and elements of value as of the time of the gift shall be considered. Where the subject of a gift is an interest in a business, the value of items of property in the inventory of the business generally should be reflected in the value of the business. For valuation of interests in businesses, see § 25.2512–3. See § 25.2512–2 and §§ 25.2512–4 through 25.2512–6 for further information concerning the valuation of other particular kinds of property. See § 25.2702–6 for an adjustment to the total amount of an individual's taxable gifts where the individual's current taxable gifts include the transfer of certain interests in trust that were previously valued under the provisions of section 2702.

[T.D. 6826, 30 FR 7709, June 15, 1965; as amended by T.D. 8395, 57 FR 4254, Feb. 4, 1992]

### § 25.2512–2 Stocks and bonds.

(a) *In general.* The value of stocks and bonds is the fair market value per share or bond on the date of the gift.

(b) *Based on selling prices.* (1) In general, 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 date of the gift is the fair market value per share or bond. If there were no sales on the date of the gift but there were sales on dates within a reasonable period both before and after the date of the gift, 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 date of the gift. The average is to be weighted inversely by the respective numbers of trading days between the selling dates and the date of the gift. 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 available in a generally available listing or publication of general circulation, the records of such combined exchanges should be employed. In valuing listed securities, the donor should be careful to consult accurate records to obtain values as of the date of the gift. If quotations of unlisted securities are obtained from brokers, or evidence as to their sale is obtained from the officers of the issuing companies, copies of letters furnishing such quotations or evidence of sale should be attached to the return.

(2) 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 date of the gift in a generally available listing or publication of general circulation but that closing prices are so available, the fair market value per bond is the mean between the quoted closing selling price on the date of the gift and the quoted closing selling price on the trading day before the date of the gift. If there were no sales on the trading day before the date of the gift but there were sales on dates within a reasonable period before the date of the gift, the fair market value is determined by taking a weighted average of the quoted closing selling prices on the date of the gift and the nearest date before the date of the gift. The closing selling price for the date of the gift is to be weighted by the respective number of trading days between the previous selling date and the date of the gift. If there were no sales within a reasonable period before the date of the gift but there were sales on the date of the gift, the fair market value is the closing selling price on the date of the gift. If there were no sales on the date of the gift but there were sales within a reasonable period both before and after the date of the gift, 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 date of the gift. The average is to be weighed inversely by the respective numbers of trading days between the selling dates and the date of the gift. 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. In valuing listed securities, the donor should be careful to consult accurate records to obtain values as of the date of the gift.

(3) The application of this paragraph may be illustrated by the following examples:

*Example (1).* Assume that sales of stock nearest the date of the gift (Friday, June 15) occurred two trading days before (Wednesday, June 13) and three trading days after (Wednesday, June 20) and on these days the mean sale prices per share were $10 and $15, respectively. The price of $12 is taken as representing the fair market value of a share of stock as of the date of the gift

$$[(3\times10)+(2\times15)]/5$$

*Example (2).* Assume the same facts as in example 1 except that the mean sale prices per share on June 13 and June 20 were $15 and $10 respectively. The price of $13 is taken as representing the fair market value of a share of stock as of the date of the gift

$$[(3\times15)+(2\times10)]/5$$

*Example (3).* Assume that on the date of the gift (Tuesday, April 3, 1973) the closing selling price of certain listed bonds was $25 per bond and that the highest and lowest selling prices are not available in a generally available listing or publication of general circulation for that date. Assume further, that the closing selling price of such bonds was $21 per bond on the day before the date of the gift (Monday, April 2, 1973). Thus, under paragraph (b)(2) of this section, the price of $23 is taken as representing the fair market value per bond as of the date of the gift

$$[(25+21)]/2$$

*Example (4).* Assume the same facts as in example 3 except that there were no sales on the day before the date of the gift. Assume further, that there were sales on Thursday, March 29, 1973, and that the closing selling price on that day was $23. The price of $24.50 is taken as representing the fair market value per bond as of the date of the gift

$$[(1\times23)+(3\times25)]/4$$

*Example (5).* Assume that no bonds were traded on the date of the gift (Friday, April 20). Assume further, that sales of bonds nearest the date of the gift occurred two trading days before (Wednesday, April 18) and three trading days after (Wednesday, April 25) the date of the gift and that on these two days the closing selling prices per bond were $29 and $22, respectively. The highest and lowest selling prices are not available for these dates in a generally available listing or publication of general circulation. Thus, under paragraph (b)(2) of this section the price of $26.20 is taken as representing the fair market value of a bond as of the date of the gift

$$[(3\times29)+(2\times22)]/5$$

(c) *Based on bid and asked prices.* If the provisions of paragraph (b) of this section are inapplicable because actual sales are not available during reasonable period beginning before and ending after the date of the gift, the fair market value may be determined by taking the mean between the bona fide bid and asked prices on the date of the gift, 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 date of the gift, if both such nearest dates are within a reasonable period. The average is to be determined in the manner described in paragraph (b) of this section.

(d) *Where selling prices and bid and asked prices are not available for dates both before and after the date of gift.* If the provisions of paragraphs (b) and (c) of this section are inapplicable because no actual sale prices or quoted bona fide bid and asked prices are available on a date within a reasonable period before the date of the gift, but such prices are available on a date within a reasonable period after the date of the gift, 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.

(e) *Where selling prices or bid and asked prices do not represent fair market value.* In cases in which it is established that the value per bond or share of any security determined on the basis of the selling or bid and asked prices as provided under paragraphs (b), (c), and (d) of this section does not represent the fair market value thereof, then some reasonable modification of the value determined on that basis or other relevant facts and elements of value shall be considered in determining fair market value. Where sales at or near the date of the 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 securities made the subject of each separate gift 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 donor can show that the block of stock to be valued, with reference to each separate gift, 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. Complete data in support of any allowance claimed due to the size of the block of stock being valued should be submitted with the return. On the other hand, if the block of stock to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to its true value.

(f) *Where selling prices or bid and asked prices are unavailable.* If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because 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 subparagraphs (1) and (2) of this paragraph are: The goodwill 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. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of any examinations of the company made by accountants, engineers, or any technical experts as of or near the date of the gift.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7327, 39 FR 35355, Oct. 1, 1974; T.D. 7432, 41 FR 38769, Sept. 13, 1976]

### § 25.2512–3 Valuation of interest in businesses.

(a) Care should be taken to arrive at an accurate valuation of any interest in a business which the donor transfers without an adequate and full consideration in money or money's worth. The fair market value of any interest in a business, whether a partnership 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—

(1) A fair appraisal as of the date of the gift 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 paragraph (f) of § 25.2512–2 relating to the valuation of corporate stock, to the extent applicable.

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 date of the gift.

(b) [Reserved]

### § 25.2512–4 Valuation of notes.

The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus accrued interest to the date of the gift, unless the donor establishes a lower value. Unless returned at face value, plus accrued interest, it must be shown by satisfactory evidence that the note is worth less than the unpaid amount

(because of the interest rate, or date of maturity, or other cause), or that the note is uncollectible in part (by reason of the insolvency of the party or parties liable, or for other cause), and that the property, if any, pledged or mortgaged as security is insufficient to satisfy it.

**§ 25.2512–5 Valuation of annuities, unitrust interests, interests for life or term of years, and remainder or reversionary interests transferred after April 30, 1989.**

(a) *In general.* Except as otherwise provided in paragraph (b) of this section and § 25.7520–3(b), the fair market value of annuities, unitrust interests, life estates, terms of years, remainders, and reversions transferred by gift is the present value of the interests determined under paragraph (d) of this section. Section 20.2031–7 of this chapter (Estate Tax Regulations) and related sections provide tables with standard actuarial factors and examples that illustrate how to use the tables to compute the present value of ordinary annuity, life, and remainder interests in property. These sections also refer to standard and special actuarial factors that may be necessary to compute the present value of similar interests in more unusual fact situations. These factors and examples are also generally applicable for gift tax purposes in computing the values of taxable gifts.

(b) *Commercial annuities and insurance contracts.* The value of life insurance contracts and contracts for the payment of annuities issued by companies regularly engaged in their sale is determined under § 25.2512–6.

(c) *Actuarial valuations before May 1, 1989.* The present value of annuities, unitrust interests, life estates, terms of years, remainders, and reversions transferred by gift before May 1, 1989, is determined under the following sections:

| After | Transfers | | Applicable |
|---|---|---|---|
| | Before | Regulations | |
| | Jan. 1, 1952 | 25.2512–5A(a) | |
| Dec. 31, 1951 | Jan. 1, 1971 | 25.2512–5A(b) | |
| Dec. 31, 1970 | Dec. 1, 1983 | 25.2512–5A(c) | |
| Dec. 30, 1983 | May 1, 1989 | 25.2512–5A(d) | |

(d) *Actuarial valuations after April 30, 1989*—(1) *In general.* Except as otherwise provided in paragraph (b) of this section and § 25.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances), if the valuation date for the gift is after April 30, 1989, the fair market value of annuities, life estates, terms of years, remainders, and reversions transferred after April 30, 1989, is the present value of such interests determined by use of standard or special section 7520 actuarial factors. These factors are derived by using the appropriate section 7520 interest rate and, if applicable, the mortality component for the valuation date of the interest that is being valued. See §§ 25.7520–1 through 25.7520–4. The fair market value of a qualified annuity interest described in section 2702(b)(1) and a qualified unitrust interest described in section 2702(b)(2) is the present value of such interests determined under § 25.7520–1(c).

(2) *Specific interests.* When the donor transfers property in trust or otherwise and retains an interest therein, generally, the value of the gift is the value of the property transferred less the value of the donor's retained interest. However, if the donor transfers property after October 8, 1990, to or for the benefit of a member of the donor's family, the value of the gift is the value of the property transferred less the value of the donor's retained interest as determined under section 2702. If the donor assigns or relinquishes an annuity, life estate, remainder, or reversion that the donor holds by virtue of a transfer previously made by the donor or another, the value of the gift is the value of the interest transferred. However, see section 2519 for a special rule

in the case of the assignment of an income interest by a person who received the interest from a spouse.

(i) *Charitable remainder trusts.* The fair market value of a remainder interest in a pooled income fund, as defined in § 1.642(c)–5 of this chapter (Income Tax Regulations), is its value determined under § 1.642(c)–6(e) of this chapter. The fair market value of a remainder interest in a charitable remainder annuity trust, as described in § 1.664–2(a) of this chapter, is its present value determined under § 1.664–2(c) of this chapter. The fair market value of a remainder interest in a charitable remainder unitrust, as defined in § 1.664–3 of this chapter, is its present value determined under § 1.664–4(e) of this chapter. The fair market value of a life interest or term for years in a charitable remainder unitrust is the fair market value of the property as of the date of transfer less the fair market value of the remainder interest, determined under § 1.664–4(e) of this chapter.

(ii) *Ordinary remainder and reversionary interests.* If the interest to be valued is to take effect after a definite number of years or after the death of one individual, the present value of the interest is computed by multiplying the value of the property by the appropriate remainder interest actuarial factor (that corresponds to the applicable section 7520 interest rate and remainder interest period) in Table B (for a term certain) or Table S (for one measuring life), as the case may be. Tables B and S are included in § 20.2031–7(d)(6) of this chapter (Estate Tax Regulations) and in Internal Revenue Service Publication 1457. For information about obtaining actuarial factors for other types of remainder interests, see paragraph (d)(4) of this section.

(iii) *Ordinary term-of-years and life interests.* If the interest to be valued is the right of a person to receive the income of certain property, or to use certain nonincome-producing property, for a term of years or for the life of one individual, the present value of the interest is computed by multiplying the value of the property by the appropriate term-of-years or life interest actuarial factor (that corresponds to the applicable section 7520 interest rate and term-of-years or life interest period). Internal Revenue Service Publication 1457 includes actuarial factors for an interest for a term of years in Table B and for the life of one individual in Table S. However, term-of-years and life interest actuarial factors are not included in Table B or Table S in § 20.2031–7(d)(6) of this chapter. If Internal Revenue Service Publication 1457 (or any other reliable source of term-of-years and life interest actuarial factors) is not conveniently available, an actuarial factor for the interest may be derived mathematically. This actuarial factor may be derived by subtracting the correlative remainder factor (that corresponds to the applicable section 7520 interest rate and the term of years or the life) in Table B (for a term of years) or in Table S (for the life of one individual) in § 20.2031–7(d)(6), as the case may be, from 1.000000. For information about obtaining actuarial factors for other types of term-of-years and life interests, see paragraph (d)(4) of this section.

(iv) *Annuities.* (A) If the interest to be valued is the right of a person to receive an annuity that is payable at the end of each year for a term of years or for the life of one individual, the present value of the interest is computed by multiplying the aggregate amount payable annually by the appropriate annuity actuarial factor (that corresponds to the applicable section 7520 interest rate and annuity period). Internal Revenue Service Publication 1457 includes actuarial factors in Table B (for an annuity payable for a term of years) and in Table S (for an annuity payable for the life of one individual). However, annuity actuarial factors are not included in Table B or Table S in § 20.2031–7(d)(6) of this chapter. If Internal Revenue Service Publication 1457 (or any other reliable source of annuity actuarial factors) is not conveniently available, an annuity factor for a term of years or for one life may be derived mathematically. This annuity factor may be derived by subtracting the applicable remainder factor (that corresponds to the applicable section 7520 interest rate and annuity period) in Table B (in the case of a term-of-years annuity) or in Table S (in the case of a one-life annuity) in § 20.2031–7(d)(6), as the case may be, from 1.000000 and then

dividing the result by the applicable section 7520 interest rate expressed as a decimal number. See § 20.2031–7(d)(2)(iv) of this chapter for an example that illustrates the computation of the present value of an annuity.

(B) If the annuity is payable at the end of semiannual, quarterly, monthly, or weekly periods, the product obtained by multiplying the annuity factor by the aggregate amount payable annually is then multiplied by the applicable adjustment factor set forth in Table K in § 20.2031–7(d)(6) of this chapter at the appropriate interest rate component for payments made at the end of the specified periods. The provisions of this paragraph (d)(2)(iv)(B) are illustrated by the following example:

*Example.* On July 1, 1989, the donor agrees to pay the annuitant the sum of $10,000 per year, payable in equal semiannual installments at the end of each period. The semiannual installments are to be made on each December 31st and June 30th. The annuity is payable until the annuitant's death. On July 1, 1989, the annuitant is 68 years and 5 months old. The donee annuitant's age is taken as 68 for purposes of computing the present value of the retained annuity. The section 7520 rate for July 1989 is 10.6 percent. Under Table S, the factor at 10.6 percent for determining the present value of a remainder interest payable at the death of an individual aged 68 is .31371 Converting the remainder factor to an annuity factor, as described above, the annuity factor for determining the present value of an annuity transferred to an individual age 68 is 6.4744 (1.00000 minus .31371 divided by 10.6). The adjustment factor from Table K in the column for payments made at the end of each semiannual period at the rate of 10.6 percent is 1.0258. The aggregate annual amount of the annuity, $10,000, is multiplied by the factor 6.4744 and the product multiplied by 1.0258. The present value of the annuity beneficiary's interest is, therefore, $66,414 ($10,000×6.4744×1.0258).

(C) If an annuity is payable at the beginning of annual, semiannual, quarterly, monthly, or weekly periods for a term of years, the value of the annuity is computed by multiplying the aggregate amount payable annually by the annuity factor described in paragraph (d)(2)(iv)(A) of this section; and the product so obtained is then multiplied by the adjustment factor in Table J in § 20.2031–7(d)(6) of this chapter at the appropriate interest rate component for payments made at the beginning of specified periods. If an annuity is payable at the beginning of annual, semiannual, quarterly, monthly, or weekly periods for one or more lives, the value of the annuity is the sum of the first payment plus the present value of a similar annuity, the first payment of which is not to be made until the end of the payment period, determined as provided in paragraph (d)(2)(iv)(B) of this section.

(v) *Annuity and unitrust interests for a term of years or until the prior death of an individual*—(A) *Annuity interests.* The present value of an annuity interest that is payable until the earlier to occur of the lapse of a specific number of years or the death of an individual may be computed with values from the tables in 20.2031–7(d)(6) as described in the following example:

*Example.* On January 1, 1991, the donor transfers $100,000 into a trust and retains the right to receive an annuity from the trust in the amount of $6,000 per year, payable in equal semiannual installments at the end of each period. The semiannual installments are to be made on each June 30th and December 31st. The annuity is payable for 10 years or until the donor's prior death. On January 1, 1991, the donor is 59 years and 6 months old. The donor's age is taken as 60 for purposes of computing the present value of the retained annuity. The section 7520 rate for January 1991 is 9.8 percent. The present value of the annuity beneficiary's interst is $35,424.00, determined as follows:

| | |
|---|---|
| Table S value at 9.8 percent, age 60 | .23158 |
| Table S value at 9.8 percent, age 70 | .36468 |
| Table 80CNSMT value at age 70 | .68248 |
| Table 80CNSMT value at age 60 | .83726 |
| Table B value at 9.8 percent, 10 years | .392624 |
| Table K value at 9.8 percent, | 1.0239 |

Factor for annuity beneficiary's interest at 9.8 percent:

$$\frac{(1.00000-.23158)-(.392624\times(68248/83726)\times(1.00000-.36468))=5.7662}{.098}$$

Present value of annuity beneficiary's interest:

($6,000×5.7662×1.0239) ..... $35,424.07

(B) *Unitrust interests.* The present value of a unitrust interest that is payable until the earlier to occur of the lapse of a specific number of years or the death of an individual may be computed with values from the tables in § 1.664–4(e)(6) as described in the following example:

*Example.* The donor who, as of the nearest birthday, is 60 years old transfers $100,000 to a unitrust on January 1, 1991. The trust instrument requires that each year the trust pay to the donor, in equal semiannual installments on June 30th and December 31st, 6 percent of the fair market value of the trust assets, valued as of January 1st each year, for 10 years or until the prior death of the donor. The section 7520 rate for January 1991 is 9.8 percent. Under Table F(9.8), the appropriate adjustment factor is .932539 for semiannual payments payable at the end of the semiannual period. The adjusted payout rate is 5.595 percent (6% × .932539). The present value of the unitrust beneficiary's interest is $40,495.00 determined as follows:

| | |
|---|---|
| Table U(1) value at 5.6 percent, age 60 ..... | .37017 |
| Table U(1) value at 5.6 percent, age 70 ..... | .50971 |
| Table 80CNSMT value at age 70 ..... | .68248 |
| Table 80CNSMT value at age 60 ..... | .83726 |
| Table D value at 5.6 percent, 10 years ..... | .561979 |

Factor for the unitrust beneficiary's interest at 5.6 percent: (1.000000 − .37017) − (.561979×(68248/83726)×(1.000000 − .50971))=.40523

| | |
|---|---|
| Table U(1) value at 5.4 percent, age 60 ..... | .38183 |
| Table U(1) value at 5.4 percent, age 70 ..... | .52086 |
| Table 80CNSMT value at age 70 ..... | .68248 |
| Table 80CNSMT value at age 60 ..... | .83726 |
| Table D value at 5.4 percent, 10 years ..... | .573999 |

Factor for the unitrust beneficiary's interest at 5.4 percent:

$$(1.000000-.38183)-(.573999\times(68248/83726)\times(1.000000-.52086))=.39399$$

Difference… .01124

Interpolation adjustment:

$$\frac{5.595\%-5.4\%}{0.2\%}=\frac{x}{.01124}$$

$$x=.01096$$

| | |
|---|---|
| Factor at 5.4 percent, age 60 ..... | .39399 |
| Plus: Interpolation adjustment ..... | .01096 |
| Interpolated Factor ..... | .40495 |
| Present value of unitrust beneficiary's interest: ($100,000×.40495) ..... | $40,495.00 |

(3) *Transitional rule.* (i) If the valuation date of a transfer of an interest in property by gift is after April 30, 1989, and before June 10, 1994, a donor can rely on Notice 89–24, 1989–1C.B. 660, or Notice 89–60, 1989–1 C.B. 700, in valuing the transferred interest. (See § 601.601(d)(2)(ii)(*b*) of this chapter.)

(ii) If a donor transferred an interest in property by gift after December 31, 1988, and before May 1, 1989, retaining an interest in the same property, and after April 30, 1989, and before January

1, 1990, transferred the retained interest in property, the donor may, at the option of the donor, value the transfer of the retained interest under this section or under § 25.2512–5A(d).

(4) *Publications and actuarial computations by the Internal Revenue Service.* Many standard actuarial factors not included in § 20.2031–7(d)(6) of this chapter are included in Internal Revenue Service Publication 1457, ''Actuarial Values, Alpha Volume,'' (8–89). Internal Revenue Service Publication 1457 also includes examples that illustrate how to compute many special factors for more unusual situations. A copy of this publication may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. If a special factor is required in the case of a completed gift, the Service may furnish the factor to the donor upon a request for a ruling. The request for a ruling must be accompanied by a recitation of the facts including a statement of the date of birth for each measuring life, the date of the gift, any other applicable dates, and a copy of the will, trust, or other relevant documents. A request for a ruling must comply with the instructions for requesting a ruling published periodically in the Internal Revenue Bulletin (see §§ 601.201 and 601.601(d)(2)(ii)(*b*) of this chapter) and include payment of the required user fee.

(e) *Effective date.* This section is effective as of May 1, 1989.

[T.D. 8540, 59 FR 30174, June 10, 1994]

### § 25.2512–6 Valuation of certain life insurance and annuity contracts; valuation of shares in an open-end investment company.

(a) *Valuation of certain life insurance and annuity contracts.* The value of a life insurance contract or of a contract for the payment of an annuity issued by a company regularly engaged in the selling of contracts of that character is established through the sale of the particular contract by the company, or through the sale by the company of comparable contracts. As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used. The following examples, so far as relating to life insurance contracts, are of gifts of such contracts on which there are no accrued dividends or outstanding indebtedness.

*Example (1).* A donor purchases from a life insurance company for the benefit of another a life insurance contract or a contract for the payment of an annuity. The value of the gift is the cost of the contract.

*Example (2).* An annuitant purchased from a life insurance company a single payment annuity contract by the terms of which he was entitled to receive payments of $1,200 annually for the duration of his life. Five years subsequent to such purchase, and when of the age of 50 years, he gratuitously assigns the contract. The value of the gift is the amount which the company would charge for an annuity contract providing for the payment of $1,200 annually for the life of a person 50 years of age.

*Example (3).* A donor owning a life insurance policy on which no further payments are to be made to the company (e.g., a single premium policy or paid-up policy) makes a gift of the contract. The value of the gift is the amount which the company would charge for a single premium contract of the same specified amount on the life of a person of the age of the insured.

*Example (4).* A gift is made four months after the last premium due date of an ordinary life insurance policy issued nine years and four months prior to the gift thereof by the insured, who was 35 years of age at date of issue. The gross annual premium is $2,811. The computation follows:

| | |
|---|---|
| Terminal reserve at end of tenth year | $14,601.00 |
| Terminal reserve at end of ninth year | 12,965.00 |
| Increase | 1,636.00 |
| One-third of such increase (the gift having been made four months following the last preceding premium due date), is | 545.33 |
| Terminal reserve at end of ninth year | 12,965.00 |
| Interpolated terminal reserve at date of gift | 13,510.33 |
| Two-thirds of gross premium ($2,811) | 1,874.00 |
| Value of the gift | 15,384.33 |

*Example (5).* A donor purchases from a life insurance company for $15,198, a joint and

survivor annuity contract which provides for the payment of $60 a month to the donor during his lifetime, and then to his sister for such time as she may survive him. The premium which would have been charged by the company for an annuity of $60 monthly payable during the life of the donor alone is $10,690. The value of the gift is $4,508 ($15,198 less $10,690).

(b) *Valuation of shares in an open-end investment company.* (1) 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 the gift, the last public redemption price quoted by the company for the date of the gift shall be presumed to be the applicable public redemption price. If there is no public redemption price quoted by the company for the date of the gift (e.g., the date of the gift 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 date of the gift for which there is a quotation. As used in this paragraph the term ''open-end investment company'' includes only a company which on the date of the gift was engaged in offering its shares to the public in the capacity of an open-end investment company.

(2) The provisions of this paragraph shall apply with respect to gifts made after December 31, 1954.

[T.D. 6680, 28 FR 10872, Oct. 10, 1963, as amended by T.D. 7319, 39 FR 26723, July 23, 1974]

### § 25.2512–7 Effect of excise tax.

If jewelry, furs or other property, the purchase of which is subject to an excise tax, is purchased at retail by a taxpayer and made the subject of gifts within a reasonable time after purchase, the purchase price, including the excise tax, is considered to be the fair market value of the property on the date of the gift, in the absence of evidence that the market price of similar articles has increased or decreased in the meantime. Under other circumstances, the excise tax is taken into account in determining the fair market value of property to the extent, and only to the extent, that it affects the price at which the property would change hands between a willing buyer and a willing seller, as provided in § 25.2512–1.

### § 25.2512–8 Transfers for insufficient consideration.

Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth. A consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be 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, shall not be considered to any extent a consideration ''in money or money's worth.'' See, however, section 2516 and the regulations thereunder with respect to certain transfers incident to a divorce. See also sections 2701, 2702, 2703 and 2704 and the regulations at §§ 25.2701–0 through 25.2704–3 for special rules for valuing transfers of business interests, transfers in trust, and transfers pursuant to options and purchase agreements.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958; 25 FR 14021, Dec. 31, 1960; as amended by T.D. 8395, 57 FR 4255, Feb. 4, 1992]

### § 25.2513–1 Gifts by husband or wife to third party considered as made one-half by each.

(a) A gift made by one spouse to a person other than his (or her) spouse may, for the purpose of the gift tax, be

considered as made one-half by his spouse, but only if at the time of the gift each spouse was a citizen or resident of the United States. For purposes of this section, an individual is to be considered as the spouse of another individual only if he was married to such individual at the time of the gift and does not remarry during the remainder of the ''calendar period'' (as defined in § 25.2502–1(c)(1)).

(b) The provisions of this section will apply to gifts made during a particular ''calendar period'' (as defined in § 25.2502–1(c)(1)) only if both spouses signify their consent to treat all gifts made to third parties during that calendar period by both spouses while married to each other as having been made one-half by each spouse. As to the manner and time for signifying consent, see § 25.2513–2. Such consent, if signified with respect to any calendar period, is effective with respect to all gifts made to third parties during such calendar period except as follows:

(1) If the consenting spouses were not married to each other during a portion of the calendar period, the consent is not effective with respect to any gifts made during such portion of the calendar period. Where the consent is signified by an executor or administrator of a deceased spouse, the consent is not effective with respect to gifts made by the surviving spouse during the portion of the calendar period that his spouse was deceased.

(2) If either spouse was a nonresident not a citizen of the United States during any portion of the calendar period, the consent is not effective with respect to any gift made during that portion of the calendar period.

(3) The consent is not effective with respect to a gift by one spouse of a property interest over which he created in his spouse a general power of appointment (as defined in section 2514(c)).

(4) If one spouse transferred property in part to his spouse and in part to third parties, the consent is effective with respect to the interest transferred to third parties only insofar as such interest is ascertainable at the time of the gift and hence severable from the interest transferred to his spouse. See § 25.2512–5 for the principles to be applied in the valuation of annuities, life estates, terms for years, remainders and reversions.

(5) The consent applies alike to gifts made by one spouse alone and to gifts made partly by each spouse, provided such gifts were to third parties and do not fall within any of the exceptions set forth in subparagraphs (1) through (4) of this paragraph. The consent may not be applied only to a portion of the property interest constituting such gifts. For example, a wife may not treat gifts made by her spouse from his separate property to third parties as having been made one-half by her if her spouse does not consent to treat gifts made by her to third parties during the same calendar period as having been made one-half by him. If the consent is effectively signified on either the husband's return or the wife's return, all gifts made by the spouses to third parties (except as described in subparagraphs (1) through (4) of this paragraph), during the calendar period will be treated as having been made one-half by each spouse.

(c) If a husband and wife consent to have the gifts made to third party donees considered as made one-half by each spouse, and only one spouse makes gifts during the ''calendar period'' (as defined in § 25.2502–1(c)(1)), the other spouse is not required to file a gift tax return provided: (1) The total value of the gifts made to each third party donee since the beginning of the calendar year is not in excess of $20,000 ($6,000 for calendar years prior to 1982), and (2) no portion of the property transferred constitutes a gift of a future interest. If a transfer made by either spouse during the calendar period to a third-party represents a gift of a future interest in property and the spouses consent to have the gifts considered as made one-half by each, a gift tax return for such calendar period must be filed by each spouse regardless of the value of the transfer. (See § 25.2503–3 for the definition of a future interest.)

(d) The following examples illustrate the application of this section relating to the requirements for the filing of a return, assuming that a consent was effectively signified:

(1) A husband made gifts valued at $7,000 during the second quarter of 1971 to a third party and his wife made no gifts during this time. Each spouse is required to file a return for the second calendar quarter of 1971.

(2) A husband made gifts valued at $5,000 to each of two third parties during the year 1970 and his wife made no gifts. Only the husband is required to file a return. (See § 25.6019–2.)

(3) During the third quarter of 1971, a husband made gifts valued at $5,000 to a third party, and his wife made gifts valued at $2,000 to the same third party. Each spouse is required to file a return for the third calendar quarter of 1971.

(4) A husband made gifts valued at $5,000 to a third party and his wife made gifts valued at $3,000 to another third party during the year 1970. Only the husband is required to file a return for the calendar year 1970. (See § 25.6019–2.)

(5) A husband made gifts valued at $2,000 during the first quarter of 1971 to third parties which represented gifts of future interests in property (see § 25.2503–3), and his wife made no gifts during such calendar quarter. Each spouse is required to file a return for the first calendar quarter of 1971.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7238, 37 FR 28729, Dec. 29, 1972; T.D. 7910, 48 FR 40374, Sept. 7, 1983]

### § 25.2513–2 Manner and time of signifying consent.

(a)(1) Consent to the application of the provisions of section 2513 with respect to a ''calendar period'' (as defined in § 25.2502–1(c)(1)) shall, in order to be effective, be signified by both spouses. If both spouses file gift tax returns within the time for signifying consent, it is sufficient if—

(i) The consent of the husband is signified on the wife's return, and the consent of the wife is signified on the husband's return;

(ii) The consent of each spouse is signified on his own return; or

(iii) The consent of both spouses is signified on one of the returns.

If only one spouse files a gift tax return within the time provided for signifying consent, the consent of both spouses shall be signified on that return. However, whereover possible, the notice of the consent is to be shown on both returns and it is preferred that the notice be executed in the manner described in subdivision (i) of this subparagraph. The consent may be revoked only as provided in § 25.2513–3. If one spouse files more than one gift tax return for a calendar period on or before the due date of the return, the last return so filed shall, for the purpose of determining whether a consent has been signified, be considered as the return. (See §§ 25.6075–1 and 25.6075–2 for the due date of a gift tax return.)

(2) For gifts made after December 31, 1970, and before January 1, 1982 subject to the limitations of paragraph (b) of this section, the consent signified on a return filed for a calendar quarter will be effective for a previous calendar quarter of the same calendar year for which no return was filed because the gifts made during such previous calendar quarter did not exceed the annual exclusion provided by section 2503(b), if the gifts in such previous calendar quarter are listed on that return. Thus, for example, if A gave $2,000 to his son in the first quarter of 1972 (and filed no return because of section 2503(b)) and gave a further $4,000 to such son in the last quarter of the year, A and his spouse could signify consent to the application of section 2513 on the return filed for the fourth quarter and have it apply to the first quarter as well, provided that the $2,000 gift is listed on such return.

(b)(1) With respect to gifts made after December 31, 1981, or before January 1, 1971, the consent may be signified at any time following the close of the calendar year, subject to the following limitations:

(i) The consent may not be signified after the 15th day of April following the close of the calendar year, unless before such 15th day no return has been filed for the year by either spouse, in which case the consent may not be signified after a return for the year is filed by either spouse; and

(ii) The consent may not be signified for a calendar year after a notice of deficiency in gift tax for that year has been sent to either spouse in accordance with the provisions of section 6212(a).

(2) With respect to gifts made after December 31, 1970 and before January 1, 1982, the consent may be signified at any time following the close of the calendar quarter in which the gift was made, subject to the following limitations:

(i) The consent may not be signified after the 15th day of the second month following the close of such calendar quarter, unless before such 15th day, no return has been filed for such calendar quarter by either spouse, in which case the consent may not be signified after a return for such calendar quarter is filed by either spouse; and

(ii) The consent may not be signified after a notice of deficiency with respect to the tax for such calendar quarter has been sent to either spouse in accordance with section 6212(a).

(c) The executor or administrator of a deceased spouse, or the guardian or committee of a legally incompetent spouse, as the case may be, may signify the consent.

(d) If the donor and spouse consent to the application of section 2513, the return or returns for the ''calendar period'' (as defined in § 25.2502–1(c)(1)) must set forth, to the extent provided thereon, information relative to the transfers made by each spouse.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7238, 37 FR 28730, Dec. 29, 1972; T.D. 7910, 48 FR 40375, Sept. 7, 1983]

### § 25.2513–3 Revocation of consent.

(a)(1) With respect to gifts made after December 31, 1981, or before January 1, 1971, if the consent to the application of the provisions of section 2513 for a calendar year was effectively signified on or before the 15th day of April following the close of the calendar year, either spouse may revoke the consent by filing in duplicate a signed statement of revocation, but only if the statement is filed on or before such 15th day of April. Therefore, a consent that was not effectively signified until after the 15th day of April following the close of the calendar year to which it applies may not be revoked.

(2) With respect to gifts made after December 31, 1970, and before January 1, 1982, if the consent to the application of the provisions of section 2513 for a calendar quarter was effectively signified on or before the 15th day of the second month following the close of such calendar quarter, either spouse may revoke the consent by filing in duplicate a signed statement of revocation, but only if the statement is filed on or before such 15th day of the second month following the close of such calendar quarter. Therefore, a consent that was not effectively signified until after the 15th day of the second month following the close of the calendar quarter to which it applies may not be revoked.

(b) Except as provided in paragraph (b) of § 301.6091–1 of this chapter (relating to hand-carried documents), the statement referred to in paragraph (a) of this section shall be filed with the internal revenue officer with whom the gift tax return is required to be filed, or with whom the gift tax return would be required to be filed if a return were required.

[T.D. 7238, 37 FR 28730, Dec. 29, 1972, as amended by T.D. 7910, 48 FR 40375, Sept. 7, 1983]

### § 25.2513–4 Joint and several liability for tax.

If consent to the application of the provisions of section 2513 is signified as provided in § 25.2513–2, and not revoked as provided in § 25.2513–3, the liability with respect to the entire gift tax of each spouse for such ''calendar period'' (as defined in § 25.2502–1(c)(1)) is joint and several. See paragraph (d) of § 25.2511–1.

[T.D. 7238, 37 FR 28730, Dec. 29, 1972, as amended by T.D. 7910, 48 FR 40375, Sept. 7, 1983]

### § 25.2514–1 Transfers under power of appointment.

(a) *Introductory*. (1) Section 2514 treats the exercise of a general power of appointment created on or before October 21, 1942, as a transfer of property for purposes of the gift tax. The section also treats as a transfer of property the exercise or complete release of a general power of appointment created after October 21, 1942, and under certain circumstances the exercise of a power of appointment (not a general power of appointment) created after October 21, 1942, by the creation of another power of appointment. See

paragraph (d) of § 25.2514–3. Under certain circumstances, also, the failure to exercise a power of appointment created after October 21, 1942, within a specified time, so that the power lapses, constitutes a transfer of property. Paragraphs (b) through (e) of this section contain definitions of certain terms used in §§ 25.2514–2 and 25.2514–3. See § 25.2514–2 for specific rules applicable to certain powers created on or before October 21, 1942. See § 25.2514–3 for specific rules applicable to powers created after October 21, 1942.

(2) [Reserved]

(b) *Definition of ''power of appointment''*—(1) *In general.* The term ''power of appointment'' includes all powers which are in substance and effect powers of appointment received by the donee of the power from another person, regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example, if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment. Similarly, a power given to a donee to affect the beneficial enjoyment of a trust property or its income by altering, amending or revoking the trust instrument or terminating the trust is a power of appointment. A power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and A, another person, has the unrestricted power to remove or discharge the trustee at any time and appoint any other person, including himself, A is considered as having a power of appointment. However, he would not be considered to have a power of appointment if he only had the power to appoint a successor, including himself, under limited conditions which did not exist at the time of exercise, release or lapse of the trustee's power, without an accompanying unrestricted power of removal. Similarly, a power to amend only the administrative provisions of a trust instrument, which cannot substantially affect the beneficial enjoyment of the trust property or income, is not a power of appointment. The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment. Further, the right in a beneficiary of a trust to assent to a periodic accounting, thereby relieving the trustee from further accountability, is not a power of appointment if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein.

(2) *Relation to other sections.* For purposes of §§ 25.2514–1 through 25.2514–3, the term ''power of appointment'' does not include powers reserved by a donor to himself. No provision of section 2514 or of §§ 25.2514–1 through 25.2514–3 is to be construed as in any way limiting the application of any other section of the Internal Revenue Code or of these regulations. The power of the owner of a property interest already possessed by him to dispose of his interest, and nothing more, is not a power of appointment, and the interest is includible in the amount of his gifts to the extent it would be includible under section 2511 or other provisions of the Internal Revenue Code. For example, if a trust created by S provides for payment of the income to A for life with power in A to appoint the entire trust property by deed during her lifetime to a class consisting of her children, and a further power to dispose of the entire corpus by will to anyone, including her estate, and A exercises the inter vivos power in favor of her children, she has necessarily made a transfer of her income interest which constitutes a taxable gift under section 2511(a), without regard to section 2514. This transfer also results in a relinquishment of her general power to appoint by will which constitutes a transfer under section 2514 if the power was created after October 21, 1942.

(3) *Powers over a portion of property.* If a power of appointment exists as to

part of an entire group of assets or only over a limited interest in property, section 2514 applies only to such part or interest.

(c) *Definition of ''general power of appointment''*—(1) *In general.* The term ''general power of appointment'' as defined in section 2514(c) means any power of appointment exercisable in favor of the person possessing the power (referred to as the ''possessor''), his estate, his creditors, or the creditors of his estate, except (i) joint powers, to the extent provided in §§ 25.2514–2 and 25.2514–3 and (ii) certain powers limited by an ascertainable standard, to the extent provided in subparagraph (2) of this paragraph. A power of appointment exercisable to meet the estate tax, or any other taxes, debts, or charges which are enforceable against the possessor or his estate, is included within the meaning of a power of appointment exercisable in favor of the possessor, his estate, his creditors, or the creditors of his estate. A power of appointment exercisable for the purpose of discharging a legal obligation of the possessor or for his pecuniary benefit is considered a power of appointment exercisable in favor of the possessor or his creditors. However, for purposes of §§ 25.2514–1 through 25.2514–3, a power of appointment not otherwise considered to be a general power of appointment is not treated as a general power of appointment merely by reason of the fact that an appointee may, in fact, be a creditor of the possessor or his estate. A power of appointment is not a general power if by its terms it is either—

*(a)* Exercisable only in favor of one or more designated persons or classes other than the possessor or his creditors, or the possessor's estate, or the creditors of his estate, or

*(b)* Expressly not exercisable in favor of the possessor or his creditors, the possessor's estate, or the creditors of his estate.

A beneficiary may have two powers under the same instrument, one of which is a general power of appointment and the other of which is not. For example, a beneficiary may have a general power to withdraw a limited portion of trust corpus during his life, and a further power exercisable during his lifetime to appoint the corpus among his children. The later power is not a general power of appointment (but its exercise may result in the exercise of the former power; see paragraph (d) of this section).

(2) *Powers limited by an ascertainable standard.* A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the possessor which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor is, by reason of section 2514(c)(1), not a general power of appointment. A power is limited by such a standard if the extent of the possessor'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. 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.

(3) *Certain powers under wills of decedents dying between January 1 and April 2, 1948.* Section 210 of the Technical Changes Act of 1953 provides that if a decedent died after December 31, 1947, but before April 3, 1948, certain property interests described therein may, if the decedent's surviving spouse so elects, be accorded special treatment in the determination of the marital deduction to be allowed the decedent's estate under the provisions of section 812(e) of the Internal Revenue Code of 1939. See paragraph (h) of § 81.47a of

Regulations 105 (26 CFR (1939) 81.47a(h)). The section further provides that property affected by the election shall be considered property with respect to which the surviving spouse has a general power of appointment. Therefore, notwithstanding any other provision of law or of §§ 25.2514–1 through 25.2514–3, if the surviving spouse has made an election under section 210 of the Technical Changes Act of 1953, the property which was the subject of the election shall be considered as property with respect to which she has a general power of appointment created after October 21, 1942, exercisable by deed or will, to the extent it was treated as an interest passing to the surviving spouse and not passing to any other person for the purpose of the marital deduction in the prior decedent's estate.

(d) *Definition of ''exercise.''* Whether a power of appointment is in fact exercised may depend upon local law. However, regardless of local law, a power of appointment is considered as exercised for purposes of section 2514 even though the exercise is in favor of the taker in default of appointment, and irrespective of whether the appointed interest and the interest in default of appointment are identical or whether the appointee renounces any right to take under the appointment. A power of appointment is also considered as exercised even though the disposition cannot take effect until the occurrence of an event after the exercise takes place, if the exercise is irrevocable and, as of the time of the exercise, the condition was not impossible of occurrence. For example, if property is left in trust to A for life, with a power in A to appoint the remainder by an instrument filed with the trustee during his life, and A exercises his power by appointing the remainder to B in the event that B survives A, A is considered to have exercised his power if the exercise was irrevocable. Furthermore, if a person holds both a presently exercisable general power of appointment and a presently exercisable nongeneral power of appointment over the same property, the exercise of the nongeneral power is considered the exercise of the general power only to the extent that immediately after the exercise of the nongeneral power the amount of money or property subject to being transferred by the exercise of the general power is decreased. For example, assume A has a noncumulative annual power to withdraw the greater of $5,000 or 5 percent of the value of a trust having a value of $300,000 and a lifetime nongeneral power to appoint all or a portion of the trust corpus to A's child or grandchildren. If A exercises the nongeneral power by appointing $150,000 to A's child, the exercise of the nongeneral power is treated as the exercise of the general power to the extent of $7,500 (maximum exercise of general power before the exercise of the nongeneral power, 5% of $300,000 or $15,000, less maximum exercise of the general power after the exercise of the nongeneral power, 5% of $150,000 or $7,500).

(e) *Time of creation of power.* A power of appointment created by will is, in general, considered as created on the date of the testator's death. However, section 2514(f) provides that a power of appointment created by a will executed on or before October 21, 1942, is considered a power created on or before that date if the testator dies before July 1, 1949, without having republished the will, by codicil or otherwise, after October 21, 1942. A power of appointment created by an inter vivos instrument is considered as created on the date the instrument takes effect. Such a power is not considered as created at some future date merely because it is not exercisable on the date the instrument takes effect, or because it is revocable, or because the identity of its holders is not ascertainable until after the date the instrument takes effect. However, if the holder of a power exercises it by creating a second power, the second power is considered as created at the time of the exercise of the first. The application of this paragraph may be illustrated by the following examples:

*Example (1).* A created a revocable trust before October 22, 1942, providing for payment of income to B for life with remainder as B shall appoint by deed or will. Even though A dies after October 21, 1942, without having exercised his power of revocation, B's power of appointment is considered a power created before October 22, 1942.

*Example (2).* C created an irrevocable inter vivos trust before October 22, 1942, naming T

as trustee and providing for payment of income to D for life with remainder to E. T was given the power to pay corpus to D and the power to appoint a successor trustee. If T resigns after October 21, 1942, and appoints D as successor trustee, D is considered to have a power of appointment created before October 22, 1942.

*Example (3).* F created an irrevocable inter vivos trust before October 22, 1942, providing for payment of income to G for life with remainder as G shall appoint by deed or will, but in default of appointment income to H for life with remainder as H shall appoint by deed or will. If G died after October 21, 1942, without having exercised his power of appointment, H's power of appointments is considered a power created before October 22, 1942, even though it was only a contingent interest until G's death.

*Example (4).* If in example (3) above G had exercised by will his power of appointment, by creating a similar power in J, J's power of appointment would be considered a power created after October 21, 1942.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 6582, 26 FR 11861, Dec. 12, 1961, T.D. 9757, 46 FR 6929, Jan. 22, 1981]

### § 25.2514–2 Powers of appointment created on or before October 21, 1942.

(a) *In general.* The exercise of a general power of appointment created on or before October 21, 1942, is deemed to be a transfer of property by the individual possessing the power.

(b) *Joint powers created on or before October 21, 1942.* Section 2514(c)(2) provides that a power created on or before October 21, 1942, which at the time of the exercise is not exercisable by the possessor except in conjunction with another person, is not deemed a general power of appointment.

(c) *Release or lapse.* A failure to exercise a general power of appointment created on or before October 21, 1942, or a complete release of such a power is not considered to be an exercise of a general power of appointment. The phrase ''a complete release'' means a release of all powers over all or a portion of the property subject to a power of appointment, as distinguished from the reduction of a power of appointment to a lesser power. Thus, if the possessor completely relinquished all powers over one-half of the property subject to a power of appointment, the power is completely released as to that one-half. If at or before the time a power of appointment is relinquished, the holder of the power exercises the power in such a manner or to such an extent that the relinquishment results in the reduction, enlargement, or shift in a beneficial interest in property, the relinquishment will be considered to be an exercise and not a release of the power. For example, assume that A created a trust in 1940 providing for payment of the income to B for life with the power in B to amend the trust, and for payment of the remainder to such persons as B shall appoint or, upon default of appointment, to C. If B amended the trust in 1948 by providing that upon his death the remainder was to be paid to D, and if he further amended the trust in 1955 by deleting his power to amend the trust, such relinquishment will be considered an exercise and not a release of a general power of appointment. On the other hand, if the 1948 amendment became ineffective before or at the time of the 1955 amendment, or if B in 1948 merely amended the trust by changing the purely ministerial powers of the trustee, his relinquishment of the power in 1955 will be considered as release of a power of appointment.

(d) *Partial release.* If a general power of appointment created on or before October 21, 1942, is partially released so that it is not thereafter a general power of appointment, a subsequent exercise of the partially released power is not an exercise of a general power of appointment if the partial release occurs before whichever is the later of the following dates:

(1) November 1, 1951; or

(2) If the possessor was under a legal disability to release the power on October 21, 1942, the day after the expiration of 6 months following the termination of such legal disability.

However, if a general power created on or before October 21, 1942, is partially released on or after the later of those dates, a subsequent exercise of the power will constitute an exercise of a general power of appointment. The legal disability referred to in this paragraph is determined under local law and may include the disability of an insane person, a minor, or an unborn child. The fact that the type of general power of appointment possessed by the

holder actually was not generally releasable under the local law does not place the holder under a legal disability within the meaning of this paragraph. In general, however, it is assumed that all general powers of appointment are releasable, unless the local law on the subject is to the contrary, and it is presumed that the method employed to release the power is effective, unless it is not in accordance with the local law relating specifically to releases or, in the absence of such local law, is not in accordance with the local law relating to similar transactions.

(e) *Partial exercise.* If a general power of appointment created on or before October 21, 1942, is exercised only as to a portion of the property subject to the power, the exercise is considered to be a transfer only as to the value of that portion.

### § 25.2514–3 Powers of appointment created after October 21, 1942.

(a) *In general.* The exercise, release, or lapse (except as provided in paragraph (c) of this section) of a general power of appointment created after October 21, 1942, is deemed to be a transfer of property by the individual possessing the power. The exercise of a power of appointment that is not a general power is considered to be a transfer if it is exercised to create a further power under certain circumstances (see paragraph (d) of this section). See paragraph (c) of § 25.2514–1 for the definition of various terms used in this section. See paragraph (b) of this section for the rules applicable to determine the extent to which joint powers created after October 21, 1942, are to be treated as general powers of appointment.

(b) *Joint powers created after October 21, 1942.* The treatment of a power of appointment created after October 21, 1942, which is exercisable only in conjuction with another person is governed by section 2514(c)(3), which provides as follows:

(1) Such a power is not considered as a general power of appointment if it is not exercisable by the possessor except with the consent or joinder of the creator of the power.

(2) Such power is not considered as a general power of appointment if it is not exercisable by the possessor except with the consent or joinder of a person having a substantial interest in the property subject to the power which is adverse to the exercise of the power in favor of the possessor, his estate, his creditors, or the creditors of his estate. An interest adverse to the exercise of a power is considered as substantial if its value in relation to the total value of the property subject to the power is not insignificant. For this purpose, the interest is to be valued in accordance with the actuarial principles set forth in § 25.2512–5 or, if it is not susceptible to valuation under those provisions, in accordance with the general principles set forth in § 25.2512–1. A taker in default of appointment under a power has an interest which is adverse to an exercise of the power. A coholder of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a coholder of a power is considered as having an adverse interest where he may possess the power after the possessor's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. Thus, for example, if X, Y, and Z held a power jointly to appoint among a group of persons which includes themselves and if on the death of X the power will pass to Y and Z jointly, then Y and Z are considered to have interests adverse to the exercise of the power in favor of X. Similarly, if on Y's death the power will pass to Z, Z is considered to have an interest adverse to the exercise of the power in favor of Y. The application of this subparagraph may be further illustrated by the following examples in each of which it is assumed that the value of the interest in question is substantial:

*Example (1).* The taxpayer and R are trustees of a trust under which the income is to be paid to the taxpayer for life and then to M for life, and R is remainderman. The trustees have power to distribute corpus to the taxpayer. Since R's interest is substantially adverse to an exercise of the power in favor of the taxpayer, the latter does not have a general power of appointment. If M and the taxpayer were trustees, M's interest would likewise be adverse.

*Example (2).* The taxpayer and L are trustees of a trust under which the income is to be paid to L for life and then to M for life, and the taxpayer is remainderman. The trustees have power to distribute corpus to the taxpayer during L's life. Since L's interest is adverse to an exercise of the power in favor of the taxpayer, the taxpayer does not have a general power of appointment. If the taxpayer and M were trustees, M's interest would likewise be adverse.

*Example (3).* The taxpayer and L are trustees of a trust under which the income is to be paid to L for life. The trustees can designate whether corpus is to be distributed to the taxpayer or to A after L's death. L's interest is not adverse to an exercise of the power in favor of the taxpayer, and the taxpayer therefore has a general power of appointment.

(3) A power which is exercisable only in conjunction with another person, and which after application of the rules set forth in subparagraphs (1) and (2) of this paragraph, constitutes a general power of appointment, will be treated as though the holders of the power who are permissible appointees of the property were joint owners of property subject to the power. The possessor, under this rule, will be treated as possessed of a general power of appointment over an aliquot share of the property to be determined with reference to the number of joint holders, including the possessor, who (or whose estates or creditors) are permissible appointees. Thus, for example, if X, Y, and Z hold an unlimited power jointly to appoint among a group of persons, including themselves, but on the death of X the power does not pass to Y and Z jointly, then Y and Z are not considered to have interests adverse to the exercise of the power in favor of X. In this case, X is considered to possess a general power of appointment as to one-third of the property subject to the power.

(c) *Partial releases, lapses, and disclaimers of general powers of appointment created after October 21, 1942*—(1) *Partial release of power.* The general principles set forth in § 25.2511–2 for determining whether a donor of property (or of a property right or interest) has divested himself of all or any portion of his interest therein to the extent necessary to effect a completed gift are applicable in determining whether a partial release of a power of appointment constitutes a taxable gift. Thus, if a general power of appointment is partially released so that thereafter the donor may still appoint among a limited class of persons not including himself the partial release does not effect a complete gift, since the possessor of the power has retained the right to designate the ultimate beneficiaries of the property over which he holds the power and since it is only the termination of such control which completes a gift.

(2) *Power partially released before June 1, 1951.* If a general power of appointment created after October 21, 1942, was partially released prior to June 1, 1951, so that it no longer represented a general power of appointment, as defined in paragraph (c) of § 25.2514–1, the subsequent exercise, release, or lapse of the partially released power at any time thereafter will not constitute the exercise or release of a general power of appointment. For example, assume that A created a trust in 1943 under which B possessed a general power of appointment. By an instrument executed in 1948 such general power of appointment was reduced in scope by B to an excepted power. The inter vivos exercise in 1955, or in any ''calendar period'' (as defined in § 25.2502–1(c)(1)) thereafter, of such excepted power is not considered an exercise or release of a general power of appointment for purposes of the gift tax.

(3) *Power partially released after May 31, 1951.* If a general power of appointment created after October 21, 1942, was partially released after May 31, 1951, the subsequent exercise, release or a lapse of the power at any time thereafter, will constitute the exercise or release of a general power of appointment for gift tax purposes.

(4) *Release or lapse of power.* A release of a power of appointment need not be formal or express in character. For example, the failure to exercise a general power of appointment created after October 21, 1942, within a specified time so that the power lapses, constitutes a release of the power. In any case where the possessor of a general power of appointment is incapable of validly exercising or releasing a power, by reason of minority, or otherwise, and the power may not be validly exercised or released on his behalf, the failure to exercise or release the power is not a

lapse of the power. If a trustee has in his capacity as trustee a power which is considered as a general power of appointment, his resignation or removal as trustee will cause a lapse of his power. However, section 2514(e) provides that a lapse during any calendar year is considered as a release so as to be subject to the gift tax only to the extent that the property which could have been appointed by exercise of the lapsed power of appointment exceeds the greater of (i) $5,000, or (ii) 5 percent of the aggregate value, at the time of the lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed power could be satisfied. For example, if an individual has a noncumulative right to withdraw $10,000 a year from the principal of a trust fund, the failure to exercise this right of withdrawal in a particular year will not constitute a gift if the fund at the end of the year equals or exceeds $200,000. If, however, at the end of the particular year the fund should be worth only $100,000, the failure to exercise the power will be considered a gift to the extent of $5,000, the excess of $10,000 over 5 percent of a fund of $100,000. Where the failure to exercise a power, such as a right of withdrawal, occurs in more than a single year, the value of the taxable transfer will be determined separately for each year.

(5) *Disclaimer of power created after December 31, 1976.* A disclaimer or renunciation of a general power of appointment created in a transfer made after December 31, 1976, is not considered a release of the power for gift tax purposes if the disclaimer or renunciation is a qualified disclaimer as described in section 2518 and the corresponding regulations. For rules relating to when a transfer creating the power occurs, see § 25.2518–2(c)(3). If the disclaimer or renunciation is not a qualified disclaimer, it is considered a release of the power.

(6) *Disclaimer of power created before January 1, 1977.* A disclaimer or renunciation of a general power of appointment created in a taxable transfer before January 1, 1977, in the person disclaiming is not considered a release of the power. The disclaimer or renunciation must be unequivocal and effective under local law. A disclaimer is a complete and unqualified refusal to accept the rights to which one is entitled. There can be no disclaimer or renunciation of a power after its acceptance. In the absence of facts to the contrary, the failure to renounce or disclaim within a reasonable time after learning of the existence of a power shall be presumed to constitute an acceptance of the power. In any case where a power is purported to be disclaimed or renounced as to only a portion of the property subject to the power, the determination as to whether there has been a complete and unqualified refusal to accept the rights to which one is entitled will depend on all the facts and circumstances of the particular case, taking into account the recognition and effectiveness of such a disclaimer under local law. Such rights refer to the incidents of the power and not to other interests of the possessor of the power in the property. If effective under local law, the power may be disclaimed or renounced without disclaiming or renouncing such other interests.

(7) The first and second sentences of paragraph (c)(5) of this section are applicable for transfers creating the power to be disclaimed made on or after December 31, 1997.

(d) *Creation of another power in certain cases.* Paragraph (d) of section 2514 provides that there is a transfer for purposes of the gift tax of the value of property (or of property rights or interests) with respect to which a power of appointment, which is not a general power of appointment, created after October 21, 1942, is exercised by creating another power of appointment which, under the terms of the instruments creating and exercising the first power and under applicable local law, can be validly exercised so as to (1) postpone the vesting of any estate or interest in the property for a period ascertainable without regard to the date of the creation of the first power, or (2) (if the applicable rule against perpetuities is stated in terms of suspensions of ownership or of the power of alienation, rather than of vesting) suspend the absolute ownership or the power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.

For the purpose of section 2514(d), the value of the property subject to the second power of appointment is considered to be its value unreduced by any precedent or subsequent interest which is not subject to the second power. Thus, if a donor has a power to appoint $100,000 among a group consisting of his children or grandchildren and during his lifetime exercises the power by making an outright appointment of $75,000 and by giving one appointee a power to appoint $25,000, no more than $25,000 will be considered a gift under section 2514(d). If, however, the donor appoints the income from the entire fund to a beneficiary for life with power in the beneficiary to appoint the remainder, the entire $100,000 will be considered a gift under section 2514(d), if the exercise of the second power can validly postpone the vesting of any estate or interest in the property or can suspend the absolute ownership or power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.

(e) *Examples.* The application of this section may be further illustrated by the following examples in each of which it is assumed, unless otherwise stated, that S has transferred property in trust after October 21, 1942, with the remainder payable to R at L's death, and that neither L nor R has any interest in or power over the enjoyment of the trust property except as is indicated separately in each example:

*Example (1).* The income is payable to L for life. L has the power to cause the income to be paid to R. The exercise of the right constitutes the making of a transfer of property under section 2511. L's power does not constitute a power of appointment since it is only a power to dispose of his income interest, a right otherwise possessed by him.

*Example (2).* The income is to be accumulated during L's life. L has the power to have the income distributed to himself. If L's power is limited by an ascertainable standard (relating to health, etc.) as defined in paragraph (c)(2) of § 25.2514–1, the lapse of such power will not constitute a transfer of property for gift tax purposes. If L's power is not so limited, its lapse or release during L's lifetime may constitute a transfer of property for gift tax purposes. See especially paragraph (c)(4) of § 25.2514–3.

*Example (3).* The income is to be paid to L for life. L has a power, exercisable at any time, to cause the corpus to be distributed to himself. L has a general power of appointment over the remainder interest, the release of which constitutes a transfer for gift tax purposes of the remainder interest. If in this example L had a power to cause the corpus to be distributed only to X, L would have a power of appointment which is not a general power of appointment, the exercise or release of which would not constitute a transfer of property for purposes of the gift tax. Although the exercise or release of the nongeneral power is not taxable under this section, see § 25.2514–1(b)(2) for the gift tax consequences of the transfer of the life income interest.

*Example (4).* The income is payable to L for life. R has the right to cause the corpus to be distributed to L at any time. R's power is not a power of appointment, but merely a right to dispose of his remainder interest, a right already possessed by him. In such a case, the exercise of the right constitutes the making of a transfer of property under section 2511 of the value, if any, of his remainder interest. See paragraph (e) of § 25.2511–1.

*Example (5).* The income is to be paid to L. R has the right to appoint the corpus to himself at any time. R's general power of appointment over the corpus includes a general power to dispose of L's income interest therein. The lapse or release of R's general power over the income interest during his life may constitute the making of a transfer of property. See especially paragraph (c)(4) of § 25.2514–3.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7238, 37 FR 28730, Dec. 29, 1972; T.D. 7776, 46 FR 27642, May 21, 1981; T.D. 7910, 48 FR 40375, Sept. 7, 1983; T.D. 8095, 51 FR 28370, Aug. 7, 1986; T.D. 8744, 62 FR 68185, Dec. 31, 1997]

### § 25.2515–1 Tenancies by the entirety; in general.

(a) *Scope*—(1) *In general.* This section and §§ 25.2515–2 through 25.2515–4 do not apply to the creation of a tenancy by the entirety after December 31, 1981, and do not reflect changes made to the Internal Revenue Code by sections 702(k)(1)(A) of the Revenue Act of 1978, or section 2002(c)(2) of the Tax Reform Act of 1976.

(2) *Special rule in the case of tenancies created after July 13, 1988, if the donee spouse is not a United States citizen.* Under section 2523(i)(3), applicable (subject to the special treaty rule contained in Public Law 101–239, section 7815(d)(14)) in the case of tenancies by the entirety and joint tenancies created between spouses after July 13,

1988, if the donee spouse is not a citizen of the United States, the principles contained in section 2515 and §§ 25.2515–1 through 25.2515–4 apply in determining the gift tax consequences with respect to the creation and termination of the tenancy, except that the election provided in section 2515(a) (prior to repeal by the Economic Recovery Tax Act of 1981) and § 25.2515–2 (relating to the donor's election to treat the creation of the tenancy as a transfer for gift tax purposes) does not apply.

(3) *Nature of.* An estate by the entirety in real property is essentially a joint tenancy between husband and wife with the right of survivorship. As used in this section and §§ 25.2515–2 through 25.2515–4, the term ''tenancy by the entirety'' includes a joint tenancy between husband and wife in real property with right of survivorship, or a tenancy which accords to the spouses rights equivalent thereto regardless of the term by which such a tenancy is described in local property law.

(b) *Gift upon creation of tenancy by the entirety; in general.* During calendar years prior to 1955 the contribution made by a husband or wife in the creation of a tenancy by the entirety constituted a gift to the extent that the consideration furnished by either spouse exceeded the value of the rights retained by that spouse. The contribution made by either or both spouses in the creation of such a tenancy during the calendar year 1955, any calendar year beginning before January 1, 1971, or any calendar quarter beginning after December 31, 1970, is not deemed a gift by either spouse, regardless of the proportion of the total consideration furnished by either spouse, unless the donor spouse elects (see § 25.2515–2) under section 2515(c) to treat such transaction as a gift in the calendar quarter or calendar year in which the transaction is effected. See § 25.2502–1(c)(1) for the definition of calendar quarter. However, there is a gift upon the termination of such a tenancy, other than by the death of a spouse, if the proceeds received by one spouse on termination of the tenancy are larger than the proceeds allocable to the consideration furnished by that spouse to the tenancy. The creation of a tenancy by the entirety takes place if (1) a husband or his wife purchases property and causes the title thereto to be conveyed to themselves as tenants by the entirety, (2) both join in such a purchase, or (3) either or both cause to be created such a tenancy in property already owned by either or both of them. The rule prescribed herein with respect to the creation of a tenancy by the entirety applies also to contributions made in the making of additions to the value of such a tenancy (in the form of improvements, reductions in the indebtedness, or otherwise), regardless of the proportion of the consideration furnished by each spouse. See § 25.2516–1 for transfers made pursuant to a property settlement agreement incident to divorce.

(c) *Consideration*—(1) *In general.* (i) The consideration furnished by a person in the creation of a tenancy by the entirety or the making of additions to the value thereof is the amount contributed by him in connection therewith. The contribution may be made by either spouse or by a third party. It may be furnished in the form of money, other property, or an interest in property. If it is furnished in the form of other property or an interest in property, the amount of the contribution is the fair market value of the property or interest at the time it was transferred to the tenancy or was exchanged for the property which became the subject of the tenancy. For example, if a decedent devised real property to the spouses as tenants by the entirety and the fair market value of the property was $30,000 at the time of the decedent's death, the amount of the decedent's contribution to the creation of the tenancy was $30,000. As another example, assume that in 1950 the husband purchased real property for $25,000, taking it in his own name as sole owner, and that in 1956 when the property had a fair market value of $40,000 he caused it to be transferred to himself and his wife as tenants by the entirety. Here, the amount of the husband's contribution to the creation of the tenancy was $40,000 (the fair market value of the property at the time it was transferred to the tenancy). Similarly, assume that in 1950 the husband purchased, as sole owner, corporate

shares for $25,000 and in 1956, when the shares had a fair market value of $35,000, he exchanged them for real property which was transferred to the husband and his wife as tenants by the entirety. The amount of the husband's contribution to the creation of the tenancy was $35,000 (the fair market value of the shares at the time he exchanged them for the real property which became the subject of the tenancy).

(ii) Whether consideration derived from third-party sources is deemed to have been furnished by a third party or to have been furnished by the spouses will depend upon the terms under which the transfer is made. If a decedent devises real property to the spouses as tenants by the entirety, the decedent, and not the spouses, is the person who furnished the consideration for the creation of the tenancy. Likewise, if a decedent in his will directs his executor to discharge an indebtedness of the tenancy, the decedent, and not the spouses, is the person who furnished the consideration for the addition to the value of the tenancy. However, if the decedent bequeathed a general legacy to the husband and the wife and they used the legacy to discharge an indebtedness of the tenancy, the spouses, and not the decedent, are the persons who furnished the consideration for the addition to the value of the tenancy. The principles set forth in this subdivision with respect to transfers by decedents apply equally well to inter vivos transfers by third parties.

(iii) Where a tenancy is terminated in part (e.g., where a portion of the property subject to the tenancy is sold to a third party, or where the original property is disposed of and in its place there is substituted other property of lesser value acquired through reinvestment under circumstances which satisfy the requirements of paragraph (d)(2)(ii) of this section), the proportionate contribution of each person to the remaining tenancy is in general the same as his proportionate contribution to the original tenancy, and the character of his contribution remains the same. These proportions are applied to the cost of the remaining or substituted property. Thus, if the total contribution to the cost of the property was $20,000 and a fourth of the property was sold, the contribution to the remaining portion of the tenancy is normally $15,000. However, if it is shown that at the time of the contribution more or less than one-fourth thereof was attributable to the portion sold, the contribution is divided between the portion sold and the portion retained in the proper proportion. If the portion sold was acquired as a separate tract, it is treated as a separate tenancy. As another example of the application of this subdivision, assume that in 1950 X (a third party) gave to H and W (H's wife), as tenants by the entirety, real property then having a value of $15,000. In 1955, H spent $5,000 thereon in improvements and under section 2515(c) elected to treat his contribution as a gift. In 1956, W spent $10,000 in improving the property but did not elect to treat her contribution as a gift. Between 1957 and 1960 the property appreciated in value by $30,000. In 1960, the property was sold for $60,000, and $45,000 of the proceeds of the sale were, under circumstances that satisfy the requirements of paragraph (d)(2)(ii) of this section, reinvested in other real property. Since X contributed one-half of the total consideration for the original property and the additions to its value, he is considered as having furnished $22,500 (one-half of $45,000) toward the creation of the remaining portion of the tenancy and the making of additions to the value thereof. Similarly, H is considered as having furnished $7,500 (one-sixth of $45,000) which was treated as a gift in the year furnished, and W is considered as having furnished $15,000 (one-third of $45,000) which was not treated as a gift in the year furnished.

(2) *Proportion of consideration attributable to appreciation.* Any general appreciation (appreciation due to fluctuations in market value) in the value of the property occurring between two successive contribution dates which can readily be measured and which can be determined with reasonable certainty to be allocable to any particular contribution or contributions previously furnished is to be treated, for the purpose of the computations in §§ 25.2515–3 and 25.2515–4, as though it were additional consideration furnished by the person who furnished the

prior consideration. Any general depreciation in value is treated in a comparable manner. For the purpose of the first sentence of this subparagraph, successive contribution dates are the two consecutive dates on which any contributions to the tenancy are made, not necessarily by the same party. Further, appreciation allocable to the prior consideration falls in the same class as the prior consideration to which it relates. The application of this subparagraph may be illustrated by the following examples:

*Example (1).* In 1940, H purchased real property for $15,000 which he caused to be transferred to himself and W (his wife) as tenants by the entirety. In 1956 when the fair market value of the property was $30,000, W made $5,000 improvements to the property. In 1957 the property was sold for $35,000. The general appreciation of $15,000 which occurred between the date of purchase and the date of W's improvements to the property constitutes an additional contribution by H, having the same characteristics as his original contribution of $15,000.

*Example (2).* In 1955 real property was purchased by H and W and conveyed to them as tenants by the entirety. The purchase price of the property was $15,000 of which H contributed $10,000 and W, $5,000. In 1960 when the fair market value of the property is $21,000, W makes improvements thereto of $5,000. The property then is sold for $26,000. The appreciation in value of $6,000 results in an additional contribution of $4,000 (10,000/15,000×$6,000) by H, and an additional contribution by W of $2,000 (5,000/15,000×$6,000). H's total contribution to the tenancy is $14,000 ($10,000+$4,000) and W's total contribution is $12,000 ($5,000+ $2,000+$5,000).

*Example (3).* In 1956 real property was purchased by H and W and conveyed to them as tenants by the entirety. The purchase price of the property was $15,000, on which a down payment of $3,000 was made. The remaining $12,000 was to be paid in monthly installments over a period of 15 years. H furnished $2,000 of the down payment and W, $1,000. H paid all the monthly installments. During the period 1956 to 1971 the property gradually appreciates in value to $24,000. Here, the appreciation is so gradual and the contributions so numerous that the amount allocable to any particular contribution cannot be ascertained with any reasonable certainty. Accordingly, in such a case the appreciation in value may be disregarded in determining the amount of consideration furnished in making the computations provided for in §§ 25.2515–3 and 25.2515–4.

(d) *Gift upon termination of tenancy by the entirety*—(1) *In general.* Upon the termination of the tenancy, whether created before, during, or subsequent to the calendar year 1955, a gift may result, depending upon the disposition made of the proceeds of the termination (whether the proceeds be in the form of cash, property, or interests in property). A gift may result notwithstanding the fact that the contribution of either spouse to the tenancy was treated as a gift. See § 25.2515–3 for the method of determining the amount of any gift that may result from the termination of the tenancy in those cases in which no portion of the consideration contributed was treated as a gift by the spouses in the calendar quarter or calendar year in which it was furnished. See § 25.2515–4 for the method of determining the amount of any gift that may result from the termination of the tenancy in those cases in which all or a portion of the consideration contributed was treated as constituting a gift by the spouses in the calendar quarter or calendar year in which it was furnished. See § 25.2515–2 for the procedure to be followed by a donor who elects under section 2515(c) to treat the creation of a tenancy by the entirety (or the making of additions to its value) as a transfer subject to the gift tax in the calendar quarter (calendar year with respect to such transfers made before January 1, 1971) in which the transfer is made, and for the method of determining the amount of the gift. See § 25.2502–1(c)(1) for the definition of calendar quarter.

(2) *Termination*—(i) *In general.* Except as indicated in subdivision (ii) of this subparagraph, a termination of a tenancy is effected when all or a portion of the property so held by the spouses is sold, exchanged, or otherwise disposed of, by gift or in any other manner, or when the spouses through any form of conveyance or agreement become tenants in common of the property or otherwise alter the nature of their respective interests in the property formerly held by them as tenants by the entirety. In general, any increase in the indebtedness on a tenancy constitutes a termination of the tenancy to the extent of the increase in the indebtedness. However, such an increase will not constitute a termination of the tenancy to the extent that the increase

is offset by additions to the tenancy within a reasonable time after such increase. Such additions (to the extent of the increase in the indebtedness) shall not be treated by the spouses as contributions within the meaning of paragraph (c) of this section.

(ii) *Exchange or reinvestment.* A termination is not considered as effected to the extent that the property subject to the tenancy is exchanged for other real property, the title of which is held by the spouses in an identical tenancy. For this purpose, a tenancy is considered identical if the proportionate values of the spouses' respective rights (other than any change in the proportionate values resulting solely from the passing of time) are identical to those held in the property which was sold. In addition the sale, exchange (other than an exchange described above), or other disposition of property held as tenants by the entirety is not considered as a termination if all three of the following conditions are satisfied:

*(a)* There is no division of the proceeds of the sale, exchange or other disposition of the property held as tenants by the entirety;

*(b)* On or before the due date for the filing of a gift tax return for the calendar quarter or calendar year (see § 25.6075–1 for the time for filing gift tax returns) in which the property held as tenants by the entirety was sold, exchanged, or otherwise disposed of, the spouses enter into a binding contract for the purchase of other real property; and

*(c)* After the sale, exchange or other disposition of the former property and within a reasonable time after the date of the contract referred to in *(b)* of this subdivision, such other real property actually is acquired by the spouses and held by them in an identical tenancy.

To the extent that all three of the conditions set forth in this subdivision are not met (whether by reason of the death of one of the spouses or for any other reason), the provisions of the preceding sentence shall not apply, and the sale, exchange or other disposition of the property will constitute a termination of the tenancy. As used in subdivision *(c)* the expression ''a reasonable time'' means the time which, under the particular facts in each case, is needed for those matters which are incident to the acquisition of the other property (i.e., perfecting of title, arranging for financing, construction, etc.). The fact that proceeds of a sale are deposited in the name of one tenant or of both tenants separately or jointly as a convenience does not constitute a division within the meaning of subdivision *(a)* if the other requirements of this subdivision are met. The proceeds of a sale, exchange, or other disposition of property held as tenants by the entirety will be deemed to have been used for the purchase of other real property if applied to the purchase or construction of improvements which themselves constitute real property and which are additions to other real property held by the spouses in a tenancy identical to that in which they held the property which was sold, exchanged, or otherwise disposed of.

(3) *Proceeds of termination.* (i) The proceeds of termination may be received by a spouse in the form of money, property, or an interest in property. Where the proceeds are received in the form of property (other than money) or an interest in property, the value of the proceeds received by that spouse is the fair market value, on the date of termination of the tenancy by the entirety, of the property or interest received. Thus, if a tenancy by the entirety is terminated so that thereafter each spouse owns an undivided half interest in the property as tenant in common, the value of the proceeds of termination received by each spouse is one-half the value of the property at the time of the termination of the tenancy by the entirety. If under local law one spouse, without the consent of the other, can bring about a severance of his or her interest in a tenancy by the entirety and does so by making a gift of his or her interest to a third party, that spouse is considered as having received proceeds of termination in the amount of the fair market value, at the time of the termination, of his severable interest determined in accordance with the rules prescribed in § 25.2512–5. He has, in addition, made a gift to the third party of the fair market value of the interest conveyed to the third party. In such a case, the other spouse

also is considered as having received as proceeds of termination the fair market value, at the time of termination, of the interest which she thereafter holds in the property as tenant in common with the third party. However, since section 2515(b) contemplates that the spouses may divide the proceeds of termination in some proportion other than that represented by the values of their respective legal interests in the property, if both spouses join together in making a gift to a third party of property held by them as tenants by the entirety, the value of the proceeds of termination which will be treated as received by each is the amount which each reports (on his or her gift tax return filed for the calendar quarter or calendar year in which the termination occurs) as the value of his or her gift to the third party. This amount is the amount which each reports without regard to whether the spouses elect under section 2513 to treat the gifts as made one-half by each. For example, assume that H and W (his wife) hold real property as tenants by the entirety; that in the first calendar quarter of 1972, when the property has a fair market value of $60,000, they give it to their son; and that on their gift tax returns for such calendar quarter, H reports himself as having made a gift to the son of $36,000 and W reports herself as having made a gift to the son of $24,000. Under these circumstances, H is considered as having received proceeds of termination valued at $36,000, and W is considered as having received proceeds of termination valued at $24,000.

(ii) Except as provided otherwise in subparagraph (2)(ii) of this paragraph (under which certain tenancies by the entirety are considered not to be terminated), where the proceeds of a sale, exchange, or other disposition of the property are not actually divided between the spouses but are held (whether in a bank account or otherwise) in their joint names or in the name of one spouse as custodian or trustee for their joint interests, each spouse is presumed, in the absence of a showing to the contrary, to have received, as of the date of termination, proceeds of termination equal in value to the value of his or her enforceable property rights in respect of the proceeds.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7238, 37 FR 28731, Dec. 29, 1972, as amended by T.D. 8522, 59 FR 9656, Mar. 1, 1994]

### § 25.2515–2 Tenancies by the entirety; transfers treated as gifts; manner of election and valuation.

(a) The election to treat the creation of a tenancy by the entirety in real property, or additions made to its value, as constituting a gift in the calendar quarter or calendar year in which effected, shall be exercised by including the value of such gifts in the gift tax return of the donor for such calendar quarter or calendar year in which the tenancy was created, or the additions in value were made to the property. See section 6019 and the regulations thereunder. The election may be exercised only in a return filed within the time prescribed by law, or before the expiration of any extension of time granted pursuant to law for the filing of the return. See section 6075 for the time for filing the gift tax return and section 6081 for extensions of time for filing the return, together with the regulations thereunder. In order to make the election, a gift tax return must be filed for the calendar quarter or calendar year in which the tenancy was created, or additions in value thereto made, even though the value of the gift involved does not exceed the amount of the exclusion provided by section 2503(b). See § 25.2502–1(c)(1) for the definition of calendar quarter.

(b) If the donor spouse exercises the election as provided in paragraph (a) of this section, the amount of the gift at the creation of the tenancy is the amount of his contribution to the tenancy less the value of his retained interest in it, determined as follows:

(1) If under the law of the jurisdiction governing the rights of the spouses, either spouse, acting alone, can bring about a severance of his or her interest in the property, the value of the donor's retained interest is one-half the value of the property.

(2) If, under the law of the jurisdiction governing the rights of the spouses each is entitled to share in the

income or other enjoyment of the property but neither, acting alone, may defeat the right of the survivor of them to the whole of the property, the amount of retained interest of the donor is determined by use of the appropriate actuarial factors for the spouses at their respective attained ages at the time the transaction is effected.

(c) Factors representing the respective interests of the spouses, under a tenancy by the entirety, at their attained ages at the time of the transaction may be readily computed based on the method described in § 25.2512–5. State law may provide that the husband only is entitled to all of the income or other enjoyment of the real property held as tenants by the entirety, and the wife's interest consists only of the right of survivorship with no right of severance. In such a case, a special factor may be needed to determine the value of the interests of the respective spouses. See § 25.2512–5(d)(4) for the procedure for obtaining special factors from the Internal Revenue Service in appropriate cases.

(d) The application of this paragraph may be illustrated by the following example:

*Example.* A husband with his own funds acquires real property valued at $10,000 and has it conveyed to himself and his wife as tenants by the entirety. Under the law of the jurisdiction governing the rights of the parties, each spouse is entitled to share in the income from the property but neither spouse acting alone could bring about a severance of his or her interest. The husband elects to treat the transfer as a gift in the year in which effected. At the time of transfer, the ages of the husband and wife are 45 and 40, respectively, on their birthdays nearest to the date of transfer. The value of the gift to the wife is $5,502.90, computed as follows:

| | |
|---|---|
| Value of property transferred | $10,000.00 |
| Less $10,000×0.44971 (factor for value of donor's retained rights) | 4,497.10 |
| Value of gift | 5,502.90 |

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7150, 36 FR 22900, Dec. 2, 1971; T.D. 7238, 37 FR 28731, Dec. 29, 1972; T.D. 8540, 59 FR 30177, June 10, 1994]

## § 25.2515–3 Termination of tenancy by the entirety; cases in which entire value of gift is determined under section 2515(b).

(a) In any case in which—(1) The creation of a tenancy by the entirety (including additions in value thereto) was not treated as a gift, and

(2) The entire consideration for the creation of the tenancy, and any additions in value thereto, was furnished solely by the spouses (see paragraph (c)(1)(ii) of § 25.2515–1),

the termination of the tenancy (other than by the death of a spouse) always results in the making of a gift by a spouse who receives a smaller share of the proceeds of the termination (whether received in cash, property or interests in property) than the share of the proceeds attributable to the total consideration furnished by him. See paragraph (c) of § 25.2515–1 for a discussion of what constitutes consideration and the value thereof. Thus, a gift is effected at the time of termination of the tenancy by the spouse receiving less than one-half of the proceeds of termination if such spouse (regardless of age) furnished one-half or more of the total consideration for the purchase and improvements, if any, of the property held in the tenancy. Also, if one spouse furnished the entire consideration, a gift is made by such spouse to the extent that the other spouse receives any portion of the proceeds of termination. See § 25.2515–4 for determination of the amount of the gift, if any, in cases in which the creation of the tenancy was treated as a gift or a portion of the consideration was furnished by a third person. See paragraph (d)(2) of § 25.2515–1 as to the acts which effect a termination of the tenancy.

(b) In computing the value of the gift under the circumstances described in paragraph (a) of this section, it is first necessary to determine the spouse's share of the proceeds attributable to the consideration furnished by him. This share is computed by multiplying the total value of the proceeds of the termination by a fraction, the numerator of which is the total consideration furnished by the donor spouse and the

denominator of which is the total consideration furnished by both spouses. From this amount there is subtracted the value of the proceeds of termination received by the donor spouse. The amount remaining is the value of the gift. In arriving at the ''total consideration furnished by the donor spouse'' and the ''total consideration furnished by both spouses'', for purposes of the computation provided for in this paragraph, the consideration furnished (see paragraph (c) of § 25.2515–1) is not reduced by any amounts which otherwise would have been excludable under section 2503(b) in determining the amounts of taxable gifts for calendar quarters or calendar years in which the consideration was furnished. (See § 25.2502–1 (c)(1) for the definition of calendar quarter.) As an example assume that in 1955, real property was purchased for $30,000, the husband and wife each contributing $12,000 and the remaining $6,000 being obtained through a mortgage on the property. In each of the years 1956 and 1957, the husband paid $3,000 on the principal of the indebtedness, but did not disclose the value of these transfers on his gift tax returns for those years. The total consideration furnished by the husband is $18,000, the total consideration furnished by the wife is $12,000, and the total consideration furnished by both spouses is $30,000.

(c) The application of this section may be illustrated by the following examples:

*Example (1).* In 1956 the husband furnished $30,000 and his wife furnished $10,000 of the consideration for the purchase and subsequent improvement of real property held by them as tenants by the entirety. The husband did not elect to treat the consideration furnished as a gift. The property later is sold for $60,000, the husband receiving $35,000 and his wife receiving $25,000 of the proceeds of the termination. The termination of the tenancy results in a gift of $10,000 by the husband to his wife, computed as follows:

[$30,000 (consideration furnished by husband)÷$40,000 (total consideration furnished by both spouses)]×$60,000 (proceeds of termination)=$45,000

$45,000−$35,000 (proceeds received by husband)=$10,000 gift by husband to wife.

*Example (2).* In 1950 the husband purchased shares of X Company for $10,000. In 1955 when those shares had a fair market value of $30,000, he and his wife purchased real property from A and had it conveyed to them as tenants by the entirety. In payment for the real property, the husband transferred his shares of X Company to A and the wife paid A the sum of $10,000. They later sold the real property for $60,000, divided $24,000 (each taking $12,000) and reinvested the remaining $36,000 in other real property under circumstances that satisfied the conditions set forth in paragraph (d)(2)(ii) of § 25.2515–1. The tenancy was terminated only with respect to the $24,000 divided between them. This termination of the tenancy resulted in a gift of $6,000 by the husband to the wife, computed as follows:

[$30,000 (consideration furnished by husband)÷$40,000 (total consideration furnished by both spouses)]×$24,000 (proceeds of termination)=$18,000

$18,000−$12,000 (proceeds received by husband)=$6,000 gift by husband to wife.

Since the tenancy was terminated only in part, with respect to the remaining portion of the tenancy each spouse is considered as having furnished that proportion of the total consideration for the remaining portion of the tenancy as the consideration furnished by him before the sale bears to the total consideration furnished by both spouses before the sale. See paragraph (c) of § 25.2515–1. The consideration furnished by the husband for the reduced tenancy is $27,000, computed as follows:

[$30,000 (consideration furnished by husband before sale)÷$40,000 (total consideration furnished by both spouses before sale)]×$36,000 (consideration for reduced tenancy)=$27,000

The consideration furnished by the wife is $9,000, computed in a similar manner.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7238, 37 FR 28732, Dec. 29, 1972]

### § 25.2515–4 Termination of tenancy by entirety; cases in which none, or a portion only, of value of gift is determined under section 2515(b).

(a) *In general.* The rules provided in section 2515(b) (see § 25.2515–3) are not applied in determining whether a gift has been made at the termination of a tenancy to the extent that the consideration furnished for the creation of the tenancy was treated as a gift or if the consideration for the creation of the tenancy was furnished by a third party. Consideration furnished for the creation of the tenancy was treated as a gift if it was furnished either (1) during calendar years prior to 1955, or (2)

during the calendar year 1955 and subsequent calendar years and calendar quarters and the donor spouse exercised the election to treat the furnishing of consideration as a gift. (For the definition of calendar quarter see § 25.2502–1(c)(1).) See paragraph (b) of this section for the manner of computing the value of gifts resulting from the termination of the tenancy under these circumstances. See paragraph (c) of this section for the rules to be applied where part of the total consideration for the creation of the tenancy and additions to the value thereof was not treated as a gift and part either was treated as a gift or was furnished by a third party.

(b) *Value of gift when entire consideration is of the type described in paragraph (a) of this section.* If the entire consideration for the creation of a tenancy by the entirety was treated as a gift or contributed by a third party, the determination of the amount, if any, of a gift made at the termination of the tenancy will be made by the application of the general principles set forth in § 25.2511–1. Under those principles, when a spouse surrenders a property interest in a tenancy, the creation of which was treated as a gift, and in return receives an amount (whether in the form of cash, property, or an interest in property) less than the value of the property interest surrendered, that spouse is deemed to have made a gift in an amount equal to the difference between the value at the time of termination, of the property interest surrendered by such spouse and the amount received in exchange. Thus, if the husband's interest in such a tenancy at the time of termination is worth $44,971 and the wife's interest therein at the time is worth $55,029, the property is sold for $100,000, and each spouse received $50,000 out of the proceeds of the sale, the wife has made a gift to the husband of $5,029. The principles applied in paragraph (c) of § 25.2515–2 for the method of determining the value of the respective interests of the spouses at the time of the creation of a tenancy by the entirety are equally applicable in determining the value of each spouse's interest in the tenancy at termination, except that the actuarial factors to be applied are those for the respective spouses at the ages attained at the date of termination.

(c) *Valuation of gift where both types of consideration are involved.* If the consideration furnished consists in part of the type described in paragraph (a) of § 25.2515–3 (consideration furnished by the spouses after 1954, and not treated as a gift in the calendar quarter or calendar year in which it was furnished) and in part of the type described in paragraph (a) of this section (consideration furnished by the spouses and treated as a gift or furnished by a third party), the amount of the gift is determined as follows:

(1) By applying the principles set forth in paragraph (b) of § 25.2515–3 to that portion of the total proceeds of termination which the consideration described in paragraph (a) of § 25.2515–3 bears to the total consideration furnished;

(2) By applying the principles set forth in paragraph (b) of this section to the remaining portion of the total proceeds of termination; and

(3) By subtracting the proceeds of termination received by the donor from the total of the amounts which under the principles referred to in subparagraphs (1) and (2) of this paragraph are to be compared with the proceeds of termination received by a spouse in determining whether a gift was made by that spouse. For example, assume that consideration of $30,000 was furnished by the husband in 1954. Assume also that on February 1, 1955, the husband contributed $12,000 and the wife $8,000, the husband's contribution not being treated as a gift (see paragraph (b) of § 25.2515–1). Assume further that between 1957 and 1965 the property appreciated in value by $40,000 and was sold in 1965 for $90,000 (of which the husband received $40,000 and the wife $50,000). The principles set forth in paragraph (b) of § 25.2515–3 are applied to $36,000 (20,000/50,000×$90,000) in arriving at the amount which is compared with the proceeds of termination received by a spouse. Applying the principles set forth in paragraph (b) of § 25.2515–3, this amount in the case of the husband is $21,600 (12,000/20,000×$36,000). Similarly, the principles set forth in paragraph (b) of this section are applied to $54,000

($90,000 − 36,000), the remaining portion of the proceeds of termination, in arriving at the amount which is compared with the proceeds of termination received by a spouse. If in this case either spouse, without the consent of the other spouse, can bring about a severance of his interest in the tenancy, the amount determined under paragraph (b) of this section in the case of the husband would be $27,000 (½ of $54,000). The total of the two amounts which are to be compared with the proceeds of termination received by the husband is $48,600 ($21,600+27,000). This sum of $48,600 is then compared with the $40,000 proceeds received by the husband, and the termination of the tenancy has resulted, for gift tax purposes, in a transfer of $8,600 by the husband to his wife in 1965. See paragraph (d) of this section for an additional example illustrating the application of this paragraph.

(d) The application of paragraph (c) of this section may further be illustrated by the following example:

*Example.* X died in 1948 and devised real property to Y and Z (Y's wife) as tenant by the entirety. Under the law of the jurisdiction, both spouses are entitled to share equally in the income from, or the enjoyment of, the property, but neither spouse, acting alone, may defeat the right of the survivor of them to the whole of the property. The fair market value of the property at the time of X's death was $100,000 and this amount is the consideration which X furnished toward the creation of the tenancy. In 1955, at which time the fair market value of the property was the same as at the time of X's death, improvements of $50,000 were made to the property, of which Y furnished $40,000 out of his own funds and Z furnished $10,000 out of her own funds. Y did not elect to treat his transfer to the tenancy as resulting in the making of a gift in 1955. In 1956 the property was sold for $300,000 and Y and Z each received $150,000 of the proceeds. At the time the property was sold Y and Z were 45 and 40 years of age, respectively, on their birthdays nearest the date of sale. The value of the gift made by Y to Z is $19,942, computed as follows:

Amount determined under principles set forth in § 25.2515–3:

$50,000 (consideration not treated as gift in year furnished)÷$150,000 (total consideration furnished)×$300,000 (proceeds of termination)=$100,000 (proceeds of termination to which principles set forth in § 25.2515–3 apply)

$40,000 (consideration furnished by H and not treated as gift)÷$50,000 (total consideration not treated as gift)×$100,000=$80,000

Amount determined under principles set forth in paragraph (b) of this section:

$300,000 (total proceeds of termination)—$100,000 (proceeds to which principles set forth in § 25.2515–3 apply)=$200,000 (proceeds to which principles set forth in paragraph (b) apply) 0.44971 (factor for Y's latest)×$200,000=$89,942

| | |
|---|---|
| Amount of gift: | |
| Amount determined under § 25.2515–3 | $80,000 |
| Amount determined under paragraph (b) | 89,942 |
| Total | 169,942 |
| Less: Proceeds received by Y | 150,000 |
| Amount of gift made by Y to Z | 19,942 |

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7238, 37 FR 28732, Dec. 29, 1972]

## § 25.2516–1 Certain property settlements.

(a) Section 2516 provides that 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 two years after entering into the agreement.

(b) See paragraph (b) of § 25.6019–3 for the circumstances under which information relating to property settlements must be disclosed on the transferor's gift tax return for the ''calendar period'' (as defined in § 25.2502–1(c)(1)) in which the agreement becomes effective.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7238, 37 FR 28732, Dec. 29, 1972; T.D. 7910, 48 FR 40375, Sept. 7, 1983]

## § 25.2516–2 Transfers in settlement of support obligations.

Transfers to provide a reasonable allowance for the support of children (including legally adopted children) of a marriage during minority are not subject to the gift tax if made pursuant to an agreement which satisfies the requirements of section 2516.

**§ 25.2518–1 Qualified disclaimers of property; in general.**

(a) *Applicability*—(1) *In general.* The rules described in this section, § 25.2518–2, and § 25.2518–3 apply to the qualified disclaimer of an interest in property which is created in the person disclaiming by a transfer made after December 31, 1976. In general, a qualified disclaimer is an irrevocable and unqualified refusal to accept the ownership of an interest in property. For rules relating to the determination of when a transfer creating an interest occurs, see § 25.2518–2(c) (3) and (4).

(2) *Example.* The provisions of paragraph (a)(1) of this section may be illustrated by the following example:

*Example.* W creates an irrevocable trust on December 10, 1968, and retains the right to receive the income for life. Upon the death of W, which occurs after December 31, 1976, the trust property is distributable to W's surviving issue, *per stirpes.* The transfer creating the remainder interest in the trust occurred in 1968. See § 25.2511–1(c)(2). Therefore, section 2518 does not apply to the disclaimer of the remainder interest because the transfer creating the interest was made prior to January 1, 1977. If, however, W had caused the gift to be incomplete by also retaining the power to designate the person or persons to receive the trust principal at death, and, as a result, no transfer (within the meaning of § 25.2511–1(c)(2)) of the remainder interest was made at the time of the creation of the trust, section 2518 would apply to any disclaimer made after W's death with respect to an interest in the trust property.

(3) Paragraph (a)(1) of this section is applicable for transfers creating the interest to be disclaimed made on or after December 31, 1997.

(b) *Effect of a qualified disclaimer.* If a person makes a qualified disclaimer as described in section 2518(b) and § 25.2518–2, 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 the decedent's executor or administrator on behalf of the decedent, has made a qualified disclaimer. If the disclaimer is not a qualified disclaimer, for the purposes of the Federal estate, gift, and generation-skipping transfer tax provisions, the disclaimer is disregarded and the disclaimant is treated as having received the interest.

(c) *Effect of local law*—(1) *In general*—(i) *Interests created before 1982.* A disclaimer of an interest created in a taxable transfer before 1982 which otherwise meets the requirements of a qualified disclaimer under section 2518 and the corresponding regulations but which, by itself, is not effective under applicable local law to divest ownership of the disclaimed property from the disclaimant and vest it in another, is nevertheless treated as a qualified disclaimer under section 2518 if, under applicable local law, the disclaimed interest in property is transferred, as a result of attempting the disclaimer, to another person without any direction on the part of the disclaimant. An interest in property will not be considered to be transferred without any direction on the part of the disclaimant if, under applicable local law, the disclaimant has any discretion (whether or not such discretion is exercised) to determine who will receive such interest. Actions by the disclaimant which are required under local law merely to divest ownership of the property from the disclaimant and vest ownership in another person will not disqualify the disclaimer for purposes of section 2518(a). See § 25.2518–2(d)(1) for rules relating to the immediate vesting of title in the disclaimant.

(ii) *Interests created after 1981.* [Reserved]

(2) *Creditor's claims.* The fact that a disclaimer is voidable by the disclaimant's creditors has no effect on the determination of whether such disclaimer constitutes a qualified disclaimer. However, a disclaimer that is wholly void or that is voided by the disclaimant's creditors cannot be a qualified disclaimer.

(3) *Examples.* The provisions of paragraphs (c) (1) and (2) of this section

may be illustrated by the following examples:

*Example (1).* F dies testate in State Y on June 17, 1978. G and H are beneficiaries under the will. The will provides that any disclaimed property is to pass to the residuary estate. H has no interest in the residuary estate. Under the applicable laws of State Y, a disclaimer must be made within 6 months of the death of the testator. Seven months after F's death, H disclaimed the real property H received under the will. The disclaimer statute of State Y has a provision stating that an untimely disclaimer will be treated as an assignment of the interest disclaimed to those persons who would have taken had the disclaimer been valid. Pursuant to this provision, the disclaimed property became part of the residuary estate. Assuming the remaining requirements of section 2518 are met, H has made a qualified disclaimer for purposes of section 2518 (a).

*Example (2).* Assume the same facts as in example (1) except that the law of State Y does not treat an ineffective disclaimer as a transfer to alternative takers. H assigns the disclaimed interest by deed to those who would have taken had the disclaimer been valid. Under these circumstances, H has not made a qualified disclaimer for purposes of section 2518 (a) because the disclaimant directed who would receive the property.

*Example (3).* Assume the same facts as in example (1) except that the law of State Y requires H to pay a transfer tax in order to effectuate the transfer under the ineffective disclaimer provision. H pays the transfer tax. H has make a qualified disclaimer for purposes of section 2518 (a).

(d) *Cross-reference.* For rules relating to the effect of qualified disclaimers on the estate tax charitable and marital deductions, see §§ 20.2055–2(c) and 20.2056(d)–1 respectively. For rules relating to the effect of a qualified disclaimer of a general power of appointment, see § 20.2041–3(d).

[T.D. 8095, 51 FR 28370, Aug. 7, 1986, as amended by T.D. 8744, 62 FR 68185, Dec. 31, 1997]

### § 25.2518–2 Requirements for a qualified disclaimer.

(a) *In general.* For the purposes of section 2518(a), a disclaimer shall be a qualified disclaimer only if it satisfies the requirements of this section. In general, to be a qualified disclaimer—

(1) The disclaimer must be irrevocable and unqualified:

(2) The disclaimer must be in writing;

(3) The writing must be delivered to the person specified in paragraph (b) (2) of this section within the time limitations specified in paragraph (c)(1) of this section;

(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.

(b) *Writing*—(1) *Requirements.* A disclaimer is a qualified disclaimer only if it is in writing. The writing must identify the interest in property disclaimed and be signed either by the disclaimant or by the disclaimant's legal representative.

(2) *Delivery.* The writing described in paragraph (b)(1) of this section must be delivered to the transferor of the interest, the transferor's legal representative, the holder of the legal title to the property to which the interest relates, or the person in possession of such property.

(c) *Time limit*—(1) *In general.* A disclaimer is a qualified disclaimer only if the writing described in paragraph (b)(1) of this section is delivered to the persons described in paragraph (b)(2) of this section no later than the date which is 9 months after the later of—

(i) The date on which the transfer creating the interest in the disclaimant is made, or

(ii) The day on which the disclaimant attains age 21.

(2) *A timely mailing of a disclaimer treated as a timely delivery.* Although section 7502 and the regulations under that section apply only to documents to be filed with the Service, a timely mailing of a disclaimer to the person described in paragraph (b)(2) of this section is treated as a timely delivery if the mailing requirements under paragraphs (c)(1), (c)(2) and (d) of § 301.7502–1 are met. Further, if the last day of the period specified in paragraph (c)(1) of this section falls on Saturday, Sunday or a legal holiday (as defined in paragraph (b) of § 301.7503–1), then the delivery of the writing described in paragraph (b)(1) of this section shall be considered timely if delivery is made on the first succeeding day which is not Saturday, Sunday or a legal holiday. See paragraph (d)(3) of this section

for rules applicable to the exception for individuals under 21 years of age.

(3) *Transfer.* (i) For purposes of the time limitation described in paragraph (c)(1)(i) of this section, the 9-month period for making a disclaimer generally is to be determined with reference to the transfer creating the interest in the disclaimant. With respect to inter vivos transfers, a transfer creating an interest 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 under section 2503(b) are regarded as transfers creating an interest for this purpose. With respect to transfers made by a decedent at death or transfers that become irrevocable at death, the transfer creating the interest occurs on the date of the decedent's death, even if an estate tax is not imposed on the transfer. For example, a bequest of foreign-situs property by a nonresident alien decedent is regarded as a transfer creating an interest in property even if the transfer would not be subject to estate tax. If there is a transfer creating an interest in property during the transferor's lifetime and such interest is later included in the transferor's gross estate for estate tax purposes (or would have been included if such interest were subject to estate tax), the 9-month period for making the qualified disclaimer is determined with reference to the earlier transfer creating the interest. In the case of a general power of appointment, the holder of the power has a 9-month period after the transfer creating the power in which to disclaim. If a person to whom any interest in property passes by reason of the exercise, release, or lapse of a general power desires to make a qualified disclaimer, the disclaimer must be made within a 9-month period after the exercise, release, or lapse regardless of whether the exercise, release, or lapse is subject to estate or gift tax. In the case of a nongeneral power of appointment, the holder of the power, permissible appointees, or takers in default of appointment must disclaim within a 9-month period after the original transfer that created or authorized the creation of the power. If the transfer is for the life of an income beneficiary with succeeding interests to other persons, both the life tenant and the other remaindermen, whether their interests are vested or contingent, must disclaim no later than 9 months after the original transfer creating an interest. In the case of a remainder interest in property which an executor elects to treat as qualified terminable interest property under section 2056(b)(7), the remainderman must disclaim within 9 months of the transfer creating the interest, rather than 9 months from the date such interest is subject to tax under section 2044 or 2519. A person who receives an interest in property as the result of a qualified disclaimer of the interest must disclaim the previously disclaimed interest no later than 9 months after the date of the transfer creating the interest in the preceding disclaimant. Thus, if A were to make a qualified disclaimer of a specific bequest and as a result of the qualified disclaimer the property passed as part of the residue, the beneficiary of the residue could make a qualified disclaimer no later than 9 months after the date of the testator's death. See paragraph (d)(3) of this section for the time limitation rule with reference to recipients who are under 21 years of age.

(ii) Sentences 1 through 10 and 12 of paragraph (c)(3)(i) of this section are applicable for transfers creating the interest to be disclaimed made on or after December 31, 1997.

(4) *Joint property*—(i) *Interests in joint tenancy with right of survivorship or tenancies by the entirety.* Except as provided in paragraph (c)(4)(iii) of this section (with respect to joint bank, brokerage, and other investment accounts), in the case of an interest in a joint tenancy with right of survivorship or a tenancy by the entirety, a qualified disclaimer of the interest to which the disclaimant succeeds upon creation of the tenancy must be made no later than 9 months after the creation of the tenancy regardless of whether such interest can be unilaterally severed under local law. A qualified disclaimer of the survivorship interest to which the survivor succeeds by operation of law upon the death of the first joint tenant to die must be

made no later than 9 months after the death of the first joint tenant to die regardless of whether such interest can be unilaterally severed under local law and, except as provided in paragraph (c)(4)(ii) of this section (with respect to certain tenancies created on or after July 14, 1988), such interest is deemed to be a one-half interest in the property. (See, however, section 2518(b)(2)(B) for a special rule in the case of disclaimers by persons under age 21.) This is the case regardless of the portion of the property attributable to consideration furnished by the disclaimant and regardless of the portion of the property that is included in the decedent's gross estate under section 2040 and regardless of whether the interest can be unilaterally severed under local law. See paragraph (c)(5), Examples (*7*) and (*8*), of this section.

(ii) *Certain tenancies in real property between spouses created on or after July 14, 1988.* In the case of a joint tenancy between spouses or a tenancy by the entirety in real property created on or after July 14, 1988, to which section 2523(i)(3) applies (relating to the creation of a tenancy where the spouse of the donor is not a United States citizen), the surviving spouse may disclaim any portion of the joint interest that is includible in the decedent's gross estate under section 2040. See paragraph (c)(5), *Example (9),* of this section.

(iii) *Special rule for joint bank, brokerage, and other investment accounts (e.g., accounts held at mutual funds) established between spouses or between persons other than husband and wife.* In the case of a transfer to a joint bank, brokerage, or other investment account (e.g., an account held at a mutual fund), if a transferor may unilaterally regain the transferor's own contributions to the account without the consent of the other cotenant, such that the transfer is not a completed gift under § 25.2511–1(h)(4), the transfer creating the survivor's interest in the decedent's share of the account occurs on the death of the deceased cotenant. Accordingly, if a surviving joint tenant desires to make a qualified disclaimer with respect to funds contributed by a deceased cotenant, the disclaimer must be made within 9 months of the cotenant's death. The surviving joint tenant may not disclaim any portion of the joint account attributable to consideration furnished by that surviving joint tenant. See paragraph (c)(5), *Examples (12), (13),* and (*14*), of this section, regarding the treatment of disclaimed interests under sections 2518, 2033 and 2040.

(iv) *Effective date.* This paragraph (c)(4) is applicable for disclaimers made on or after December 31, 1997.

(5) *Examples.* The provisions of paragraphs (c)(1) through (c)(4) of this section may be illustrated by the following examples. For purposes of the following examples, assume that all beneficiaries are over 21 years of age.

*Example (1).* On May 13, 1978, in a transfer which constitutes a completed gift for Federal gift tax purposes, A creates a trust in which B is given a lifetime interest in the income from the trust. B is also given a nongeneral testamentary power of appointment over the corpus of the trust. The power of appointment may be exercised in favor of any of the issue of A and B. If there are no surviving issue at B's death or if the power is not exercised, the corpus is to pass to E. On May 13, 1978, A and B have two surviving children, C and D. If A, B, C or D wishes to make a qualified disclaimer, the disclaimer must be made no later than 9 months after May 13, 1978.

*Example (2).* Assume the same facts as in example (1) except that B is given a general power of appointment over the corpus of the trust. B exercises the general power of appointment in favor of C upon B's death on June 17, 1989. C may make a qualified disclaimer no later than 9 months after June 17, 1989. If B had died without exercising the general power of appointment, E could have made a qualified disclaimer no later than 9 months after June 17, 1989.

*Example (3).* F creates a trust on April 1, 1978, in which F's child G is to receive the income from the trust for life. Upon G's death, the corpus of the trust is to pass to G's child H. If either G or H wishes to make a qualified disclaimer, it must be made no later than 9 months after April 1, 1978.

*Example (4).* A creates a trust on February 15, 1978, in which B is named the income beneficiary for life. The trust further provides that upon B's death the proceeds of the trust are to pass to C, if then living. If C predeceases D, the proceeds shall pass to D or D's estate. To have timely disclaimers for purposes of section 2518, B, C, and D must disclaim their respective interests no later than 9 months after February 15, 1978.

*Example (5).* A, a resident of State Q, dies on January 10, 1979, devising certain real

property to B. The disclaimer laws of State Q require that a disclaimer be made within a reasonable time after a transfer. B disclaims the entire interest in real property on November 10, 1979. Although B's disclaimer may be effective under State Q law, it is not a qualified disclaimer under section 2518 because the disclaimer was made later than 9 months after the taxable transfer to B.

*Example (6).* A creates a revocable trust on June 1, 1980, in which B and C are given the income interest for life. Upon the death of the last income beneficiary, the remainder interest is to pass to D. The creation of the trust is not a completed gift for Federal gift tax purposes, but each distribution of trust income to B and C is a completed gift at the date of distribution. B and C must disclaim each income distribution no later than 9 months after the date of the particular distribution. In order to disclaim an income distribution in the form of a check, the recipient must return the check to the trustee uncashed along with a written disclaimer. A dies on September 1, 1982, causing the trust to become irrevocable, and the trust corpus is includible in A's gross estate for Federal estate tax purposes under section 2038. If B or C wishes to make a qualified disclaimer of his income interest, he must do so no later than 9 months after September 1, 1982. If D wishes to make a qualified disclaimer of his remainder interest, he must do so no later than 9 months after September 1, 1982.

*Example (7).* On February 1, 1990, A purchased real property with A's funds. Title to the property was conveyed to ''A and B, as joint tenants with right of survivorship.'' Under applicable state law, the joint interest is unilaterally severable by either tenant. B dies on May 1, 1998, and is survived by A. On January 1, 1999, A disclaims the one-half survivorship interest in the property to which A succeeds as a result of B's death. Assuming that the other requirements of section 2518(b) are satisfied, A has made a qualified disclaimer of the one-half survivorship interest (but not the interest retained by A upon the creation of the tenancy, which may not be disclaimed by A). The result is the same whether or not A and B are married and regardless of the proportion of consideration furnished by A and B in purchasing the property.

*Example (8).* Assume the same facts as in *Example (7)* except that A and B are married and title to the property was conveyed to ''A and B, as tenants by the entirety.'' Under applicable state law, the tenancy cannot be unilaterally severed by either tenant. Assuming that the other requirements of section 2518(b) are satisfied, A has made a qualified disclaimer of the one-half survivorship interest (but not the interest retained by A upon the creation of the tenancy, which may not be disclaimed by A). The result is the same regardless of the proportion of consideration furnished by A and B in purchasing the property.

*Example (9).* On March 1, 1989, H and W purchase a tract of vacant land which is conveyed to them as tenants by the entirety. The entire consideration is paid by H. W is not a United States citizen. H dies on June 1, 1998. W can disclaim the entire joint interest because this is the interest includible in H's gross estate under section 2040(a). Assuming that W's disclaimer is received by the executor of H's estate no later than 9 months after June 1, 1998, and the other requirements of section 2518(b) are satisfied, W's disclaimer of the property would be a qualified disclaimer. The result would be the same if the property was held in joint tenancy with right of survivorship that was unilaterally severable under local law.

*Example (10).* In 1986, spouses A and B purchased a personal residence taking title as tenants by the entirety. B dies on July 10, 1998. A wishes to disclaim the one-half undivided interest to which A would succeed by right of survivorship. If A makes the disclaimer, the property interest would pass under B's will to their child C. C, an adult, and A resided in the residence at B's death and will continue to reside there in the future. A continues to own a one-half undivided interest in the property. Assuming that the other requirements of section 2518(b) are satisfied, A may make a qualified disclaimer with respect to the one-half undivided survivorship interest in the residence if A delivers the written disclaimer to the personal representative of B's estate by April 10, 1999, since A is not deemed to have accepted the interest or any of its benefits prior to that time and A's occupancy of the residence after B's death is consistent with A's retained undivided ownership interest. The result would be the same if the property was held in joint tenancy with right of survivorship that was unilaterally severable under local law.

*Example (11).* H and W, husband and wife, reside in state X, a community property state. On April 1, 1978, H and W purchase real property with community funds. The property is not held by H and W as jointly owned property with rights of survivorship. H and W hold the property until January 3, 1985, when H dies. H devises his portion of the property to W. On March 15, 1985, W disclaims the portion of the property devised to her by H. Assuming all the other requirements of section 2518 (b) have been met, W has made a qualified disclaimer of the interest devised to her by H. However, W could not disclaim the interest in the property that she acquired on April 1, 1978.

*Example (12).* On July 1, 1990, A opens a bank account that is held jointly with B, A's spouse, and transfers $50,000 of A's money to

the account. A and B are United States citizens. A can regain the entire account without B's consent, such that the transfer is not a completed gift under § 25.2511–1(h)(4). A dies on August 15, 1998, and B disclaims the entire amount in the bank account on October 15, 1998. Assuming that the remaining requirements of section 2518(b) are satisfied, B made a qualified disclaimer under section 2518(a) because the disclaimer was made within 9 months after A's death at which time B had succeeded to full dominion and control over the account. Under state law, B is treated as predeceasing A with respect to the disclaimed interest. The disclaimed account balance passes through A's probate estate and is no longer joint property includible in A's gross estate under section 2040. The entire account is, instead, includible in A's gross estate under section 2033. The result would be the same if A and B were not married.

*Example (13).* The facts are the same as Example (12), except that B, rather than A, dies on August 15, 1998. A may not make a qualified disclaimer with respect to any of the funds in the bank account, because A furnished the funds for the entire account and A did not relinquish dominion and control over the funds.

*Example (14).* The facts are the same as Example (12), except that B disclaims 40 percent of the funds in the account. Since, under state law, B is treated as predeceasing A with respect to the disclaimed interest, the 40 percent portion of the account balance that was disclaimed passes as part of A's probate estate, and is no longer characterized as joint property. This 40 percent portion of the account balance is, therefore, includible in A's gross estate under section 2033. The remaining 60 percent of the account balance that was not disclaimed retains its character as joint property and, therefore, is includible in A's gross estate as provided in section 2040(b). Therefore, 30 percent (½×60 percent) of the account balance is includible in A's gross estate under section 2040(b), and a total of 70 percent of the aggregate account balance is includible in A's gross estate. If A and B were not married, then the 40 percent portion of the account subject to the disclaimer would be includible in A's gross estate as provided in section 2033 and the 60 percent portion of the account not subject to the disclaimer would be includible in A's gross estate as provided in section 2040(a), because A furnished all of the funds with respect to the account.

(d) *No acceptance of benefits*—(1) *Acceptance.* A qualified disclaimer cannot be made with respect to an interest in property if the disclaimant has accepted the interest or any of its benefits, expressly or impliedly, prior to making the disclaimer. Acceptance is manifested by an affirmative act which is consistent with ownership of the interest in property. Acts indicative of acceptance include using the property or the interest in property; accepting dividends, interest, or rents from the property; and directing others to act with respect to the property or interest in property. However, merely taking delivery of an instrument of title, without more, does not constitute acceptance. Moreover, a disclaimant is not considered to have accepted property merely because under applicable local law title to the property vests immediately in the disclaimant upon the death of a decedent. The acceptance of one interest in property will not, by itself, constitute an acceptance of any other separate interests created by the transferor and held by the disclaimant in the same property. In the case of residential property, held in joint tenancy by some or all of the residents, a joint tenant will not be considered to have accepted the joint interest merely because the tenant resided on the property prior to disclaiming his interest in the property. The exercise of a power of appointment to any extent by the donee of the power is an acceptance of its benefits. In addition, the acceptance of any consideration in return for making the disclaimer is an acceptance of the benefits of the entire interest disclaimed.

(2) *Fiduciaries.* If a beneficiary who disclaims an interest in property is also a fiduciary, actions taken by such person in the exercise of fiduciary powers to preserve or maintain the disclaimed property shall not be treated as an acceptance of such property or any of its benefits. Under this rule, for example, an executor who is also a beneficiary may direct the harvesting of a crop or the general maintenance of a home. A fiduciary, however, cannot retain a wholly discretionary power to direct the enjoyment of the disclaimed interest. For example, a fiduciary's disclaimer of a beneficial interest does not meet the requirements of a qualified disclaimer if the fiduciary exercised or retains a discretionary power to allocate enjoyment of that interest among members of a designated class. See paragraph (e) of this section for

rules relating to the effect of directing the redistribution of disclaimed property.

(3) *Under 21 years of age.* A beneficiary who is under 21 years of age has until 9 months after his twenty-first 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 twenty-first birthday will not be an acceptance by the beneficiary of the interest.

(4) *Examples.* The provisions of paragraphs (d) (1), (2) and (3) of this section may be illustrated by the following examples:

*Example (1).* On April 9, 1977, A established a trust for the benefit of B, then age 22. Under the terms of the trust, the current income of the trust is to be paid quarterly to B. Additionally, one half the principal is to be distributed to B when B attains the age of 30 years. The balance of the principal is to be distributed to B when B attains the age of 40 years. Pursuant to the terms of the trust, B received a distribution of income on June 30, 1977. On August 1, 1977, B disclaimed B's right to receive both the income from the trust and the principal of the trust, B's disclaimer of the income interest is not a qualified disclaimer for purposes of section 2518(a) because B accepted income prior to making the disclaimer. B's disclaimer of the principal, however, does satisfy section 2518(b)(3). See also § 25.2518–3 for rules relating to the disclaimer of less than an entire interest in property.

*Example (2).* B is the recipient of certain property devised to B under the will of A. The will stated that any disclaimed property was to pass to C. B and C entered into negotiations in which it was decided that B would disclaim all interest in the real property that was devised to B. In exchange, C promised to let B live in the family home for life. B's disclaimer is not a qualified disclaimer for purposes of section 2518(a) because B accepted consideration for making the disclaimer.

*Example (3).* A received a gift of Blackacre on December 25, 1978. A never resided on Blackacre but when property taxes on Blackacre became due on July 1, 1979, A paid them out personal funds. On August 15, 1979, A disclaimed the gift of Blackacre. Assuming all the requirements of section 2518 (b) have been met, A has made a qualified disclaimer of Blackacre. Merely paying the property taxes does not constitute an acceptance of Blackacre even though A's personal funds were used to pay the taxes.

*Example (4).* A died on February 15, 1978. Pursuant to A's will, B received a farm in State Z. B requested the executor to sell the farm and to give the proceeds to B. The executor then sold the farm pursuant to B's request. B then disclaimed $50,000 of the proceeds from the sale of the farm. B's disclaimer is not a qualified disclaimer. By requesting the executor to sell the farm B accepted the farm even though the executor may not have been legally obligated to comply with B's request. See also § 25.2518–3 for rules relating to the disclaimer of less than an entire interest in property.

*Example (5).* Assume the same facts as in example (4) except that instead of requesting the executor to sell the farm, B pledged the farm as security for a short-term loan which was paid off prior to distribution of the estate. B then disclaimed his interest in the farm. B's disclaimer is not a qualified disclaimer. By pledging the farm as security for the loan, B accepted the farm.

*Example (6).* A delivered 1,000 shares of stock in Corporation X to B as a gift on February 1, 1980. A had the shares registered in B's name on that date. On April 1, 1980, B disclaimed the interest in the 1,000 shares. Prior to making the disclaimer, B did not pledge the shares, accept any dividends or otherwise commit any acts indicative of acceptance. Assuming the remaining requirements of section 2518 are satisfied, B's disclaimer is a qualified disclaimer.

*Example (7).* On January 1, 1980, A created an irrevocable trust in which B was given a testamentary general power of appointment over the trust's corpus. B executed a will on June 1, 1980, in which B provided for the exercise of the power of appointment. On September 1, 1980, B disclaimed the testamentary power of appointment. Assuming the remaining requirements of section 2518 (b) are satisfied, B's disclaimer of the testamentary power of appointment is a qualified disclaimer.

*Example (8).* H and W reside in X, a community property state. On January 1, 1981, H and W purchase a residence with community funds. They continue to reside in the house until H dies testate on February 1, 1990. Although H could devise his portion of the residence to any person, H devised his portion of the residence to W. On September 1, 1990, W disclaims the portion of the residence devised to her pursuant to H's will but continues to live in the residence. Assuming the remaining requirements of section 2518(b) are satisfied, W's disclaimer is a qualified disclaimer under section 2518 (a). W's continued occupancy of the house prior to making the disclaimer will not by itself be treated as an acceptance of the benefits of the portion of the residence devised to her by H.

*Example (9).* In 1979, D established a trust for the benefit of D's minor children E and F. Under the terms of the trust, the trustee is

given the power to make discretionary distributions of current income and corpus to both children. The corpus of the trust is to be distributed equally between E and F when E becomes 35 years of age. Prior to attaining the age of 21 years on April 8, 1982, E receives several distributions of income from the trust. E receives no distributions of income between April 8, 1982 and August 15, 1982, which is the date on which E disclaims all interest in the income from the trust. As a result of the disclaimer the income will be distributed to F. If the remaining requirements of section 2518 are met, E's disclaimer is a qualified disclaimer under section 2518(a). To have a qualified disclaimer of the interest in corpus, E must disclaim the interest no later than 9 months after April 8, 1982, E's 21st birthday.

*Example (10).* Assume the same facts as in example (9) except that E accepted a distribution of income on May 13, 1982. E's disclaimer is not a qualified disclaimer under section 2518 because by accepting an income distribution after attaining the age of 21, E accepted benefits from the income interest.

*Example (11).* F made a gift of 10 shares of stock to G as custodian for H under the State X Uniform Gifts to Minors Act. At the time of the gift, H was 15 years old. At age 18, the local age of majority, the 10 shares were delivered to and registered in the name of H. Between the receipt of the shares and H's 21st birthday, H received dividends from the shares. Within 9 months of attaining age 21, H disclaimed the 10 shares. Assuming H did not accept any dividends from the shares after attaining age 21, the disclaimer by H is a qualified disclaimer under section 2518.

(e) *Passage without direction by the disclaimant of beneficial enjoyment of disclaimed interest*—(1) *In general.* A disclaimer is not a qualified disclaimer unless the disclaimed interest passes without any direction on the part of the disclaimant to a person other than the disclaimant (except as provided in paragraph (e)(2) of this section). If there is an express or implied agreement that the disclaimed interest in property is to be given or bequeathed to a person specified by the disclaimant, the disclaimant shall be treated as directing the transfer of the property interest. The requirements of a qualified disclaimer under section 2518 are not satisfied if—

(i) The disclaimant, either alone or in conjunction with another, directs the redistribution or transfer of the property or interest in property to another person (or has the power to direct the redistribution or transfer of the property or interest in property to another person unless such power is limited by an ascertainable standard); or

(ii) The disclaimed property or interest in property passes to or for the benefit of the disclaimant as a result of the disclaimer (except as provided in paragraph (e)(2) of this section).

If a power of appointment is disclaimed, the requirements of this paragraph (e)(1) are satisfied so long as there is no direction on the part of the disclaimant with respect to the transfer of the interest subject to the power or with respect to the transfer of the power to another person. A person may make a qualified disclaimer of a beneficial interest in property even if after such disclaimer the disclaimant has a fiduciary power to distribute to designated beneficiaries, but only if the power is subject to an ascertainable standard. See examples (11) and (12) of paragraph (e)(5) of this section.

(2) *Disclaimer by surviving spouse.* In the case of a disclaimer made by a decedent's surviving spouse with respect to property transferred by the decedent, the disclaimer satisfies the requirements of this paragraph (e) if the interest passes as a result of the disclaimer without direction on the part of the surviving spouse either to the surviving spouse or to another person. If the surviving spouse, however, retains the right to direct the beneficial enjoyment of the disclaimed property in a transfer that is not subject to Federal estate and gift tax (whether as trustee or otherwise), such spouse will be treated as directing the beneficial enjoyment of the disclaimed property, unless such power is limited by an ascertainable standard. See examples (4), (5), and (6) in paragraph (e)(5) of this section.

(3) *Partial failure of disclaimer.* If a disclaimer made by a person other than the surviving spouse is not effective to pass completely an interest in property to a person other than the disclaimant because—

(i) The disclaimant also has a right to receive such property as an heir at law, residuary beneficiary, or by any other means; and

(ii) The disclaimant does not effectively disclaim these rights, the disclaimer is not a qualified disclaimer with respect to the portion of the disclaimed property which the disclaimant has a right to receive. If the portion of the disclaimed interest in property which the disclaimant has a right to receive is not severable property or an undivided portion of the property, then the disclaimer is not a qualified disclaimer with respect to any portion of the property. Thus, for example, if a disclaimant who is not a surviving spouse receives a specific bequest of a fee simple interest in property and as a result of the disclaimer of the entire interest, the property passes to a trust in which the disclaimant has a remainder interest, then the disclaimer will not be a qualified disclaimer unless the remainder interest in the property is also disclaimed. See § 25.2518–3 (a)(1)(ii) for the definition of severable property.

(4) *Effect of precatory language.* Precatory language in a disclaimer naming takers of disclaimed property will not be considered as directing the redistribution or transfer of the property or interest in property to such persons if the applicable State law gives the language no legal effect.

(5) *Examples.* The provisions of this paragraph (e) may be illustrated by the following examples:

*Example (1).* A, a resident of State X, died on July 30, 1978. Pursuant to A's will, B, A's son and heir at law, received the family home. In addition, B and C each received 50 percent of A's residuary estate. B disclaimed the home. A's will made no provision for the distribution of property in the case of a beneficiary's disclaimer. Therefore, pursuant to the disclaimer laws of State X, the disclaimed property became part of the residuary estate. Because B's 50 percent share of the residuary estate will be increased by 50 percent of the value of the family home, the disclaimed property will not pass solely to another person. Consequently, B's disclaimer of the family home is a qualified disclaimer only with respect to the 50 percent portion that passes solely to C. Had B also disclaimed B's 50 percent interest in the residuary estate, the disclaimer would have been a qualified disclaimer under section 2518 of the entire interest in the home (assuming the remaining requirements of a qualified disclaimer were satisfied). Similarly, if under the laws of State X, the disclaimer has the effect of divesting B of all interest in the home, both as devisee and as a beneficiary of the residuary estate, including any property resulting from its sale, the disclaimer would be a qualified disclaimer of B's entire interest in the home.

*Example (2).* D, a resident of State Y, died testate on June 30, 1978. E, an heir at law of D, received specific bequests of certain severable personal property from D. E disclaimed the property transferred by D under the will. The will made no provision for the distribution of property in the case of a beneficiary's disclaimer. The disclaimer laws of State Y provide that such property shall pass to the decedent's heirs at law in the same manner as if the disclaiming beneficiary had died immediately before the testator's death. Because State Y's law treats E as predeceasing D, the property disclaimed by E does not pass to E as an heir at law or otherwise. Consequently, if the remaining requirements of section 2518(b) are satisfied, E's disclaimer is a qualified disclaimer under section 2518(a).

*Example (3).* Assume the same facts as in example (2) except that State Y has no provision treating the disclaimant as predeceasing the testator. E's disclaimer satisfies section 2518 (b)(4) only to the extent that E does not have a right to receive the property as an heir at law. Had E disclaimed both the share E received under D's will and E's intestate share, the requirement of section 2518 (b)(4) would have been satisfied.

*Example (4).* B died testate on February 13, 1980. B's will established both a marital trust and a nonmarital trust. The decedent's surviving spouse, A, is an income beneficiary of the marital trust and has a testamentary general power of appointment over its assets. A is also an income beneficiary of the nonmarital trust, but has no power to appoint or invade the corpus. The provisions of the will specify that any portion of the marital trust disclaimed is to be added to the nonmarital trust. A disclaimed 30 percent of the marital trust. (See § 25.2518–3 (b) for rules relating to the disclaimer of an undivided portion of an interest in property.) Pursuant to the will, this portion of the marital trust property was transferred to the nonmarital trust without any direction on the part of A. This disclaimer by A satisfies section 2518 (b)(4).

*Example (5).* Assume the same facts as in example (4) except that A, the surviving spouse, has both an income interest in the nonmarital trust and a testamentary nongeneral power to appoint among designated beneficiaries. This power is not limited by an ascertainable standard. The requirements of section 2518 (b)(4) are not satisfied unless A also disclaims the nongeneral power to appoint the portion of the trust corpus that is attributable to the property that passed to the nonmarital trust as a result of A's disclaimer. Assuming that the fair market value of the disclaimed property on the date of the disclaimer is $250,000 and that the fair

market value of the nonmarital trust (including the disclaimed property) immediately after the disclaimer is $750,000, A must disclaim the power to appoint one-third of the nonmarital trust's corpus. The result is the same regardless of whether the nongeneral power is testamentary or inter vivos.

*Example (6).* Assume the same facts as in example (4) except that A has both an income interest in the nonmarital trust and a power to invade corpus if needed for A's health or maintenance. In addition, an independent trustee has power to distribute to A any portion of the corpus which the trustee determines to be desirable for A's happiness. Assuming the other requirements of section 2518 are satisfied. A may make a qualified disclaimer of interests in the marital trust without disclaiming any of A's interests in the nonmarital trust.

*Example (7).* B died testate on June 1, 1980. B's will created both a marital trust and a nonmarital trust. The decedent's surviving spouse, C, is an income beneficiary of the marital trust and has a testamentary general power of appointment over its assets. C is an income beneficiary of the nonmarital trust, and additionally has the noncumulative right to withdraw yearly the greater of $5,000 or 5 percent of the aggregate value of the principal. The provisions of the will specify that any portion of the marital trust disclaimed is to be added to the nonmarital trust. C disclaims 50 percent of the marital trust corpus. Pursuant to the will, this amount is transferred to the nonmarital trust. Assuming the remaining requirements of section 2518(b) are satisfied, C's disclaimer is a qualified disclaimer.

*Example (8).* A, a resident of State X, died on July 19, 1979. A was survived by a spouse B, and three children, C, D, and E. Pursuant to A's will, B received one-half of A's estate and the children received equal shares of the remaining one-half of the estate. B disclaimed the entire interest B had received. The will made no provisions for the distribution of property in the case of a beneficiary's disclaimer. The disclaimer laws of State X provide that under these circumstances disclaimed property passes to the decedent's heirs at law in the same manner as if the disclaiming beneficiary had died immediately before the testator's death. As a result, C, D, and E are A's only remaining heirs at law, and will divide the disclaimed property equally among themselves. B's disclaimer includes language stating that ''it is my intention that C, D, and E will share equally in the division of this property as a result of my disclaimer.'' State X considers these to be precatory words and gives them no legal effect. B's disclaimer meets all other requirements imposed by State X on disclaimers, and is considered an effective disclaimer under which the property will vest solely in C, D, and E in equal shares without any further action required by B. Therefore, B is not treated as directing the redistribution or transfer of the property. If the remaining requirements of secton 2518 are met, B's disclaimer is a qualified disclaimer.

*Example (9).* C died testate on January 1, 1979. According to C's will, D was to receive ⅓ of the residuary estate with any disclaimed property going to E. D was also to receive a second ⅓ of the residuary estate with any disclaimed property going to F. Finally, D was to receive a final ⅓ of the residuary estate with any disclaimed property going to G. D specifically states that he is disclaiming the interest in which the disclaimed property is designated to pass to E. D has effectively directed that the disclaimed property will pass to E and therefore D's disclaimer is not a qualified disclaimer under section 2518(a).

*Example (10).* Assume the same facts as in example (9) except that C's will also states that D was to receive Blackacre and Whiteacre. C's will further provides that if D disclaimed Blackacre then such property was to pass to E and that if D disclaimed Whiteacre then Whiteacre was to pass to F. D specifically disclaims Blackacre with the intention that it pass to E. Assuming the other requirements of section 2518 are met, D has made a qualified disclaimer of Blackacre. Alternatively, D could disclaim an undivided portion of both Blackacre and Whiteacre. Assuming the other requirements of section 2518 are met, this would also be a qualified disclaimer.

*Example (11).* G creates an irrevocable trust on February 16, 1983, naming H, I and J as the income beneficiaries for life and F as the remainderman. F is also named the trustee and as trustee has the discretionary power to invade the corpus and make discretionary distributions to H, I or J during their lives. F disclaims the remainder interest on August 8, 1983, but retains his discretionary power to invade the corpus. F has not made a qualified disclaimer because F retains the power to direct enjoyment of the corpus and the retained fiduciary power is not limited by an ascertainable standard.

*Example (12).* Assume the same facts as in example (11) except that F may only invade the corpus to make distributions for the health, maintenance or support of H, I or J during their lives. If the other requirements of section 2518(b) are met, F has made a qualified disclaimer of the remainder interest because the retained fiduciary power is limited by an ascertainable standard.

[T.D. 8095, 51 FR 28371, Aug. 7, 1986; 51 FR 31939, Sept. 8, 1986, as amended by T.D. 8744, 62 FR 68185, Dec. 31, 1997]

**§25.2518–3 Disclaimer of less than an entire interest.**

(a) *Disclaimer of a partial interest*—(1) *In general*—(i) *Interest.* If the requirements of this section are met, the disclaimer of all or an undivided portion of any separate interest in property may be a qualified disclaimer even if the disclaimant has another interest in the same property. In general, each interest in property that is separately created by the transferor is treated as a separate interest. For example, if an income interest in securities is bequeathed to A for life, then to B for life, with the remainder interest in such securities bequeathed to A's estate, and if the remaining requirements of section 2518(b) are met, A could make a qualified disclaimer of either the income interest or the remainder, or an undivided portion of either interest. A could not, however, make a qualified disclaimer of the income interest for a certain number of years. Further, where local law merges interests separately created by the transferor, a qualified disclaimer will be allowed only if there is a disclaimer of the entire merged interest or an undivided portion of such merged interest. See example (12) in paragraph (d) of this section. See §25.2518–3(b) for rules relating to the disclaimer of an undivided portion. Where the merger of separate interests would occur but for the creation by the transferor of a nominal interest (as defined in paragraph (a)(1)(iv) of this section), a qualified disclaimer will be allowed only if there is a disclaimer of all the separate interests, or an undivided portion of all such interests, which would have merged but for the nominal interest.

(ii) *Severable property.* A disclaimant shall be treated as making a qualified disclaimer of a separate interest in property if the disclaimer relates to severable property and the disclaimant makes a disclaimer which would be a qualified disclaimer if such property were the only property in which the disclaimant had an interest. If applicable local law does not recognize a purported disclaimer of severable property, the disclaimant must comply with the requirements of paragraph (c)(1) of §25.2518–1 in order to make a qualified disclaimer of the severable property. Severable property is property which can be divided into separate parts each of which, after severance, maintains a complete and independent existence. For example, a legatee of shares of corporate stock may accept some shares of the stock and make a qualified disclaimer of the remaining shares.

(iii) *Powers of appointment.* A power of appointment with respect to property is treated as a separate interest in such property and such power of appointment with respect to all or an undivided portion of such property may be disclaimed independently from any other interests separately created by the transferor in the property if the requirements of section 2518(b) are met. See example (21) of paragraph (d) of this section. Further, a disclaimer of a power of appointment with respect to property is a qualified disclaimer only if any right to direct the beneficial enjoyment of the property which is retained by the disclaimant is limited by an ascertainable standard. See example (9) of paragraph (d) of this section.

(iv) *Nominal interest.* A nominal interest is an interest in property created by the transferor that—

(A) Has an actuarial value (as determined under §20.2031–7) of less than 5 percent of the total value of the property at the time of the taxable transfer creating the interest,

(B) Prevents the merger under local law or two or more other interests created by the transferor, and

(C) Can be clearly shown from all the facts and circumstances to have been created primarily for the purpose of preventing the merger of such other interests.

Factors to be considered in determining whether an interest is created primarily for the purpose of preventing merger include (but are not limited to) the following: the relationship between the transferor and the interest holder; the age difference between the interest holder and the beneficiary whose interests would have merged; the interest holder's state of health at the time of the taxable transfer; and, in the case of a contingent remainder, any other factors which indicate that the possibility of the interest vesting as a fee simple is so remote as to be negligible.

(2) *In trust.* A disclaimer is not a qualified disclaimer under section 2518 if the beneficiary disclaims income derived from specific property transferred in trust while continuing to accept income derived from the remaining properties in the same trust unless the disclaimer results in such property being removed from the trust and passing, without any direction on the part of the disclaimant, to persons other than the disclaimant or to the spouse of the decedent. Moreover, a disclaimer of both an income interest and a remainder interest in specific trust assets is not a qualified disclaimer if the beneficiary retains interests in other trust property unless, as a result of the disclaimer, such assets are removed from the trust and pass, without any direction on the part of the disclaimant, to persons other than the disclaimant or to the spouse of the decedent. The disclaimer of an undivided portion of an interest in a trust may be a qualified disclaimer. See also paragraph (b) of this section for rules relating to the disclaimer of an undivided portion of an interest in property.

(b) *Disclaimer of undivided portion.* A disclaimer of an undivided portion of a separate interest in property which meets the other requirements of a qualified disclaimer under section 2518(b) and the corresponding regulations is a qualified disclaimer. An undivided portion of a disclaimant's separate interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the disclaimant in such property and must extend over the entire term of the disclaimant's interest in such property and in other property into which such property is converted. A disclaimer of some specific rights while retaining other rights with respect to an interest in the property is not a qualified disclaimer of an undivided portion of the disclaimant's interest in property. Thus, for example, a disclaimer made by the devisee of a fee simple interest in Blackacre is not a qualified disclaimer if the disclaimant disclaims a remainder interest in Blackacre but retains a life estate.

(c) *Disclaimer of a pecuniary amount.* A disclaimer of a specific pecuniary amount out of a pecuniary or nonpecuniary bequest or gift which satisfies the other requirements of a qualified disclaimer under section 2518 (b) and the corresponding regulations is a qualified disclaimer provided that no income or other benefit of the disclaimed amount inures to the benefit of the disclaimant either prior to or subsequent to the disclaimer. Thus, following the disclaimer of a specific pecuniary amount from a bequest or gift, the amount disclaimed and any income attributable to such amount must be segregated from the portion of the gift or bequest that was not disclaimed. Such a segregation of assets making up the disclaimer of a pecuniary amount must be made on the basis of the fair market value of the assets on the date of the disclaimer or on a basis that is fairly representative of value changes that may have occurred between the date of transfer and the date of the disclaimer. A pecuniary amount distributed to the disclaimant from the bequest or gift prior to the disclaimer shall be treated as a distribution of corpus from the bequest or gift. However, the acceptance of a distribution from the gift or bequest shall also be considered to be an acceptance of a proportionate amount of income earned by the bequest or gift. The proportionate share of income considered to be accepted by the disclaimant shall be determined at the time of the disclaimer according to the following formula:

$$\frac{\text{Total amount of distributions received by the disclaimant out of the gift or bequest}}{\text{Total value of the gift or bequest on the date of transfer}} \times \text{Total amount of income earned by the gift or bequest between date of transfer and date of disclaimer}$$

See examples (17), (18), and (19) in § 25.2518–3(d) for illustrations of the rules set forth in this paragraph (c).

(d) *Examples.* The provisions of this section may be illustrated by the following examples:

*Example (1).* A, a resident of State Q, died on August 1, 1978. A's will included specific bequests of 100 shares of stock in X corporation; 200 shares of stock in Y corporation; 500 shares of stock in Z corporation; personal effects consisting of paintings, home furnishings, jewelry, and silver, and a 500 acre farm consisting of a residence, various outbuildings, and 500 head of cattle. The laws of State Q provide that a disclaimed interest passes in the same manner as if the disclaiming beneficiary had died immediately before the testator's death. Pursuant to A's will, B was to receive both the personal effects and the farm. C was to receive all the shares of stock in Corporation X and Y and D was to receive all the shares of stock in Corporation Z. B disclaimed 2 of the paintings and all the jewelry, C disclaimed 50 shares of Y corporation stock, and D disclaimed 100 shares of Z corporation stock. If the remaining requirements of section 2518(b) and the corresponding regulations are met, each of these disclaimers is a qualified disclaimer for purposes of section 2518(a).

*Example (2).* Assume the same facts as in example (1) except that D disclaimed the income interest in the shares of Z corporation stock while retaining the remainder interest in such shares. D's disclaimer is not a qualified disclaimer.

*Example (3).* Assume the same facts as in example (1) except that B disclaimed 300 identified acres of the 500 acres. Assuming that B's disclaimer meets the remaining requirements of section 2518(b), it is a qualified disclaimer.

*Example (4).* Assume the same facts as in example (1) except that A devised the income from the farm to B for life and the remainder interest to C. B disclaimed 40 percent of the income from the farm. Assuming that it meets the remaining requirements of section 2518(b), B's disclaimer of an undivided portion of the income is a qualified disclaimer.

*Example (5).* E died on September 13, 1978. Under the provisions of E's will, E's shares of stock in X, Y, and Z corporations were to be transferred to a trust. The trust provides that all income is to be distributed currently to F and G in equal parts until F attains the age of 45 years. At that time the corpus of the trust is to be divided equally between F and G. F disclaimed the income arising from the shares of X stock. G disclaimed 20 percent of G's interest in the trust. F's disclaimer is not a qualified disclaimer because the X stock remains in the trust. If the remaining requirements of section 2518(b) are met, G's disclaimer is a qualified disclaimer.

*Example (6).* Assume the same facts as in example (5) except that F disclaimed both the income interest and the remainder interest in the shares of X stock. F's disclaimer results in the X stock being transferred out of the trust to G without any direction on F's part. F's disclaimer is a qualified disclaimer under section 2518(b).

*Example (7).* Assume the same facts as in example (5) except that F is only an income beneficiary of the trust. The X stock remains in the trust after F's disclaimer of the income arising from the shares of X stock. F's disclaimer is not a qualified disclaimer under section 2518.

*Example (8).* Assume the same facts as in example (5) except that F disclaimed the entire income interest in the trust while retaining the interest F has in corpus. Alternatively, assume that G disclaimed G's entire corpus interest while retaining G's interest in the income from the trust. If the remaining requirements of section 2518(b) are met, either disclaimer will be a qualified disclaimer.

*Example (9).* G creates an irrevocable trust on May 13, 1980, with H, I, and J as the income beneficiaries. In addition, H, who is the trustee, holds the power to invade corpus for H's health, maintenance, support and happiness and a testamentary power of appointment over the corpus. In the absence of the exercise of the power of appointment, the property passes to I and J in equal shares. H disclaimed the power to invade corpus for H's health, maintenance, support and happiness. Because H retained the testamentary power to appoint the property in the corpus, H's disclaimer is not a qualified disclaimer. If H also disclaimed the testamentary power of appointment, H's disclaimer would have been a qualified disclaimer.

*Example (10).* E creates an irrevocable trust on May 1, 1980, in which D is the income beneficiary for life. Subject to the trustee's discretion, E's children, A, B, and C, have the right to receive corpus during D's lifetime. The remainder passes to D if D survives A, B, C, and all their issue. D also holds an inter vivos power to appoint the trust corpus to A, B, and C. On September 1, 1980, D disclaimed the remainder interest. D's disclaimer is not a qualified disclaimer because D retained the power to direct the use and enjoyment of corpus during D's life.

*Example (11).* Under H's will, a trust is created from which W is to receive all of the income for life. The trustee has the power to invade the trust corpus for the support or maintenance of D during the life of W. The trust is to terminate at W's death, at which time the trust property is to be distributed to D. D makes a timely disclaimer of the right to corpus during W's lifetime, but does

not disclaim the remainder interest. D's disclaimer is a qualified disclaimer assuming the remaining requirements of section 2518 are met.

*Example (12).* Under the provisions of G's will A received a life estate in a farm, and was the sole beneficiary of property in the residuary estate. The will also provided that the remainder interest in the farm pass to the residuary estate. Under local law A's interests merged to give A a fee simple in the farm. A made a timely disclaimer of the life estate. A's disclaimer of a partial interest is not a qualified disclaimer under section 2518(a). If A makes a disclaimer of the entire merged interest in the farm or an undivided portion of such merged interest then A would be making a qualified disclaimer assuming all the other requirements of section 2518(b) are met.

*Example (13).* A, a resident of State Z, dies on September 3, 1980. Under A's will, Blackacre is devised to C for life, then to D for 1 month, remainder to C. Had A not created D's interest, State Z law would have merged C's life estate and the remainder to C to create a fee simple interest in C. Assume that the actuarial value of D's interest is less than 5 percent of the total value of Blackacre on the date of A's death. Further assume that facts and circumstances (particularly the duration of D's interest) clearly indicate that D's interest was created primarily for the purpose of preventing the merger of C's two interests in Blackacre. D's interest in Blackacre is a nominal interest and C's two interests will, for purposes of making a qualified disclaimer, be considered to have merged. Thus, C cannot make a qualified disclaimer of his remainder while retaining the life estate. C can, however, make a qualified disclaimer of both of these interests entirely or an undivided portion of both.

*Example (14).* A, a resident of State X, dies on October 12, 1978. Under A's will, Blackacre was devised to B for life, then to C for life if C survives B, remainder to B's estate. On the date of A's death, B and C are both 8 year old grandchildren of A. In addition, C is in good health. The actual value of C's interest is less than 5 percent of the total value of Blackacre on the date of A's death. No facts are present which would indicate that the possibility of C's contingent interest vesting is so remote as to be negligible. Had C's contingent life estate not been created, B's life estate and remainder interests would have merged under local law to give B a fee simple interest in Blackacre. Although C's interest prevents the merger of B's two interests and has an actual value of less than 5 percent, C's interest is not a nominal interest within the meaning of § 25.2518–3(a)(1)(iv) because the facts and circumstances do not clearly indicate that the interest was created primarily for the purpose of preventing the merger of other interests in the property. Assuming all the other requirements of section 2518(b) are met, B can make a qualified disclaimer of the remainder while retaining his life estate.

*Example (15).* In 1981, A transfers $60,000 to a trust created for the benefit of B who was given the income interest for life and who also has a testamentary nongeneral power of appointment over the corpus. A transfers an additional $25,000 to the trust on June 1, 1984. At that time the trust corpus (exclusive of the $25,000 transfer) has a fair market value of $75,000. On January 1, 1985, B disclaims the right to receive income attributable to 25 percent of the corpus

$$\left(\frac{\$25{,}000\,(1984\text{ transfer})}{\$100{,}000\,(\text{Fair market value of corpus immediately after the 1984 transfer})} = 25\%.\right)$$

Assuming that no distributions were made to B attributable to the $25,000, B's disclaimer is a qualified disclaimer for purposes of section 2518(a) if all the remaining requirements of section 2518(b) are met.

*Example (16).* Under the provisions of B's will, A is left an outright cash legacy of $50,000 and has no other interest in B's estate. A timely disclaimer by A of any stated dollar amount is a qualified disclaimer under section 2518(a).

*Example (17).* D bequeaths his brokerage account to E. The account consists of stocks and bonds and a cash amount earning interest. The total value of the cash and assets in the account on the date of D's death is $100,000. Four months after D's death, E makes a withdrawal of cash from the account for personal use amounting to $40,000. Eight months after D's death, E disclaims $60,000 of the account without specifying any particular assets or cash. The cumulative fair market value of the stocks and bonds in the account on the date of the disclaimer is equal to the value of such stocks and bonds on the date of D's death. The income earned by the account between the date of D's death and the date of E's disclaimer was $20,000. The amount of income earned by the account that E accepted by withdrawing $40,000 from the account prior to the disclaimer is determined by applying the formula set forth in § 25.2518–3(c) as follows:

$$\frac{\$40{,}000}{\$100{,}000} \times \$20{,}000 = \$8{,}000$$

E is considered to have accepted $8,000 of the income earned by the account. If (i) the $60,000 disclaimed by E and the $12,000 of income earned prior to the disclaimer which is attributable to that amount are segregated from the $8,000 of income E is considered to have accepted, (ii) E does not accept any benefits of the $72,000 so segregated, and (iii) the other requirements of section 2518 (b) are met, then E's disclaimer of $60,000 from the account is a qualified disclaimer.

*Example (18).* A bequeathed his residuary estate to B. The residuary estate had a value of $1 million on the date of A's death. Six months later, B disclaimed $200,000 out of this bequest. B received distributions of all the income from the entire estate during the period of administration. When the estate was distributed, B received the entire residuary estate except for $200,000 in cash. B did not make a qualified disclaimer since he accepted the benefits of the $200,000 during the period of estate administration.

*Example (19).* Assume the same facts as in example (18) except that no income was paid to B and the value of the residuary estate on the date of the disclaimer (including interest earned from date of death) was $1.5 million. In addition, as soon as B's disclaimer was made, the executor of A's estate set aside assets worth $300,000

$$\left(\frac{\$200,000}{\$1,000,000} \times \$1,500,000\right)$$

and the interest earned after the disclaimer on that amount in a separate fund so that none of the income was paid to B. B's disclaimer is a qualified disclaimer under section 2518(a).

*Example (20).* A bequeathed his residuary estate to B. B disclaims a fractional share of the residuary estate. Any disclaimed property will pass to A's surviving spouse, W. The numerator of the fraction disclaimed is the smallest amount which will allow A's estate to pass free of Federal estate tax and the denominator is the value of the residuary estate. B's disclaimer is a qualified disclaimer.

*Example (21).* A created a trust on July 1, 1979. The trust provides that all current income is to be distributed equally between B and C for the life of B. B also is given a testamentary general power of appointment over the corpus. If the power is not exercised, the corpus passes to C or C's heirs. B disclaimed the testamentary power to appoint an undivided one-half of the trust corpus. Assuming the remaining requirements of section 2518(b) are satisfied, B's disclaimer is a qualified disclaimer under section 2518(a).

[T.D. 8095, 51 FR 28375, Aug. 7, 1986; 51 FR 31939, Sept. 8, 1986, as amended by T.D. 8540, 59 FR 30103, June 10, 1994]

ACTUARIAL TABLES APPLICABLE BEFORE MAY 1, 1989

### § 25.2512–5A Valuation of annuities, unitrust interests, interests for life or term of years, and remainder or reversionary interests transferred before May 1, 1989.

(a) *Valuation of annuities, interests for life or term of years, and remainder or reversionary interests transferred before January 1, 1952.* Except as otherwise provided in § 25.2512–5(b), if the transfer was made before January 1, 1952, the present value of annuities, life estates, terms of years, remainders, and reversions is their present value determined under this section. If the valuation of the interest involved is dependent upon the continuation or termination of one or more lives or upon a term certain concurrent with one or more lives, the factor for the present value is computed on the basis of interest at the rate of 4 percent a year, compounded annually, and life contingencies for each life involved from values that are based upon the ''Actuaries' or Combined Experience Table of Mortality, as extended.'' This table and many additional factors are described in former § 86.19 (as contained in the 26 CFR part 81 edition revised as of April 1, 1958). The present value of an interest measured by a term of years is computed on the basis of interest at the rate of 4 percent a year.

(b) *Valuation of annuities, interests for life or term of years, and remainder or reversionary interests transferred after December 31, 1951, and before January 1, 1971.* Except as otherwise provided in § 25.2512–5(b), the present value of annuities, life estates, terms of years, remainders, and reversions transferred after December 31, 1951, and before January 1, 1971, is the present value of

such interests determined under this section. If the value of the interest involved is dependent upon the continuation or termination of one or more lives, the factor for the present value is computed on the basis of interest at the rate of 3½ percent a year, compounded annually, and life contingencies for each life involved from U.S. Life Table 38. This table and many accompanying factors are set forth in former § 25.2512–5 (as contained in the 26 CFR part 25 edition revised as of April 1, 1984). Special factors involving one and two lives may be found in or computed with the use of tables contained in Internal Revenue Service Publication Number 11, ''Actuarial Values for Estate and Gift Tax,'' (Rev. 5–59). This publication is no longer available for purchase from the Superintendent of Documents. However, it may be obtained by requesting a copy from: CC:DOM:CORP:T:R (IRS Publication 11), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. The present value of an interest measured by a term of years is computed on the basis of interest at the rate of 3½ percent a year.

(c) *Valuation of annuities, interests for life or term of years, and remainder or reversionary interests transferred after December 31, 1970, and before December 1, 1983.* Except as otherwise provided in § 25.2512–5(b), the present value of annuities, life estates, terms of years, remainders, and reversions transferred after December 31, 1970, and before December 1, 1983, is the present value of such interests determined under this section. If the interest to be valued is dependent upon the continuation or termination of one or more lives or upon a term certain concurrent with one or more lives, the factor for the present value is computed on the basis of interest at the rate of 6 percent a year, compounded annually, and life contingencies determined for each male and female life involved, from the values that are set forth in Table LN. Table LN contains values that are taken from the life table for total males and the life table for total females appearing as Tables 2 and 3, respectively, in United States Life Tables: 1959–61, published by the Department of Health and Human Services, Public Health Service. Table LN and accompanying factors are set forth in former § 25.2512–9 (as contained in the 26 CFR part 25 edition revised as of April 1, 1994). Special factors involving one and two lives may be found in or computed with the use of tables contained in Internal Revenue Service Publication 723, entitled ''Actuarial Values I: Valuation of Last Survivor Charitable Remainders'' (12–70), and Internal Revenue Service Publication 723A, entitled ''Actuarial Values II: Factors at 6 Percent Involving One and Two Lives'' (12–70). These publications are no longer available for purchase from the Superintendent of Documents. However, a copy of each may be obtained from: CC:DOM:CORP:T:R (IRS Publication 723/723A), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. The present value of an interest measured by a term of years is computed on the basis of interest at the rate of 6 percent a year.

(d) *Valuation of annuities, interests for life or term of years, and remainder or reversionary interests transferred after November 30, 1983, and before May 1, 1989*—(1) *In general.* (i)(A) Except as otherwise provided in § 25.2512–5(b) and in this paragraph (d)(1)(i)(A), the fair market value of annuities, life estates, terms of years, remainders, and reversions transferred after November 30, 1983, and before May 1, 1989, is the present value of such interests determined under this section. The value of annuities issued by companies regularly engaged in their sale and of insurance policies issued by companies regularly engaged in their sale is determined under § 25.2512–6. The fair market value of a remainder interest in a charitable remainder unitrust, as defined in § 1.664–3, is its present value determined under § 1.664–4. The fair market value of a life interest or term for years in a charitable remainder unitrust is the fair market value of the property as of the date of transfer less the fair market value of the remainder interest on such date determined under § 1.664–4. The fair market value of interests in a pooled income fund, as defined in § 1.642(c)–5, is their value determined under § 1.642(c)–6. Where the donor

transfers property in trust or otherwise and retains an interest therein, the value of the gift is the value of the property transferred less the value of the donor's retained interest. See section 2702 and the regulations at § 25.2702 for special rules for valuing transfers of interests in trust after October 8, 1990. See § 25.2512–9 with respect to the valuation of annuities, life estates, terms for years, remainders, and reversions transferred after December 31, 1970, and before December 1, 1983.

(B) If the donor transfers in December of 1983, either—

(*1*) A remainder or a reversion subject to a life interest or a term for years where the life interest or term for years was transferred by the donor after December 31, 1982, and before December 1, 1983, or

(*2*) A life interest or term for years, the remainder interest of which was transferred by the donor after December 31, 1982, and before December 1, 1983,

the donor shall make an election. The donor may elect to value both interests transferred in 1983 under § 25.2512–5A(c) as if such section applied to all transfers made before January 1, 1984, or the donor may elect to have both interests transferred valued under this section. The donor shall indicate the election being made in a statement attached to the donor's gift tax return for 1983.

(C) If the donor transfers in calendar year 1984, either—

(*1*) A remainder on a reversion subject to a life interest or a term for years where the life interest or term for years was transferred by the donor in the first eleven months of 1983, or

(*2*) A life interest or term for years, the remainder interest of which was transferred by the donor in the first eleven months of 1983,

the donor shall make an election. The donor may elect to value the interest transferred in 1984 under § 25.2512–5A(c) as if such section applied to all transfers made before January 1, 1985, or the donor may elect to have the transfer valued under this section. If the donor elects to value the interest transferred in 1984 under § 25.2512–5A(c), the donor shall indicate that the election is being made by attaching a statement to the donor's gift tax return for 1984. If the donor elects to value the interest transferred in 1984 under this section the election shall not be effective unless the donor declares, in a statement attached to the donor's gift tax return for 1984, that the donor has filed an amended gift tax return for 1983, in which the donor has revalued the transfers made in the first eleven months of 1983 under this section as if this section applied to transfers made after December 31, 1982.

(ii) The present value of an annuity, life estate, remainder, or reversion determined under this section which is dependent on the continuation or termination of the life of one person is computed by the use of Table A in paragraph (d)(6) of this section. The present value of an annuity, term for years, remainder, or reversion dependent on a term certain is computed by the use of Table B in paragraph (d)(6) of this section. If the interest to be valued is dependent upon more than one life or there is a term certain concurrent with one or more lives, see paragraph (d)(5) of this section. For purposes of the computations described in this section, the age of the person is to be taken at his or her nearest birthday.

(iii) In all examples set forth in this section, the interest is assumed to have been transferred after November 30, 1983, and before May 1, 1989.

(2) *Annuities.* (i) If an annuity is payable annually at the end of each year during the life of an individual (as for example if the first payment is due one year after the date of the gift), the amount payable annually is multiplied by the figure in column 2 of Table A opposite the number of years in column 1 nearest the age of the individual whose life measures the duration of the annuity. If the annuity is payable annually at the end of each year for a definite number of years, the amount payable annually is multiplied by the figure in column 2 of Table B opposite the number of years in column 1 representing the duration of the annuity. The application of this paragraph (d)(2)(i) may be illustrated by the following examples:

*Example (1).* The donor assigns an annuity of $10,000 a year payable annually during the donor's life immediately after an annual payment has been made. The age of the

donor on the date of assignment is 40 years and eight months. By reference to Table A, it is found that the figure in column 2 opposite 41 years is 9.1030. The value of the gift is, therefore, $91,030 ($10,000 multiplied by 9.1030).

*Example (2).* The donor was entitled to receive an annuity of $10,000 a year payable annually at the end of annual periods throughout a term of 20 years. The donor, when 15 years have elapsed, makes a gift thereof to the donor's son. By reference to Table B, it is found that the figure in column 2 opposite five years, the unexpired portion of the 20-year period, is 3.7908. The present value of the annuity is, therefore, $37,908 (10,000 multiplied by 3.7908).

(ii) If an annuity is payable at the end of semiannual, quarterly, monthly, or weekly periods during the life of an individual (as for example if the first payment is due one month after the date of the gift), the aggregate amount to be paid within a year is first multiplied by the figure in column 2 of Table A opposite the number of years in column 1 nearest the age of the individual whose life measures the duration of the annuity. The product so obtained is then multiplied by whichever of the following factors is appropriate:

1.0244 for semiannual payments,
1.0368 for quarterly payments,
1.0450 for monthly payments,
1.0482 for weekly payments.

If the annuity is payable at the end of semiannual, quarterly, monthly, or weekly periods for a definite number of years the aggregate amount to be paid within a year is first multiplied by the figure in column 2 of Table B opposite the number of years in column 1 representing the duration of the annuity. The product so obtained is then multiplied by whichever of the above factors is appropriate. The application of this paragraph (d)(2)(ii) may be illustrated by the following example:

*Example.* The facts are the same as those contained in example (1) set forth in paragraph (d)(2)(i) above, except that the annuity is payable semiannually. The aggregate annual amount, $10,000 is multiplied by the factor 9.1030, and the product multiplied by 1.0244. The value of the gift is, therefore, $93,251.13 ($10,000×9.1030×1.0244).

(iii)(A) If the first payment of an annuity for the life of an individual is due at the beginning of the annual or other payment period rather than at the end (as for example if the first payment is to be made immediately after the date of the gift), the value of the annuity is the sum of (A) the first payment plus (B) the present value of a similar annuity, the first payment of which is not to be made until the end of the payment period, determined as provided in paragraph (d)(2)(i) or (ii) of this section. The application of this paragraph (d)(2)(iii)(A) may be illustrated by the following example:

*Example.* The donee is made the beneficiary for life of an annuity of $50 a month from the income of a trust, subject to the right reserved by the donor to cause the annuity to be paid for the donor's own benefit or for the benefit of another. On the day a payment is due, the donor relinquishes the reserved power. The donee is then 50 years of age. The value of the gift is $50 plus the product of $50×12×8.4743 (see Table A)×1.0450. That is, $50 plus $5,313.39, or $5,363.39.

(B) If the first payment of an annuity for a definite number of years is due at the beginning of the annual or other payment period, the applicable factor is the product of the factor shown in Table B multiplied by whichever of the following factors is appropriate:

1.1000 for annual payments,
1.0744 for semiannual payments,
1.0618 for quarterly payments,
1.0534 for monthly payments, or
1.0502 for weekly payments.

The application of this paragraph (d)(2)(iii)(B) may be illustrated by the following example:

*Example.* The donee is the beneficiary of an annuity of $50 a month, subject to a reserved right in the donor to cause the annuity or the cash value thereof to be paid for the donor's own benefit or the benefit of another. On the day a payment is due, the donor relinquishes the power. There are 300 payments to be made covering a period of 25 years, including the payment due. The value of the gift is the product of $50×12×9.0770 (factor for 25 years Table B)×1.0534, or $5,737.03.

(3) *Life estates and terms for years.* If the interest to be valued is the right of a person for his or her life, or for the life of another person, to receive the income of certain property or to use non-income-producing property, the value of the interest is the value of the property multiplied by the figure in column 3 of Table A opposite the number of years nearest to the actual age

of the measuring life. If the interest to be valued is the right to receive income of property or to use nonincome-producing property for a term of years, column 3 of Table B is used. The application of this paragraph (d)(3) may be illustrated by the following example:

*Example.* The donor who during the donor's life is entitled to receive the income from property worth $50,000, makes a gift of such interest. The donor is 31 years old on the date of the gift. The value of the gift is $47,627 ($50,000×.95254).

(4) *Remainders or reversionary interests.* If the interest to be valued is a remainder or reversionary interest subject to a life estate, the value of the interest should be obtained by multiplying the value of the property at the date of the gift by the figure in column 4 of Table A opposite the number of years nearest the age of the life tenant. If the remainder or reversion is to take effect at the end of a term for years, column 4 of Table B should be used. The application of this paragraph (d)(4) may be illustrated by the following example:

*Example.* The donor transfers by gift a remainder interest in property worth $50,000, subject to the donor's sister's right to receive the income therefrom for her life. The sister at the date of the gift is 31 years of age. By reference to Table A it is found that the figure in column 4 opposite age 31 is .04746. The value of the gift is, therefore, $2,373 ($50,000 x .04746).

(5) *Actuarial computations by the Internal Revenue Service.* If the interest to be valued is dependent upon the continuation or termination of more than one life, or there is a term certain concurrent with one or more lives, or if the retained interest of the donor is conditioned upon survivorship, a special factor is necessary. The factor is to be computed on the basis of interest at the rate of 10 percent a year, compounded annually, and life contingencies are determined for each person involved from the values of *lx* that are set forth in column 2 of Table LN in § 20.2031–7A(d)(6) of this chapter. Table LN contains values of *lx* taken from the life table for the total population appearing as Table 1 in United States Life Tables: 1969–71, published by the Department of Health and Human Services, Public Health Service. A copy of the publication containing many such special factors, may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. However, if a special factor is required in the case of an actual gift, the Commissioner will furnish the factor to the donor upon request. The request must be accompanied by a statement of the date of birth of each person the duration of whose life may affect the value of the interest, and by copies of the relevant instruments. Special factors are not furnished for prospective transfers.

(6) *Tables.* (i) For actuarial factors showing the present worth at 10 percent of a single life annuity, a life interest, and a remainder interest postponed for a single life, see § 20.2031–7A(d)(6) of this chapter, Table A, of the Estate Tax Regulations.

(ii) For actuarial factors showing the present worth at 10 percent of an annuity for a term certain, an income interest for a term certain, and a remainder interest postponed for a term certain, see § 20.2031–7A(d)(6) of this chapter, Table B, of the Estate Tax Regulations.

[T.D. 8540, 59 FR 30173, June 10, 1994, as amended at 59 FR 30173, 30174, June 10, 1994]

DEDUCTIONS

## § 25.2519–1 Dispositions of certain life estates.

(a) *In general.* If a donee spouse makes a disposition of all or part of a qualifying income interest for life in any property for which a deduction was allowed under section 2056(b)(7) or section 2523(f) for the transfer creating the qualifying income interest, the donee spouse is treated for purposes of chapters 11 and 12 of subtitle B of the Internal Revenue Code as transferring all interests in property other than the qualifying income interest. For example, if the donee spouse makes a disposition of part of a qualifying income interest for life in trust corpus, the spouse is treated under section 2519 as making a transfer subject to chapters 11 and 12 of the entire trust other than the qualifying income interest for life. Therefore, the donee spouse is treated as making a gift under section 2519 of

the entire trust less the qualifying income interest, and is treated for purposes of section 2036 as having transferred the entire trust corpus, including that portion of the trust corpus from which the retained income interest is payable. A transfer of all or a portion of the income interest of the spouse is a transfer by the spouse under section 2511. See also section 2702 for special rules applicable in valuing the gift made by the spouse under section 2519.

(b) *Presumption.* Unless the donee spouse establishes to the contrary, section 2519 applies to the entire trust at the time of the disposition. If a deduction is taken on either the estate or gift tax return with respect to the transfer which created the qualifying income interest, it is presumed that the deduction was allowed for purposes of section 2519. To avoid the application of section 2519 upon a transfer of all or part of the donee spouse's income interest, the donee spouse must establish that a deduction was not taken for the transfer of property which created the qualifying income interest. For example, to establish that a deduction was not taken, the donee spouse may produce a copy of the estate or gift tax return filed with respect to the transfer creating the qualifying income interest for life establishing that no deduction was taken under section 2056(b)(7) or section 2523(f). In addition, the donee spouse may establish that no return was filed on the original transfer by the donor spouse because the value of the first spouse's gross estate was below the threshold requirement for filing under section 6018. Similarly, the donee spouse could establish that the transfer creating the qualifying income interest for life was made before the effective date of section 2056(b)(7) or section 2523(f), whichever is applicable.

(c) *Amount treated as a transfer*—(1) *In general.* The amount treated as a transfer under this section upon a disposition of all or part of a qualifying income interest for life in qualified terminable interest property is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under section 2503(b) with respect to the transfer creating the interest), less the value of the qualifying income interest in the property on the date of the disposition. The gift tax consequences of the disposition of the qualifying income interest are determined separately under § 25.2511–2.

(2) *Disposition of interest in property with respect to which a partial election was made.* If, in connection with the transfer of property that created the spouse's qualifying income interest for life, a deduction was allowed under section 2056(b)(7) or section 2523(f) for less than the entire interest in the property (i.e., for a fractional or percentage share of the entire interest in the transferred property) the amount treated as a transfer by the donee spouse under this section is equal to the fair market value of the entire property subject to the qualifying income interest on the date of the disposition, less the value of the qualifying income interest for life, multiplied by the fractional or percentage share of the interest for which the deduction was taken.

(3) *Reduction for distributions charged to nonelective portion of trust.* The amount determined under paragraph (c)(2) of this section (if applicable) is appropriately reduced if—

(i) The donee spouse's interest is in a trust and distributions of principal have been made to the donee spouse;

(ii) The trust provides that distributions of principal are made first from the qualified terminable interest share of the trust; and

(iii) The donee spouse establishes the reduction in that share based on the fair market value of the trust assets at the time of each distribution.

(4) *Effect of gift tax recovered under section 2207A on the amount of the transfer.* [Reserved]

(5) *Interest in previously severed trust.* If the donee spouse's interest is in a trust consisting of only qualified terminable interest property, and the trust was previously severed (in compliance with § 20.2056(b)–7(b)(2)(ii) of this chapter or § 25.2523(f)–l(b)(3)(ii) from a trust that, after the severance,

held only property that was not qualified terminable interest property, only the value of the property in the severed portion of the trust at the time of the disposition is treated as transferred under this section.

(d) *Identification of property transferred.* If only part of the property in which a donee spouse has a qualifying income interest for life is qualified terminable interest property, the donee spouse is, in the case of a disposition of all or part of the income interest within the meaning of section 2519, deemed to have transferred a pro rata portion of the entire qualified terminable interest property for purposes of this section.

(e) *Exercise of power of appointment.* The exercise by any person of a power to appoint qualified terminable interest property to the donee spouse is not treated as a disposition under section 2519, even though the donee spouse subsequently disposes of the appointed property.

(f) *Conversion of qualified terminable interest property.* The conversion of qualified terminable interest property into other property in which the donee spouse has a qualifying income interest for life is not, for purposes of this section, treated as a disposition of the qualifying income interest. Thus, the sale and reinvestment of assets of a trust holding qualified terminable interest property is not a disposition of the qualifying income interest, provided that the donee spouse continues to have a qualifying income interest for life in the trust after the sale and reinvestment. Similarly, the sale of real property in which the spouse possesses a legal life estate and thus meets the requirements of qualified terminable interest property, followed by the transfer of the proceeds into a trust which also meets the requirements of qualified terminable interest property, or by the reinvestment of the proceeds in income producing property in which the donee spouse has a qualifying income interest for life, is not considered a disposition of the qualifying income interest. On the other hand, the sale of qualified terminable interest property, followed by the payment to the donee spouse of a portion of the proceeds equal to the value of the donee spouse's income interest, is considered a disposition of the qualifying income interest.

(g) *Examples.* The following examples illustrate the application of paragraphs (a) through (f) of this section. Except as provided otherwise in the examples below, assume that the decedent, D, was survived by spouse, S, that in each example the section 2503(b) exclusion has already been fully utilized for each year with respect to the donee in question, and that section 2503(e) is not applicable to the amount deemed transferred.

*Example 1. Transfer of the spouse's life estate in residence.* Under D's will, a personal residence valued for estate tax purposes at $250,000 passes to S for life, and after S's death to D's children. D's executor made a valid election to treat the property as qualified terminable interest property. During 1995, when the fair market value of the property is $300,000 and the value of S's life interest in the property is $100,000, S makes a gift of S's entire interest in the property to D's children. Pursuant to section 2519, S makes a gift in the amount of $200,000 (i.e., the fair market value of the qualified terminable interest property of $300,000 less the fair market value of S's qualifying income interest in the property of $100,000). In addition, under section 2511, S makes a gift of $100,000 (i.e., the fair market value of S's income interest in the property). See § 25.2511–2.

*Example 2. Sale of spouse's life estate.* The facts are the same as in *Example 1* except that during 1995, S sells S's interest in the property to D's children for $100,000. Pursuant to section 2519, S makes a gift of $200,000 ($300,000 less $100,000 value of the qualifying income interest in the property). S does not make a gift of the income interest under section 2511, because the consideration received for S's income interest is equal to the value of the income interest.

*Example 3. Transfer of income interest in trust subject to partial election.* D's will established a trust valued for estate tax purposes at $500,000, all of the income of which is payable annually to S for life. After S's death, the principal of the trust is to be distributed to D's children. Assume that only 50 percent of the trust was treated as qualified terminable interest property. During 1995, S makes a gift of all of S's interest in the trust to D's children at which time the fair market value of the trust is $400,000 and the fair market value of S's life income interest in the trust is $100,000. Pursuant to section 2519, S makes a gift of $150,000 (the fair market value of the qualified terminable interest property, 50 percent of $400,000, less the $50,000 income interest in the qualified terminable interest

property). S also makes a gift pursuant to section 2511 of $100,000 (i.e., the fair market value of S's life income interest).

*Example 4. Transfer of a portion of income interest in trust subject to a partial election.* The facts are the same as in *Example 3* except that S makes a gift of only 40 percent of S's interest in the trust. Pursuant to section 2519, S makes a gift of $150,000 (i.e., the fair market value of the qualified terminable interest property, 50 percent of $400,000, less the $50,000 value of S's qualified income interest in the qualified terminable interest property). S also makes a gift pursuant to section 2511 of $40,000 (i.e., the fair market value of 40 percent of S's life income interest). See also section 2702 for additional rules that may affect the value of the total amount of S's gift under section 2519 to take into account the fact that S's 30 percent retained income interest attributable to the qualifying income interest is valued at zero under that section, thereby increasing the value of S's section 2519 gift to $180,000. In addition, under § 25.2519–1(d), S's disposition of 40 percent of the income interest is deemed to be a transfer of a pro rata portion of the qualified terminable interest property. Thus, assuming no further lifetime dispositions by S, 30 percent (60 percent of 50 percent) of the trust property is included in S's gross estate under section 2036 and an adjustment is made to S's adjusted taxable gifts under section 2001(b)(1)(B). If S later disposes of all or a portion of the retained income interest, see § 25.2702–6.

*Example 5. Transfer of a portion of spouse's interest in a trust from which corpus was previously distributed to the spouse.* D's will established a trust valued for estate tax purposes at $500,000, all of the income of which is payable annually to S for life. The trustee is granted the discretion to distribute trust principal to S. All appointments of principal must be made from the portion of the trust subject to the section 2056(b)(7) election. After S's death, the principal of the trust is to be distributed to D's children. The executor makes the section 2056(b)(7) election with respect to 50 percent of the trust. In 1994, pursuant to the terms of D's will, the trustee distributed $50,000 of principal to S and charged the entire distribution to the qualified terminable interest portion of the trust.

Immediately prior to the distribution, the value of the entire trust was $550,000 and the value of the qualified terminable interest portion was $275,000 (50 percent of $550,000). Provided S can establish the above facts, the qualified terminable interest portion of the trust immediately after the distribution is $225,000 or 45 percent of the value of the trust ($225,000/$500,000). In 1996, when the value of the trust is $400,000 and the value of S's income interest is $100,000, S makes a transfer of 40 percent of S's income interest. S's gift under section 2519 is $135,000; i.e., the fair market value of the qualified terminable interest property, 45 percent of $400,000 ($180,000), less the value of the income interest in the qualified terminable interest property, $45,000 (45 percent of $100,000). S also makes a gift under section 2511 of $40,000; i.e., the fair market value of 40 percent of S's income interest. S's disposition of 40 percent of the income interest is deemed to be a transfer under section 2519 of the entire 45 percent portion of the remainder subject to the section 2056(b)(7) election. Since S retained 60 percent of the income interest, 27 percent (60 percent of 45 percent) of the trust property is includible in S's gross estate under section 2036. See also section 2702 and *Example 4* as to the principles applicable in valuing S's gift under section 2702 and adjusted taxable gifts upon S's subsequent death.

*Example 6. Transfer of Spousal Annuity Payable From Trust.* D died prior to October 24, 1992. D's will established a trust valued for estate tax purposes at $500,000. The trust instrument required the trustee to pay an annuity to S of $20,000 a year for life. All the trust income other than the amounts paid to S as an annuity are to be accumulated in the trust and may not be distributed during S's lifetime to any person other than S. After S's death, the principal of the trust is to be distributed to D's children. Because D died prior to the effective date of section 1941 of the Energy Policy Act of 1992, S's annuity interest qualifies as a qualifying income interest for life. Under § 20.2056(b)–7(e) of this chapter, based on an applicable 10 percent interest rate, 40 percent of the property, or $200,000, is the value of the deductible interest. During 1996, S makes a gift of the annuity interest to D's children at which time the fair market value of the trust is $800,000 and the fair market value of S's annuity interest in the trust is $100,000. Pursuant to section 2519, S is treated as making a gift of $220,000 (the fair market value of the qualified terminable interest property, 40 percent of $800,000 ($320,000), less the $100,000 annuity interest in the qualified terminable interest property). S is also treated pursuant to section 2511 as making a gift of $100,000 (the fair market value of S's annuity interest).

[T.D. 8522, 59 FR 9656, Mar. 1, 1994]

### § 25.2519–2 Effective date.

Except as specifically provided in § 25.2519–1(g), *Example 6*, the provisions of § 25.2519–1 are effective with respect to gifts made after March 1, 1994. With respect to gifts made on or before such date, the donee spouse of a section 2056(b)(7) or section 2523(f) transfer may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of § 25.2519–1

(as well as project LR–211–76, 1984–1 C.B., page 598, see §601.601(d)(2)(ii)(*b*) of this chapter), are considered a reasonable interpretation of the statutory provisions.

[T.D. 8522, 59 FR 9658, Mar. 1, 1994]

**§25.2521–1 Specific exemption.**

(a) In determining the amount of taxable gifts for the calendar quarter (calendar year with respect to gifts made before January 1, 1971) there may be deducted, if the donor was a resident or citizen of the United States at the time the gifts were made, a specific exemption of $30,000, less the sum of the amounts claimed and allowed as an exemption in prior calendar quarters or calendar years. The exemption, at the option of the donor, may be taken in the full amount of $30,000 in a single calendar quarter or calendar year, or be spread over a period of time in such amounts as the donor sees fit, but after the limit has been reached no further exemption is allowable. Except as otherwise provided in a tax convention between the United States and another country, a donor who was a nonresident not a citizen of the United States at the time the gift or gifts were made is not entitled to this exemption. For the definition of calendar quarter see §25.2502–1(c)(1).

(b) No part of a donor's lifetime specific exemption of $30,000 may be deducted from the value of a gift attributable to his spouse where a husband and wife consent, under the provisions of section 2513, to have the gifts made during a calendar quarter or calendar year considered as made one-half by each of them. The ''gift-splitting'' provisions of section 2513 do not authorize the filing of a joint gift tax return nor permit a donor to claim any of his spouse's specific exemption. For example, if a husband has no specific exemption remaining available, but his wife does, and the husband makes a gift to which his wife consents under the provisions of section 2513, the specific exemption remaining available may be claimed only on the return of the wife with respect to one-half of the gift. The husband may not claim any specific exemption since he has none available.

(c)(1) With respect to gifts made after December 31, 1970, the amount by which the specific exemption claimed and allowed in gift tax returns for prior calendar quarters and calendar years exceeds $30,000 is includible in determining the aggregate sum of the taxable gifts for preceding calendar years and calendar quarters. See paragraph (b) of §25.2504–1.

(2) With respect to gifts made before January 1, 1971, the amount by which the specific exemption claimed and allowed in gift tax returns for prior calendar years exceeds $30,000 is includible in determining the aggregate sum of the taxable gifts for preceding calendar years. See paragraph (b) of §25.2504–1.

[T.D. 7238, 37 FR 28732, Dec. 29, 1972]

**§25.2522(a)–1 Charitable and similar gifts; citizens or residents.**

(a) In determining the amount of taxable gifts for the ''calendar period'' (as defined in §25.2502–1(c)(1)) there may be deducted, in the case of a donor who was a citizen or resident of the United States at the time the gifts were made, all gifts included in the ''total amount of gifts'' made by the donor during the calendar period (see section 2503 and the regulations thereunder) and made to or for the use of:

(1) The United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes.

(2) Any corporation, trust, community chest, fund, or foundation organized and operated exclusively for religious charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, if no part of the net earnings of the organization inures to the benefit of any private shareholder or individual, if it is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and if, in the case of gifts made after December 31, 1969, it does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office.

(3) A fraternal society, order, or association, operating under the lodge system, provided the gifts are to be used

by the society, order or association exclusively for one or more of the purposes set forth in subparagraph (2) of this paragraph.

(4) Any post or organization of war veterans or auxiliary unit or society thereof, if organized in the United States or any of its possessions, and if no part of its net earnings inures to the benefit of any private shareholder or individual.

The deduction is not limited to gifts for use within the United States, or to gifts to or for the use of domestic corporations, trusts, community chests, funds, or foundations, or fraternal societies, orders, or associations operating under the lodge system. An organization will not be considered to meet the requirements of subparagraph (2) of this paragraph, or of paragraph (b) (2) or (3) of this section, if such organization engages in any activity which would cause it to be classified as an ''action'' organization under paragraph (c)(3) of § 1.501(c)(3)–1 of this chapter (Income Tax Regulations). For the deductions for charitable and similar gifts made by a nonresident who was not a citizen of the United States at the time the gifts were made, see § 25.2522(b)–1. See §§ 25.2522(c)–1 and 25.2522(c)–2 for rules relating to the disallowance of deductions to trusts and organizations which engage in certain prohibited transactions or whose governing instruments do not contain certain specified requirements.

(b) The deduction under section 2522 is not allowed for a transfer to a corporation, trust, community chest, fund, or foundation unless the organization or trust meets the following four tests:

(1) It must be organized and operated exclusively for one or more of the specified purposes.

(2) It must not be disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation.

(3) In the case of gifts made after December 31, 1969, it must not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

(4) Its net earnings must not inure in whole or in part to the benefit of private shareholders or individuals other than as legitimate objects of the exempt purposes.

For further limitations see § 25.2522(c)–1, relating to gifts to trusts and organizations which have engaged in a prohibited transaction described in section 681(b)(2) or section 503(c).

(c) In order to prove the right to the charitable, etc., deduction provided by section 2522 the donor must submit such data as may be requested by the Internal Revenue Service. As to the extent the deductions provided by this section are allowable, see section 2524.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7012, 34 FR 7691, May 15, 1969; T.D. 7238, 37 FR 28733, Dec. 29, 1972; T.D. 7318, 39 FR 25457, July 11, 1974; T.D. 7910, 48 FR 40375, Sept. 7, 1983; T.D. 8308, 55 FR 35594, Aug. 31, 1990]

### § 25.2522(a)–2 Transfers not exclusively for charitable, etc., purposes in the case of gifts made before August 1, 1969.

(a) *Remainders and similar interests.* If a trust is created or property is transferred for both a charitable and a private purpose, deduction may be taken of the value of the charitable beneficial interest only insofar as that interest is presently ascertainable, and hence severable from the noncharitable interest. The present value of a remainder or other deferred payment to be made for a charitable purpose is to be determined in accordance with the rules stated in § 25.2512–5. Thus, if money or property is placed in trust to pay the income to an individual during his life, or for a term of years, and then to pay the principal to a charitable organization, the present value of the remainder is deductible. If the interest involved is such that its value is to be determined by a special computation, see § 25.2512–5(d)(4). If the Commissioner does not furnish the factor, the claim for deduction must be supported by a full statement of the computation of the present value made in accordance with the principles set forth in the applicable paragraph of § 25.2512–5.

(b) *Transfers subject to a condition or a power.* If, as of the date of the gift, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent

event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an estate or interest passes to or is vested in charity on the date of the gift and the estate or interest would be defeated by the performance of some act or the happening of some event, the occurrence of which appeared to have been highly improbable on the date of the gift, the deduction is allowable. If the donee or trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so given by the donor, the deduction will be limited to that portion of the property or fund which is exempt from the exercise of the power. The deduction is not allowed in the case of a transfer in trust conveying to charity a present interest in income if by reason of all the conditions and circumstances surrounding the transfer it appears that the charity may not receive the beneficial enjoyment of the interest. For example, assume that assets placed in trust by the donor consists of stock in a corporation, the fiscal policies of which are controlled by the donor and his family, that the trustees and remaindermen are likewise members of the donor's family, and that the governing instrument contains no adequate guarantee of the requisite income to the charitable organization. Under such circumstances, no deduction will be allowed. Similarly, if the trustees are not members of the donor's family but have no power to sell or otherwise dispose of closely held stock, or otherwise insure the requisite enjoyment of income to the charitable organization, no deduction will be allowed.

(c) *Effective date.* This section applies only to gifts made before August 1, 1969. In the case of gifts made after July 31, 1969, see §25.2522(c)–2.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958; 25 FR 14021 Dec. 31, 1960, as amended by T.D. 7318, 39 FR 25457, July 11, 1974; T.D. 8540, 59 FR 30177, June 10, 1994]

**§25.2522(b)–1 Charitable and similar gifts; nonresidents not citizens.**

(a) The deduction for charitable and similar gifts, in the case of a nonresident who was not a citizen of the United States at the time he made the gifts, is governed by the same rules as those applying to gifts by citizens or residents, subject, however, to the following exceptions:

(1) If the gifts are made to or for the use of a corporation, the corporation must be one created or organized under the laws of the United States or of any State or Territory thereof.

(2) If the gifts are made to or for the use of a trust, community chest, fund or foundation, or a fraternal society, order or association operating under the lodge system, the gifts must be for use within the United States exclusively for religious, charitable, scientific, literary or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals.

(b) [Reserved]

**§25.2522(c)–1 Disallowance of charitable, etc., deductions because of "prohibited transactions" in the case of gifts made before January 1, 1970.**

(a) Sections 503(e) and 681(b)(5) provide that no deduction which would otherwise be allowable under section 2522 for a gift for religious, charitable, scientific, literary or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, is allowed if—

(1) The gift is made in trust and, for income tax purposes for the taxable year of the trust in which the gift is made, the deduction otherwise allowable to the trust under section 642(c) is limited by section 681(b)(1) by reason of the trust having engaged in a prohibited transaction described in section 681(b)(2); or

(2) The gift is made to any corporation, community chest, fund or foundation which, for its taxable year in which the gift is made is not exempt from income tax under section 501(a) by reason of having engaged in a prohibited transaction described in section 503(c).

(b) For purposes of section 503(e) and section 681(b)(5) the term ''gift'' includes any gift, contribution, or transfer without adequate consideration.

(c) Regulations relating to the income tax contain the rules for the determination of the taxable year of the trust for which the deduction under section 642(c) is limited by section 681(b), and for the determination of the taxable year of the organization for which an exemption is denied under section 503(a). Generally, such taxable year is a taxable year subsequent to the taxable year during which the trust or organization has been notified by the Internal Revenue Service that it has engaged in a prohibited transaction. However, if the trust or organization during or prior to the taxable year entered into the prohibited transaction for the purpose of diverting its corpus or income from the charitable or other purposes by reason of which it is entitled to a deduction or exemption, and the transaction involves a substantial part of such income or corpus, then the deduction of the trust under section 642(c) for such taxable year is limited by section 681(b), or the exemption of the organization for such taxable year is denied under section 503(a), whether or not the organization has previously received notification by the Internal Revenue Service that it has engaged in a prohibited transaction. In certain cases, the limitation of section 503 or 681 may be removed or the exemption may be reinstated for certain subsequent taxable years under the rules set forth in the income tax regulations under sections 503 and 681.

(d) In cases in which prior notification by the Internal Revenue Service is not required in order to limit the deduction of the trust under section 681(b), or to deny exemption of the organization under section 503, the deduction otherwise allowable under § 25.2522(a)–1 is not disallowed with respect to gifts made during the same taxable year of the trust or organization in which a prohibited transaction occurred, or in a prior taxable year, unless the donor or a member of his family was a party to the prohibited transaction. For purposes of the preceding sentence, the members of the donor's family include only his brothers and sisters (whether by whole or half blood), spouse, ancestors, and lineal descendants.

(e) This section applies only to gifts made before January 1, 1970. In the case of gifts made after December 31, 1969, see § 25.2522(c)–2.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7318, 39 FR 25458, July 11, 1974]

### § 25.2522(c)–2 Disallowance of charitable, etc., deductions in the case of gifts made after December 31, 1969.

(a) *Organizations subject to section 507(c) tax.* Section 508(d)(1) provides that, in the case of gifts made after December 31, 1969, a deduction which would otherwise be allowable under section 2522 for a gift to or for the use of an organization upon which the tax provided by section 507(c) has been imposed shall not be allowed if the gift is made by the donor after notification is made under section 507(a) or if the donor is a substantial contributor (as defined in section 507(d)(2)) who makes such gift in his taxable year (as defined in section 441) which includes the first day on which action is taken by such organization that culminates in the imposition of the tax under section 507(c) and any subsequent taxable year. This paragraph does not apply if the entire amount of the unpaid portion of the tax imposed by section 507(c) is abated under section 507(g) by the Commissioner or his delegate.

(b) *Taxable private foundations, section 4947 trusts, etc.* Section 508(d)(2) provides that, in the case of gifts made after December 31, 1969, a deduction which would otherwise be allowable under section 2522 shall not be allowed if the gift is made to or for the use of—

(1) A private foundation or a trust described in section 4947(a)(2) in a taxable year of such organization for which such organization fails to meet the governing instrument requirements of section 508(e) (determined without regard to section 508(e)(2) (B) and (C)), or

(2) Any organization in a period for which it is not treated as an organization described in section 501(c)(3) by reason of its failure to give notification under section 508(a) of its status to the Commissioner.

For additional rules, see §1.508–2(b)(1) of this chapter (Income Tax Regulations).

(c) *Foreign organizations with substantial support from foreign sources.* Section 4948(c)(4) provides that, in the case of gifts made after December 31, 1969, a deduction which would otherwise be allowable under section 2522 for a gift to or for the use of a foreign organization which has received substantially all of its support (other than gross investment income) from sources without the United States shall not be allowed if the gift is made (1) after the date on which the Commissioner has published notice that he has notified such organization that it has engaged in a prohibited transaction, or (2) in a taxable year of such organization for which it is not exempt from taxation under section 501(a) because it has engaged in a prohibited transaction after December 31, 1969.

[T.D. 7318, 39 FR 25458, July 11, 1974]

### §25.2522(c)–3 Transfers not exclusively for charitable, etc., purposes in the case of gifts made after July 31, 1969.

(a) *Remainders and similar interests.* If a trust is created or property is transferred for both a charitable and a private purpose, deduction may be taken of the value of the charitable beneficial interest only insofar as that interest is presently ascertainable, and hence severable from the noncharitable interest.

(b) *Transfers subject to a condition or a power.* (1) If, as of the date of the gift, a transfer for charitable purposes is dependent upon the performance of some act or of the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an estate or interest has passed to, or is vested in, charity on the date of the gift and the estate or interest would be defeated by the performance of some act or the happening of some event, the possibility of occurrence of which appeared on such date to be so remote as to be negligible, the deduction is allowable. If the donee or trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so given by the donor, the deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of the power.

(2) The application of this paragraph may be illustrated by the following examples:

*Example (1).* In 1965, A transfers certain property in trust in which charity is to receive the income for his life. The assets placed in trust by the donor consist of stock in a corporation the fiscal policies of which are controlled by the donor and his family. The trustees of the trust and the remainderman are members of the donor's family and the governing instrument contains no adequate guarantee of the requisite income to the charitable organization. Under such circumstances, no deduction will be allowed. Similarly, if the trustees are not members of the donor's family but have no power to sell or otherwise dispose of the closely held stock, or otherwise insure the requisite enjoyment of income to the charitable organization, no deduction will be allowed.

*Example (2).* C transfers a tract of land to a city government for as long as the land is used by the city for a public park. If on the date of gift the city does plan to use the land for a public park and the possibility that the city will not use the land for a public park is so remote as to be negligible, a deduction will be allowed.

(c) *Transfers of partial interest in property*—(1) *Disallowance of deduction*—(i) *In general.* If a donor transfers an interest in property after July 31, 1969, for charitable purposes and an interest in the same property is retained by the donor, or is transferred or has been transferred for private purposes after such date (for less than an adequate and full consideration in money or money's worth), no deduction is allowed under section 2522 for the value of the interest which is transferred or has been transferred for charitable purposes unless the interest in property is a deductible interest described in subparagraph (2) of this paragraph. The principles that are used in applying section 2523 and the regulations thereunder shall apply for purposes of determining under this paragraph (c)(1)(i) whether an interest in property is retained by the donor, or is transferred or has been transferred by the donor. If, however, as of the date of the gift, a

retention of any interest by a donor, or a transfer for a private purpose, is dependent upon the performance of some act or the happening of a precedent event in order that it may become effective, an interest in property will be considered retained by the donor, or transferred for a private purpose, unless the possibility of occurrence of such act or event is so remote as to be negligible. The application of this paragraph (c)(1)(i) may be illustrated by the following examples, in each of which it is assumed that the property interest which is transferred for private purposes is not transferred for an adequate and full consideration in money or money's worth:

*Example (1).* In 1973, H creates a trust which is to pay the income of the trust to W for her life, the reversionary interest in the trust being retained by H. In 1975, H gives the reversionary interest to charity, while W is still living. For purposes of this paragraph (c)(1)(i), interests in the same property have been transferred by H for charitable purposes and for private purposes.

*Example (2).* In 1973, H creates a trust which is to pay the income of the trust to W for her life and upon termination of the life estate to transfer the remainder to S. In 1975, S gives his remainder interest to charity, while W is still living. For purposes of this paragraph (c)(1)(i), interests in the same property have not been transferred by H or S for charitable purposes and for private purposes.

*Example (3).* H transfers Blackacre to A by gift, reserving the right to the rentals of Blackacre for a term of 20 years. After 4 years H transfers the right to the remaining rentals to charity. For purposes of this paragraph (c)(1)(i) the term ''property'' refers to Blackacre, and the right to rentals from Blackacre consist of an interest in Blackacre. An interest in Blackacre has been transferred by H for charitable purposes and for private purposes.

*Example (4).* H transfers property in trust for the benefit of A and a charity. An annuity of $5,000 a year is to be paid to charity for 20 years. Upon termination of the 20-year term the corpus is to be distributed to A if living. However, if A should die during the 20-year term, the corpus is to be distributed to charity upon termination of the term. An interest in property has been transferred by H for charitable purposes. In addition, an interest in the same property has been transferred by H for private purposes unless the possibility that A will survive the 20-year term is so remote as to be negligible.

*Example (5).* H transfers property in trust, under the terms of which an annuity of $5,000 a year is to be paid to charity for 20 years. Upon termination of the term, the corpus is to pass to such of A's children and their issue as A may appoint. However, if A should die during the 20-year term without exercising the power of appointment, the corpus is to be distributed to charity upon termination of the term. Since the possible appointees include private persons, an interest in the corpus of the trust is considered to have been transferred by H for private purposes.

(ii) *Works of art and copyright treated as separate properties.* For purposes of paragraphs (c)(1)(i) and (c)(2) of this section, rules similar to the rules in § 20.2055–2(e)(1)(ii) shall apply in the case of transfers made after December 31, 1981.

(2) *Deductible interests.* A deductible interest for purposes of subparagraph (1) of this paragraph is a charitable interest in property where—

(i) *Undivided portion of donor's entire interest.* The charitable interest is an undivided portion, not in trust, of the donor's entire interest in property. An undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property and in other property into which such property is converted. For example, if the donor gave a life estate in an office building to his wife for her life and retained a reversionary interest in the office building, the gift by the donor of one-half of that reversionary interest to charity while his wife is still alive will not be considered the transfer of a deductible interest; because an interest in the same property has already passed from the donor for private purposes, the reversionary interest will not be considered the donor's entire interest in the property. If, on the other hand, the donor had been given a life estate in Blackacre for the life of his wife and the donor had no other interest in Blackacre on or before the time of gift, the gift by the donor of one-half of that life estate to charity would be considered the transfer of a deductible interest; because the life estate would be considered the donor's entire interest in the property, the gift would be of

an undivided portion of such entire interest. An undivided portion of a donor's entire interest in property includes an interest in property whereby the charity is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property. However, except as provided in paragraphs (c)(2)(ii), (iii), and (iv) of this section, for purposes of this subdivision a charitable contribution of an interest in property not in trust where the decedent transfers some specific rights to one party and transfers other substantial rights to another party will not be considered a contribution of a undivided portion of the decedent's entire interest in property. A gift of an open space easement in gross in perpetuity shall be considered a gift of a undivided portion of the donor's entire interest in property. A gift to charity made on or before December 17, 1980, of an open space easement in gross in perpetuity shall be considered the transfer to charity of an undivided portion of the donor's entire interest in property.''.

(ii) *Remainder interest in a personal residence.* The charitable interest is an irrevocable remainder interest, not in trust, in a personal residence. Thus, for example, if the donor gives to charity a remainder interest in a personal residence and retains an estate in such property for life or a term of years the value of such remainder interest is deductible under section 2522. For purposes of this subdivision, the term ''personal residence'' means any property which is used by the donor as his personal residence even though it is not used as his principal residence. For example, a donor's vacation home may be a personal residence for purposes of this subdivision. The term ''personal residence'' also includes stock owned by the donor on the date of gift as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b) (1) and (2)) if the dwelling which the donor is entitled to occupy as such stockholder is used by him as his personal residence.

(iii) *Remainder interest in a farm.* The charitable interest is an irrevocable remainder interest, not in trust, in a farm. Thus, for example, if the donor gives to charity a remainder interest in a farm and retains an estate in such property for life or a term of years, the value of such remainder interest is deductible under section 2522. For purposes of this subdivision, the term ''farm'' means any land used by the donor or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock. The term ''livestock'' includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry. A farm includes the improvements thereon.

(iv) *Qualified conservation contribution.* The charitable interest is a qualified conservation contribution. For the definition of a qualified conservation contribution, see § 1.170A–14.

(v) *Charitable remainder trust and pooled income funds.* The charitable interest is a remainder interest in a trust which is a charitable remainder annuity trust, as defined in section 664(d)(1) and § 1.664–2 of this chapter; a charitable remainder unitrust, as defined in section 664(d) (2) and (3) and § 1.664–3 of this chapter; or a pooled income fund, as defined in section 642(c)(5) and § 1.642(c)–5 of this chapter. The charitable organization to or for the use of which the remainder interest is transferred must meet the requirements of both section 2522 (a) or (b) and section 642(c)(5)(A), section 664(d)(1)(C), or section 664(d)(2)(C), whichever applies. For example, the charitable organization to which the remainder interest in a charitable remainder annuity trust is transferred may not be a foreign corporation.

(vi) *Guaranteed annuity interest.* (*a*) The charitable interest is a guaranteed annuity interest, whether or not such interest is in trust. For purposes of this paragraph (c)(2)(vi), the term ''guaranteed annuity interest'' means an irrevocable right pursuant to the instrument of transfer to receive a guaranteed annuity. A guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually, for a specified term or for the life or lives of a named individual or individuals, each of whom must be living at the date of

the gift and can be ascertained at such date. For example, the annuity may be paid for the life of A plus a term of years. An amount is determinable if the exact amount which must be paid under the conditions specified in the instrument of transfer can be ascertained as of the date of gift. For example, the amount to be paid may be a stated sum for a term, or for the life of an individual, at the expiration of which it may be changed by a specified amount, but it may not be redetermined by reference to a fluctuating index such as the cost of living index. In further illustration, the amount to be paid may be expressed as a fraction or percentage of the cost of living index on the date of gift.

*(b)* A charitable interest is a guaranteed annuity interest only if it is a guaranteed annuity interest in every respect. For example, if the charitable interest is the right to receive from a trust each year a payment equal to the lesser of a sum certain or a fixed percentage of the net fair market value of the trust assets, determined annually, such interest is not a guaranteed annuity interest.

*(c)* Where a charitable interest in the form of a guaranteed annuity interest is not in trust, the interest will be considered a guaranteed annuity interest only if it is to be paid by an insurance company or by an organization regularly engaged in issuing annuity contracts.

*(d)* Where a charitable interest in the form of a guaranteed annuity interest is in trust, the governing instrument of the trust may provide that income of the trust which is in excess of the amount required to pay the guaranteed annuity interest shall be paid to or for the use of a charity. Nevertheless, the amount of the deduction under section 2522 shall be limited to the fair market value of the guaranteed annuity interest as determined under paragraph (d)(2)(iv) of this section.

*(e)* Where a charitable interest in the form of a guaranteed annuity interest is in trust and the present value on the date of gift of all income interests for a charitable purpose exceeds 60 percent of the aggregate fair market value of all amounts in such trust (after the payment of liabilities), the charitable interest will not be considered a guaranteed annuity interest unless the governing instrument of the trust prohibits both the acquisition and the retention of assets which would give rise to a tax under section 4944 if the trustee had acquired such assets. The requirement in this *(e)* for a prohibition in the governing instrument against the retention of assets which would give rise to a tax under section 4944 if the trustee had acquired the assets shall not apply to a gift made on or before May 21, 1972.

*(f)* Where a charitable interest in the form of a guaranteed annuity interest is in trust, and the gift of such interest is made after May 21, 1972, the charitable interest will not be considered a guaranteed annuity interest if any amount other than an amount in payment of a guaranteed annuity interest may be paid by the trust for a private purpose before the expiration of all the income interests for a charitable purpose, unless such amount for a private purpose is paid from a group of assets which, pursuant to the governing instrument of the trust, are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947(a)(2)(B). The exception in the immediately preceding sentence with respect to any guaranteed annuity for a private purpose shall apply only if the obligation to pay the annuity for a charitable purpose begins as of the date of creation of the trust and the obligation to pay the guaranteed annuity for a private purpose does not precede in point of time the obligation to pay the annuity for a charitable purpose and only if the governing instrument of the trust does not provide for any preference or priority in respect of any payment of the guaranteed annuity for a private purpose as opposed to any payment of any annuity for a charitable purpose. For purposes of this *(f)*, an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See § 53.4947–1(c) of this chapter (Foundation Excise Tax Regulations) for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust.

*(g)* For rules relating to certain governing instrument requirements and to the imposition of certain excise taxes where the guaranteed annuity interest is in trust and for rules governing payment of private income interests by a split-interest trust, see section 4947(a)(2) and (b)(3)(A), and the regulations thereunder.

(vii) *Unitrust interest. (a)* The charitable interest is a unitrust interest, whether or not such interest is in trust. For purposes of this paragraph (c)(2)(vii), the term ''unitrust interest'' means an irrevocable right pursuant to the instrument of transfer to receive payment, not less often than annually, of a fixed percentage of the net fair market value, determined annually, of the property which funds the unitrust interest. In computing the net fair market value of the property which funds the unitrust interest, all assets and liabilities shall be taken into account without regard to whether particular items are taken into account in determining the income from the property. The net fair market value of the property which funds the unitrust interest may be determined on any one date during the year or by taking the average of valuations made on more than one date during the year, provided that the same valuation date or dates and valuation methods are used each year. Where the charitable interest is a unitrust interest to be paid by a trust and the governing instrument of the trust does not specify the valuation date or dates, the trustee shall select such date or dates and shall indicate his selection on the first return on Form 1041 which the trust is required to file. Payments under a unitrust interest may be paid for a specified term or for the life or lives of an individual or individuals, each of whom must be living at the date of the gift and can be ascertained at such date. For example, the unitrust interest may be paid for the life of A plus a term of years.

*(b)* A charitable interest is a unitrust interest only if it is a unitrust interest in every respect. For example, if the charitable interest is the right to receive from a trust each year a payment equal to the lesser of a sum certain or a fixed percentage of the net fair market value of the trust assets, determined annually, such interest is not a unitrust interest.

*(c)* Where a charitable interest in the form of a unitrust interest is not in trust, the interest will be considered a unitrust interest only if it is to be paid by an insurance company or by an organization regularly engaged in issuing interests otherwise meeting the requirements of a unitrust interest.

*(d)* Where a charitable interest in the form of a unitrust interest is in trust, the governing instrument of the trust may provide that income of the trust which is in excess of the amount required to pay the unitrust interest shall be paid to or for the use of a charity. Nevertheless, the amount of the deduction under section 2522 shall be limited to the fair market value of the unitrust interest as determined under paragraph (d)(2)(v) of this section.

*(e)* Where a charitable interest in the form of a unitrust interest is in trust, the charitable interest will not be considered a unitrust interest if any amount other than an amount in payment of a unitrust interest may be paid by the trust for a private purpose before the expiration of all the income interests for a charitable purpose, unless such amount for a private purpose is paid from a group of assets which, pursuant to the governing instrument of the trust, are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947(a)(2)(B). The exception in the immediately preceding sentence with respect to any unitrust interest for a private purpose shall apply only if the obligation to pay the unitrust interest for a charitable purpose begins as of date of creation of the trust and the obligation to pay the unitrust interest for a private purpose does not precede in point of time the obligation to pay the unitrust interest for a charitable purpose and only if the governing instrument of the trust does not provide for any preference or priority in respect of any payment of the unitrust for a private purpose as opposed to any payments of any unitrust for a charitable purpose. For purposes of this *(e)*, an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See § 53.4947–1(c) of this chapter

(Foundation Excise Tax Regulations) for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust.

*(f)* For rules relating to certain governing instrument requirements and to the imposition of certain excise taxes where the unitrust interest is in trust and for rules governing payment of private income interests by a split-interest trust, see sections 4947(a)(2) and (b)(3)(A), and the regulations thereunder.

(d) *Valuation of charitable interest*—(1) *In general.* The amount of the deduction in the case of a contribution of a partial interest in property to which this section applies is the fair market value of the partial interest on the date of gift. The fair market value of an annuity, life estate, term for years, remainder, reversion or unitrust interest is its present value.

(2) *Certain transfers after July 31, 1969.* In the case of a transfer after July 31, 1969, of an interest described in paragraph (c)(2) (v), (vi), or (vii) of this section, the present value of such interest is to be determined under the following rules:

(i) The present value of a remainder interest in a charitable remainder annuity trust is to be determined under § 1.664–2(c) of this chapter (Income Tax Regulations).

(ii) The present value of a remainder interest in a charitable remainder unitrust is to be determined under § 1.664–4 of this chapter.

(iii) The present value of a remainder interest in a pooled income fund is to be determined under § 1.642(c)–6 of this chapter.

(iv) The present value of a guaranteed annuity interest described in paragraph (c)(2)(vi) of this section is to be determined under § 25.2512–5, except that, if the annuity is issued by a company regularly engaged in the sale of annuities, the present value is to be determined under § 25.2512–6. If by reason of all the conditions and circumstances surrounding a transfer of an income interest in property in trust it appears that the charity may not receive the beneficial enjoyment of the interest, a deduction will be allowed under section 2522 only for the minimum amount it is evident the charity will receive.

*Example (1).* In 1975, B transfers $20,000 in trust with the requirement that a designated charity be paid a guaranteed annuity interest (as defined in paragraph (c)(2)(vi) of this section) of $4,100 a year, payable annually at the end of each year for a period of 6 years and that the remainder be paid to his children. The fair market value of an annuity of $4,100 a year for a period of 6 years is $20,160.93 ($4,100 × 4.9173), as determined under § 25.2512–5A(c). The deduction with respect to the guaranteed annuity interest will be limited to $20,000, which is the minimum amount it is evident the charity will receive.

*Example (2).* In 1975, C transfers $40,000 in trust with the requirement that D, an individual, and X Charity be paid simultaneously guaranteed annuity interests (as defined in paragraph (c)(2)(vi) of this section) of $5,000 a year each, payable annually at the end of each year, for a period of 5 years and that the remainder be paid to C's children. The fair market value of two annuities of $5,000 each a year for a period of 5 years is $42,124 ([$5,000 × 4.2124] × 2), as determined under § 25.2512–5A(c). The trust instrument provides that in the event the trust fund is insufficient to pay both annuities in a given year, the trust fund will be evenly divided between the charitable and private annuitants. The deduction with respect to the charitable annuity will be limited to $20,000, which is the minimum amount it is evident the charity will receive.

*Example (3).* In 1975, D transfers $65,000 in trust with the requirement that a guaranteed annuity interest (as defined in paragraph (c)(2)(vi) of this section) of $5,000 a year, payable annually at the end of each year, be paid to Y Charity for a period of 10 years and that a guaranteed annuity interest (as defined in paragraph (c)(2)(vi) of this section) of $5,000 a year, payable annually at the end of each year, be paid to W, his wife, aged 62, for 10 years or until her prior death. The annuities are to be paid simultaneously, and the remainder is to be paid to D's children. The fair market value of the private annuity is $33,877 ($5,000 × 6.7754), as determined pursuant to § 25.2512–5A(c) and by the use of factors involving one life and a term of years as published in Publication 723A (12–70). The fair market value of the charitable annuity is $36,800.50 ($5,000 × 7.3601), as determined under § 25.2512–5A(c). It is not evident from the governing instrument of the trust or from local law that the trustee would be required to apportion the trust fund between the wife and charity in the event the fund were insufficient to pay both annuities in a given year. Accordingly, the deduction with respect to the charitable annuity will be limited to $31,123 ($65,000 less $33,877 [the value of the private annuity]), which is the minimum amount it is evident the charity will receive.

*Example (4).* In 1975, E transfers $75,000 in trust with the requirement that an annuity of $5,000 a year, payable annually at the end of each year, be paid to B, an individual, for a period of 5 years and thereafter an annuity of $5,000 a year, payable annually at the end of each year, be paid to M Charity for a period of 5 years. The remainder is to be paid to C, an individual. No deduction is allowed under section 2522(a) with respect to the charitable annuity because it is not a ''guaranteed annuity interest'' within the meaning of paragraph (c)(2)(vi)*(e)* of this section.

(v) The present value of a unitrust interest described in paragraph (c)(2)(vii) of this section is to be determined by subtracting the present value of all interests in the transferred property other than the unitrust interest from the fair market value of the transferred property.

(3) *Other transfers.* The present value of an interest not described in paragraph (d)(2) of this section is to be determined under §25.2512–5.

(4) *Special computations.* If the interest transferred is such that its present value is to be determined by a special computation, a request for a special factor, accompanied by a statement of the date of birth and sex of each individual the duration of whose life may affect the value of the interest, and by copies of the relevant instruments, may be submitted by the donor to the Commissioner who may, if conditions permit, supply the factor requested. If the Commissioner furnishes the factor, a copy of the letter supplying the factor must be attached to the tax return in which the deduction is claimed. If the Commissioner does not furnish the factor, the claim for deduction must be supported by a full statement of the computation of the present value made in accordance with the principles set forth in this paragraph.

(e) *Effective date.* This section applies only to gifts made after July 31, 1969.

[T.D. 7318, 39 FR 25458, July 11, 1974; 39 FR 26154, July 17, 1974, as amended by T.D. 7340, 40 FR 1240, Jan. 7, 1975; T.D. 7955, 49 FR 19998, May 11, 1984; T.D. 7957, 49 FR 20812, May 17, 1984; T.D. 8069, 51 FR 1507, Jan. 14, 1986; 51 FR 5323, Feb. 13, 1986; 51 FR 6319, Feb. 21, 1986; T.D. 8540, 59 FR 30103, 30177, June 10, 1994; T.D. 8630, 60 FR 63919, Dec. 13, 1995]

### §25.2522(c)–4 Disallowance of double deduction in the case of qualified terminable interest property.

No deduction is allowed under section 2522 for the transfer of an interest in property if a deduction is taken from the *total amount of gifts* with respect to that property by reason of section 2523(f). See §25.2523(h)–1.

[T.D. 8522, 59 FR 9658, Mar. 1, 1994]

### §25.2522(d)–1 Additional cross references.

(a) See section 14 of the Wild and Scenic Rivers Act (Pub. L. 90–542, 82 Stat. 918) for provisions relating to the claim and allowance of the value of certain easements as a gift under section 2522.

(b) For treatment of gifts accepted by the Secretary of State or the Secretary of Commerce, for the purpose of organizing and holding an international conference to negotiate a Patent Corporation Treaty, as gifts to or for the use of the United States, see section 3 of Joint Resolution of December 24, 1969 (Pub. L. 91–160, 83 Stat. 443).

(c) For treatment of gifts accepted by the Secretary of the Department of Housing and Urban Development, for the purpose of aiding or facilitating the work of the Department, as gifts to or for the use of the United States, see section 7(k) of the Department of Housing and Urban Development Act (42 U.S.C. 3535), as added by section 905 of Pub. L. 91–609 (84 Stat. 1809).

(d) For treatment of certain property accepted by the Chairman of the Administrative Conference of the United States, for the purpose of aiding and facilitating the work of the Conference, as gifts to the United States, see 5 U.S.C. 575(c)(12), as added by section 1(b) of the Act of October 21, 1972 (Pub. L. 92–526, 86 Stat. 1048).

(e) For treatment of the Board for International Broadcasting as a corporation described in section 2522(a)(2), see section 7 of the Board for International Broadcasting Act of 1973 (Pub. L. 93–129, 87 Stat. 459).

[T.D. 7318, 39 FR 25461, July 11, 1974]

**§ 25.2523(a)–1 Gift to spouse; in general.**

(a) *In general.* In determining the amount of taxable gifts for the calendar quarter (with respect to gifts made after December 31, 1970, and before January 1, 1982), or calendar year (with respect to gifts made before January 1, 1971, or after December 31, 1981), a donor may deduct the value of any property interest transferred by gift to a donee who at the time of the gift is the donor's spouse, except as limited by paragraphs (b) and (c) of this section. See § 25.2502–l(c)(1) for the definition of calendar quarter. This deduction is referred to as the *marital deduction*. In the case of gifts made prior to July 14, 1988, no marital deduction is allowed with respect to a gift if, at the time of the gift, the donor is a nonresident not a citizen of the United States. Further, in the case of gifts made on or after July 14, 1988, no marital deduction is allowed (regardless of the donor's citizenship or residence) for transfers to a spouse who is not a citizen of the United States at the time of the transfer. However, for certain special rules applicable in the case of estate and gift tax treaties, see section 7815(d)(14) of Public Law 101–239. The donor must submit any evidence necessary to establish the donor's right to the marital deduction.

(b) *''Deductible interests'' and ''nondeductible interests''*—(1) *In general.* The property interests transferred by a donor to his spouse consist of either transfers with respect to which the marital deduction is authorized (as described in subparagraph (2) of this paragraph) or transfers with respect to which the marital deduction is not authorized (as described in subparagraph (3) of this paragraph). These transfers are referred to in this section and in §§ 25.2523(b)–1 through 25.2523(f)–1 as ''deductible interests'' and ''nondeductible interests'', respectively.

(2) *''Deductible interest''.* A property interest transferred by a donor to his spouse is a ''deductible interest'' if it does not fall within either class of ''nondeductible interests'' described in subparagraph (3) of this paragraph.

(3) *''Nondeductible interests''.* (i) A property interest transferred by a donor to his spouse which is a ''terminable interest'', as defined in § 25.2523(b)–1, is a ''nondeductible interest'' to the extent specified in that section.

(ii) Any property interest transferred by a donor to the donor's spouse is a *nondeductible interest* to the extent it is not required to be included in a gift tax return for a calendar quarter (for gifts made after December 31, 1970, and before January 1, 1982) or calendar year (for gifts made before January 1, 1971, or after December 31, 1981).

(c) *Computation*—(1) *In general.* The amount of the marital deduction depends upon when the interspousal gifts are made, whether the gifts are terminable interests, whether the limitations of § 25.2523(f)–1A (relating to gifts of community property before January 1, 1982) are applicable, and whether § 25.2523(f)–1 (relating to the election with respect to life estates) is applicable, and (with respect to gifts made on or after July 14, 1988) whether the donee spouse is a citizen of the United States (see section 2523(i)).

(2) *Gifts prior to January 1, 1977.* Generally, with respect to gifts made during a calendar quarter prior to January 1, 1977, the marital deduction allowable under section 2523 is 50 percent of the aggregate value of the deductible interests. See section 2524 for an additional limitation on the amount of the allowable deduction.

(3) *Gifts after December 31, 1976, and before January 1, 1982.* Generally, with respect to gifts made during a calendar quarter beginning after December 31, 1976, and ending prior to January 1, 1982, the marital deduction allowable under section 2523 is computed as a percentage of the deductible interests in those gifts. If the aggregate amount of deductions for such gifts is $100,000 or less, a deduction is allowed for 100 percent of the deductible interests. No deduction is allowed for otherwise deductible interests in an aggregate amount that exceeds $100,000 and is equal to or less than $200,000. For deductible interests in excess of $200,000, the deduction is limited to 50 percent of such deductible interests. If a donor remarries, the computations in this paragraph (c)(3) are made on the basis of aggregate gifts to all persons who at the time of the gifts are the donor's

spouse. See section 2524 for an additional limitation on the amount of the allowable deduction.

(4) *Gifts after December 31, 1981.* Generally, with respect to gifts made during a calendar year beginning after December 31, 1981 (other than gifts made on or after July 14, 1988, to a spouse who is not a United States citizen on the date of the transfer), the marital deduction allowable under section 2523 is 100 percent of the aggregate value of the deductible interests. See section 2524 for an additional limitation on the amount of the allowable deduction, and section 2523(i) regarding disallowance of the marital deduction for gifts to a spouse who is not a United States citizen.

(d) *Examples.* The following examples (in which it is assumed that the donors have previously utilized any specific exemptions provided by section 2521 for gifts prior to January 1, 1977) illustrate the application of paragraph (c) of this section and the interrelationship of sections 2523 and 2503.

*Example 1.* A donor made a transfer by gift of $6,000 cash to his spouse on December 25, 1971. The donor made no other transfers during 1971. The amount of the marital deduction for the fourth calendar quarter of 1971 is $3,000 (one-half of $6,000); the amount of the annual exclusion under section 2503(b) is $3,000; and the amount of taxable gifts is zero ($6,000 − $3,000 (annual exclusion) − $3,000 (marital deduction)).

*Example 2.* A donor made transfers by gift to his spouse of $3,000 cash on January 1, 1971, and $3,000 cash on May 1, 1971. The donor made no other transfers during 1971. For the first calendar quarter of 1971 the marital deduction is zero because the amount excluded under section 2503(b) is $3,000, and the amount of taxable gifts is also zero. For the second calendar quarter of 1971 the marital deduction is $1,500 (one-half of $3,000), and the amount of taxable gifts is $1,500 ($3,000 − $1,500 (marital deduction)). Under section 2503(b) no amount of the second $3,000 gift may be excluded because the entire $3,000 annual exclusion was applied against the gift made in the first calendar quarter of 1971.

*Example 3.* A donor made a transfer by gift to his spouse of $10,000 cash on April 1, 1972. The donor made no other transfers during 1972. For the second calendar quarter of 1972 the amount of the marital deduction is $5,000 (one-half of $10,000); the amount excluded under section 2503(b) is $3,000; the amount of taxable gifts is $2,000 ($10,000 − $3,000 (annual exclusion) − $5,000 (marital deduction)).

*Example 4.* A donor made transfers by gift to his spouse of $2,000 cash on January 1, 1971, $2,000 cash on April 5, 1971, and $10,000 cash on December 1, 1971. The donor made no other transfers during 1971. For the first calendar quarter of 1971 the marital deduction is zero because the amount excluded under section 2503(b) is $2,000, and the amount of taxable gifts is also zero. For the second calendar quarter of 1971 the marital deduction is $1,000 (one-half of $2,000) (see section 2524); the amount excluded under section 2503(b) is $1,000 because $2,000 of the $3,000 annual exclusion was applied against the gift made in the first calendar quarter of 1971; and the amount of taxable gifts is zero ($2,000–$1,000 (annual exclusion) –$1,000 (marital deduction)). For the fourth calendar quarter of 1971, the marital deduction is $5,000 (one-half of $10,000); the amount excluded under section 2503(b) is zero because the entire $3,000 annual exclusion was applied against the gifts made in the first and second calendar quarters of 1971; and the amount of taxable gifts is $5,000 ($10,000 − $5,000 (marital deduction)).

*Example 5.* A donor made transfers by gift to his spouse of $2,000 cash on January 10, 1972, $2,000 cash on May 1, 1972, and a remainder interest valued at $16,000 on June 1, 1972. The donor made no other transfers during 1972. For the first calendar quarter of 1972, the marital deduction is zero because $2,000 is excluded under section 2503(b), and the amount of taxable gifts is also zero. For the second calendar quarter of 1972 the marital deduction is $9,000 (one-half of $16,000 plus one-half of $2,000); the amount excluded under section 2503(b) is $1,000 because $2,000 of the $3,000 annual exclusion was applied against the gift made in the first calendar quarter of 1971; and the amount of taxable gifts is $8,000 ($18,000 − $1,000 (annual exclusion) − $9,000 (marital deduction)).

*Example 6.* A donor made transfers by gift to his spouse of $2,000 cash on January 1, 1972, a remainder interest valued at $16,000 on January 5, 1972, and $2,000 cash on April 30, 1972. The donor made no other transfers during 1972. For the first calendar quarter of 1972, the marital deduction is $9,000 (one-half of $16,000 plus one-half of $2,000); the amount excluded under section 2503(b) is $2,000; and the amount of taxable gifts is $7,000 ($18,000 − $2,000 (annual exclusion) − $9,000 marital deduction)). For the second calendar quarter of 1972 the marital deduction is $1,000 (one-half of $2,000); the amount excluded under section 2503(b) is $1,000 because $2,000 of the $3,000 annual exclusion was applied against the gift of the present interest in the first calendar quarter of 1971; and the amount of taxable gifts is zero ($2,000 − $1,000 (annual exclusion) − $1,000 (marital deduction)).

*Example 7.* A donor made a transfer by gift to his spouse of $12,000 cash on July 1, 1955. The donor made no other transfers during

1955. For the calendar year 1955 the amount of the marital deduction is $6,000 (one-half of $12,000); the amount excluded under section 2503(b) is $3,000; and the amount of taxable gifts is $3,000 ($12,000 −$3,000 (annual exclusion) −$6,000 (marital deduction)).

*Example 8.* A donor made a transfer by gift to the donor's spouse, a United States citizen, of $200,000 cash on January 1, 1995. The donor made no other transfers during 1995. For calendar year 1995, the amount excluded under section 2503(b) is $10,000; the marital deduction is $190,000; and the amount of taxable gifts is zero ($200,000—$10,000 (annual exclusion)—$190,000 (marital deduction)).

(e) *Valuation.* If the income from property is made payable to the donor or another individual for life or for a term of years, with remainder to the donor's spouse or to the estate of the donor's spouse, the marital deduction is computed (pursuant to § 25.2523(a)–1(c)) with respect to the present value of the remainder, determined under section 7520. The present value of the remainder (that is, its value as of the date of gift) is to be determined in accordance with the rules stated in § 25.2512–5 or, for certain prior periods, § 25.2512–5A. See the example in paragraph (d) of § 25.2512–5. If the remainder is such that its value is to be determined by a special computation, a request for a specific factor, accompanied by a statement of the dates of birth of each person, the duration of whose life may affect the value of the remainder, and by copies of the relevant instruments may be submitted by the donor to the Commissioner who, if conditions permit, may supply the factor requested. If the Commissioner does not furnish the factor, the claim for deduction must be supported by a full statement of the computation of the present value, made in accordance with the principles set forth in § 25.2512–5(d) or, for certain prior periods, § 25.2512–5A.

[T.D. 7238, 37 FR 28733, Dec. 29, 1972, as amended by T.D. 7955, 49 FR 19998, May 11, 1984, T.D. 8522, 59 FR 9658, Mar. 1, 1994; T.D. 8540, 59 FR 30103, June 10, 1994; 60 FR 16382, Mar. 30, 1995]

### § 25.2523(b)–1 Life estate or other terminable interest.

(a) *In general.* (1) The provisions of section 2523(b) generally disallow a marital deduction with respect to certain property interests (referred to generally as *terminable interests* and defined in paragraph (a)(3) of this section) transferred to the donee spouse under the circumstances described in paragraph (a)(2) of this section, unless the transfer comes within the purview of one of the exceptions set forth in § 25.2523(d)–1 (relating to certain joint interests); § 25.2523(e)–1 (relating to certain life estates with powers of appointment); § 25.2523(f)–1 (relating to certain qualified terminable interest property); or § 25.2523(g)–1 (relating to certain qualified charitable remainder trusts).

(2) 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—

(i) Transferred an interest in the same property to another donee (see paragraph (b) of this section), or

(ii) Retained an interest in the same property in himself (see paragraph (c) of this section), or

(iii) Retained a power to appoint an interest in the same property (see paragraph (d) of this section).

Notwithstanding the preceding sentence, the marital deduction is disallowed under these circumstances only if the other donee, the donor, or the possible appointee, may, by reason of the transfer or retention, possess or enjoy any part of the property after the termination or failure of the interest therein transferred to the donee spouse.

(3) For purposes of this section, a distinction is to be drawn between ''property,'' as such term is used in section 2523, and an ''interest in property.'' The ''property'' referred to is the underlying property in which various interests exist; each such interest is not, for this purpose, to be considered as ''property.'' 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.

(b) *Interest in property which another donee may possess or enjoy.* (1) Section 2523(b) provides that no marital deduction shall be allowed with respect to the transfer to the donee spouse of a ''terminable interest'' in property, in case—

(i) The donor transferred (for less than an adequate and full consideration in money or money's worth) an interest in the same property to any person other than the donee spouse (or the estate of such spouse), and

(ii) By reason of such transfer, such person (or his heirs or assigns) may possess or enjoy any part of such property after the termination or failure of the interest therein transferred to the donee spouse.

(2) In determining whether the donor transferred an interest in property to any person other than the donee spouse, it is immaterial whether the transfer to the person other than the donee spouse was made at the same time as the transfer to such spouse, or at any earlier time.

(3) Except as provided in § 25.2523(e)–1 or 25.2523(f)–1, if at the time of the transfer it is impossible to ascertain the particular person or persons who may receive a property interest transferred by the donor, such interest is considered as transferred to a person other than the donee spouse for the purpose of section 2523(b). This rule is particularly applicable in the case of the transfer of a property interest by the donor subject to a reserved power. See § 25.2511–2. Under this rule, any property interest over which the donor reserved a power to revest the beneficial title in himself, or over which the donor reserved the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves, is for the purpose of section 2523(b), considered as transferred to a ''person other than the donee spouse.'' The following examples, in which it is assumed that the donor did not make an election under sections 2523(f)(2)(C) and (f)(4), illustrate the application of the provisions of this paragraph (b)(3):

*Example 1.* If a donor transferred property in trust naming his wife as the irrevocable income beneficiary for 10 years, and providing that, upon the expiration of that term, the corpus should be distributed among his wife and children in such proportions as the trustee should determine, the right to the corpus, for the purpose of the marital deduction, is considered as transferred to a ''person other than the donee spouse.''

*Example 2.* If, in the above example, the donor had provided that, upon the expiration of the 10-year term, the corpus was to be paid to his wife, but also reserved the power to revest such corpus in himself, the right to corpus, for the purpose of the marital deduction, is considered as transferred to a ''person other than the donee spouse.''

(4) The term ''person other than the donee spouse'' includes the possible unascertained takers of a property interest, as, for example, the members of a class to be ascertained in the future. As another example, assume that the donor created a power of appointment over a property interest, which does not come within the purview of § 25.2523(e)–1. In such a case, the term ''person other than the donee spouse'' refers to the possible appointees and takers in default (other than the spouse) of such property interest.

(5) An exercise or release at any time by the donor (either alone or in conjunction with any person) of a power to appoint an interest in property, even though not otherwise a transfer by him is considered as a transfer by him in determining, for the purpose of section 2523(b), whether he transferred an interest in such property to a person other than the donee spouse.

(6) The following examples illustrate the application of this paragraph. In each example, it is assumed that the donor made no election under sections 2523(f)(2)(C) and (f)(4) and that the property interest that the donor transferred to a person other than the donee spouse is not transferred for adequate and full consideration in money or money's worth:

*Example 1.* H (the donor) transferred real property to W (his wife) for life, with remainder to A and his heirs. No marital deduction may be taken with respect to the interest transferred to W, since it will terminate upon her death and A (or his heirs or assigns) will thereafter possess or enjoy the property.

*Example 2.* H transferred property for the benefit of W and A. The income was payable to W for life and upon her death the principal was to be distributed to A or his issue. However, if A should die without issue, leaving W

surviving, the principal was then to be distributed to W. No marital deduction may be taken with respect to the interest transferred to W, since it will terminate in the event of his issue will thereafter possess or enjoy the property.

*Example 3.* H purchased for $100,000 a life annuity for W. If the annuity payments made during the life of W should be less than $100,000, further payments were to be made to A. No marital deduction may be taken with respect to the interest transferred to W; since A may possess or enjoy a part of the property following the termination of W's interest. If, however, the contract provided for no continuation of payments, and provided for no refund upon the death of W, or provided that any refund was to go to the estate of W, then a marital deduction may be taken with respect to the gift.

*Example 4.* H transferred property to A for life with remainder to W provided W survives A, but if W predeceases A, the property is to pass to B and his heirs. No marital deduction may be taken with respect to the interest transferred to W.

*Example 5.* H transferred real property to A, reserving the right to the rentals of the property for a term of 20 years. H later transferred the right to the remaining rentals to W. No marital deduction may be taken with respect to the interest since it will terminate upon the expiration of the balance of the 20-year term and A will thereafter possess or enjoy the property.

*Example 6.* H transferred a patent to W and A as tenants in common. In this case, the interest of W will terminate upon the expiration of the term of the patent, but possession and enjoyment of the property by A must necessarily cease at the same time. Therefore, since A's possession or enjoyment cannot outlast the termination of W's interest, the provisions of section 2523(b) do not disallow the marital deduction with respect to the interest.

(c) *Interest in property which the donor may possess or enjoy.* (1) Section 2523(b) provides that no marital deduction is allowed with respect to the transfer to the donee spouse of a ''terminable interest'' in property, if—

(i) The donor retained in himself an interest in the same property, and

(ii) By reason of such retention, the donor (or his heirs or assigns) may possess or enjoy any part of the property after the termination or failure of the interest transferred to the donee spouse. However, as to a transfer to the donee spouse as sole joint tenant with the donor or as tenant by the entirety, see § 25.2523(d)–1.

(2) In general, the principles illustrated by the examples under paragraph (b) of this section are applicable in determining whether the marital deduction may be taken with respect to a property interest transferred to the donee spouse subject to the retention by the donor of an interest in the same property. The application of this paragraph may be further illustrated by the following example, in which it is assumed that the donor made no election under sections 2523(f)(2)(C) and (f)(4).

*Example.* The donor purchased three annuity contracts for the benefit of his wife and himself. The first contract provided for payments to the wife for life, with refund to the donor in case the aggregate payments made to the wife were less than the cost of the contract. The second contract provided for payments to the donor for life, and then to the wife for life if she survived the donor. The third contract provided for payments to the donor and his wife for their joint lives and then to the survivor of them for life. No marital deduction may be taken with respect to the gifts resulting from the purchases of the contracts since, in the case of each contract, the donor may possess or enjoy a part of the property after the termination or failure of the interest transferred to the wife.

(d) *Interest in property over which the donor retained a power to appoint.* (1) Section 2523(b) provides that no marital deduction is allowed with respect to the transfer to the donee spouse of a terminable interest'' in property if—

(i) The donor had, immediately after the transfer, a power to appoint an interest in the same property, and

(ii) The donor's power was exercisable (either alone or in conjunction with any person) in such manner that the appointee may possess or enjoy any part of the property after the termination or failure of the interest transferred to the donee spouse.

(2) For the purposes of section 2523(b), the donor is to be considered as having, immediately after the transfer to the donee spouse, such a power to appoint even though the power cannot be exercised until after the lapse of time, upon the occurrence of an event or contingency, or upon the failure of an event or contingency to occur. It is immaterial whether the power retained by the donor was a taxable power of appointment under section 2514.

(3) The principles illustrated by the examples under paragraph (b) of this section are generally applicable in determining whether the marital deduction may be taken with respect to a property interest transferred to the donee spouse subject to retention by the donor of a power to appoint an interest in the same property. The application of this paragraph may be further illustrated by the following example:

*Example.* The donor, having a power of appointment over certain property, appointed a life estate to his spouse. No marital deduction may be taken with respect to such transfer, since, if the retained power to appoint the remainder interest is exercised, the appointee thereunder may possess or enjoy the property after the termination or failure of the interest taken by the donee spouse.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8522, 59 FR 9659, Mar. 1, 1994]

### § 25.2523(c)–1 Interest in unidentified assets.

(a) Section 2523(c) provides that if an interest passing to a donee spouse may be satisfied out of a group of assets (or their proceeds) which include a particular asset that would be a nondeductible interest if it passed from the donor to his spouse, the value of the interest passing to the spouse is reduced, for the purpose of the marital deduction, by the value of the particular asset.

(b) In order for this section to apply, two circumstances must coexist, as follows:

(1) The property interest transferred to the donee spouse must be payable out of a group of assets. An example of a property interest payable out of a group of assets is a right to a share of the corpus of a trust upon its termination.

(2) The group of assets out of which the property interest is payable must include one or more particular assets which, if transferred by the donor to the donee spouse, would not qualify for the marital deduction. Therefore, section 2523 (c) is not applicable merely because a group of assets includes a terminable interest, but would only be applicable if the terminable interest were nondeductible under the provisions of § 25.2523(b)–1.

(c) If both of the circumstances set forth in paragraph (b) of this section exist, only a portion of the property interest passing to the spouse is a deductible interest. The portion qualifying as a deductible interest is an amount equal to the excess, if any, of the value of the property interest passing to the spouse over the aggregate value of the asset (or assets) that if transferred to the spouse would not qualify for the marital deduction. See paragraph (c) of § 25.2523(a)–l to determine the percentage of the deductible interest allowable as a marital deduction. The application of this section may be illustrated by the following example:

*Example.* H was absolute owner of a rental property and on July 1, 1950, transferred it to A by gift, reserving the income for a period of 20 years. On July 1, 1955, he created a trust to last for a period of 10 years. H was to receive the income from the trust and at the termination of the trust the trustee is to turn over to H's wife, W, property having a value of $100,000. The trustee has absolute discretion in deciding which properties in the corpus he shall turn over to W in satisfaction of the gift to her. The trustee received two items of property from H. Item (1) consisted of shares of corporate stock. Item (2) consisted of the right to receive the income from the rental property during the unexpired portion of the 20-year term. Assume that at the termination of the trust on July 1, 1965, the value of the right to the rental income for the then unexpired term of 5 years (item (2)) will be $30,000. Since item (2) is a nondeductible interest and the trustee can turn it over to W in partial satisfaction of her gift, only $70,000 of the $100,000 receivable by her on July 1, 1965, will be considered as property with respect to which a marital deduction is allowable. The present value on July 1, 1955, of the right to receive $70,000 at the end of 10 years is $49,624.33 as determined under § 25.2512–5A(c). The value of the property qualifying for the marital deduction, therefore, is $49,624.33 and a marital deduction is allowed for one-half of that amount, or $24,812.17.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8522, 59 FR 9659, Mar. 1, 1994; T.D. 8540, 59 FR 30103, June 10, 1994]

### § 25.2523(d)–1 Joint interests.

Section 2523(d) provides that if a property interest is transferred to the donee spouse as sole joint tenant with

the donor or as a tenant by the entirety, the interest of the donor in the property which exists solely by reason of the possibility that the donor may survive the donee spouse, or that there may occur a severance of the tenancy, is not for the purposes of section 2523(b), to be considered as an interest retained by the donor in himself. Under this provision, the fact that the donor may, as surviving tenant, possess or enjoy the property after the termination of the interest transferred to the donee spouse does not preclude the allowance of the marital deduction with respect to the latter interest. Thus, if the donor purchased real property in the name of the donor and the donor's spouse as tenants by the entirety or as joint tenants with rights of survivorship, a marital deduction is allowable with respect to the value of the interest of the donee spouse in the property (subject to the limitations set forth in § 25.2523(a)–1). See paragraph (c) of § 25.2523(b)–1, and section 2524.

[T.D. 7238, 37 FR 28734, Dec. 29, 1972, as amended by T.D. 8522, 59 FR 9659, Mar. 1, 1994]

### § 25.2523(e)–1 Marital deduction; life estate with power of appointment in donee spouse.

(a) *In general.* Section 2523(e) provides that if an interest in property is transferred by a donor to his spouse (whether or not in trust) and the spouse is entitled for life to all the income from a specific portion of the entire interest, with a power in her to appoint the entire interest of all the income from interest or the specific portion, the interest transferred to her is a deductible interest, to the extent that it satisfies all five of the conditions set forth below (see paragraph (b) of this section if one or more of the conditions is satisfied as to only a portion of the interest):

(1) The donee spouse must be entitled for life to all of the income from the entire interest or a specific portion of the entire interest, or to a specific portion of all the income from the entire interest.

(2) The income payable to the donee spouse must be payable annually or at more frequent intervals.

(3) The donee spouse must have the power to appoint the entire interest of the specific portion to either herself or her estate.

(4) The power in the donee spouse must be exercisable by her alone and (whether exercisable by will or during life) must be exercisable in all events.

(5) The entire interest or the specific portion must not be subject to a power in any other person to appoint any part to any person other than the donee spouse.

(b) *Specific portion; deductible amount.* If either the right to income or the power of appointment given to the donee spouse pertains only to a specific portion of a property interest, the portion of the interest which qualifies as a deductible interest is limited to the extent that the rights in the donee spouse meet all of the five conditions described in paragraph (a) of this section. While the rights over the income and the power must coexist as to the same interest in property, it is not necessary that the rights over the income or the power as to such interest be in the same proportion. However, if the rights over income meeting the required conditions set forth in paragraph (a) (1) and (2) of this section extend over a smaller share of the property interest than the share with respect to which the power of appointment requirements set forth in paragraph (a) (3) through (5) of this section are satisfied, the deductible interest is limited to the smaller share. Conversely, if a power of appointment meeting all the requirements extends to a smaller portion of the property interest than the portion over which the income rights pertain, the deductible interest cannot exceed the value of the portion to which such power of appointment applies. Thus, if the donor gives to the donee spouse the right to receive annually all of the income from a particular property interest and a power of appointment meeting the specifications prescribed in paragraph (a) (3) through (5) of this section as to only one-half of the property interest, then only one-half of the property interest is treated as a deductible interest. Correspondingly, if the income interest of the spouse satisfying the requirements extends to only one-fourth

of the property interest and a testamentary power of appointment satisfying the requirements extends to all of the property interest, then only one-fourth of the interest in the spouse qualifies as a deductible interest. Further, if the donee spouse has no right to income from a specific portion of a property interest but a testamentary power of appointment which meets the necessary conditions over the entire interest, then none of the interest qualifies for the deduction. In addition, if, from the time of the transfer, the donee spouse has a power of appointment meeting all of the required conditions over three-fourths of the entire property interest and the prescribed income rights over the entire interest, but with a power in another person to appoint one-half of the entire interest, the value of the interest in the donee spouse over only one-half of the property interest will qualify as a deductible interest.

(c) *Meaning of specific portion*—(1) *In general.* Except as provided in paragraphs (c)(2) and (c)(3) of this section, a partial interest in property is not treated as a *specific portion* of the entire interest. In addition, any specific portion of an entire interest in property is nondeductible to the extent the specific portion is subject to invasion for the benefit of any person other than the donee spouse, except in the case of a deduction allowable under section 2523(e), relating to the exercise of a general power of appointment by the donee spouse.

(2) *Fraction or percentage share.* Under section 2523(e), a partial interest in property is treated as a specific portion of the entire interest if the rights of the donee spouse in income, and the required rights as to the power described in § 25.2523(e)–1(a), constitute a fractional or percentage share of the entire property interest, so that the donee spouse's interest reflects its proportionate share of the increase or decrease in the value of the entire property interest to which the income rights and the power relate. Thus, if the spouse's right to income and the spouse's power extend to a specified fraction or percentage of the property, or its equivalent, the interest is in a specific portion of the property. In accordance with paragraph (b) of this section, if the spouse has the right to receive the income from a specific portion of the trust property (after applying paragraph (c)(3) of this section) but has a power of appointment over a different specific portion of the property (after applying paragraph (c)(3) of this section), the marital deduction is limited to the lesser specific portion.

(3) *Special rule in the case of gifts made on or before October 24, 1992.* In the case of gifts within the purview of the effective date rule contained in paragraph (c)(3)(iii) of this section:

(i) A specific sum payable annually, or at more frequent intervals, out of the property and its income that is not limited by the income of the property is treated as the right to receive the income from a specific portion of the property. The specific portion, for purposes of paragraph (c)(2) of this section, is the portion of the property that, assuming the interest rate generally applicable for the valuation of annuities at the time of the donor's gift, would produce income equal to such payments. However, a pecuniary amount payable annually to a donee spouse is not treated as a right to the income from a specific portion of trust property for purposes of this paragraph (c)(3)(i) if any person other than the donee spouse may receive, during the donee spouse's lifetime, any distribution of the property. To determine the applicable interest rate for valuing annuities, see sections 2512 and 7520 and the regulations under those sections.

(ii) The right to appoint a pecuniary amount out of a larger fund (or trust corpus) is considered the right to appoint a specific portion of such fund or trust in an amount equal to such pecuniary amount.

(iii) The rules contained in paragraphs (c)(3) (i) and (ii) of this section apply with respect to gifts made on or before October 24, 1992.

(4) *Local law.* A partial interest in property is treated as a specific portion of the entire interest if it is shown that the donee spouse has rights under local law that are identical to those the donee spouse would have acquired had the partial interest been expressed in terms satisfying the requirements of paragraph (c)(2) of this section (or

paragraph (c)(3) of this section if applicable).

(5) *Examples.* The following examples illustrate the application of paragraphs (b) and (c) of this section, where D, the donor, transfers property to D's spouse, S:

*Example 1. Spouse entitled to the lesser of an annuity or a fraction of trust income.* Prior to October 24, 1992, D transferred in trust 500 identical shares of X Company stock, valued for gift tax purposes at $500,000. The trust provided that during the lifetime of D's spouse, S, the trustee is to pay annually to S the lesser of one-half of the trust income or $20,000. Any trust income not paid to S is to be accumulated in the trust and may not be distributed during S's lifetime. S has a testamentary general power of appointment over the entire trust principal. The applicable interest rate for valuing annuities as of the date of D's gift under section 7520 is 10 percent. For purposes of paragraphs (a) through (c) of this section, S is treated as receiving all of the income from the lesser of one-half of the stock ($250,000), or $200,000, the specific portion of the stock which, as determined in accordance with § 25.2523(e)-1(c)(3)(i) of this chapter, would produce annual income of $20,000 (20,000/.10). Accordingly, the marital deduction is limited to $200,000 (200,000/500,000 or ⅖ of the value of the trust.)

*Example 2. Spouse possesses power and income interest over different specific portions of trust.* The facts are the same as in *Example 1* except that S's testamentary general power of appointment is exercisable over only ¼ of the trust principal. Consequently, under section 2523(e), the marital deduction is allowable only for the value of ¼ of the trust ($125,000); i.e., the lesser of the value of the portion with respect to which S is deemed to be entitled to all of the income (⅖ of the trust or $200,000), or the value of the portion with respect to which S possesses the requisite power of appointment (¼ of the trust or $125,000).

*Example 3. Power of appointment over shares of stock constitutes a power over a specific portion.* D transferred 250 identical shares of Y company stock to a trust under the terms of which trust income is to be paid annually to S, during S's lifetime. S was given a testamentary general power of appointment over 100 shares of stock. The trust provides that if the trustee sells the Y company stock, S's general power of appointment is exercisable with respect to the sale proceeds or the property in which the proceeds are reinvested. Because the amount of property represented by a single share of stock would be altered if the corporation split its stock, issued stock dividends, made a distribution of capital, etc., a power to appoint 100 shares at the time of S's death is not necessarily a power to appoint the entire interest that the 100 shares represented on the date of D's gift. If it is shown that, under local law, S has a general power to appoint not only the 100 shares designated by D but also 100/250 of any distributions by the corporation that are included in trust principal, the requirements of paragraph (c)(2) of this section are satisfied and S is treated as having a general power to appoint 100/250 of the entire interest in the 250 shares. In that case, the marital deduction is limited to 40 percent of the trust principal. If local law does not give S that power, the 100 shares would not constitute a specific portion under § 25.2523(e)–1(c) (including § 25.2523(e)–1(c)(3)(ii)). The nature of the asset is such that a change in the capitalization of the corporation could cause an alteration in the original value represented by the shares at the time of the transfer and is thus not a specific portion of the trust.

(d) *Definition of ''entire interest''.* Since a marital deduction is allowed for each qualifying separate interest in property transferred by the donor to the donee spouse, for purposes of paragraphs (a) and (b) of this section, each property interest with respect to which the donee spouse received some rights is considered separately in determining whether her rights extend to the entire interest or to a specific portion of the entire interest. A property interest which consists of several identical units of property (such as a block of 250 shares of stock, whether the ownership is evidenced by one or several certificates) is considered one property interest, unless certain of the units are to be segregated and accorded different treatment, in which case each segregated group of items is considered a separate property interest. The bequest of a specified sum of money constitutes the bequest of a separate property interest if immediately following the transfer and thenceforth it, and the investments made with it, must be so segregated or accounted for as to permit its identification as a separate item of property. The application of this paragraph may be illustrated by the following examples:

*Example (1).* The donor transferred to a trustee three adjoining farms, Blackacre, Whiteacre, and Greenacre. The trust instrument provided that during the lifetime of the donee spouse the trustee should pay her all of the income from the trust. Upon her death, all of Blackacre, a one-half interest in Whiteacre, and a one-third interest in

Greenacre were to be distributed to the person or persons appointed by her in her will. The donee spouse is considered as being entitled to all of the income from the entire interest in Blackacre, all of the income from the entire interest in Whiteacre, and all of the income from the entire interest in Greenacre. She also is considered as having a power of appointment over the entire interest in Blackacre, over one-half of the entire interest in Whiteacre, and over one-third of the entire interest in Greenacre.

*Example (2).* The donor transferred $250,000 to C, as trustee. C is to invest the money and pay all of the income from the investments to W, the donor's spouse, annually. W was given a general power, exercisable by will, to appoint one-half of the corpus of the trust. Here, immediately following establishment of the trust, the $250,000 will be sufficiently segregated to permit its identification as a separate item, and the $250,000 will constitute an entire property interest. Therefore, W has a right to income and a power of appointment such that one-half of the entire interest is a deductible interest.

*Example (3).* The donor transferred 100 shares of Z Corporation stock to D, as trustee. W, the donor's spouse, is to receive all of the income of the trust annually and is given a general power, exercisable by will, to appoint out of the trust corpus the sum of $25,000. In this case the $25,000 is not, immediately following establishment of the trust, sufficiently segregated to permit its identification as a separate item of property in which the donee spouse has the entire interest. Therefore, the $25,000 does not constitute the entire interest in a property for the purpose of paragraphs (a) and (b) of this section.

(e) *Application of local law.* In determining whether or not the conditions set forth in paragraphs (a) (1) through (5) of this section are satisfied by the instrument of transfer, regard is to be had to the applicable provisions of the law of the jurisdiction under which the interest passes and, if the transfer is in trust, the applicable provisions of the law governing the administration of the trust. For example, silence of a trust instrument as to the frequency of payment will not be regarded as a failure to satisfy the condition set forth in paragraph (a)(2) of this section that income must be payable to the donee spouse annually or more frequently unless the applicable law permits payment to be made less frequently than annually. The principles outlined in this paragraph and paragraphs (f) and (g) of this section which are applied in determining whether transfers in trust meet such conditions are equally applicable in ascertaining whether, in the case of interests not in trust, the donee spouse has the equivalent in rights over income and over the property.

(f) *Right to income.* (1) If an interest is transferred in trust, the donee spouse is ''entitled for life to all of the income from the entire interest or a specific portion of the entire interest,'' for the purpose of the condition set forth in paragraph (a)(1) of this section, if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trust accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Such degree of enjoyment is given only if it was the donor's intention, as manifested by the terms of the trust instrument and the surrounding circumstances, that the trust should produce for the donee spouse during her life such an income, or that the spouse should have such use of the trust property as is consistent with the value of the trust corpus and with its preservation. The designation of the spouse as sole income beneficiary for life of the entire interest or a specific portion of the entire interest will be sufficient to qualify the trust unless the terms of the trust and the surrounding circumstances considered as a whole evidence an intention to deprive the spouse of the requisite degree of enjoyment. In determining whether a trust evidences that intention, the treatment required or permitted with respect to individual items must be considered in relation to the entire system provided for the administration of the trust.

(2) If the over-all effect of a trust is to give to the donee spouse such enforceable rights as will preserve to her the requisite degree of enjoyment, it is immaterial whether that result is effected by rules specifically stated in the trust instrument, or, in their absence, by the rules for the management of the trust property and the allocation of receipts and expenditures supplied by the State law. For example, a provision in the trust instrument for amortization of bond premium by appropriate periodic charges to interest will not disqualify the interest transferred

in trust even though there is no State law specifically authorizing amortization or there is a State law denying amortization which is applicable only in the absence of such a provision in the trust instrument.

(3) In the case of a trust, the rules to be applied by the trustee in allocation of receipts and expenses between income and corpus must be considered in relation to the nature and expected productivity of the assets transferred in trust, the nature and frequency of occurrence of the expected receipts, and any provisions as to change in the form of investments. If it is evident from the nature of the trust assets and the rules provided for management of the trust that the allocation to income of such receipts as rents, ordinary cash dividends and interest will give to the spouse the substantial enjoyment during life required by the statute, provisions that such receipts as stock dividends and proceeds from the conversion of trust assets shall be treated as corpus will not disqualify the interest transferred in trust. Similarly, provision for a depletion charge against income in the case of trust assets which are subject to depletion will not disqualify the interest transferred in trust, unless the effect is to deprive the spouse of the requisite beneficial enjoyment. The same principle is applicable in the case of depreciation, trustees' commissions, and other charges.

(4) Provisions granting administrative powers to the trustees will not have the effect of disqualifying an interest transferred in trust unless the grant of powers evidences the intention to deprive the donee spouse of the beneficial enjoyment required by the statute. Such an intention will not be considered to exist if the entire terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers. Among the powers which if subject to reasonable limitations will not disqualify the interest transferred in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus, the power to apply the income or corpus for the benefit of the spouse, and the power to retain the assets transferred to the trust. For example, a power to retain trust assets which consist substantially of unproductive property will not disqualify the interest if the applicable rules for the administration of the trust require, or permit the spouse to require, that the trustee either make the property productive or convert it within a reasonable time. Nor will such a power disqualify the interest if the applicable rules for administration of the trust require the trustee to use the degree of judgment and care in the exercise of the power which a prudent man would use if he were owner of the trust assets. Further, a power to retain a residence for the spouse or other property for the personal use of the spouse will not disqualify the interest transferred in trust.

(5) An interest transferred in trust will not satisfy the condition set forth in paragraph (a)(1) of this section that the donee spouse be entitled to all the income if the primary purpose of the trust is to safeguard property without providing the spouse with the required beneficial enjoyment. Such trusts include not only trusts which expressly provide for the accumulation of the income but also trusts which indirectly accomplish a similar purpose. For example, assume that the corpus of a trust consists substantially of property which is not likely to be income producing during the life of the donee spouse and that the spouse cannot compel the trustee to convert or otherwise deal with the property as described in subparagraph (4) of this paragraph. An interest transferred to such a trust will not qualify unless the applicable rules for the administration require, or permit the spouse to require, that the trustee provide the required beneficial enjoyment, such as by payments to the spouse out of other assets of the trust.

(6) If a trust may be terminated during the life of the donee spouse, under her exercise of a power of appointment or by distribution of the corpus to her, the interest transferred in trust satisfies the condition set forth in paragraph (a)(1) of this section (that the spouse be entitled to all the income) if she (i) is entitled to the income until the trust terminates, or (ii) has the right, exercisable in all events, to have

the corpus distributed to her at any time during her life.

(7) An interest transferred in trust fails to satisfy the condition set forth in paragraph (a)(1) of this section, that the spouse be entitled to all the income, to the extent that the income is required to be accumulated in whole or in part or may be accumulated in the discretion of any person other than the donee spouse; to the extent that the consent of any person other than the donee spouse is required as a condition precedent to distribution of the income; or to the extent that any person other than the donee spouse has the power to alter the terms of the trust so as to deprive her of her right to the income. An interest transferred in trust will not fail to satisfy the condition that the spouse be entitled to all the income merely because its terms provide that the right of the donee spouse to the income shall not be subject to assignment, alienation, pledge, attachment or claims of creditors.

(8) In the case of an interest transferred in trust, the terms ''entitled for life'' and ''payable annually or at more frequent intervals'', as used in the conditions set forth in paragraph (a) (1) and (2) of this section, require that under the terms of the trust the income referred to must be currently (at least annually; see paragraph (e) of this section) distributable to the spouse or that she must have such command over the income that it is virtually hers. Thus, the conditions in paragraph (a) (1) and (2) of this section are satisfied in this respect if, under the terms of the trust instrument, the donee spouse has the right exercisable annually (or more frequently) to require distribution to herself of the trust income, and otherwise the trust income is to be accumulated and added to corpus. Similarly, as respects the income for the period between the last distribution date and the date of the spouse's death, it is sufficient if that income is subject to the spouse's power to appoint. Thus, if the trust instrument provides that income accrued or undistributed on the date of the spouse's death is to be disposed of as if it had been received after her death, and if the spouse has a power of appointment over the trust corpus, the power necessarily extends to the undistributed income.

(g) *Power of appointment in donee spouse.* (1) The conditions set forth in paragraphs (a) (3) and (4) of this section, that is, that the donee spouse must have a power of appointment exercisable in favor of herself or her estate and exercisable alone and in all events, are not met unless the power of the donee spouse to appoint the entire interest or a specific portion of it falls within one of the following categories:

(i) A power so to appoint fully exercisable in her own favor at any time during her life (as, for example, an unlimited power to invade); or

(ii) A power so to appoint exercisable in favor of her estate. Such a power, if exercisable during life, must be fully exercisable at any time during life, or if exercisable by will, must be fully exercisable irrespective of the time of her death; or

(iii) A combination of the powers described under subdivisions (i) and (ii) of this subparagraph. For example, the donee spouse may, until she attains the age of 50 years, have a power to appoint to herself and thereafter have a power to appoint to her estate. However, the condition that the spouse's power must be exercisable in all events is not satisfied unless irrespective of when the donee spouse may die the entire interest or a specific portion of it will at the time of her death be subject to one power or the other.

(2) The power of the donee spouse must be a power to appoint the entire interest or a specific portion of it as unqualified owner (and free of the trust if a trust is involved, or free of the joint tenancy if a joint tenancy is involved) or to appoint the entire interest or a specific portion of it as a part of her estate (and free of the trust if a trust is involved), that is, in effect, to dispose of it to whomsoever she pleases. Thus, if the donor transferred property to a son and the donee spouse as joint tenants with right of survivorship and under local law the donee spouse has a power of severance exercisable without consent of the other joint tenant, and by exercising this power could acquire a one-half interest in the property as a tenant in common, her power of severance will satisfy the condition

set forth in paragraph (a)(3) of this section that she have a power of appointment in favor of herself or her estate. However, if the donee spouse entered into a binding agreement with the donor to exercise the power only in favor of their issue, that condition is not met. An interest transferred in trust will not be regarded as failing to satisfy the condition merely because takers in default of the donee spouse's exercise of the power are designated by the donor. The donor may provide that, in default of exercise of the power, the trust shall continue for an additional period.

(3) A power is not considered to be a power exercisable by a donee spouse alone and in all events as required by paragraph (a)(4) of this section if the exercise of the power in the donee spouse to appoint the entire interest or a specific portion of it to herself or to her estate requires the joinder or consent of any other person. The power is not ''exercisable in all events'', if it can be terminated during the life of the donee spouse by any event other than her complete exercise or release of it. Further, a power is not ''exercisable in all events'' if it may be exercised for a limited purpose only. For example, a power which is not exercisable in the event of the spouse's remarriage is not exercisable in all events. Likewise, if there are any restrictions, either by the terms of the instrument or under applicable local law, on the exercise of a power to consume property (whether or not held in trust) for the benefit of the spouse, the power is not exercisable in all events. Thus, if a power of invasion is exercisable only for the spouse's support, or only for her limited use, the power is not exercisable in all events. In order for a power of invasion to be exercisable in all events, the donee spouse must have the unrestricted power exercisable at any time during her life to use all or any part of the property subject to the power, and to dispose of it in any manner, including the power to dispose of it by gift (whether or not she has power to dispose of it by will).

(4) If the power is in existence at all times following the transfer of the interest, limitations of a formal nature will not disqualify the interest. Examples of formal limitations on a power exercisable during life are requirements that an exercise must be in a particular form, that it must be filed with a trustee during the spouse's life, that reasonable notice must be given, or that reasonable intervals must elapse between successive partial exercises. Examples of formal limitations on a power exercisable by will are that it must be exercised by a will executed by the donee spouse after the making of the gift or that exercise must be by specific reference to the power.

(5) If the donee spouse has the requisite power to appoint to herself or her estate, it is immaterial that she also has one or more lesser powers. Thus, if she has a testamentary power to appoint to her estate, she may also have a limited power of withdrawal or of appointment during her life. Similarly, if she has an unlimited power of withdrawal, she may have a limited testamentary power.

(h) *Existence of a power in another.* Paragraph (a)(5) of this section provides that a transfer described in paragraph (a) is nondeductible to the extent that the donor created a power in the trustee or in any other person to appoint a part of the interest to any person other than the donee spouse. However, only powers in other persons which are in opposition to that of the donee spouse will cause a portion of the interest to fail to satisfy the condition set forth in paragraph (a)(5) of this section. Thus, a power in a trustee to distribute corpus to or for the benefit of the donee spouse will not disqualify the trust. Similarly, a power to distribute corpus to the spouse for the support of minor children will not disqualify the trust if she is legally obligated to support such children. The application of this paragraph may be illustrated by the following examples:

*Example (1).* Assume that a donor created a trust, designating his spouse as income beneficiary for life with an unrestricted power in the spouse to appoint the corpus during her life. The donor further provided that in the event the donee spouse should die without having exercised the power, the trust should continue for the life of his son with a power in the son to appoint the corpus. Since the power in the son could become exercisable only after the death of the donee spouse, the interest is not regarded as failing to satisfy

the condition set forth in paragraph (a)(5) of this section.

*Example (2).* Assume that the donor created a trust, designating his spouse as income beneficiary for life and as donee of a power to appoint by will the entire corpus. The donor further provided that the trustee could distribute 30 percent of the corpus to the donor's son when he reached the age of 35 years. Since the trustee has a power to appoint 30 percent of the entire interest for the benefit of a person other than the donee spouse, only 70 percent of the interest placed in trust satisfied the condition set forth in paragraph (a)(5) of this section. If, in this case, the donee spouse had a power, exercisable by her will, to appoint only one-half of the corpus as it was constituted at the time of her death, it should be noted that only 35 percent of the interest placed in the trust would satisfy the condition set forth in paragraph (a)(3) of this section.

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### § 25.2523(f)–1 Election with respect to life estate transferred to donee spouse.

(a) *In general.* (1) With respect to gifts made after December 31, 1981, subject to section 2523(i), a marital deduction is allowed under section 2523(a) for transfers of *qualified terminable interest property*. Qualified terminable interest property is terminable interest property described in section 2523(b)(1) that satisfies the requirements of section 2523(f)(2) and this section. Terminable interests that are described in section 2523(b)(2) cannot qualify as qualified terminable interest property. Thus, if the donor retains a power described in section 2523(b)(2) to appoint an interest in qualified terminable interest property, no deduction is allowable under section 2523(a) for the property.

(2) All of the property for which a deduction is allowed under this paragraph (a) is treated as passing to the donee spouse (for purposes of § 25.2523(a)–1), and no part of the property is treated as retained by the donor or as passing to any person other than the donee spouse (for purposes of § 25.2523(b)–1(b)).

(b) *Qualified terminable interest property*—(1) *Definition.* Section 2523(f)(2) provides the definition of *qualified terminable interest property*.

(2) *Meaning of property.* For purposes of section 2523(f)(2), the term *property* generally means an *entire interest in property* (within the meaning of § 25.2523(e)–l(d)) or a *specific portion of the entire interest* (within the meaning of § 25.2523(e)–l(c)).

(3) *Property for which the election may be made*—(i) *In general.* The election may relate to all or any part of property that meets the requirements of section 2523(f)(2) (A) and (B), provided that any partial election must be made with respect to a fractional or percentage share of the property so that the elective portion reflects its proportionate share of the increase or decrease in the entire property for purposes of applying sections 2044 or 2519. Thus, if the interest of the donee spouse in a trust (or other property in which the spouse has a qualifying income interest) meets the requirements of this section, the election may be made under section 2523(f)(2)(C) with respect to a part of the trust (or other property) only if the election relates to a defined fraction or percentage of the entire trust (or other property) or specific portion thereof within the meaning of § 25.2523(e)–1(c). The fraction or percentage may be defined by formula.

(ii) *Division of trusts.* If the interest of the donee spouse in a trust meets the requirements of this section, the trust may be divided into separate trusts to reflect a partial election that has been made, if authorized under the terms of the governing instrument or otherwise permissible under local law. A trust may be divided only if the fiduciary is required, either by applicable local law or by the express or implied provisions of the governing instrument, to divide the trust according to the fair market value of the assets of the trust at the time of the division. The division of the trusts must be done on a fractional or percentage basis to reflect the partial election. However, the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust.

(4) *Manner and time of making election.* (i) An election under section 2523(f)(2)(C) (other than a deemed election with respect to a joint and survivor annuity as described in section 2523(f)(6)), is made on a gift tax return

for the calendar year in which the interest is transferred. The return must be filed within the time prescribed by section 6075(b) (determined without regard to section 6019(a)(2)), including any extensions authorized under section 6075(b)(2) (relating to an automatic extension of time for filing a gift tax return where the donor is granted an extension of time to file the income tax return).

(ii) If the election is made on a return for the calendar year that includes the date of death of the donor, the return (as prescribed by section 6075(b)(3)) must be filed no later than the time (including extensions) for filing the estate tax return. The election, once made, is irrevocable.

(c) *Qualifying income interest for life*—(1) *In general.* For purposes of this section, the term *qualifying income interest for life* is defined as provided in section 2056(b)(7)(B)(ii) and § 20.2056(b)–7(d)(1).

(i) *Entitled for life to all the income.* The principles outlined in § 25.2523(e)–1(f) (relating to whether the spouse is entitled for life to all of the income from the entire interest or a specific portion of the entire interest) apply in determining whether the donee spouse is entitled for life to all the income from the property, regardless of whether the interest passing to the donee spouse is in trust. An income interest granted for a term of years, or a life estate subject to termination upon the occurrence of a specified event (e.g., divorce) is not a qualifying income interest for life.

(ii) *Income between last distribution date and date of spouse's death.* An income interest does not fail to constitute a qualifying income interest for life solely because income for the period between the last distribution date and the date of the donee spouse's death is not required to be distributed to the estate of the donee spouse. See § 20.2044–1 of this chapter relating to the inclusion of such undistributed income in the gross estate of the donee spouse.

(iii) *Pooled income funds.* An income interest in a pooled income fund described in section 642(c)(5) constitutes a qualifying income interest for life for purposes of this section.

(iv) *Distribution of principal for the benefit of the donee spouse.* An income interest does not fail to constitute a qualifying income interest for life solely because the trustee has a power to distribute principal to or for the benefit of the donee spouse. The fact that property distributed to a donee spouse may be transferred by the spouse to another person does not result in a failure to satisfy the requirement of section 2056(b)(7)(B)(ii)(II). However, if the governing instrument requires the donee spouse to transfer the distributed property to another person without full and adequate consideration in money or money's worth, the requirement of section 2056(b)(7)(B)(ii)(II) is not satisfied.

(2) *Immediate right to income.* In order to constitute a qualifying income interest for life, the donee spouse must be granted the immediate right to receive the income from the property. Thus, an income interest does not constitute a qualifying income interest for life if the donee spouse receives the right to trust income commencing at some time in the future, e.g., on the termination of a preceding life income interest of the donor spouse.

(3) *Annuities payable from trusts in the case of gifts made on or before October 24, 1992.* (i) In the case of gifts made on or before October 24, 1992, a donee spouse's lifetime annuity interest payable from a trust or other group of assets passing from the donor is treated as a qualifying income interest for life for purposes of section 2523(f)(2)(B). The deductible interest, for purposes of § 25.2523(a)–1(b), is the specific portion of the property that, assuming the applicable interest rate for valuing annuities at the time the annuity interest is transferred, would produce income equal to the minimum amount payable annually to the donee spouse. If, based on the applicable interest rate, the entire property from which the annuity may be satisfied is insufficient to produce income equal to the minimum annual payment, the value of the deductible interest is the entire value of the property. The value of the deductible interest may not exceed the value of the property from which the annuity is payable. If the annual payment may increase, the increased amount is not

taken into account in valuing the deductible interest.

(ii) An annuity interest is not treated as a qualifying income interest for life for purposes of section 2523(f)(2)(B) if any person other than the donee spouse may receive during the donee spouse's lifetime, any distribution of the property or its income from which the annuity is payable.

(iii) To determine the applicable interest rate for valuing annuities, see sections 2512 and 7520 and the regulations under those sections.

(4) *Joint and survivor annuities.* [Reserved]

(d) *Treatment of interest retained by the donor spouse*—(1) *In general.* Under section 2523(f)(5)(A), if a donor spouse retains an interest in qualified terminable interest property, any subsequent transfer by the donor spouse of the retained interest in the property is not treated as a transfer for gift tax purposes. Further, the retention of the interest until the donor spouse's death does not cause the property subject to the retained interest to be includable in the gross estate of the donor spouse.

(2) *Exception.* Under section 2523(f)(5)(B), the rule contained in paragraph (d)(1) of this section does not apply to any property after the donee spouse is treated as having transferred the property under section 2519, or after the property is includable in the gross estate of the donee spouse under section 2044.

(e) *Application of local law.* The provisions of local law are taken into account in determining whether or not the conditions of section 2523(f)(2) (A) and (B), and the conditions of paragraph (c) of this section, are satisfied. For example, silence of a trust instrument on the frequency of payment is not regarded as a failure to satisfy the requirement that the income must be payable to the donee spouse annually or more frequently unless applicable local law permits payments less frequently to the donee spouse.

(f) *Examples.* The following examples illustrate the application of this section, where D, the donor, transfers property to D's spouse, S. Unless stated otherwise, it is assumed that S is not the trustee of any trust established for S's benefit:

*Example 1. Life estate in residence.* D transfers by gift a personal residence valued at $250,000 on the date of the gift to S and D's children, giving S the exclusive and unrestricted right to use the property (including the right to continue to occupy the property as a personal residence or rent the property and receive the income for her lifetime). After S's death, the property is to pass to D's children. Under applicable local law, S's consent is required for any sale of the property. If D elects to treat all of the transferred property as qualified terminable interest property, the deductible interest is $250,000, the value of the property for gift tax purposes.

*Example 2. Power to make property productive.* D transfers assets having a fair market value of $500,000 to a trust pursuant to which S is given the right exercisable annually to require distribution of all the trust income to S. No trust property may be distributed during S's lifetime to any person other than S. The assets used to fund the trust include both income producing assets and nonproductive assets. Applicable local law permits S to require that the trustee either make the trust property productive or sell the property and reinvest the proceeds in productive property within a reasonable time after the transfer. If D elects to treat the entire trust as qualified terminable interest property, the deductible interest is $500,000. If D elects to treat only 20 percent of the trust as qualified terminable interest property, the deductible interest is $100,000; i.e., 20 percent of $500,000.

*Example 3. Power of distribution over fraction of trust income.* The facts are the same as in *Example 2* except that S is given the power exercisable annually to require distribution to S of only 50 percent of the trust income for life. The remaining trust income may be accumulated or distributed among D's children and S in the trustee's discretion. The maximum amount that D may elect to treat as qualified terminable interest property is $250,000; i.e., the value of the trust for gift tax purposes ($500,000) multiplied by the percentage of the trust in which S has a qualifying income interest for life (50 percent). If D elects to treat only 20 percent of the portion of the trust in which S has a qualifying income interest as qualified terminable interest property, the deductible interest is $50,000; i.e, 20 percent of $250,000.

*Example 4. Power to distribute trust corpus to other beneficiaries.* D transfers $500,000 to a trust providing that all the trust income is to be paid to D's spouse, S, during S's lifetime. The trustee is given the power to use annually $5,000 from the trust for the maintenance and support of S's minor child, C. Any such distribution does not necessarily relieve S of S's obligation to support and maintain C. S does not have a qualifying income interest for life in any portion of the

trust because the gift fails to satisfy the condition in sections 2523(f)(3) and 2056(b)(7)(B)(ii)(II) that no person have a power, other than a power the exercise of which takes effect only at or after S's death, to appoint any part of the property to any person other than S. The trust would also be nondeductible under section 2523(f) if S, rather than the trustee, were given the power to appoint a portion of the principal to C. However, in the latter case, if S made a qualified disclaimer (within the meaning of section 2518) of the power to appoint to C, the trust could qualify for the marital deduction pursuant to section 2523(f), assuming that the power was personal to S and S's disclaimer terminates the power. Similarly, if C made a qualified disclaimer of the right to receive distributions from the trust, the trust would qualify under section 2523(f) assuming that C's disclaimer effectively negates the trustee's power under local law.

*Example 5. Spouse's interest terminable on divorce.* The facts are the same as in *Example 3* except that if S and D divorce, S's interest in the trust will pass to C. S's income interest is not a qualifying income interest for life because it is terminable upon S's divorce. Therefore, no portion of the trust is deductible under section 2523(f).

*Example 6. Spouse's interest in trust in the form of an annuity.* Prior to October 24, 1992, D established a trust funded with income producing property valued for gift tax purposes at $800,000. The trustee is required by the trust instrument to pay $40,000 a year to S for life. Any income in excess of the annuity amount is to be accumulated in the trust and may not be distributed during S's lifetime. S's lifetime annuity interest is treated as a qualifying income interest for life. If D elects to treat the entire portion of the trust in which S has a qualifying income interest as qualified terminable interest property, the value of the deductible interest is $400,000, because that amount would yield an income to S of $40,000 a year (assuming a 10 percent interest rate applies in valuing annuities at the time of the transfer).

*Example 7. Value of spouse's annuity exceeds value of trust corpus.* The facts are the same as in *Example 6*, except that the trustee is required to pay S $100,000 a year for S's life. If D elects to treat the entire portion of the trust in which S has a qualifying income interest for life as qualified terminable interest property, the value of the deductible interest is $800,000, which is the lesser of the entire value of the property ($800,000) or the amount of property that (assuming a 10 percent interest rate) would yield an income to S of $100,000 a year ($1,000,000).

*Example 8. Transfer to pooled income fund.* D transfers $200,000 on June 1, 1994, to a pooled income fund (described in section 642(c)(5)) designating S as the only life income beneficiary. If D elects to treat the entire $200,000 as qualified terminable interest property, the deductible interest is $200,000.

*Example 9. Retention by donor spouse of income interest in property.* On October 1, 1994, D transfers property to an irrevocable trust under the terms of which trust income is to be paid to D for life, then to S for life and, on S's death, the trust corpus is to be paid to D's children. Because S does not possess an immediate right to receive trust income, S's interest does not qualify as a qualifying income interest for life under section 2523(f)(2). Further, under section 2702(a)(2) and § 25.2702–2(b), D is treated for gift tax purposes as making a gift with a value equal to the entire value of the property. If D dies in 1996 survived by S, the trust corpus will be includible in D's gross estate under section 2036. However, in computing D's estate tax liability, D's adjusted taxable gifts under section 2001(b)(1)(B) are adjusted to reflect the inclusion of the gifted property in D's gross estate. In addition, if S survives D, the trust property is eligible for treatment as qualified terminable interest property under section 2056(b)(7) in D's estate.

*Example 10. Retention by donor spouse of income interest in property.* On October 1, 1994, D transfers property to an irrevocable trust under the terms of which trust income is to be paid to S for life, then to D for life and, on D's death, the trust corpus is to be paid to D's children. D elects under section 2523(f) to treat the property as qualified terminable interest property. D dies in 1996, survived by S. S subsequently dies in 1998. Under § 2523(f)–1(d)(1), because D elected to treat the transfer as qualified terminable interest property, no part of the trust corpus is includible in D's gross estate because of D's retained interest in the trust corpus. On S's subsequent death in 1998, the trust corpus is includible in S's gross estate under section 2044.

*Example 11. Retention by donor spouse of income interest in property.* The facts are the same as in *Example 10*, except that S dies in 1996 survived by D, who subsequently dies in 1998. Because D made an election under section 2523(f) with respect to the trust, on S's death the trust corpus is includible in S's gross estate under section 2044. Accordingly, under section 2044(c), S is treated as the transferor of the property for estate and gift tax purposes. Upon D's subsequent death in 1998, because the property was subject to inclusion in S's gross estate under section 2044, the exclusion rule in § 25.2523(f)–1(d)(1) does not apply under § 25.2523(f)–1(d)(2). However, because S is treated as the transferor of the property, the property is not subject to inclusion in D's gross estate under section 2036 or section 2038. If the executor of S's estate made a section 2056(b)(7) election with respect to the trust, the trust is includible in

D's gross estate under section 2044 upon D's later death.

[T.D. 8522, 59 FR 9660, Mar. 1, 1994]

### § 25.2523(g)–1 Special rule for charitable remainder trusts.

(a) *In general.* (1) With respect to gifts made after December 31, 1981, subject to section 2523(i), if the donor's spouse is the only noncharitable beneficiary (other than the donor) of a charitable remainder annuity trust or charitable remainder unitrust described in section 664 (qualified charitable remainder trust), section 2523(b) does not apply to the interest in the trust transferred to the donee spouse. Thus, the value of the annuity or unitrust interest passing to the spouse qualifies for a marital deduction under section 2523(g) and the value of the remainder interest qualifies for a charitable deduction under section 2522.

(2) A marital deduction for the value of the donee spouse's annuity or unitrust interest in a qualified charitable remainder trust to which section 2523(g) applies is allowable only under section 2523(g). Therefore, if an interest in property qualifies for a marital deduction under section 2523(g), no election may be made with respect to the property under section 2523(f).

(3) The donee spouse's interest need not be an interest for life to qualify for a marital deduction under section 2523(g). However, for purposes of section 664, an annuity or unitrust interest payable to the spouse for a term of years cannot be payable for a term that exceeds 20 years or the trust does not qualify under section 2523(g).

(4) A deduction is allowed under section 2523(g) even if the transfer to the donee spouse is conditioned on the donee spouse's payment of state death taxes, if any, attributable to the qualified charitable remainder trust.

(5) For purposes of this section, the term *noncharitable beneficiary* means any beneficiary of the qualified charitable remainder trust other than an organization described in section 170(c).

(b) *Charitable remainder trusts where the donee spouse and the donor are not the only noncharitable beneficiaries.* In the case of a charitable remainder trust where the donor and the donor's spouse are not the only noncharitable beneficiaries (for example, where the noncharitable interest is payable to the donor's spouse for life and then to another individual (other than the donor) for life), the qualification of the interest as qualified terminable interest property is determined solely under section 2523(f) and not under section 2523(g). Accordingly, if the transfer to the trust is made prior to October 24, 1992, the spousal annuity or unitrust interest may qualify under § 25.2523(f)–(1)(c)(3) as a qualifying income interest for life.

[T.D. 8522, 59 FR 9663, Mar. 1, 1994]

### § 25.2523(h)–1 Denial of double deduction.

The value of an interest in property may not be deducted for Federal gift tax purposes more than once with respect to the same donor. For example, assume that D, a donor, transferred a life estate in a farm to D's spouse, S, with a remainder to charity and that D elects to treat the property as qualified terminable interest property. The entire value of the property is deductible under section 2523(f). No part of the value of the property qualifies for a charitable deduction under section 2522 for gift tax purposes.

[T.D. 8522, 59 FR 9663, Mar. 1, 1994]

### § 25.2523(h)–2 Effective dates.

Except as specifically provided, in §§ 25.2523(e)–1(c)(3), 25.2523(f)–1(c)(3), and 25.2523(g)–1(b), the provisions of §§ 25.2523(e)–1(c), 25.2523(f)–1, 25.2523(g)–1, and 25.2523(h)–1 are effective with respect to gifts made after March 1, 1994. With respect to gifts made on or before such date, donors may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of §§ 25.2523(e)–1(c), 25.2523(f)–1, 25.2523(g)–1, and 25.2523(h)–1, (as well as project LR–211–76, 1984–1 C.B., page 598, see § 601.601(d)(2)(ii)(*b*) of this chapter), are considered a reasonable interpretation of the statutory provisions.

[T.D. 8522, 59 FR 9663, Mar. 1, 1994]

### § 25.2523(i)–1 Disallowance of marital deduction when spouse is not a United States citizen.

(a) *In general.* Subject to § 20.2056A–1(c) of this chapter, section 2523(i)(1)

disallows the marital deduction if the spouse of the donor is not a citizen of the United States at the time of the gift. If the spouse of the donor is a citizen of the United States at the time of the gift, the gift tax marital deduction under section 2523(a) is allowed regardless of whether the donor is a citizen or resident of the United States at the time of the gift, subject to the otherwise applicable rules of section 2523.

(b) *Exception for certain joint and survivor annuities.* Paragraph (a) does not apply to disallow the marital deduction with respect to any transfer resulting in the acquisition of rights by a noncitizen spouse under a joint and survivor annuity described in section 2523(f)(6).

(c) *Increased annual exclusion*—(1) *In general.* In the case of gifts made from a donor to the donor's spouse for which a marital deduction is not allowable under this section, if the gift otherwise qualifies for the gift tax annual exclusion under section 2503(b), the amount of the annual exclusion under section 2503(b) is $100,000 in lieu of $10,000. However, in the case of gifts made after June 29, 1989, in order for the increased annual exclusion to apply, the gift in excess of the otherwise applicable annual exclusion under section 2503(b) must be in a form that qualifies for the marital deduction but for the disallowance provision of section 2523(i)(1). See paragraph (d), *Example 4,* of this section.

(2) *Status of donor.* The $100,000 annual exclusion for gifts to a noncitizen spouse is available regardless of the status of the donor. Accordingly, it is immaterial whether the donor is a citizen, resident or a nonresident not a citizen of the United States, as long as the spouse of the donor is not a citizen of the United States at the time of the gift and the conditions for allowance of the increased annual exclusion have been satisfied. See § 25.2503–2(f).

(d) *Examples.* The principles outlined in this section are illustrated in the following examples. Assume in each of the examples that the donee, *S,* is *D's* spouse and is not a United States citizen at the time of the gift.

*Example 1. Outright transfer of present interest.* In 1995, *D,* a United States citizen, transfers to *S,* outright, 100 shares of *X* corporation stock valued for federal gift tax purposes at $130,000. The transfer is a gift of a present interest in property under section 2503(b). Additionally, the gift qualifies for the gift tax marital deduction except for the disallowance provision of section 2523(i)(1). Accordingly, $100,000 of the $130,000 gift is excluded from the total amount of gifts made during the calendar year by *D* for gift tax purposes.

*Example 2. Transfer of survivor benefits.* In 1995, *D,* a United States citizen, retires from employment in the United States and elects to receive a reduced retirement annuity in order to provide *S* with a survivor annuity upon *D's* death. The transfer of rights to *S* in the joint and survivor annuity is a gift by *D* for gift tax purposes. However, under paragraph (b) of this section, the gift qualifies for the gift tax marital deduction even though *S* is not a United States citizen.

*Example 3. Transfer of present interest in trust property.* In 1995, *D,* a resident alien, transfers property valued at $500,000 in trust to *S,* who is also a resident alien. The trust instrument provides that the trust income is payable to *S* at least quarterly and *S* has a testamentary general power to appoint the trust corpus. The transfer to *S* qualifies for the marital deduction under section 2523 but for the provisions of section 2523(i)(1). Because *S* has a life income interest in the trust, *S* has a present interest in a portion of the trust. Accordingly, *D* may exclude the present value of *S*'s income interest (up to $100,000) from *D*'s total 1995 calendar year gifts.

*Example 4. Transfer of present interest in trust property.* The facts are the same as in *Example 3,* except that *S* does not have a testamentary general power to appoint the trust corpus. Instead, *D*'s child, *C,* has a remainder interest in the trust. If *S* were a United States citizen, the transfer would qualify for the gift tax marital deduction if a qualified terminable interest property election was made under section 2523(f)(4). However, because *S* is not a U.S. citizen, *D* may not make a qualified terminable interest property election. Accordingly, the gift does not qualify for the gift tax marital deduction but for the disallowance provision of section 2523(i)(1). The $100,000 annual exclusion under section 2523(i)(2) is not available with respect to *D*'s transfer in trust and *D* may not exclude the present value of *S*'s income interest in excess of $10,000 from *D*'s total 1995 calendar year gifts.

*Example 5. Spouse becomes citizen after transfer. D,* a United States citizen, transfers a residence valued at $350,000 on December 20, 1995, to *D*'s spouse, *S,* a resident alien. On January 31, 1996, *S* becomes a naturalized United States citizen. On *D*'s federal gift tax return for 1995, *D* must include $250,000 as a gift ($350,000 transfer less $100,000 exclusion). Although *S* becomes a citizen in January, 1996, *S* is not a citizen of the United States at the time the transfer is made. Therefore, no

gift tax marital deduction is allowable. However, the transfer does qualify for the $100,000 annual exclusion.

[T.D. 8612, 60 FR 43552, Aug. 22, 1995]

### § 25.2523(i)–2 Treatment of spousal joint tenancy property where one spouse is not a United States citizen.

(a) *In general.* In the case of a joint tenancy with right of survivorship between spouses, or a tenancy by the entirety, where the donee spouse is not a United States citizen, the gift tax treatment of the creation and termination of the tenancy (regardless of whether the donor is a citizen, resident or nonresident not a citizen of the United States at such time), is governed by the principles of sections 2515 and 2515A (as such sections were in effect before their repeal by the Economic Recovery Tax Act of 1981). However, in applying these principles, the donor spouse may not elect to treat the creation of a tenancy in real property as a gift, as provided in section 2515(c) (prior to its repeal by the Economic Recovery Tax Act of 1981, Pub. L. 97–34, 95 Stat. 172).

(b) *Tenancies by the entirety and joint tenancies in real property*—(1) *Creation of the tenancy on or after July 14, 1988.* Under the principles of section 2515 (without regard to section 2515(c)), the creation of a tenancy by the entirety (or joint tenancy) in real property (either by one spouse alone or by both spouses), and any additions to the value of the tenancy in the form of improvements, reductions in indebtedness thereon, or otherwise, is not deemed to be a transfer of property for purposes of the gift tax, regardless of the proportion of the consideration furnished by each spouse, but only if the creation of the tenancy would otherwise be a gift to the donee spouse who is not a citizen of the United States at the time of the gift.

(2) *Termination*—(i) *Tenancies created after December 31, 1954 and before January 1,1982 not subject to an election under section 2515(c), and tenancies created on or after July 14, 1988.* When a tenancy to which this paragraph (b) applies is terminated on or after July 14, 1988, other than by reason of the death of a spouse, then, under the principles of section 2515, a spouse is deemed to have made a gift to the extent that the proportion of the total consideration furnished by the spouse, multiplied by the proceeds of the termination (whether in the form of cash, property, or interests in property), exceeds the value of the proceeds of termination received by the spouse. See section 2523(i), and § 25.2523(i)–1 and § 25.2503–2(f) as to certain of the tax consequences that may result upon termination of the tenancy. This paragraph (b)(2)(i) applies to tenancies created after December 31, 1954, and before January 1, 1982, not subject to an election under section 2515(c), and to tenancies created on or after July 14, 1988.

(ii) *Tenancies created after December 31, 1954 and before January 1, 1982 subject to an election under section 2515(c) and tenancies created after December 31, 1981 and before July 14, 1988.* When a tenancy to which this paragraph (b) applies is terminated on or after July 14, 1988, other than by reason of the death of a spouse, then, under the principles of section 2515, a spouse is deemed to have made a gift to the extent that the proportion of the total consideration furnished by the spouse, multiplied by the proceeds of the termination (whether in the form of cash, property, or interests in property), exceeds the value of the proceeds of termination received by the spouse. See section 2523(i), and §§ 25.2523(i)–1 and 25.2503–2(f) as to certain of the tax consequences that may result upon termination of the tenancy. In the case of tenancies to which this paragraph applies, if the creation of the tenancy was treated as a gift to the noncitizen donee spouse under section 2515(c) (in the case of tenancies created prior to 1982) or section 2511 (in the case of tenancies created after December 31, 1981 and before July 14, 1988), then, upon termination of the tenancy, for purposes of applying the principles of section 2515 and the regulations thereunder, the amount treated as a gift on creation of the tenancy is treated as consideration originally belonging to the noncitizen spouse and never acquired by the noncitizen spouse from the donor spouse. This paragraph (b)(2)(ii) applies to tenancies

created after December 31, 1954, and before January 1, 1982, subject to an election under section 2515(c), and to tenancies created after December 31, 1981, and before July 14, 1988.

(3) *Miscellaneous provisions*—(i) *Tenancy by the entirety*. For purposes of this section, *tenancy by the entirety* includes a joint tenancy between husband and wife with right of survivorship.

(ii) *No election to treat as gift*. The regulations under section 2515 that relate to the election to treat the creation of a tenancy by the entirety as constituting a gift and the consequences of such an election upon termination of the tenancy (§§ 25.2515–2 and 25.2515–4) do not apply for purposes of section 2523(i)(3).

(4) *Examples*. The application of this section may be illustrated by the following examples:

*Example 1*. In 1992, *A*, a United States citizen, furnished $200,000 and *A*'s spouse *B*, a resident alien, furnished $50,000 for the purchase and subsequent improvement of real property held by them as tenants by the entirety. The property is sold in 1998 for $300,000. *A* receives $225,000 and *B* receives $75,000 of the sales proceeds. The termination results in a gift of $15,000 by *A* to *B*, computed as follows:

$$\frac{\$200{,}000\ \text{(consideration furnished by A)}}{\$250{,}000\ \text{(total consideration furnished by both spouses)}} \times \$300{,}000\ \text{(proceeds of termination)} = \$240{,}000\ \text{(Proceeds of termination attributable to } \underline{\text{A}}.\text{)}$$

$240,000 − $225,000 (proceeds received by *A*)=$15,000 gift by *A* to *B*.

*Example 2*. In 1986, *A* purchased real property for $300,000 and took title in the names of *A* and *B*, *A*'s spouse, as joint tenants. Under section 2511 and § 25.2511–1(h)(1) of the regulations, *A* was treated as making a gift of one-half of the value of the property ($150,000) to *B*. In 1995, the real property is sold for $400,000 and *B* receives the entire proceeds of sale. For purposes of determining the amount of the gift on termination of the tenancy under the principles of section 2515 and the regulations thereunder, the amount treated as a gift to *B* on creation of the tenancy under section 2511 is treated as *B*'s contribution towards the purchase of the property. Accordingly, the termination of the tenancy results in a gift of $200,000 from *A* to *B* determined as follows:

$$\frac{\$150{,}000\ \text{(consideration furnished by A)}}{\$300{,}000\ \text{(total consideration deemed furnished by both spouses)}} \times \$400{,}000\ \text{(proceeds of termination)} = \$200{,}000\ \text{(Proceeds of termination attributable to } \underline{\text{A}}.\text{)}$$

$200,000 − 0 (proceeds received by *A*)=$200,000 gift by *A* to *B*.

(c) *Tenancies by the entirety in personal property where one spouse is not a United States citizen*—(1) *In general*. In the case of the creation (either by one spouse alone or by both spouses where at least one of the spouses is not a United States citizen) of a joint interest in personal property with right of survivorship, or additions to the value thereof in the form of improvements, reductions in the indebtedness thereof, or otherwise, the retained interest of each spouse, solely for purposes of determining whether there has been a gift by the donor to the spouse who is not a citizen of the United States at the time of the gift, is treated as one-half of the value of the joint interest. See section 2523(i) and §§ 25.2523(i)–1 and 25.2503–2(f) as to certain of the tax consequences that may result upon creation and termination of the tenancy.

(2) *Exception*. The rule provided in paragraph (c)(1) of this section does not

apply with respect to any joint interest in property if the fair market value of the interest in property (determined as if each spouse had a right to sever) cannot reasonably be ascertained except by reference to the life expectancy of one or both spouses. In these cases, actuarial principles may need to be resorted to in determining the gift tax consequences of the transaction.

[T.D. 8612, 60 FR 43553, Aug. 22, 1995]

### § 25.2523(i)–3 Effective date.

The provisions of §§ 25.2523(i)–1 and 25.2523(i)–2 are effective in the case of gifts made after August 22, 1995.

[T.D. 8612, 60 FR 43554, Aug. 22, 1995]

### § 25.2524–1 Extent of deductions.

Under the provisions of section 2524, the charitable deduction provided for in section 2522 and the marital deduction provided for in section 2523 are allowable only to the extent that the gifts, with respect to which those deductions are authorized, are included in the ''total amount of gifts'' made during the ''calendar period'' (as defined in § 25.2502–1(c)(1)), computed as provided in section 2503 and § 25.2503–1 (i.e., the total gifts less exclusions). The following examples (in both of which it is assumed that the donor has previously utilized his entire $30,000 specific exemption provided by section 2521, which was in effect at the time) illustrate the application of the provisions of this section:

*Example (1).* A donor made transfers by gift to his spouse of $5,000 cash on January 1, 1971, and $1,000 cash on April 5, 1971. The donor made no other transfers during 1971. The first $3,000 of such gifts for the calendar year is excluded under the provisions of section 2503(b) in determining the ''total amount of gifts'' made during the first calendar quarter of 1971. The marital deduction for the first calendar quarter of $2,500 (one-half of $5,000) otherwise allowable is limited by section 2524 to $2,000. The amount of taxable gifts is zero ($5,000 − $3,000 (annual exclusion) —$2,000 (marital deduction)). For the second calendar quarter of 1971, the marital deduction is $500 (one-half of $1,000); the amount excluded under section 2503(b) is zero because the entire $3,000 annual exclusion was applied against the gift in the first calendar quarter of 1971; and the amount of taxable gifts is $500 ($1,000 − $500 (marital deduction)).

*Example (2).* The only gifts made by a donor to his spouse during calendar year 1969 were a gift of $2,400 in May and a gift of $3,000 in August. The first $3,000 of such gifts is excluded under the provisions of section 2503(b) in determining the ''total amount of gifts'' made during the calendar year. The marital deduction for 1969 of $2,700 (one-half of $2,400 plus one-half $3,000) otherwise allowable is limited by section 2524 to $2,400. The amount of taxable gifts is zero ($5,400 − $3,000 (annual exclusion) − $2,400 (marital deduction)).

[T.D. 7238, 37 FR 28734, Dec. 29, 1972, as amended by T.D. 7910, 48 FR 40375, Sept. 7, 1983]

## DEDUCTIONS PRIOR TO 1982

### § 25.2523(f)–1A Special rule applicable to community property transferred prior to January 1, 1982.

(a) *In general.* With respect to gifts made prior to January 1, 1982, the marital deduction is allowable with respect to any transfer by a donor to the donor's spouse only to the extent that the transfer is shown to represent a gift of property that was not, at the time of the gift, held as *community property,* as defined in paragraph (b) of this section. The burden of establishing the extent to which a transfer represents a gift of property not so held rests upon the donor.

(b) *Definition of ''community property.''* (1) For the purpose of paragraph (a) of this section, the term ''community property'' is considered to include—

(i) Any property held by the donor and his spouse as community property under the law of any State, Territory, or possession of the United States, or of any foreign country, except property in which the donee spouse had at the time of the gift merely an expectant interest. The donee spouse is regarded as having, at any particular time, merely an expectant interest in property held at that time by the donor and herself as community property under the law of any State, Territory, or possession of the United States, or of any foreign country, if, in case such property were transferred by gift into the separate property of the donee spouse, the entire value of such property (and not merely one-half of it), would be treated as the amount of the gift.

(ii) Separate property acquired by the donor as a result of a ''conversion'', after December 31, 1941, of property

held by him and the donee spouse as community property under the law of any State, Territory, or possession of the United States, or of any foreign country (except such property in which the donee spouse had at the time of the ''conversion'' merely an expectant interest), into their separate property, subject to the limitation with respect to value contained in subparagraph (5) of this paragraph.

(iii) Property acquired by the donor in exchange (by one exchange or a series of exchanges) for separate property resulting from such ''conversion.''

(2) The characteristics of property which acquired a noncommunity instead of a community status by reason of an agreement (whether antenuptial or post-nuptial) are such that section 2523(f) classifies the property as community property of the donor and his spouse in the computation of the marital deduction. In distinguishing property which thus acquired a noncommunity status from property which acquired such a status solely by operation of the community property law, section 2523(f) refers to the former category of property as ''separate property'' acquired as a result of a ''conversion'' of ''property held as such community property.'' As used in section 2523(f) the phrase ''property held as such community property'' is used to denote the body of property comprehended within the community property system; the expression ''separate property'' includes any noncommunity property, whether held in joint tenancy, tenancy by the entirety, tenancy in common, or otherwise; and the term ''conversion'' includes any transaction or agreement which transforms property from a community status into a noncommunity status.

(3) The separate property which section 2523(f) classifies as community property is not limited to that which was in existence at the time of the conversion. The following are illustrative of the scope of section 2523(f):

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

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

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

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

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

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

*Example.* During 1942 the donor and his spouse partitioned certain real property held by them under community property laws. The real property then had a value of $224,000. A portion of the property, then having a value of $160,000, was converted into the

donor's separate property, and the remaining portion, then having a value of $64,000, was converted into his spouse's separate property. In 1955 the donor made a gift to his spouse of the property acquired by him as a result of the partition, which property then had a value of $200,000. The portion of the property transferred by gift which is considered as community property is

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

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

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

SPECIAL VALUATION RULES

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

## § 25.2701–1 Special valuation rules in the case of transfers of certain interests in corporations and partnerships.

(a) *In general*—(1) *Scope of section 2701.* Section 2701 provides special valuation rules to determine the amount of the gift when an individual transfers an equity interest in a corporation or partnership to a member of the individual's family. For section 2701 to apply, the transferor or an applicable family member (as defined in paragraph (d)(2) of this section) must, immediately after the transfer, hold an applicable retained interest (a type of equity interest defined in § 25.2701–2(b)(1)). If certain subsequent payments with respect to the applicable retained interest do not conform to the assumptions used in valuing the interest at the time of the initial transfer, § 25.2701–4 provides a special rule to increase the individual's later taxable gifts or taxable estate. Section 25.2701–5 provides an adjustment to mitigate the effects of double taxation when an applicable retained interest is subsequently transferred.

(2) *Effect of section 2701.* If section 2701 applies to a transfer, the amount of the transferor's gift, if any, is determined using a subtraction method of valuation (described in § 25.2701–3). Under this method, the amount of the gift is determined by subtracting the value of any family-held applicable retained interests and other non-transferred equity interests from the aggregate value of family-held interests in the corporation or partnership (the ''entity''). Generally, in determining the value of any applicable retained interest held by the transferor or an applicable family member—

(i) Any put, call, or conversion right, any right to compel liquidation, or any similar right is valued at zero if the right is an ''extraordinary payment right'' (as defined in § 25.2701–2(b)(2));

(ii) Any distribution right in a controlled entity (*e.g.*, a right to receive dividends) is valued at zero unless the right is a ''qualified payment right'' (as defined in § 25.2701–2(b)(6)); and

(iii) Any other right (including a qualified payment right) is valued as if any right valued at zero did not exist but otherwise without regard to section 2701.

(3) *Example.* The following example illustrates rules of this paragraph (a).

*Example.* A, an individual, holds all the outstanding stock of S Corporation. A exchanges A's shares in S for 100 shares of 10-percent cumulative preferred stock and 100 shares of voting common stock. A transfers the common stock to A's child. Section 2701 applies to the transfer because A has transferred an equity interest (the common stock) to a member of A's family, and immediately thereafter holds an applicable retained interest (the preferred stock). A's preferred stock is valued under the rules of section 2701. A's gift is determined under the subtraction method by subtracting the value of A's preferred stock from the value of A's interest in S immediately prior to the transfer.

(b) *Transfers and other triggering events*—(1) *Completed transfers.* Section 2701 applies to determine the existence and amount of any gift, whether or not the transfer would otherwise be a taxable gift under chapter 12 of the Internal Revenue Code. For example, section 2701 applies to a transfer that would not otherwise be a gift under chapter 12 because it was a transfer for full and adequate consideration.

(2) *Transactions treated as transfers*—(i) *In general.* Except as provided in

paragraph (b)(3) of this section, for purposes of section 2701, transfer includes the following transactions:

(A) A contribution to the capital of a new or existing entity;

(B) A redemption, recapitalization, or other change in the capital structure of an entity (a ''capital structure transaction''), if—

(*1*) The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction;

(*2*) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest that is junior to the applicable retained interest (a ''subordinate interest'') and receives property other than an applicable retained interest; or

(*3*) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity (other than a subordinate interest) and the fair market value of the applicable retained interest is increased; or

(C) The termination of an indirect holding in an entity (as defined in § 25.2701–6) (or a contribution to capital by an entity to the extent an individual indirectly holds an interest in the entity), if—

(*1*) The property is held in a trust as to which the indirect holder is treated as the owner under subchapter J of chapter 1 of the Internal Revenue Code; or

(*2*) If the termination (or contribution) is not treated as a transfer under paragraph (b)(2)(i)(C)(*1*) of this section, to the extent the value of the indirectly-held interest would have been included in the value of the indirect holder's gross estate for Federal estate tax purposes if the indirect holder died immediately prior to the termination.

(ii) *Multiple attribution.* For purposes of paragraph (b)(2)(i)(C) of this section, if the transfer of an indirect holding in property is treated as a transfer with respect to more than one indirect holder, the transfer is attributed in the following order:

(A) First, to the indirect holder(s) who transferred the interest to the entity (without regard to section 2513);

(B) Second, to the indirect holder(s) possessing a presently exercisable power to designate the person who shall possess or enjoy the property;

(C) Third, to the indirect holder(s) presently entitled to receive the income from the interest;

(D) Fourth, to the indirect holder(s) specifically entitled to receive the interest at a future date; and

(E) Last, to any other indirect holder(s) proportionally.

(3) *Excluded transactions.* For purposes of section 2701, a transfer does not include the following transactions:

(i) A capital structure transaction, if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction. For this purpose, common stock with non-lapsing voting rights and nonvoting common stock are interests that are substantially the same;

(ii) A shift of rights occurring upon the execution of a qualified disclaimer described in section 2518; and

(iii) A shift of rights occurring upon the release, exercise, or lapse of a power of appointment other than a general power of appointment described in section 2514, except to the extent the release, exercise, or lapse would otherwise be a transfer under chapter 12.

(c) *Circumstances in which section 2701 does not apply.* To the extent provided, section 2701 does not apply in the following cases:

(1) *Marketable transferred interests.* Section 2701 does not apply if there are readily available market quotations on an established securities market for the value of the transferred interests.

(2) *Marketable retained interests.* Section 25.2701–2 does not apply to any applicable retained interest if there are readily available market quotations on an established securities market for the value of the applicable retained interests.

(3) *Interests of the same class.* Section 2701 does not apply if the retained interest is of the same class of equity as

the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest. A class is the same class as (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability). For purposes of this section, non-lapsing provisions necessary to comply with partnership allocation requirements of the Internal Revenue Code (*e.g.*, section 704(b)) are non-lapsing differences with respect to limitations on liability. A right that lapses by reason of Federal or State law is treated as a non-lapsing right unless the Secretary determines, by regulation or by published revenue ruling, that it is necessary to treat such a right as a lapsing right to accomplish the purposes of section 2701. An interest in a partnership is not an interest in the same class as the transferred interest if the transferor or applicable family members have the right to alter the liability of the transferee.

(4) *Proportionate transfers.* Section 2701 does not apply to a transfer by an individual to a member of the individual's family of equity interests to the extent the transfer by that individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer. Thus, for example, section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P's child in a manner that reduces each interest held by P and any applicable family members, in the aggregate, by 10 percent even if the transfer does not proportionately reduce P's interest in each class. See § 25.2701–6 regarding indirect holding of interests.

(d) *Family definitions*—(1) *Member of the family.* A member of the family is, with respect to any transferor—

(i) The transferor's spouse;

(ii) Any lineal descendant of the transferor or the transferor's spouse; and

(iii) The spouse of any such lineal descendant.

(2) *Applicable family member.* An applicable family member is, with respect to any transferor—

(i) The transferor's spouse;

(ii) Any ancestor of the transferor or the transferor's spouse; and

(iii) The spouse of any such ancestor.

(3) *Relationship by adoption.* For purposes of section 2701, any relationship by legal adoption is the same as a relationship by blood.

(e) *Examples.* The following examples illustrate provisions of this section:

*Example 1.* P, an individual, holds all the outstanding stock of X Corporation. Assume the fair market value of P's interest in X immediately prior to the transfer is $1.5 million. X is recapitalized so that P holds 1,000 shares of $1,000 par value preferred stock bearing an annual cumulative dividend of $100 per share (the aggregate fair market value of which is assumed to be $1 million) and 1,000 shares of voting common stock. P transfers the common stock to P's child. Section 2701 applies to the transfer because P has transferred an equity interest (the common stock) to a member of P's family and immediately thereafter holds an applicable retained interest (the preferred stock). P's right to receive annual cumulative dividends is a qualified payment right and is valued for purposes of section 2701 at its fair market value of $1,000,000. The amount of P's gift, determined using the subtraction method of § 25.2701–3, is $500,000 ($1,500,000 minus $1,000,000).

*Example 2.* The facts are the same as in *Example 1,* except that the preferred dividend right is noncumulative. Under § 25.2701–2, P's preferred dividend right is valued at zero because it is a distribution right in a controlled entity, but is not a qualified payment right. All of P's other rights in the preferred stock are valued as if P's dividend right does not exist but otherwise without regard to section 2701. The amount of P's gift, determined using the subtraction method, is $1,500,000 ($1,500,000 minus $0). P may elect, however, to treat the dividend right as a qualified payment right as provided in § 25.2701–2(c)(2).

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

### § 25.2701–2 Special valuation rules for applicable retained interests.

(a) *In general.* In determining the amount of a gift under § 25.2701–3, the value of any applicable retained interest (as defined in paragraph (b)(1) of

this section) held by the transferor or by an applicable family member is determined using the rules of chapter 12, with the modifications prescribed by this section. See § 25.2701–6 regarding the indirect holding of interests.

(1) *Valuing an extraordinary payment right.* Any extraordinary payment right (as defined in paragraph (b)(2) of this section) is valued at zero.

(2) *Valuing a distribution right.* Any distribution right (as defined in paragraph (b)(3) of this section) in a controlled entity is valued at zero, unless it is a qualified payment right (as defined in paragraph (b)(6) of this section). Controlled entity is defined in paragraph (b)(5) of this section.

(3) *Special rule for valuing a qualified payment right held in conjunction with an extraordinary payment right.* If an applicable retained interest confers a qualified payment right and one or more extraordinary payment rights, the value of all these rights is determined by assuming that each extraordinary payment right is exercised in a manner that results in the lowest total value being determined for all the rights, using a consistent set of assumptions and giving due regard to the entity's net worth, prospective earning power, and other relevant factors (the ''lower of'' valuation rule). See §§ 20.2031–2(f) and 20.2031–3 for rules relating to the valuation of business interests generally.

(4) *Valuing other rights.* Any other right (including a qualified payment right not subject to the prior paragraph) is valued as if any right valued at zero does not exist and as if any right valued under the lower of rule is exercised in a manner consistent with the assumptions of that rule but otherwise without regard to section 2701. Thus, if an applicable retained interest carries no rights that are valued at zero or under the lower of rule, the value of the interest for purposes of section 2701 is its fair market value.

(5) *Example.* The following example illustrates rules of this paragraph (a).

*Example.* P, an individual, holds all 1,000 shares of X Corporation's $1,000 par value preferred stock bearing an annual cumulative dividend of $100 per share and holds all 1,000 shares of X's voting common stock. P has the right to put all the preferred stock to X at any time for $900,000. P transfers the common stock to P's child and immediately thereafter holds the preferred stock. Assume that at the time of the transfer, the fair market value of X is $1,500,000, and the fair market value of P's annual cumulative dividend right is $1,000,000. Because the preferred stock confers both an extraordinary payment right (the put right) and a qualified payment right (*i.e.*, the right to receive cumulative dividends), the lower of rule applies and the value of these rights is determined as if the put right will be exercised in a manner that results in the lowest total value being determined for the rights (in this case, by assuming that the put will be exercised immediately). The value of P's preferred stock is $900,000 (the lower of $1,000,000 or $900,000). The amount of the gift is $600,000 ($1,500,000 minus $900,000).

(b) *Definitions*—(1) *Applicable retained interest.* An applicable retained interest is any equity interest in a corporation or partnership with respect to which there is either—

(i) An extraordinary payment right (as defined in paragraph (b)(2) of this section), or

(ii) In the case of a controlled entity (as defined in paragraph (b)(5) of this section), a distribution right (as defined in paragraph (b)(3) of this section).

(2) *Extraordinary payment right.* Except as provided in paragraph (b)(4) of this section, an extraordinary payment right is any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest. A call right includes any warrant, option, or other right to acquire one or more equity interests.

(3) *Distribution right.* A distribution right is the right to receive distributions with respect to an equity interest. A distribution right does not include—

(i) Any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest;

(ii) Any extraordinary payment right; or

(iii) Any right described in paragraph (b)(4) of this section.

(4) *Rights that are not extraordinary payment rights or distribution rights.* Mandatory payment rights, liquidation

participation rights, rights to guaranteed payments of a fixed amount under section 707(c), and non-lapsing conversion rights are neither extraordinary payment rights nor distribution rights.

(i) *Mandatory payment right.* A mandatory payment right is a right to receive a payment required to be made at a specific time for a specific amount. For example, a mandatory redemption right in preferred stock requiring that the stock be redeemed at its fixed par value on a date certain is a mandatory payment right and therefore not an extraordinary payment right or a distribution right. A right to receive a specific amount on the death of the holder is a mandatory payment right.

(ii) *Liquidation participation rights.* A liquidation participation right is a right to participate in a liquidating distribution. If the transferor, members of the transferor's family, or applicable family members have the ability to compel liquidation, the liquidation participation right is valued as if the ability to compel liquidation—

(A) Did not exist, or

(B) If the lower of rule applies, is exercised in a manner that is consistent with that rule.

(iii) *Right to a guaranteed payment of a fixed amount under section 707(c).* The right to a guaranteed payment of a fixed amount under section 707(c) is the right to a guaranteed payment (within the meaning of section 707(c)) the amount of which is determined at a fixed rate (including a rate that bears a fixed relationship to a specified market interest rate). A payment that is contingent as to time or amount is not a guaranteed payment of a fixed amount.

(iv) *Non-lapsing conversion right*—(A) *Corporations.* A non-lapsing conversion right, in the case of a corporation, is a non-lapsing right to convert an equity interest in a corporation into a fixed number or a fixed percentage of shares of the same class as the transferred interest (or into an interest that would be of the same class but for non-lapsing differences in voting rights), that is subject to proportionate adjustments for changes in the equity ownership of the corporation and to adjustments similar to those provided in section 2701(d) for unpaid payments.

(B) *Partnerships.* A non-lapsing conversion right, in the case of a partnership, is a non-lapsing right to convert an equity interest in a partnership into a specified interest (other than an interest represented by a fixed dollar amount) of the same class as the transferred interest (or into an interest that would be of the same class but for non-lapsing differences in management rights or limitations on liability) that is subject to proportionate adjustments for changes in the equity ownership of the partnership and to adjustments similar to those provided in section 2701(d) for unpaid payments.

(C) *Proportionate adjustments in equity ownership.* For purposes of this paragraph (b)(4), an equity interest is subject to proportionate adjustments for changes in equity ownership if, in the case of a corporation, proportionate adjustments are required to be made for splits, combinations, reclassifications, and similar changes in capital stock, or, in the case of a partnership, the equity interest is protected from dilution resulting from changes in the partnership structure.

(D) *Adjustments for unpaid payments.* For purposes of this paragraph (b)(4), an equity interest is subject to adjustments similar to those provided in section 2701(d) if it provides for—

(*1*) Cumulative payments;

(*2*) Compounding of any unpaid payments at the rate specified in § 25.2701–4(c)(2); and

(*3*) Adjustment of the number or percentage of shares or the size of the interest into which it is convertible to take account of accumulated but unpaid payments.

(5) *Controlled entity*—(i) *In general.* For purposes of section 2701, a controlled entity is a corporation or partnership controlled, immediately before a transfer, by the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse. See § 25.2701–6 regarding indirect holding of interests.

(ii) *Corporations*—(A) *In general.* In the case of a corporation, control means the holding of at least 50 percent of the total voting power or total fair market value of the equity interests in the corporation.

(B) *Voting rights.* Equity interests that carry no right to vote other than on liquidation, merger, or a similar event are not considered to have voting rights for purposes of this paragraph (b)(5)(ii). Generally, a voting right is considered held by an individual to the extent that the individual, either alone or in conjunction with any other person, is entitled to exercise (or direct the exercise of) the right. However, if an equity interest carrying voting rights is held in a fiduciary capacity, the voting rights are not considered held by the fiduciary, but instead are considered held by each beneficial owner of the interest and by each individual who is a permissible recipient of the income from the interest. A voting right does not include a right to vote that is subject to a contingency that has not occurred, other than a contingency that is within the control of the individual holding the right.

(iii) *Partnerships.* In the case of any partnership, control means the holding of at least 50 percent of either the capital interest or the profits interest in the partnership. Any right to a guaranteed payment under section 707(c) of a fixed amount is disregarded in making this determination. In addition, in the case of a limited partnership, control means the holding of any equity interest as a general partner. See § 25.2701–2(b)(4)(iii) for the definition of a right to a guaranteed payment of a fixed amount under section 707(c).

(6) *Qualified payment right*—(i) *In general.* A qualified payment right is a right to receive qualified payments. A qualified payment is a distribution that is—

(A) A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate;

(B) Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount; or

(C) Any distribution right for which an election has been made pursuant to paragraph (c)(2) of this section.

(ii) *Fixed rate.* For purposes of this section, a payment rate that bears a fixed relationship to a specified market interest rate is a payment determined at a fixed rate.

(c) *Qualified payment elections*—(1) *Election to treat a qualified payment right as other than a qualified payment right.* Any transferor holding a qualified payment right may elect to treat all rights held by the transferor of the same class as rights that are not qualified payment rights. An election may be a partial election, in which case the election must be exercised with respect to a consistent portion of each payment right in the class as to which the election has been made.

(2) *Election to treat other distribution rights as qualified payment rights.* Any individual may elect to treat a distribution right held by that individual in a controlled entity as a qualified payment right. An election may be a partial election, in which case the election must be exercised with respect to a consistent portion of each payment right in the class as to which the election has been made. An election under this paragraph (c)(2) will not cause the value of the applicable retained interest conferring the distribution right to exceed the fair market value of the applicable retained interest (determined without regard to section 2701). The election is effective only to the extent—

(i) Specified in the election, and

(ii) That the payments elected are permissible under the legal instrument giving rise to the right and are consistent with the legal right of the entity to make the payment.

(3) *Elections irrevocable.* Any election under paragraph (c)(1) or (c)(2) of this section is revocable only with the consent of the Commissioner.

(4) *Treatment of certain payments to applicable family members.* Any payment right described in paragraph (b)(6) of this section held by an applicable family member is treated as a payment right that is not a qualified payment right unless the applicable family member elects (pursuant to paragraph (c)(2) of this section) to treat the payment right as a qualified payment right. An election may be a partial election, in which case the election must be exercised with respect to a consistent portion of each payment

right in the class as to which the election has been made.

(5) *Time and manner of elections.* Any election under paragraph (c)(1) or (c)(2) of this section is made by attaching a statement to the Form 709, Federal Gift Tax Return, filed by the transferor on which the transfer is reported. An election filed after the time of the filing of the Form 709 reporting the transfer is not a valid election. An election filed as of April 6, 1992, for transfers made prior to its publication is effective. The statement must—

(i) Set forth the name, address, and taxpayer identification number of the electing individual and of the transferor, if different;

(ii) If the electing individual is not the transferor filing the return, state the relationship between the individual and the transferor;

(iii) Specifically identify the transfer disclosed on the return to which the election applies;

(iv) Describe in detail the distribution right to which the election applies;

(v) State the provision of the regulation under which the election is being made; and

(vi) If the election is being made under paragraph (c)(2) of this section—

(A) State the amounts that the election assumes will be paid, and the times that the election assumes the payments will be made;

(B) Contain a statement, signed by the electing individual, in which the electing individual agrees that—

(*1*) If payments are not made as provided in the election, the individual's subsequent taxable gifts or taxable estate will, upon the occurrence of a taxable event (as defined in § 25.2701–4(b)), be increased by an amount determined under § 25.2701–4(c), and

(*2*) The individual will be personally liable for any increase in tax attributable thereto.

(d) *Examples.* The following examples illustrate provisions of this section:

*Example 1.* On March 30, 1991, P transfers non-voting common stock of X Corporation to P's child, while retaining $100 par value voting preferred stock bearing a cumulative annual dividend of $10. Immediately before the transfer, P held 100 percent of the stock. Because X is a controlled entity (within the meaning of paragraph (b)(5) of this section), P's dividend right is a distribution right that is subject to section 2701. See § 25.2701–2(b)(3). Because the distribution right is an annual cumulative dividend, it is a qualified payment right. See § 25.2701–2(b)(6).

*Example 2.* The facts are the same as in *Example 1,* except that the dividend right is non-cumulative. P's dividend right is a distribution right in a controlled entity, but is not a qualified payment right because the dividend is non-cumulative. Therefore, the non-cumulative dividend right is valued at zero under § 25.2701–2(a)(2). If the corporation were not a controlled entity, P's dividend right would be valued without regard to section 2701.

*Example 3.* The facts are the same as in *Example 1.* Because P holds sufficient voting power to compel liquidation of X, P's right to participate in liquidation is an extraordinary payment right under paragraph (b)(2) of this section. Because P holds an extraordinary payment right in conjunction with a qualified payment right (the right to receive cumulative dividends), the lower of rule applies.

*Example 4.* The facts are the same as in *Example 1,* except that immediately before the transfer, P, applicable family members of P, and members of P's family, hold 60 percent of the voting rights in X. Assume that 80 percent of the vote is required to compel liquidation of any interest in X. P's right to participate in liquidation is not an extraordinary payment right under paragraph (b)(2) of this section, because P and P's family cannot compel liquidation of X. P's preferred stock is an applicable retained interest that carries no rights that are valued under the special valuation rules of section 2701. Thus, in applying the valuation method of § 25.2701–3, the value of P's preferred stock is its fair market value determined without regard to section 2701.

*Example 5.* L holds 10-percent non-cumulative preferred stock and common stock in a corporation that is a controlled entity. L transfers the common stock to L's child. L holds no extraordinary payment rights with respect to the preferred stock. L elects under paragraph (c)(2) of this section to treat the noncumulative dividend right as a qualified payment right consisting of the right to receive a cumulative annual dividend of 5 percent. Under § 25.2701–2(c)(2), the value of the distribution right pursuant to the election is the lesser of—

(A) The fair market value of the right to receive a cumulative 5-percent dividend from the corporation, giving due regard to the corporation's net worth, prospective earning power, and dividend-paying capacity; or

(B) The value of the distribution right determined without regard to section 2701 and

without regard to the terms of the qualified payment election.

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

### § 25.2701–3 Determination of amount of gift.

(a) *Overview*—(1) *In general.* The amount of the gift resulting from any transfer to which section 2701 applies is determined by a subtraction method of valuation. Under this method, the amount of the transfer is determined by subtracting the values of all family-held senior equity interests from the fair market value of all family-held interests in the entity determined immediately before the transfer. The values of the senior equity interests held by the transferor and applicable family members generally are determined under section 2701. Other family-held senior equity interests are valued at their fair market value. The balance is then appropriately allocated among the transferred interests and other family-held subordinate equity interests. Finally, certain discounts and other appropriate reductions are provided, but only to the extent permitted by this section.

(2) *Definitions.* The following definitions apply for purposes of this section.

(i) *Family-held.* Family-held means held (directly or indirectly) by an individual described in § 25.2701–2(b)(5)(i).

(ii) *Senior equity interest.* Senior equity interest means an equity interest in the entity that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest.

(iii) *Subordinate equity interest.* Subordinate equity interest means an equity interest in the entity as to which an applicable retained interest is a senior equity interest.

(b) *Valuation methodology.* The following methodology is used to determine the amount of the gift when section 2701 applies.

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

(ii) *Special rule for contributions to capital.* In the case of a contribution to capital, determine the fair market value of the contribution.

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

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

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

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

(2) *Step 2—Subtract the value of senior equity interests.* From the value determined in Step 1, subtract the following amounts:

(i) An amount equal to the fair market value of all family-held senior equity interests, other than applicable retained interests held by the transferor or applicable family members. The fair market value of an interest is

its pro rata share of the fair market value of all family-held senior equity interests of the same class (determined as if all family-held senior equity interests were held by one individual); and

(ii) The value of all applicable retained interests held by the transferor or applicable family members determined under § 25.2701–2, taking into account the adjustment described in paragraph (b)(5) of this section.

(3) *Step 3—Allocate the remaining value among the transferred interests and other family-held subordinate equity interests.* The value remaining after Step 2 is allocated among the transferred interests and other subordinate equity interests held by the transferor, applicable family members, and members of the transferor's family. If more than one class of family-held subordinate equity interest exists, the value remaining after Step 2 is allocated, beginning with the most senior class of subordinate equity interest, in the manner that would most fairly approximate their value if all rights valued under section 2701 at zero did not exist (or would be exercised in a manner consistent with the assumptions of the rule of § 25.2702–2(a)(4), if applicable). If there is no clearly appropriate method of allocating the remaining value pursuant to the preceding sentence, the remaining value (or the portion remaining after any partial allocation pursuant to the preceding sentence) is allocated to the interests in proportion to their fair market values determined without regard to section 2701.

(4) *Step 4—Determine the amount of the gift*—(i) *In general.* The amount allocated to the transferred interests in Step 3 is reduced by the amounts determined under this paragraph (b)(4).

(ii) *Reduction for minority or similar discounts.* Except as provided in § 25.2701–3(c), if the value of the transferred interest (determined without regard to section 2701) would be determined after application of a minority or similar discount with respect to the transferred interest, the amount of the gift determined under section 2701 is reduced by the excess, if any, of—

(A) A pro rata portion of the fair market value of the family-held interests of the same class (determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701), over

(B) The value of the transferred interest (without regard to section 2701).

(iii) *Adjustment for transfers with a retained interest.* If the value of the transferor's gift (determined without regard to section 2701) would be reduced under section 2702 to reflect the value of a retained interest, the value determined under section 2701 is reduced by the same amount.

(iv) *Reduction for consideration.* The amount of the transfer (determined under section 2701) is reduced by the amount of consideration in money or money's worth received by the transferor, but not in excess of the amount of the gift (determined without regard to section 2701). The value of consideration received by the transferor in the form of an applicable retained interest in the entity is determined under section 2701 except that, in the case of a contribution to capital, the *Step 4* value of such an interest is zero.

(5) *Adjustment in Step 2*—(i) *In general.* For purposes of paragraph (b)(2) of this section, if the percentage of any class of applicable retained interest held by the transferor and by applicable family members (including any interest received as consideration for the transfer) exceeds the family interest percentage, the excess is treated as a family-held interest that is not held by the transferor or an applicable family member.

(ii) *Family interest percentage.* The family interest percentage is the highest ownership percentage (determined on the basis of relative fair market values) of family-held interests in—

(A) Any class of subordinate equity interest; or

(B) All subordinate equity interests, valued in the aggregate.

(c) *Minimum value rule*—(1) *In general.* If section 2701 applies to the transfer of an interest in an entity, the value of a junior equity interest is not less than its pro-rata portion of 10 percent of the sum of—

(i) The total value of all equity interests in the entity, and

(ii) The total amount of any indebtedness of the entity owed to the transferor and applicable family members.

(2) *Junior equity interest.* For purposes of paragraph (c)(1) of this section, junior equity interest means common stock or, in the case of a partnership, any partnership interest under which the rights to income and capital are junior to the rights of all other classes of partnership interests. Common stock means the class or classes of stock that, under the facts and circumstances, are entitled to share in the reasonably anticipated residual growth in the entity.

(3) *Indebtedness*—(i) *In general.* For purposes of paragraph (c)(1) of this section, indebtedness owed to the transferor (or an applicable family member) does not include—

(A) Short-term indebtedness incurred with respect to the current conduct of the entity's trade or business (such as amounts payable for current services);

(B) Indebtedness owed to a third party solely because it is guaranteed by the transferor or an applicable family member; or

(C) Amounts permanently set aside in a qualified deferred compensation arrangement, to the extent the amounts are unavailable for use by the entity.

(ii) *Leases.* A lease of property is not indebtedness, without regard to the length of the lease term, if the lease payments represent full and adequate consideration for use of the property. Lease payments are considered full and adequate consideration if a good faith effort is made to determine the fair rental value under the lease and the terms of the lease conform to the value so determined. Arrearages with respect to a lease are indebtedness.

(d) *Examples.* The application of the subtraction method described in this section is illustrated by the following Examples:

*Example 1.* Corporation X has outstanding 1,000 shares of $1,000 par value voting preferred stock, each share of which carries a cumulative annual dividend of 8 percent and a right to put the stock to X for its par value at any time. In addition, there are outstanding 1,000 shares of non-voting common stock. A holds 600 shares of the preferred stock and 750 shares of the common stock. The balance of the preferred and common stock is held by B, a person unrelated to A. Because the preferred stock confers both a qualified payment right and an extraordinary payment right, A's rights are valued under the ''lower of'' rule of § 25.2701–2(a)(3). Assume that A's rights in the preferred stock are valued at $800 per share under the ''lower of'' rule (taking account of A's voting rights). A transfers all of A's common stock to A's child. The method for determining the amount of A's gift is as follows—

Step l: Assume the fair market value of all the family-held interests in X, taking account of A's control of the corporation, is determined to be $1 million.

Step 2: From the amount determined under Step l, subtract $480,000 (600 shares × $800 (the section 2701 value of A's preferred stock, computed under the ''lower of'' rule of § 25.2701–2(a)(3))).

Step 3: The result of Step 2 is a balance of $520,000. This amount is fully allocated to the 750 shares of family-held common stock.

3Step 4: Because no consideration was furnished for the transfer, the adjustment under *Step 4* is limited to the amount of any appropriate minority or similar discount. Before the application of *Step 4* the amount of A's gift is $520,000.

*Example 2.* The facts are the same as in *Example 1,* except that prior to the transfer A holds only 50 percent of the common stock and B holds the remaining 50 percent. Assume that the fair market value of A's 600 shares of preferred stock is $600,000.

Step 1: Assume that the result of this step (determining the value of the family-held interest) is $980,000.

Step 2: From the amount determined under Step 1, subtract $500,000 ($400,000, the value of 500 shares of A's preferred stock determined without regard to section 2701 pursuant to the valuation adjustment determined under paragraph (b)(5) of this section). The adjustment in step 2 applies in this example because A's percentage ownership of the preferred stock (60 percent) exceeds the family interest percentage of the common stock (50 percent). Therefore, 100 shares of A's preferred stock are valued at fair market value, or $100,000 (100 × $1,000). The balance of A's preferred stock is valued under section 2701 at $400,000 (500 shares × $800). The value of A's preferred stock for purposes of section 2701 equals $500,000 ($100,000 plus $400,000).

Step 3: The result of Step 2 is $480,000 ($980,000 minus $500,000) which is allocated to the family-held common stock. Because A transferred all of the family-held subordinate equity interests, all of the value determined under Step 2 is allocated to the transferred shares. Step 4: The adjustment under *Step 4* is the same as in *Example 1.*Thus, the amount of the gift is $480,000.

*Example 3.* Corporation X has outstanding 1,000 shares of $1,000 par value non-voting preferred stock, each share of which carries

a cumulative annual dividend of 8 percent and a right to put the stock to X for its par value at any time. In addition, there are outstanding 1,000 shares of voting common stock. A holds 600 shares of the preferred stock and 750 shares of the common stock. The balance of the preferred and common stock is held by B, a person unrelated to A. Assume further that steps one through three, as in *Example 1,* result in $520,000 being allocated to the family-held common stock and that A transfers only 75 shares of A's common stock. The transfer fragments A's voting interest. Under Step 4, an adjustment is appropriate to reflect the fragmentation of A's voting rights. The amount of the adjustment is the difference between 10 percent (75/750) of the fair market value of A's common shares and the fair market value of the transferred shares, each determined as if the holder thereof had no other interest in the corporation.

*Example 4.* On December 31, 1990, the capital structure of Y corporation consists of 1,000 shares of voting common stock held three-fourths by A and one-fourth by A's child, B. On January 15, 1991, A transfers 250 shares of common stock to Y in exchange for 300 shares of nonvoting, noncumulative 8% preferred stock with a section 2701 value of zero. Assume that the fair market value of Y is $1,000,000 at the time of the exchange and that the exchange by A is for full and adequate consideration in moneys' worth. However, for purposes of section 2701, if a subordinate equity interest is transferred in exchange for an applicable retained interest, consideration in the exchange is determined with reference to the section 2701 value of the senior interest. Thus, A is treated as transferring the common stock to the corporation for no consideration. Immediately after the transfer, B is treated as holding one-third (250/750) of the common stock and A is treated as holding two-thirds (500/750). The amount of the gift is determined as follows:

Step 1. Because Y is held exclusively by A and B, the Step 1 value is $1,000,000.

Step 2. The result of Step 2 is $1,000,000 ($1,000,000 − 0).

Step 3. The amount allocated to the transferred common stock is $250,000 (250/1,000 × $1,000,000). That amount is further allocated in proportion to the respective holdings of A and B in the common stock ($166,667 and $83,333, respectively).

Step 4. There is no Step 4 adjustment because the section 2701 value of the consideration received by A was zero and no minority discount would have been involved in the exchange. Thus, the amount of the gift is $83,333. If the section 2701 value of the applicable retained interested were $100,000, the *Step 4* adjustment would have been a $33,333 reduction for consideration received ((250/750) x $100,000).

*Example 5.* The facts are the same as in *Example 4,* except that on January 6, 1992, when the fair market value of Y is still $1,000,000, A transfers A's remaining 500 shares of common stock to Y in exchange for 2500 shares of preferred stock. The second transfer is also for full and adequate consideration in money or money's worth. The result of Step 2 is the same—$1,000,000.

Step 3. The amount allocated to the transferred common stock is $666,667 (500/750 × $1,000,000). Since A holds no common stock immediately after the transfer, A is treated as transferring the entire interest to the other shareholder (B). Thus, $666,667 is fully allocated to the shares held by B.

Step 4. There is no Step 4 adjustment because the section 2701 value of the consideration received by A was zero and no minority discount would have been involved in the exchange. Thus, the amount of the gift is $666,667.

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

## § 25.2701–4 Accumulated qualified payments.

(a) *In general.* If a taxable event occurs with respect to any applicable retained interest conferring a distribution right that was previously valued as a qualified payment right (a ''qualified payment interest''), the taxable estate or taxable gifts of the individual holding the interest are increased by the amount determined under paragraph (c) of this section.

(b) *Taxable event*—(1) *In general.* Except as otherwise provided in this section, taxable event means the transfer of a qualified payment interest, either during life or at death, by the individual in whose hands the interest was originally valued under section 2701 (the ''interest holder'') or by any individual treated pursuant to paragraph (b)(3) of this section in the same manner as the interest holder. Except as provided in paragraph (a)(2) of this section, any termination of an individual's rights with respect to a qualified payment interest is a taxable event. Thus, for example, if an individual is treated as indirectly holding a qualified payment interest held by a trust, a taxable event occurs on the earlier of—

(i) The termination of the individual's interest in the trust (whether by death or otherwise), or

(ii) The termination of the trust's interest in the qualified payment interest (whether by disposition or otherwise).

(2) *Exception*. If, at the time of a termination of an individual's rights with respect to a qualified payment interest, the value of the property would be includible in the individual's gross estate for Federal estate tax purposes if the individual died immediately after the termination, a taxable transfer does not occur until the earlier of—

(i) The time the property would no longer be includible in the individual's gross estate (other than by reason of section 2035), or

(ii) The death of the individual.

(3) *Individual treated as interest holder*—(i) *In general.* If a taxable event involves the transfer of a qualified payment interest by the interest holder (or an individual treated as the interest holder) to an applicable family member of the individual who made the transfer to which section 2701 applied (other than the spouse of the individual transferring the qualified payment interest), the transferee applicable family member is treated in the same manner as the interest holder with respect to late or unpaid qualified payments first due after the taxable event. Thus, for example, if an interest holder transfers during life a qualified payment interest to an applicable family member, that transfer is a taxable event with respect to the interest holder whose taxable gifts are increased for the year of the transfer as provided in paragraph (c) of this section. The transferee is treated thereafter in the same manner as the interest holder with respect to late or unpaid qualified payments first due after the taxable event.

(ii) *Transfers to spouse*—(A) *In general.* If an interest holder (or an individual treated as the interest holder) transfers a qualified payment interest, the transfer is not a taxable event to the extent a marital deduction is allowed with respect to the transfer under sections 2056, 2106(a)(3), or 2523 or, in the case of a transfer during the individual's lifetime, to the extent the spouse furnishes consideration for the transfer. If this exception applies, the transferee spouse is treated as if he or she were the holder of the interest from the date the transferor spouse acquired the interest. If the deduction for a transfer to a spouse is allowable under section 2056(b)(8) or 2523(g) (relating to charitable remainder trusts), the transferee spouse is treated as the holder of the entire interest passing to the trust.

(B) *Marital bequests.* If the selection of property with which a marital bequest is funded is discretionary, a transfer of a qualified payment interest will not be considered a transfer to the surviving spouse unless—

(*1*) The marital bequest is funded with the qualified payment interest before the due date for filing the decedent's Federal estate tax return (including extensions actually granted) (the ''due date''), or

(*2*) The executor—

(*i*) Files a statement with the return indicating the extent to which the marital bequest will be funded with the qualified payment interest, and

(*ii*) Before the date that is one year prior to the expiration of the period of limitations on assessment of the Federal estate tax, notifies the District Director having jurisdiction over the return of the extent to which the bequest was funded with the qualified payment interest (or the extent to which the qualified payment interest has been permanently set aside for that purpose).

(C) *Purchase by the surviving spouse.* For purposes of this section, the purchase (before the date prescribed for filing the decedent's estate tax return, including extensions actually granted) by the surviving spouse (or a trust described in section 2056(b)(7)) of a qualified payment interest held (directly or indirectly) by the decedent immediately before death is considered a transfer with respect to which a deduction is allowable under section 2056 or section 2106(a)(3), but only to the extent that the deduction is allowed to the estate. For example, assume that A bequeaths $50,000 to A's surviving spouse, B, in a manner that qualifies for deduction under section 2056, and that subsequent to A's death B purchases a qualified payment interest from A's estate for $200,000, its fair market value. The economic effect of the transaction is the equivalent of a

bequest by A to B of the qualified payment interest, one-fourth of which qualifies for the marital deduction. Therefore, for purposes of this section, one-fourth of the qualified payment interest purchased by B ($50,000 ÷ $200,000) is considered a transfer of an interest with respect to which a deduction is allowed under 2056. If the purchase by the surviving spouse is not made before the due date of the decedent's return, the purchase of the qualified payment interest will not be considered a bequest for which a marital deduction is allowed unless the executor—

(*1*) Files a statement with the return indicating the qualified payment interests to be purchased by the surviving spouse (or a trust described in section 2056(b)(7)), and

(*2*) Before the date that is one year prior to the expiration of the period of limitations on assessment of the Federal estate tax, notifies the District Director having jurisdiction over the return that the purchase of the qualified payment interest has been made (or that the funds necessary to purchase the qualified payment interest have been permanently set aside for that purpose).

(c) *Amount of increase*—(1) *In general.* Except as limited by paragraph (c)(6) of this section, the amount of the increase to an individual's taxable estate or taxable gifts is the excess, if any, of—

(i) The sum of—

(A) The amount of qualified payments payable during the period beginning on the date of the transfer to which section 2701 applied (or, in the case of an individual treated as the interest holder, on the date the interest of the prior interest holder terminated) and ending on the date of the taxable event; and

(B) The earnings on those payments, determined hypothetically as if each payment were paid on its due date and reinvested as of that date at a yield equal to the appropriate discount rate (as defined below); over

(ii) The sum of—

(A) The amount of the qualified payments actually paid during the same period;

(B) The earnings on those payments, determined hypothetically as if each payment were reinvested as of the date actually paid at a yield equal to the appropriate discount rate; and

(C) To the extent required to prevent double inclusion, by an amount equal to the sum of—

(*1*) The portion of the fair market value of the qualified payment interest solely attributable to any right to receive unpaid qualified payments determined as of the date of the taxable event;

(*2*) The fair market value of any equity interest in the entity received by the individual in lieu of qualified payments and held by the individual at the taxable event, and

(*3*) The amount by which the individual's aggregate taxable gifts were increased by reason of the failure of the individual to enforce the right to receive qualified payments.

(2) *Due date of qualified payments.* With respect to any qualified payment, the ''due date'' is that date specified in the governing instrument as the date on which payment is to be made. If no date is specified in the governing instrument, the due date is the last day of each calendar year.

(3) *Appropriate discount rate.* The appropriate discount rate is the discount rate that was applied in determining the value of the qualified payment right at the time of the transfer to which section 2701 applied.

(4) *Application of payments.* For purposes of this section, any payment of an unpaid qualified payment is applied in satisfaction of unpaid qualified payments beginning with the earliest unpaid qualified payment. Any payment in excess of the total of all unpaid qualified payments is treated as a prepayment of future qualified payments.

(5) *Payment.* For purposes of this paragraph (c), the transfer of a debt obligation bearing compound interest from the due date of the payment at a rate not less than the appropriate discount rate is a qualified payment if the term of the obligation (including extensions) does not exceed four years from the date issued. A payment in the form of an equity interest in the entity is not a qualified payment. Any payment of a qualified payment made (or treated as made) either before or during the four-year period beginning on

the due date of the payment but before the date of the taxable event is treated as having been made on the due date.

(6) *Limitation*—(i) *In general.* The amount of the increase to an individual's taxable estate or taxable gifts is limited to the applicable percentage of the excess, if any, of—

(A) The sum of—

(*1*) The fair market value of all outstanding equity interests in the entity that are subordinate to the applicable retained interest, determined as of the date of the taxable event without regard to any accrued liability attributable to unpaid qualified payments; and

(*2*) Any amounts expended by the entity to redeem or otherwise acquire any such subordinate interest during the period beginning on the date of the transfer to which section 2701 applied (or, in the case of an individual treated as an interest holder, on the date the interest of the prior interest holder terminated) and ending on the date of the taxable event (reduced by any amounts received on the resale or issuance of any such subordinate interest during the same period); over

(B) The fair market value of all outstanding equity interests in the entity that are subordinate to the applicable retained interest, determined as of the date of the transfer to which section 2701 applied (or, in the case of an individual treated as an interest holder, on the date the interest of the prior interest holder terminated).

(ii) *Computation of limitation.* For purposes of computing the limitation applicable under this paragraph (c)(6), the aggregate fair market value of the subordinate interests in the entity are determined without regard to § 25.2701–3(c).

(iii) *Applicable percentage.* The applicable percentage is determined by dividing the number of shares or units of the applicable retained interest held by the interest holder (or an individual treated as the interest holder) on the date of the taxable event by the total number of such shares or units outstanding on the same date. If an individual holds applicable retained interests in two or more classes of interests, the applicable percentage is equal to the largest applicable percentage determined with respect to any class. For example, if T retains 40 percent of the class A preferred and 60 percent of the class B preferred in a corporation, the applicable percentage with respect to T's holdings is 60 percent.

(d) *Taxpayer election*—(1) *In general.* An interest holder (or individual treated as an interest holder) may elect to treat as a taxable event the payment of an unpaid qualified payment occurring more than four years after its due date. Under this election, the increase under paragraph (c) of this section is determined only with respect to that payment and all previous payments for which an election was available but not made. Payments for which an election applies are treated as having been paid on their due dates for purposes of subsequent taxable events. The election is revocable only with the consent of the Commissioner.

(2) *Limitation not applicable.* If a taxable event occurs by reason of an election described in paragraph (d)(1) of this section, the limitation described in paragraph (c)(6) of this section does not apply.

(3) *Time and manner of election*—(i) *Timely-filed returns.* The election may be made by attaching a statement to a Form 709, Federal Gift Tax Return, filed by the recipient of the qualified payment on a timely basis for the year in which the qualified payment is received. In that case, the taxable event is deemed to occur on the date the qualified payment is received.

(ii) *Election on late returns.* The election may be made by attaching a statement to a Form 709, Federal Gift Tax Return, filed by the recipient of the qualified payment other than on a timely basis for the year in which the qualified payment is received. In that case, the taxable event is deemed to occur on the first day of the month immediately preceding the month in which the return is filed. If an election, other than an election on a timely return, is made after the death of the interest holder, the taxable event with respect to the decedent is deemed to occur on the later of—

(A) The date of the recipient's death, or

(B) The first day of the month immediately preceding the month in which the return is filed.

(iii) *Requirements of statement.* The statement must—

(A) Provide the name, address, and taxpayer identification number of the electing individual and the interest holder, if different;

(B) Indicate that a taxable event election is being made under paragraph (d) of this section;

(C) Disclose the nature of the qualified payment right to which the election applies, including the due dates of the payments, the dates the payments were made, and the amounts of the payments;

(D) State the name of the transferor, the date of the transfer to which section 2701 applied, and the discount rate used in valuing the qualified payment right; and

(E) State the resulting amount of increase in taxable gifts.

(4) *Example.* The following example illustrates the rules of this paragraph (d).

*Example.* A holds cumulative preferred stock that A retained in a transfer to which section 2701 applied. No dividends were paid in years 1 through 5 following the transfer. In year 6, A received a qualified payment that, pursuant to paragraph (c)(3) of this section, is considered to be in satisfaction of the unpaid qualified payment for year 1. No election was made to treat that payment as a taxable event. In year 7, A receives a qualified payment that, pursuant to paragraph (c)(4) of this section, is considered to be in satisfaction of the unpaid qualified payment for year 2. A elects to treat the payment in year 7 as a taxable event. The election increases A's taxable gifts in year 7 by the amount computed under paragraph (c) of this section with respect to the payments due in both year l and year 2. For purposes of any future taxable events, the payments with respect to years 1 and 2 are treated as having been made on their due dates.

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

### § 25.2701–5 Adjustments to mitigate double taxation.

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

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

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

(4) *Section 2701 interest.* A section 2701 interest is an applicable retained interest that was valued using the special valuation rules of section 2701 at the

time of the initial transfer. However, an interest is a section 2701 interest only to the extent the transfer of that interest effectively reduces the aggregate ownership of such class of interest by the initial transferor and applicable family members of the initial transferor below that held by such persons at the time of the initial transfer (or the remaining portion thereof).

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

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

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

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

(2) *Transfer tax value—in general.* Except as provided in paragraph (c)(3) of this section, for purposes of paragraph (c)(1) of this section the transfer tax value of a section 2701 interest is the value of that interest as finally determined for Federal transfer tax purposes under chapter 11 or chapter 12, as the case may be (including the right to receive any distributions thereon (other than qualified payments)), reduced by the amount of any deduction allowed with respect to the section 2701 interest to the extent that the deduction would not have been allowed if the section 2701 interest were not included in the transferor's total amount of gifts for the calendar year or the transferor's gross estate, as the case may be. Rules similar to the rules of section 691(c)(2)(C) are applicable to determine the extent that a deduction would not be allowed if the section 2701 interest were not so included.

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

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

(iii) *Nonrecognition transactions.* If an individual exchanges a section 2701 interest in a nonrecognition transaction (within the meaning of section 7701(a)(45)), the exchange is not treated as a transfer of a section 2701 interest and the transfer tax value of that interest is determined as if the interest received in exchange is the section 2701 interest.

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

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

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

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

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

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

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

(3) *Additional facts applicable to Examples 4 and 5.* P's initial transfer consists of one-half of P's common stock. With respect to the initial transfer in this case, only $1,000,000 (one-half of the amount remaining after Step 2 of the subtraction method of § 25.2701–3) is allocated to the transferred stock. P's aggregate taxable gifts for 1991 (the section 2701 transfer and P's other transfers) equal $2,500,000.

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

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

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

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

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

the value of P's taxable estate is less than $1,500,000, the amount of the adjustment available to P's executor is limited to the actual value of P's taxable estate.

(iii) The result would also be the same if the preferred stock had been held by P's parent, GM, and at the time of P's death, GM had not transferred the preferred stock.

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

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

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

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

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

(2) *Transfers during joint lives.* If there is a split initial transfer and the corresponding section 2701 interest is transferred during the joint lives of the donor and the consenting spouse, for purposes of determining the reduction under paragraph (a)(2) of this section each spouse is treated as if the spouse was the initial transferor of one-half of the split initial transfer.

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

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

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

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

(iii) *Death of consenting spouse.* If the consenting spouse predeceases the donor spouse, except for any excess reduction carried forward under paragraph (a)(2) of this section, the reduction with respect to any section 2701 interest in the split initial transfer is not available to the estate of the consenting spouse (regardless of whether

the interest is included in the consenting spouse's gross estate). Similarly, if the consenting spouse predeceases the donor spouse, no reduction is available to the consenting spouse's adjusted taxable gifts under section 2001(b)(1)(B) (or section 2101(b)(1)(B)) or to the consenting spouse's gift tax payable under section 2001(b)(2) (or section 2101(b)(2)). See paragraph (a)(2) of this section for rules involving transfers by an applicable family member during the life of the initial transferor.

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

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

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

(2) On January 15, 1991, when the aggregate fair market value of the preferred stock is $1,500,000 and the aggregate fair market value of the common stock is $500,000, P transfers all 1,000 shares of the common stock to P's child. Section 2701 applies to the initial transfer because P transferred an equity interest (the common stock) to a member of P's family and immediately thereafter held an applicable retained interest (the preferred stock). The fair market value of P's interest in X immediately prior to the transfer is $2,000,000 and the section 2701 value of the preferred stock (the section 2701 interest) is zero. With respect to the initial transfer, the amount remaining after Step 2 of the subtraction method of § 25.2701–3 was $2,000,000 ($2,000,000 minus zero), all of which is allocated to the transferred stock. P had made no gifts prior to 1991. The sum of P's aggregate taxable gifts for the calendar year 1991 (including the section 2701 transfer) is $2,500,000. P's spouse, S, made no gifts prior to 1991.

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

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

*Example 2. Inter vivos transfer of portion of section 2701 interest.* P transfers one-fourth of the preferred stock to P's child. In this case, P and S are each entitled to a reduction of

$187,500, the corresponding portion of the reduction otherwise available to each spouse (one-fourth of $750,000).

*Example 3. Transfer at death of donor spouse.* P, the donor spouse in the section 2513 election, dies on October 1, 1994, while holding all of the preferred stock. The executor of P's estate is entitled to a reduction in the computation of the tentative tax under section 2001(b). Since no reduction had been previously available with respect to the section 2701 interest, P's estate is entitled to a full reduction of $750,000 with respect to the one-half share of the preferred stock as to which P was the initial transferor. In addition, P's estate is entitled to an additional reduction of up to $750,000 for the remaining section 2701 interest as to which S was the initial transferor. The reduction for the consenting spouse's remaining section 2701 interest is limited to that amount that will produce a tax saving in P's Federal estate tax of $255,500, the amount of gift tax incurred by S by reason of the application of section 2701 to the split initial transfer.

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

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

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

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

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

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

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

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

### § 25.2701–6 Indirect holding of interests.

(a) *In general*—(1) *Attribution to individuals.* For purposes of section 2701, an individual is treated as holding an equity interest to the extent the interest is held indirectly through a corporation, partnership, estate, trust, or other entity. If an equity interest is treated as held by a particular individual in more than one capacity, the interest is treated as held by the individual in the manner that attributes the largest total ownership of the equity interest. An equity interest held by a lower-tier entity is attributed to higher-tier entities in accordance with the rules of this section. For example, if an individual is a 50-percent beneficiary of a trust that holds 50 percent of the preferred stock of a corporation, 25 percent of the preferred stock is considered held by the individual under these rules.

(2) *Corporations.* A person is considered to hold an equity interest held by or for a corporation in the proportion that the fair market value of the stock the person holds bears to the fair market value of all the stock in the corporation (determined as if each class of stock were held separately by one individual). This paragraph applies to any entity classified as a corporation or as an association taxable as a corporation for federal income tax purposes.

(3) *Partnerships.* A person is considered to hold an equity interest held by or for a partnership in the proportion that the fair market value of the larger

of the person's profits interest or capital interest in the partnership bears to the total fair market value of the corresponding profits interests or capital interests in the partnership, as the case may be (determined as if each class were held by one individual). This paragraph applies to any entity classified as a partnership for federal income tax purposes.

(4) *Estates, trusts and other entities*—(i) *In general.* A person is considered to hold an equity interest held by or for an estate or trust to the extent the person's beneficial interest therein may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, assuming the maximum exercise of discretion in favor of the person. A beneficiary of an estate or trust who cannot receive any distribution with respect to an equity interest held by the estate or trust, including the income therefrom or the proceeds from the disposition thereof, is not considered the holder of the equity interest. Thus, if stock held by a decedent's estate has been specifically bequeathed to one beneficiary and the residue of the estate has been bequeathed to other beneficiaries, the stock is considered held only by the beneficiary to whom it was specifically bequeathed. However, any person who may receive distributions from a trust is considered to hold an equity interest held by the trust if the distributions may be made from current or accumulated income from or the proceeds from the disposition of the equity interest, even though under the terms of the trust the interest can never be distributed to that person. This paragraph applies to any entity that is not classified as a corporation, an association taxable as a corporation, or a partnership for federal income tax purposes.

(ii) *Special rules*—(A) Property is held by a decedent's estate if the property is subject to claims against the estate and expenses of administration.

(B) A person holds a beneficial interest in a trust or an estate so long as the person may receive distributions from the trust or the estate other than payments for full and adequate consideration.

(C) An individual holds an equity interest held by or for a trust if the individual is considered an owner of the trust (a ''grantor trust'') under subpart E, part 1, subchapter J of the Internal Revenue Code (relating to grantors and others treated as substantial owners). However, if an individual is treated as the owner of only a fractional share of a grantor trust because there are multiple grantors, the individual holds each equity interest held by the trust, except to the extent that the fair market value of the interest exceeds the fair market value of the fractional share.

(5) *Multiple attribution*—(i) *Applicable retained interests.* If this section attributes an applicable retained interest to more than one individual in a class consisting of the transferor and one or more applicable family members, the interest is attributed within that class in the following order—

(A) If the interest is held in a grantor trust, to the individual treated as the holder thereof;

(B) To the transferor;

(C) To the transferor's spouse; or

(D) To each applicable family member on a pro rata basis.

(ii) *Subordinate equity interests.* If this section attributes a subordinate equity interest to more than one individual in a class consisting of the transferor, applicable family members, and members of the transferor's family, the interest is attributed within that class in the following order—

(A) To the transferee;

(B) To each member of the transferor's family on a pro rata basis;

(C) If the interest is held in a grantor trust, to the individual treated as the holder thereof;

(D) To the transferor;

(E) To the transferor's spouse; or

(F) To each applicable family member on a pro rata basis.

(b) *Examples.* The following examples illustrate the provisions of this section:

*Example 1.* A, an individual, holds 25 percent by value of each class of stock of Y Corporation. Persons unrelated to A hold the remaining stock. Y holds 50 percent of the stock of Corporation X. Under paragraph (a)(2) of this section, Y's interests in X are attributed proportionately to the shareholders of Y. Accordingly, A is considered to hold a 12.5 percent (25 percent × 50 percent) interest in X.

*Example 2.* Z Bank's authorized capital consists of 100 shares of common stock and 100 shares of preferred stock. A holds 60 shares of each (common and preferred) and A's child, B, holds 40 shares of common stock. Z holds the balance of its own preferred stock, 30 shares as part of a common trust fund it maintains and 10 shares permanently set aside to satisfy a deferred obligation. For purposes of section 2701, A holds 60 shares of common stock and 66 shares of preferred stock in Z, 60 shares of each class directly and 6 shares of preferred stock indirectly (60 percent of the 10 shares set aside to fund the deferred obligation).

*Example 3.* An irrevocable trust holds a 10-percent general partnership interest in Partnership Q. One-half of the trust income is required to be distributed to O Charity. The other one-half of the income is to be distributed to D during D's life and thereafter to E for such time as E survives D. D holds one-half of the trust's interest in Q by reason of D's present right to receive one-half of the trust's income, and E holds one-half of the trust's interest in Q by reason of E's future right to receive one-half of the trust's income. Nevertheless, no family member is treated as holding more than one-half of the trust's interest in Q because at no time will either D or E actually hold, in the aggregate, any right with respect to income or corpus greater than one-half.

*Example 4.* An irrevocable trust holds a 10-percent general partnership interest in partnership M. One-half of the trust income is to be paid to D for D's life. The remaining income may, in the trustee's discretion, be accumulated or paid to or for the benefit of a class that includes D's child F, in such amounts as the trustee determines. On the death of the survivor of D and F, the trust corpus is required to be distributed to O Charity. The trust's interest in M is held by the trust's beneficiaries to the extent that present and future income or corpus may be distributed to them. Accordingly, D holds one-half of the trust's interest in M because D is entitled to receive one-half of the trust income currently. F holds the entire value of the interest because F is a member of the class eligible to receive the entire trust income for such time as F survives D. See paragraph (a)(5) of this section for rules applicable in the case of multiple attribution.

*Example 5.* The facts are the same as in *Example 4,* except that all the income is required to be paid to O Charity for the trust's initial year. The result is the same as in *Example 4.*

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

### § 25.2701–7 Separate interests.

The Secretary may, by regulation, revenue ruling, notice, or other document of general application, prescribe rules under which an applicable retained interest is treated as two or more separate interests for purposes of section 2701. In addition, the Commissioner may, by ruling issued to a taxpayer upon request, treat any applicable retained interest as two or more separate interests as may be necessary and appropriate to carry out the purposes of section 2701.

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

### § 25.2701–8 Effective dates.

Sections 25.2701–1 through 25.2701–4 and §§ 25.2701–6 and 25.2701–7 are effective as of January 28, 1992. For transfers made prior to January 28, 1992, taxpayers may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of the proposed regulations and the final regulations are considered a reasonable interpretation of the statutory provisions.

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

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*§ 25.2702–6 Reduction in taxable gifts.*

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

*§ 25.2702–7 Effective dates.*

**§ 25.2702–1 Special valuation rules in the case of transfers of interests in trust.**

(a) *Scope of section 2702.* Section 2702 provides special rules to determine the amount of the gift when an individual makes a transfer in trust to (or for the benefit of) a member of the individual's family and the individual or an applicable family member retains an interest in the trust. Section 25.2702–4 treats certain transfers of property as transfers in trust. Certain transfers, including transfers to a personal residence trust, are not subject to section 2702. See paragraph (c) of this section. Member of the family is defined in § 25.2702–2(a)(1). Applicable family member is defined in § 25.2701–1(d)(2).

(b) *Effect of section 2702.* If section 2702 applies to a transfer, the value of any interest in the trust retained by the transferor or any applicable family member is determined under § 25.2702–2(b). The amount of the gift, if any, is then determined by subtracting the value of the interests retained by the transferor or any applicable family member from the value of the transferred property. If the retained interest is not a qualified interest (as defined in

§ 25.2702–3), the retained interest is generally valued at zero, and the amount of the gift is the entire value of the property.

(c) *Exceptions to section 2702.* Section 2702 does not apply to the following transfers.

(1) *Incomplete gift.* A transfer no portion of which would be treated as a completed gift without regard to any consideration received by the transferor. If a transfer is wholly incomplete as to an undivided fractional share of the property transferred (without regard to any consideration received by the transferor), for purposes of this paragraph the transfer is treated as incomplete as to that share.

(2) *Personal residence trust.* A transfer in trust that meets the requirements of § 25.2702–5.

(3) *Charitable remainder trust.* (i) For transfers made on or after May 19, 1997, a transfer to a pooled income fund described in section 642(c)(5); a transfer to a charitable remainder annuity trust described in section 664(d)(1); a transfer to a charitable remainder unitrust described in section 664(d)(2) if under the terms of the governing instrument the unitrust amount can be computed only under section 664(d)(2)(A); and a transfer to a charitable remainder unitrust if under the terms of the governing instrument the unitrust amount can be computed under section 664(d)(2) and (3) and either there are only two consecutive noncharitable beneficial interests and the transferor holds the second of the two interests, or the only permissible recipients of the unitrust amount are the transferor, the transferor's U.S. citizen spouse, or both the transferor and the transferor's U.S. citizen spouse.

(ii) For transfers made before May 19, 1997, a transfer in trust if the remainder interest in the trust qualifies for a deduction under section 2522.

(4) *Pooled income fund.* A transfer of property to a pooled income fund (as defined in section 642(c)(5)).

(5) *Charitable lead trust.* A transfer in trust if the only interest in the trust, other than the remainder interest or a qualified annuity or unitrust interest, is an interest that qualifies for deduction under section 2522.

(6) *Certain assignments of remainder interests.* The assignment of a remainder interest if the only retained interest of the transferor or an applicable family member is as the permissible recipient of distributions of income in the sole discretion of an independent trustee (as defined in section 674(c)).

(7) *Certain property settlements.* A transfer in trust if the transfer of an interest to a spouse is deemed to be for full and adequate consideration by reason of section 2516 (relating to certain property settlements) and the remaining interests in the trust are retained by the other spouse.

(8) *Transfer or assignment to a Qualified Domestic Trust.* A transfer or assignment (as described in section 2056(d)(2)(B)) by a noncitizen surviving spouse of property to a Qualified Domestic Trust under the circumstances described in § 20.2056A–4(b) of this chapter, where the surviving spouse retains an interest in the transferred property that is not a qualified interest and the transfer is not described in sections 2702(a)(3)(A)(ii) or 2702(c)(4).

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

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

(a) *Definitions.* The following definitions apply for purposes of section 2702 and the regulations thereunder.

(1) *Member of the family.* With respect to any individual, member of the family means the individual's spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any brother or sister of the individual, and any spouse of the foregoing.

(2) *Transfer in trust.* A transfer in trust includes a transfer to a new or existing trust and an assignment of an interest in an existing trust. Transfer in trust does not include—

(i) The exercise, release or lapse of a power of appointment over trust property that is not a transfer under chapter 12; or

(ii) The execution of a qualified disclaimer (as defined in section 2518).

(3) *Retained.* Retained means held by the same individual both before and after the transfer in trust. In the case of the creation of a term interest, any

interest in the property held by the transferor immediately after the transfer is treated as held both before and after the transfer.

(4) *Interest.* An interest in trust includes a power with respect to a trust if the existence of the power would cause any portion of a transfer to be treated as an incomplete gift under chapter 12.

(5) *Qualified interest.* Qualified interest means a qualified annuity interest, a qualified unitrust interest, or a qualified remainder interest. Retention of a power to revoke a qualified annuity interest (or unitrust interest) of the transferor's spouse is treated as the retention of a qualified annuity interest (or unitrust interest).

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

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

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

(9) *Governing instrument.* Governing instrument means the instrument or instruments creating and governing the operation of the trust arrangement.

(b) *Valuation of retained interests*—(1) *In general.* Except as provided in paragraphs (b)(2) and (c) of this section, the value of any interest retained by the transferor or an applicable family member is zero.

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

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

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

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

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

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

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

(4) *Conversion of property*—(i) *In general.* Except as provided in paragraph (c)(4)(iii) of this section, if a term interest in property is valued under paragraph (c)(1) of this section, and during the term the property is converted into property a term interest in which would not qualify for valuation under paragraph (c)(1) of this section, the

conversion is treated as a transfer for no consideration for purposes of chapter 12 of the value of the unexpired portion of the term interest.

(ii) *Value of unexpired portion of term interest.* For purposes of paragraph (c)(4)(i) of this section, the value of the unexpired portion of a term interest is the amount that bears the same relation to the value of the term interest as of the date of conversion (determined under section 7520 using the rate in effect under section 7520 on the date of the original transfer and the fair market value of the property as of the date of the original transfer) as the value of the term interest as of the date of the original transfer (determined under paragraph (c)(1) of this section) bears to the value of the term interest as of the date of the original transfer (determined under section 7520).

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

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

(ii) *Other additions or improvements.* If an addition or improvement is made to property, a term interest in which was valued under paragraph (c)(1) of this section, and the addition or improvement does not affect the nature of the property to such an extent that the property would not be treated as property meeting the requirements of paragraph (c)(2) of this section if the property had included the addition or improvement at the time it was transferred, the addition or improvement is treated as an additional transfer (effective as of the date the addition or improvement is commenced) subject to § 25.2702–2(b)(1).

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

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

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

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

whether or not D elects to treat the transfer as a transfer of qualified terminable interest property under section 2056(b)(7).

*Example 4.* A transfers property to an irrevocable trust, under which the income is to be paid to A for life. Upon termination of the trust, the trust corpus is to be distributed to A's child. A also retains certain powers over principal that cause the transfer to be wholly incomplete for federal gift tax purposes. Section 2702 does not apply because no portion of the transfer would be treated as a completed gift.

*Example 5.* The facts are the same as in *Example 4,* except that the trust is divided into separate fractional shares and A's retained powers apply to only one of the shares. Section 2702 applies except with respect to the share of the trust as to which A's retained powers cause the transfer to be an incomplete gift.

*Example 6.* A transfers property to an irrevocable trust, retaining the right to receive the income for 10 years. Upon expiration of 10 years, the income of the trust is payable to A's spouse for 10 years if living. Upon expiration of the spouse's interest, the trust terminates and the trust corpus is payable to A's child. A retains the right to revoke the spouse's interest. Because the transfer of property to the trust is not incomplete as to all interests in the property (*i.e.,* A has made a completed gift of the remainder interest), section 2702 applies. A's power to revoke the spouse's term interest is treated as a retained interest for purposes of section 2702. Because no interest retained by A is a qualified interest, the amount of the gift is the fair market value of the property transferred to the trust.

*Example 7.* The facts are the same as in Example 6, except that both the term interest retained by A and the interest transferred to A's spouse (subject to A's right of revocation) are qualified annuity or unitrust interests. The amount of the gift is the fair market value of the property transferred to the trust reduced by the value of both A's qualified interest and the value of the qualified interest transferred to A's spouse (subject to A's power to revoke).

(2) The following facts apply for Examples 8–10 (examples illustrating § 25.2702–2(c)—tangible property exception):

*Facts.* A transfers a painting having a fair market value of $2,000,000 to A's child, B, retaining the use of the painting for 10 years. The painting does not possess an ascertainable useful life. Assume that the painting would not be depreciable if it were used in a trade or business or held for the production of income. Assume that the value of A's term interest, determined under section 7520, is $1,220,000, and that A establishes that a willing buyer of A's interest would pay $500,000 for the interest.

*Example 8.* A's term interest is not a qualified interest under § 25.2702–3. However, because of the nature of the property, A's failure to exercise A's rights with regard to the painting would not be expected to cause the value of the painting to be higher than it would otherwise be at the time it passes to B. Accordingly, A's interest is valued under § 25.2702–2(c)(1) at $500,000. The amount of A's gift is $1,500,000, the difference between the fair market value of the painting and the amount determined under § 25.2702–2(c)(1).

*Example 9.* Assume that the only evidence produced by A to establish the value of A's 10-year term interest is the amount paid by a museum for the right to use a comparable painting for 1 year. A asserts that the value of the 10-year term is 10 times the value of the 1-year term. A has not established the value of the 10-year term interest because a series of short-term rentals the aggregate duration of which equals the duration of the actual term interest does not establish what a willing buyer would pay a willing seller for the 10-year term interest. However, the value of the 10-year term interest is not less than the value of the 1-year term because it can be assumed that a willing buyer would pay no less for a 10-year term interest than a 1-year term interest.

*Example 10.* Assume that after 24 months A and B sell the painting for $2,000,000 and invest the proceeds in a portfolio of securities. A continues to hold an income interest in the securities for the duration of the 10-year term. Under § 25.2702–2(c)(4) the conversion of the painting into a type of property a term interest in which would not qualify for valuation under § 25.2702–2(c)(1) is treated as a transfer by A of the value of the unexpired portion of A's original term interest, unless the property is thereafter held in a trust meeting the requirements of a qualified annuity interest. Assume that the value of A's remaining term interest in $2,000,000 (determined under section 7520 using the section 7520 rate in effect on the date of the original transfer) is $1,060,000. The value of the unexpired portion of A's interest is $434,426, the amount that bears the same relation to $1,060,000 as $500,000 (the value of A's interest as of the date of the original transfer determined under paragraph (c)(1) of this section) bears to $1,220,000 (the value of A's interest as of the date of the original transfer determined under section 7520).

[T.D. 8395, 57 FR 4265, Feb. 4, 1992]

### § 25.2702–3 Qualified interests.

(a) *In general.* This section provides rules for determining if an interest is a qualified annuity interest, a qualified

unitrust interest, or a qualified remainder interest.

(b) *Special rules for qualified annuity interests.* An interest is a qualified annuity interest only if it meets the requirements of this paragraph and paragraph (d) of this section.

(1) *Payment of annuity amount*—(i) *In general.* A qualified annuity interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest for each taxable year of the term. A right of withdrawal, whether or not cumulative, is not a qualified annuity interest. The annuity payment may be made after the close of the taxable year, provided the payment is made no later than the date by which the trustee is required to file the Federal income tax return of the trust for the taxable year (without regard to extensions). If the trustee reports for the taxable year pursuant to §1.671–4(b) of this chapter, the annuity payment must be made no later than the date by which the trustee would have been required to file the Federal income tax return of the trust for the taxable year (without regard to extensions) had the trustee reported pursuant to §1.671–4(a) of this chapter.

(ii) *Fixed amount.* A fixed amount means—

(A) A stated dollar amount payable periodically, but not less frequently than annually, but only to the extent the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year; or

(B) A fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year.

(iii) *Income in excess of the annuity amount.* An annuity interest does not fail to be a qualified annuity interest merely because the trust permits income in excess of the amount required to pay the annuity amount to be paid to or for the benefit of the holder of the qualified annuity interest. Nevertheless, the right to receive the excess income is not a qualified interest and is not taken into account in valuing the qualified annuity interest.

(2) *Incorrect valuations of trust property.* If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of §1.664–2(a)(1)(iii) of this chapter (relating to adjustments for any incorrect determination of the fair market value of the property in the trust).

(3) *Computation of annuity amount in certain circumstances.* The governing instrument must contain provisions meeting the requirements of §1.664–2(a)(1)(iv) of this chapter (relating to the computation of the annuity amount in the case of short taxable years and the last taxable year of the term). Solely for purposes of this paragraph (b), the governing instrument meets the requirements of this section with respect to short taxable years, if any, and the last taxable year of the term if the governing instrument provides that the fixed amount or a pro-rata portion thereof must be payable for the final short period of the annuity interest.

(4) *Additional contributions prohibited.* The governing instrument must prohibit additional contributions to the trust.

(c) *Special rules for qualified unitrust interests.* An interest is a qualified unitrust interest only if it meets the requirements of this paragraph and paragraph (d) of this section.

(1) *Payment of unitrust amount*—(i) *In general.* A qualified unitrust interest is an irrevocable right to receive payment periodically, but not less frequently than annually, of a fixed percentage of the net fair market value of the trust assets, determined annually. For rules relating to computation of the net fair market value of the trust assets see §25.2522(c)–3(c)(2)(vii). The unitrust amount must be payable to (or for the benefit of) the holder of the unitrust interest for each taxable year of the term. A right of withdrawal, whether or not cumulative, is not a qualified unitrust interest. The unitrust payment may be made after the close of the taxable year, provided

that the payment is made no later than the date by which the trustee is required to file the Federal income tax return of the trust for the year (without regard to extensions). If the trustee reports for the taxable year pursuant to §1.671–4(b) of this chapter, the unitrust payment must be made no later than the date by which the trustee would have been required to file the Federal income tax return of the trust for the taxable year (without regard to extensions) had the trustee reported pursuant to §1.671–4(a) of this chapter.

(ii) *Fixed percentage.* A fixed percentage is a fraction or percentage of the net fair market value of the trust assets, determined annually, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year.

(iii) *Income in excess of unitrust amount.* A unitrust interest does not fail to be a qualified unitrust interest merely because the trust permits income in excess of the amount required to pay the unitrust amount to be paid to or for the benefit of the holder of the qualified unitrust interest. Nevertheless, the right to receive the excess income is not a qualified interest and is not taken into account in valuing the qualified unitrust interest.

(2) *Incorrect valuations of trust property.* The governing instrument must contain provisions meeting the requirements of §1.664–3(a)(1)(iii) of this chapter (relating to the incorrect determination of the fair market value of the property in the trust).

(3) *Computation of unitrust amount in certain circumstances.* The governing instrument must contain provisions meeting the requirements of §1.664–3(a)(1)(v) of this chapter (relating to the computation of the unitrust amount in the case of short taxable years and the last taxable year of the term). Solely for purposes of this paragraph (c), the governing instrument meets the requirements of this section with respect to short taxable years, if any, and the last taxable year of the term if the governing instrument provides that the fixed amount or a prorata portion thereof must be payable for the final short period of the unitrust interest.

(d) *Requirements applicable to qualified annuity interests and qualified unitrust interests*—(1) *In general.* To be a qualified annuity or unitrust interest, an interest must be a qualified annuity interest in every respect or a qualified unitrust interest in every respect. For example, if the interest consists of the right to receive each year a payment equal to the lesser of a fixed amount of the initial trust assets or a fixed percentage of the annual value of the trust assets, the interest is not a qualified interest. If, however, the interest consists of the right to receive each year a payment equal to the greater of a stated dollar amount or a fixed percentage of the initial trust assets or a fixed percentage of the annual value of the trust assets, the interest is a qualified interest that is valued at the greater of the two values. To be a qualified interest, the interest must meet the definition of and function exclusively as a qualified interest from the creation of the trust.

(2) *Amounts payable to other persons.* The governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity or unitrust interest during the term of the qualified interest.

(3) *Term of the annuity or unitrust interest.* The governing instrument must fix the term of the annuity or unitrust interest. The term must be for the life of the term holder, for a specified term of years, or for the shorter (but not the longer) of those periods. Successive term interests for the benefit of the same individual are treated as the same term interest.

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

(e) *Examples.* The following examples illustrate the rules of paragraphs (b), (c), and (d) of this section. Each example assumes that all applicable requirements for a qualified interest are met unless otherwise specifically stated.

*Example 1.* A transfers property to an irrevocable trust, retaining the right to receive the greater of $10,000 or the trust income in

each year for a term of 10-years. Upon expiration of the 10-year term, the trust is to terminate and the entire trust corpus is to be paid to A's child, provided that if A dies within the 10-year term the trust corpus is to be paid to A's estate. A's annual payment right is a qualified annuity interest to the extent of the right to receive $10,000 per year for 10 years or until A's prior death, and is valued under section 7520 without regard to the right to receive any income in excess of $10,000 per year. The contingent reversion is valued at zero. The amount of A's gift is the fair market value of the property transferred to the trust less the value of the qualified annuity interest.

*Example 2.* U transfers property to an irrevocable trust, retaining the right to receive $10,000 in each of years 1 through 3, $12,000 in each of years 4 through 6, and $15,000 in each of years 7 through 10. The interest is a qualified annuity interest to the extent of U's right to receive $10,000 per year in years 1 through 3, $12,000 in years 4 through 6, $14,400 in year 7, and $15,000 in years 8 through 10, because those amounts represent the lower of the amount actually payable each year or an amount that does not exceed 120 percent of the stated dollar amount for the preceding year.

*Example 3.* S transfers property to an irrevocable trust, retaining the right to receive $50,000 in each of years 1 through 3 and $10,000 in each of years 4 through 10. S's entire retained interest is a qualified annuity interest.

*Example 4.* R transfers property to an irrevocable trust retaining the right to receive annually an amount equal to the lesser of 8 percent of the initial fair market value of the trust property or the trust income for the year. R's annual payment right is not a qualified annuity interest to any extent because R does not have the irrevocable right to receive a fixed amount for each year of the term.

*Example 5.* A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years or until A's prior death.

*Example 6.* The facts are the same as in *Example 5,* except that if A dies within the 10-year term the unitrust amount will be paid to A's estate for an additional 35 years. The result is the same as in *Example 5,* because the 10-year term is the only term that is fixed and ascertainable at the creation of the interest.

*Example 7.* B transfers property to an irrevocable trust retaining the right to receive annually an amount equal to 8 percent of the initial fair market value of the trust property for 10 years. Upon expiration of the 10-year term, the trust is to terminate and the entire trust corpus is to be paid to B's child. The governing instrument provides that income in excess of the annuity amount may be paid to B's child in the trustee's discretion. B's interest is not a qualified annuity interest to any extent because a person other than the individual holding the term interest may receive distributions from the trust during the term.

(f) *Qualified remainder interest*—(1) *Requirements.* An interest is a qualified remainder interest only if it meets all of the following requirements:

(i) It is a qualified remainder interest in every respect.

(ii) It meets the definition of and functions exclusively as a qualified interest from the creation of the interest.

(iii) It is non-contingent. For this purpose, an interest is non-contingent only if it is payable to the beneficiary or the beneficiary's estate in all events.

(iv) All interests in the trust, other than non-contingent remainder interests, are qualified annuity interests or qualified unitrust interests. Thus, an interest is a qualified remainder interest only if the governing instrument does not permit payment of income in excess of the annuity or unitrust amount to the holder of the qualified annuity or unitrust interest.

(2) *Remainder interest.* Remainder interest is the right to receive all or a fractional share of the trust property on termination of all or a fractional share of the trust. Remainder interest includes a reversion. A transferor's right to receive an amount that is a stated or pecuniary amount is not a remainder interest. Thus, the right to receive the original value of the trust corpus (or a fractional share) is not a remainder interest.

(3) *Examples.* The following examples illustrate rules of this paragraph (f). Each example assumes that all applicable requirements of a qualified interest are met unless otherwise specifically stated.

*Example 1.* A transfers property to an irrevocable trust. The income of the trust is payable to A's child for life. On the death of A's child, the trust is to terminate and the trust

corpus is to be paid to A. A's remainder interest is not a qualified remainder interest because the interest of A's child is neither a qualified annuity interest nor a qualified unitrust interest.

*Example 2.* The facts are the same as in *Example 1,* except that A's child has the right to receive the greater of the income of the trust or $10,000 per year. A's remainder interest is not a qualified remainder interest because the right of A's child to receive income in excess of the annuity amount is not a qualified interest.

*Example 3.* A transfers property to an irrevocable trust. The trust provides a qualified annuity interest to A's child for 12 years. An amount equal to the initial value of the trust corpus is to be paid to A at the end of that period and the balance is to be paid to A's grandchild. A's interest is not a qualified remainder interest because the amount A is to receive is not a fractional share of the trust property.

*Example 4.* U transfers property to an irrevocable trust. The trust provides a qualified unitrust interest to U's child for 15 years, at which time the trust terminates and the trust corpus is paid to U or, if U is not then living, to U's child. Because U's remainder interest is contingent, it is not a qualified remainder interest.

[T.D. 8395, 57 FR 4267, Feb. 4, 1992, as amended by T.D. 8536, 59 FR 23157, May 5, 1994; T.D. 8633, 60 FR 66090, Dec. 21, 1995]

### § 25.2702–4 Certain property treated as held in trust.

(a) *In general.* For purposes of section 2702, a transfer of an interest in property with respect to which there are one or more term interests is treated as a transfer in trust. A term interest is one of a series of successive (as contrasted with concurrent) interests. Thus, a life interest in property or an interest in property for a term of years is a term interest. However, a term interest does not include a fee interest in property merely because it is held as a tenant in common, a tenant by the entireties, or a joint tenant with right of survivorship.

(b) *Leases.* A leasehold interest in property is not a term interest to the extent the lease is for full and adequate consideration (without regard to section 2702). A lease will be considered for full and adequate consideration if, under all the facts and circumstances as of the time the lease is entered into or extended, a good faith effort is made to determine the fair rental value of the property and the terms of the lease conform to the value so determined.

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

(d) *Examples.* The following examples illustrate rules of this section:

*Example 1.* A purchases a 20-year term interest in an apartment building and A's child purchases the remainder interest in the property. A and A's child each provide the portion of the purchase price equal to the value of their respective interests in the property determined under section 7520. Solely for purposes of section 2702, A is treated as acquiring the entire property and transferring the remainder interest to A's child in exchange for the portion of the purchase price provided by A's child. In determining the amount of A's gift, A's retained interest is valued at zero because it is not a qualified interest.

*Example 2.* K holds rental real estate valued at $100,000. K sells a remainder interest in the property to K's child, retaining the right to receive the income from the property for 20 years. Assume the purchase price paid by K's child for the remainder interest is equal to the value of the interest determined under section 7520. K's retained interest is not a qualified interest and is therefore valued at zero. K has made a gift in the amount of $100,000 less the consideration received from K's child.

*Example 3.* G and G's child each acquire a 50 percent undivided interest as tenants in common in an office building. The interests of G and G's child are not term interests to which section 2702 applies.

*Example 4.* B purchases a life estate in property from R, B's grandparent, for $100 and B's child purchases the remainder interest for $50. Assume that the value of the property is $300, the value of the life estate determined under section 7520 is $250 and the value of the remainder interest is $50. B is treated as acquiring the entire property and

transferring the remainder interest to B's child. However, the amount of B's gift is $100, the amount of consideration ($100) furnished by B for B's interest.

*Example 5.* H and W enter into a written agreement relative to their marital and property rights that requires W to transfer property to an irrevocable trust, the terms of which provide that the income of the trust will be paid to H for 10 years. On the expiration of the 10-year term, the trust is to terminate and the trust corpus is to be paid to W. H and W divorce within two years after the agreement is entered into. Pursuant to section 2516, the transfer to H would otherwise be deemed to be for full and adequate consideration. Section 2702 does not apply to the acquisition of the term interest by H because no member of H's family acquired an interest in the property in the same transaction or series of transactions. The result would not be the same if, on the termination of H's interest in the trust, the trust corpus were distributable to the children of H and W rather than W.

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

### § 25.2702–5 Personal residence trusts.

(a)(1) *In general.* Section 2702 does not apply to a transfer in trust meeting the requirements of this section. A transfer in trust meets the requirements of this section only if the trust is a personal residence trust (as defined in paragraph (b) of this section). A trust meeting the requirements of a qualified personal residence trust (as defined in paragraph (c) of this section) is treated as a personal residence trust. A trust of which the term holder is the grantor that otherwise meets the requirements of a personal residence trust (or a qualified personal residence trust) is not a personal residence trust (or a qualified personal residence trust) if, at the time of transfer, the term holder of the trust already holds term interests in two trusts that are personal residence trusts (or qualified personal residence trusts) of which the term holder was the grantor. For this purpose, trusts holding fractional interests in the same residence are treated as one trust.

(2) *Modification of trust.* A trust that does not comply with one or more of the regulatory requirements under paragraph (b) or (c) of this section will, nonetheless, be treated as satisfying these requirements if the trust is modified, by judicial reformation (or nonjudicial reformation if effective under state law), to comply with the requirements. In the case of a trust created after December 31, 1996, the reformation must be commenced within 90 days after the due date (including extensions) for the filing of the gift tax return reporting the transfer of the residence under section 6075 and must be completed within a reasonable time after commencement. If the reformation is not completed by the due date (including extensions) for filing the gift tax return, the grantor or grantor's spouse must attach a statement to the gift tax return stating that the reformation has been commenced or will be commenced within the 90-day period. In the case of a trust created before January 1, 1997, the reformation must be commenced within 90 days after December 23, 1997 and must be completed within a reasonable time after commencement.

(b) *Personal residence trust*—(1) *In general.* A personal residence trust is a trust the governing instrument of which prohibits the trust from holding, for the original duration of the term interest, any asset other than one residence to be used or held for use as a personal residence of the term holder and qualified proceeds (as defined in paragraph (b)(3) of this section). A residence is held for use as a personal residence of the term holder so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence. A trust does not meet the requirements of this section if, during the original duration of the term interest, the residence may be sold or otherwise transferred by the trust or may be used for a purpose other than as a personal residence of the term holder. In addition, the trust does not meet the requirements of this section unless the governing instrument prohibits the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse, at any time after the original duration of the term interest during which the trust is a grantor trust. For purposes of the preceding sentence, a sale or transfer to another

grantor trust of the grantor or the grantor's spouse is considered a sale or transfer to the grantor or the grantor's spouse; however, a distribution (for no consideration) upon or after the expiration of the original duration of the term interest to another grantor trust of the grantor or the grantor's spouse pursuant to the express terms of the trust will not be considered a sale or transfer to the grantor or the grantor's spouse if such other grantor trust prohibits the sale or transfer of the property to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse. In the event the grantor dies prior to the expiration of the original duration of the term interest, this paragraph (b)(1) does not apply to the distribution (for no consideration) of the residence to any person (including the grantor's estate) pursuant to the express terms of the trust or pursuant to the exercise of a power retained by the grantor under the terms of the trust. Further, this paragraph (b)(1) does not apply to any outright distribution (for no consideration) of the residence to the grantor's spouse after the expiration of the original duration of the term interest pursuant to the express terms of the trust. For purposes of this paragraph (b)(1), a *grantor trust* is a trust treated as owned in whole or in part by the grantor or the grantor's spouse pursuant to sections 671 through 678, and *control* is defined in § 25.2701–2(b)(5)(ii) and (iii). Expenses of the trust whether or not attributable to trust principal may be paid directly by the term holder of the trust.

(2) *Personal residence*—(i) *In general.* For purposes of this paragraph (b), a personal residence of a term holder is either—

(A) The principal residence of the term holder (within the meaning of section 1034);

(B) One other residence of the term holder (within the meaning of section 280A(d)(1) but without regard to section 280A(d)(2)); or

(C) An undivided fractional interest in either.

(ii) *Additional property.* A personal residence may include appurtenant structures used by the term holder for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location). The fact that a residence is subject to a mortgage does not affect its status as a personal residence. The term personal residence does not include any personal property (*e.g.,* household furnishings).

(iii) *Use of residence.* A residence is a personal residence only if its primary use is as a residence of the term holder when occupied by the term holder. The principal residence of the term holder will not fail to meet the requirements of the preceding sentence merely because a portion of the residence is used in an activity meeting the requirements of section 280A(c) (1) or (4) (relating to deductibility of expenses related to certain uses), provided that such use is secondary to use of the residence as a residence. A residence is not used primarily as a residence if it is used to provide transient lodging and substantial services are provided in connection with the provision of lodging (*e.g.* a hotel or a bed and breakfast). A residence is not a personal residence if, during any period not occupied by the term holder, its primary use is other than as a residence.

(iv) *Interests of spouses in the same residence.* If spouses hold interests in the same residence (including community property interests), the spouses may transfer their interests in the residence (or a fractional portion of their interests in the residence) to the same personal residence trust, provided that the governing instrument prohibits any person other than one of the spouses from holding a term interest in the trust concurrently with the other spouse.

(3) *Qualified proceeds.* Qualified proceeds means the proceeds payable as a result of damage to, or destruction or involuntary conversion (within the meaning of section 1033) of, the residence held by a personal residence trust, provided that the governing instrument requires that the proceeds (including any income thereon) be reinvested in a personal residence within two years from the date on which the proceeds are received.

(c) *Qualified personal residence trust*—(1) *In general.* A qualified personal residence trust is a trust meeting all the requirements of this paragraph (c). These requirements must be met by provisions in the governing instrument, and these governing instrument provisions must by their terms continue in effect during the existence of any term interest in the trust.

(2) *Personal residence*—(i) *In general.* For purposes of this paragraph (c), a personal residence of a term holder is either—

(A) The principal residence of the term holder (within the meaning of section 1034);

(B) One other residence of the term holder (within the meaning of section 280A(d)(1) but without regard to section 280A(d)(2)); or

(C) An undivided fractional interest in either.

(ii) *Additional property.* A personal residence may include appurtenant structures used by the term holder for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location). The fact that a residence is subject to a mortgage does not affect its status as a personal residence. The term personal residence does not include any personal property (*e.g.*, household furnishings).

(iii) *Use of residence.* A residence is a personal residence only if its primary use is as a residence of the term holder when occupied by the term holder. The principal residence of the term holder will not fail to meet the requirements of the preceding sentence merely because a portion of the residence is used in an activity meeting the requirements of section 280A(c) (1) or (4) (relating to deductibility of expenses related to certain uses), provided that such use is secondary to use of the residence as a residence. A residence is not used primarily as a residence if it is used to provide transient lodging and substantial services are provided in connection with the provision of lodging (*e.g.*, a hotel or a bed and breakfast). A residence is not a personal residence if, during any period not occupied by the term holder, its primary use is other than as a residence. A residence is not a personal residence if, during any period not occupied by the term holder, its primary use is other than as a residence.

(iv) *Interests of spouses in the same residence.* If spouses hold interests in the same residence (including community property interests), the spouses may transfer their interests in the residence (or a fractional portion of their interests in the residence) to the same qualified personal residence trust, provided that the governing instrument prohibits any person other than one of the spouses from holding a term interest in the trust concurrently with the other spouse.

(3) *Income of the trust.* The governing instrument must require that any income of the trust be distributed to the term holder not less frequently than annually.

(4) *Distributions from the trust to other persons.* The governing instrument must prohibit distributions of corpus to any beneficiary other than the transferor prior to the expiration of the retained term interest.

(5) *Assets of the trust*—(i) *In general.* Except as otherwise provided in paragraphs (c)(5)(ii) and (c)(8) of this section, the governing instrument must prohibit the trust from holding, for the entire term of the trust, any asset other than one residence to be used or held for use (within the meaning of paragraph (c)(7)(i) of this section) as a personal residence of the term holder (the ''residence'').

(ii) *Assets other than personal residence.* Except as otherwise provided, the governing instrument may permit a qualified personal residence trust to hold the following assets (in addition to the residence) in the amounts and in the manner described in this paragraph (c)(5)(ii):

(A) *Additions of cash for payment of expenses, etc.*—(*1*) *Additions.* The governing instrument may permit additions of cash to the trust, and may permit the trust to hold additions of cash in a separate account, in an amount which, when added to the cash already held in the account for such purposes, does not exceed the amount required:

(*i*) For payment of trust expenses (including mortgage payments) already incurred or reasonably expected to be

paid by the trust within six months from the date the addition is made;

(*ii*) For improvements to the residence to be paid by the trust within six months from the date the addition is made; and

(*iii*) For purchase by the trust of the initial residence, within three months of the date the trust is created, provided that no addition may be made for this purpose, and the trust may not hold any such addition, unless the trustee has previously entered into a contract to purchase that residence; and

(*iv*) For purchase by the trust of a residence to replace another residence, within three months of the date the addition is made, provided that no addition may be made for this purpose, and the trust may not hold any such addition, unless the trustee has previously entered into a contract to purchase that residence.

(*2*) *Distributions of excess cash.* If the governing instrument permits additions of cash to the trust pursuant to paragraph (c)(5)(ii)(A)(*1*) of this section, the governing instrument must require that the trustee determine, not less frequently than quarterly, the amounts held by the trust for payment of expenses in excess of the amounts permitted by that paragraph and must require that those amounts be distributed immediately thereafter to the term holder. In addition, the governing instrument must require, upon termination of the term holder's interest in the trust, any amounts held by the trust for the purposes permitted by paragraph (c)(5)(ii)(A)(*1*) of this section that are not used to pay trust expenses due and payable on the date of termination (including expenses directly related to termination) be distributed outright to the term holder within 30 days of termination.

(B) *Improvements.* The governing instrument may permit improvements to the residence to be added to the trust and may permit the trust to hold such improvements, provided that the residence, as improved, meets the requirements of a personal residence.

(C) *Sale proceeds.* The governing instrument may permit the sale of the residence (except as set forth in paragraph (c)(9) of this section) and may permit the trust to hold proceeds from the sale of the residence, in a separate account.

(D) *Insurance and insurance proceeds.* The governing instrument may permit the trust to hold one or more policies of insurance on the residence. In addition, the governing instrument may permit the trust to hold, in a separate account, proceeds of insurance payable to the trust as a result of damage to or destruction of the residence. For purposes of this paragraph, amounts (other than insurance proceeds payable to the trust as a result of damage to or destruction of the residence) received as a result of the involuntary conversion (within the meaning of section 1033) of the residence are treated as proceeds of insurance.

(6) *Commutation.* The governing instrument must prohibit commutation (prepayment) of the term holder's interest.

(7) *Cessation of use as a personal residence*—(i) *In general.* The governing instrument must provide that a trust ceases to be a qualified personal residence trust if the residence ceases to be used or held for use as a personal residence of the term holder. A residence is held for use as a personal residence of the term holder so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence. See § 25.2702–5(c)(8) for rules governing disposition of assets of a trust as to which the trust has ceased to be a qualified personal residence trust.

(ii) *Sale of personal residence.* The governing instrument must provide that the trust ceases to be a qualified personal residence trust upon sale of the residence if the governing instrument does not permit the trust to hold proceeds of sale of the residence pursuant to paragraph (c)(5)(ii)(C) of this section. If the governing instrument permits the trust to hold proceeds of sale pursuant to that paragraph, the governing instrument must provide that the trust ceases to be a qualified personal residence trust with respect to all proceeds of sale held by the trust not later than the earlier of—

(A) The date that is two years after the date of sale;

(B) The termination of the term holder's interest in the trust; or

(C) The date on which a new residence is acquired by the trust.

(iii) *Damage to or destruction of personal residence*—(A) *In general.* The governing instrument must provide that, if damage or destruction renders the residence unusable as a residence, the trust ceases to be a qualified personal residence trust on the date that is two years after the date of damage or destruction (or the date of termination of the term holder's interest in the trust, if earlier) unless, prior to such date—

(*1*) Replacement of or repairs to the residence are completed; or

(*2*) A new residence is acquired by the trust.

(B) *Insurance proceeds.* For purposes of this paragraph (C)(7)(iii), if the governing instrument permits the trust to hold proceeds of insurance received as a result of damage to or destruction of the residence pursuant to paragraph (c)(5)(ii)(D) of this section, the governing instrument must contain provisions similar to those required by paragraph (c)(7)(ii) of this section.

(8) *Disposition of trust assets on cessation as personal residence trust*—(i) *In general.* The governing instrument must provide that, within 30 days after the date on which the trust has ceased to be a qualified personal residence trust with respect to certain assets, either—

(A) The assets be distributed outright to the term holder;

(B) The assets be converted to and held for the balance of the term holder's term in a separate share of the trust meeting the requirements of a qualified annuity interest; or

(C) In the trustee's sole discretion, the trustee may elect to comply with either paragraph (c)(8)(i) (A) or (B) of this section pursuant to their terms.

(ii) *Requirements for conversion to a qualified annuity interest*—(A) *Governing instrument requirements.* For assets subject to this paragraph (c)(8) to be converted to and held as a qualified annuity interest, the governing instrument must contain all provisions required by § 25.2702–3 with respect to a qualified annuity interest.

(B) *Effective date of annuity.* The governing instrument must provide that the right of the term holder to receive the annuity amount begins on the date of sale of the residence, the date of damage to or destruction of the residence, or the date on which the residence ceases to be used or held for use as a personal residence, as the case may be (''the cessation date''). Notwithstanding the preceding sentence, the governing instrument may provide that the trustee may defer payment of any annuity amount otherwise payable after the cessation date until the date that is 30 days after the assets are converted to a qualified annuity interest under paragraph (c)(8)(i)(B) of this section (''the conversion date''); provided that any deferred payment must bear interest from the cessation date at a rate not less than the section 7520 rate in effect on the cessation date. The governing instrument may permit the trustee to reduce aggregate deferred annuity payments by the amount of income actually distributed by the trust to the term holder during the deferral period.

(C) *Determination of annuity amount*—(*1*) *In general.* The governing instrument must require that the annuity amount be no less than the amount determined under this paragraph (C).

(*2*) *Entire trust ceases to be a qualified personal residence trust.* If, on the conversion date, the assets of the trust do not include a residence used or held for use as a personal residence, the annuity may not be less than an amount determined by dividing the lesser of the value of all interests retained by the term holder (as of the date of the original transfer or transfers) or the value of all the trust assets (as of the conversion date) by an annuity factor determined—

(*i*) For the original term of the term holder's interest; and

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

(*3*) *Portion of trust continues as qualified personal residence trust.* If, on the conversion date, the assets of the trust include a residence used or held for use as a personal residence, the annuity must not be less than the amount determined under paragraph

(c)(8)(ii)(C)(*2*) of this section multiplied by a fraction. The numerator of the fraction is the excess of the fair market value of the trust assets on the conversion date over the fair market value of the assets as to which the trust continues as a qualified personal residence trust, and the denominator of the fraction is the fair market value of the trust assets on the conversion date.

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

(d) *Examples.* The following examples illustrate rules of this section. Each example assumes that all applicable requirements of a personal residence trust (or qualified personal residence trust) are met unless otherwise stated.

*Example 1.* C maintains C's principal place of business in one room of C's principal residence. The room meets the requirements of section 280A(c)(1) for deductibility of expenses related to such use. The residence is a personal residence.

*Example 2.* L owns a vacation condominium that L rents out for six months of the year, but which is treated as L's residence under section 280A(d)(1) because L occupies it for at least 18 days per year. L provides no substantial services in connection with the rental of the condominium. L transfers the condominium to an irrevocable trust, the terms of which meet the requirements of a qualified personal residence trust. L retains the right to use the condominium during L's lifetime. The trust is a qualified personal residence trust.

*Example 3.* W owns a 200-acre farm. The farm includes a house, barns, equipment buildings, a silo, and enclosures for confinement of farm animals. W transfers the farm to an irrevocable trust, retaining the use of the farm for 20 years, with the remainder to W's child. The trust is not a personal residence trust because the farm includes assets not meeting the requirements of a personal residence.

*Example 4.* A transfers A's principal residence to an irrevocable trust, retaining the right to use the residence for a 20-year term. The governing instrument of the trust does not prohibit the trust from holding personal property. The trust is not a qualified personal residence trust.

*Example 5.* T transfers a personal residence to a trust that meets the requirements of a qualified personal residence trust, retaining a term interest in the trust for 10 years. During the period of T's retained term interest, T is forced for health reasons to move to a nursing home. T's spouse continues to occupy the residence. If the residence is available at all times for T's use as a residence during the term (without regard to T's ability to actually use the residence), the residence continues to be held for T's use and the trust does not cease to be a qualified personal residence trust. The residence would cease to be held for use as a personal residence of T if the trustee rented the residence to an unrelated party, because the residence would no longer be available for T's use at all times.

*Example 6.* T transfers T's personal residence to a trust that meets the requirements

of a qualified personal residence trust, retaining the right to use the residence for 12 years. On the date the residence is transferred to the trust, the fair market value of the residence is $100,000. After 6 years, the trustee sells the residence, receiving net proceeds of $250,000, and invests the proceeds of sale in common stock. After an additional eighteen months, the common stock has paid $15,000 in dividends and has a fair market value of $260,000. On that date, the trustee purchases a new residence for $200,000. On the purchase of the new residence, the trust ceases to be a qualified personal residence trust with respect to any amount not reinvested in the new residence. The governing instrument of the trust provides that the trustee, in the trustee's sole discretion, may elect either to distribute the excess proceeds or to convert the proceeds into a qualified annuity interest. The trustee elects the latter option. The amount of the annuity is the amount of the annuity that would be payable if no portion of the sale proceeds had been reinvested in a personal residence multiplied by a fraction. The numerator of the fraction is $60,000 (the amount remaining after reinvestment) and the denominator of the fraction is $260,000 (the fair market value of the trust assets on the conversion date). The obligation to pay the annuity commences on the date of sale, but payment of the annuity that otherwise would have been payable during the period between the date of sale and the date on which the trust ceased to be a qualified personal residence trust with respect to the excess proceeds may be deferred until 30 days after the date on which the new residence is purchased. Any amount deferred must bear compound interest from the date the annuity is payable at the section 7520 rate in effect on the date of sale. The $15,000 of income distributed to the term holder during that period may be used to reduce the annuity amount payable with respect to that period if the governing instrument so provides and thus reduce the amount on which compound interest is computed.

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

### § 25.2702–6 Reduction in taxable gifts.

(a) *Transfers of retained interests in trust*—(1) *Inter vivos transfers.* If an individual subsequently transfers by gift an interest in trust previously valued (when held by that individual) under § 25.2702–2 (b)(1) or (c), the individual is entitled to a reduction in aggregate taxable gifts. The amount of the reduction is determined under paragraph (b) of this section. Thus, for example, if an individual transferred property to an irrevocable trust, retaining an interest in the trust that was valued at zero under § 25.2702–2(b)(1), and the individual later transfers the retained interest by gift, the individual is entitled to a reduction in aggregate taxable gifts on the subsequent transfer. For purposes of this section, aggregate taxable gifts means the aggregate sum of the individual's taxable gifts for the calendar year determined under section 2502(a)(1).

(2) *Testamentary transfers.* If either—

(i) A term interest in trust is included in an individual's gross estate solely by reason of section 2033, or

(ii) A remainder interest in trust is included in an individual's gross estate,

and the interest was previously valued (when held by that individual) under § 25.2702–2(b)(1) or (c), the individual's estate is entitled to a reduction in the individual's adjusted taxable gifts in computing the Federal estate tax payable under section 2001. The amount of the reduction is determined under paragraph (b) of this section.

(3) *Gift splitting on subsequent transfer.* If an individual who is entitled to a reduction in aggregate taxable gifts (or adjusted taxable gifts) subsequently transfers the interest in a transfer treated as made one-half by the individual's spouse under section 2513, the individual may assign one-half of the amount of the reduction to the consenting spouse. The assignment must be attached to the Form 709 on which the consenting spouse reports the split gift.

(b) *Amount of reduction*—(1) *In general.* The amount of the reduction in aggregate taxable gifts (or adjusted taxable gifts) is the lesser of—

(i) The increase in the individual's taxable gifts resulting from the interest being valued at the time of the initial transfer under § 25.2702–2(b)(1) or (c); or

(ii) The increase in the individual's taxable gifts (or gross estate) resulting from the subsequent transfer of the interest.

(2) *Treatment of annual exclusion.* For purposes of determining the amount under paragraph (b)(1)(ii) of this section, the exclusion under section 2503(b) applies first to transfers in that

year other than the transfer of the interest previously valued under § 25.2702–2(b)(1) or (c).

(3) *Overlap with section 2001.* Notwithstanding paragraph (b)(1) of this section, the amount of the reduction is reduced to the extent section 2001 would apply to reduce the amount of an individual's adjusted taxable gifts with respect to the same interest to which paragraph (b)(1) of this section would otherwise apply.

(c) *Examples.* The rules of this section are illustrated by the following examples. The following facts apply for *Examples 1–4:*

*Facts.* In 1992, X transferred property to an irrevocable trust retaining the right to receive the trust income for life. On the death of X, the trust is to terminate and the trust corpus is to be paid to X's child, C. X's income interest had a value under section 7520 of $40,000 at the time of the transfer; however, because X's retained interest was not a qualified interest, it was valued at zero under § 25.2702–2(b)(1) for purposes of determining the amount of X's gift. X's taxable gifts in 1992 were therefore increased by $40,000. In 1993, X transfers the income interest to C for no consideration.

*Example 1.* Assume that the value under section 7520 of the income interest on the subsequent transfer to C is $30,000. If X makes no other gifts to C in 1993, X is entitled to a reduction in aggregate taxable gifts of $20,000, the lesser of the amount by which X's taxable gifts were increased as a result of the income interest being valued at zero on the initial transfer ($40,000) or the amount by which X's taxable gifts are increased as a result of the subsequent transfer of the income interest ($30,000 minus $10,000 annual exclusion).

*Example 2.* Assume that in 1993, 4 months after X transferred the income interest to C, X transferred $5,000 cash to C. In determining the increase in taxable gifts occurring on the subsequent transfer, the annual exclusion under section 2503(b) is first applied to the cash gift. X is entitled to a reduction in aggregate taxable gifts of $25,000, the lesser of the amount by which X's taxable gifts were increased as a result of the income interest being valued at zero on the initial transfer ($40,000) or the amount by which X's taxable gifts are increased as a result of the subsequent transfer of the income interest ($25,000 (($30,000+$5,000) − $10,000 annual exclusion).

*Example 3.* Assume that the value under section 7520 of the income interest on the subsequent transfer to C is $55,000. X is entitled to reduce aggregate taxable gifts by $40,000, the lesser of the amount by which X's taxable gifts were increased as a result of the income interest being valued at zero on the initial transfer ($40,000) or the amount by which X's taxable gifts are increased as a result of the subsequent transfer of the income interest ($55,000 minus $10,000 annual exclusion = $45,000).

*Example 4.* Assume that X and X's spouse, S, split the subsequent gift to C. X is entitled to assign one-half the reduction to S. If the assignment is made, each is entitled to reduce aggregate taxable gifts by $17,500, the lesser of their portion of the increase in taxable gifts on the initial transfer by reason of the application of section 2702 ($20,000) and their portion of the increase in taxable gifts on the subsequent transfer of the retained interest ($27,500 − $10,000 annual exclusion).

*Example 5.* In 1992, A transfers property to an irrevocable trust, retaining the right to receive the trust income for 10 years. On the expiration of the 10-year term, the trust is to terminate and the trust corpus is to be paid to A's child, B. Assume that A's term interest has a value under section 7520 of $20,000 at the time of the transfer; however, because A's retained interest was not a qualified interest, it was valued at zero under § 25.2702–2(b)(1) for purposes of determining the amount of A's gift. Assume also that A and A's spouse, S, split the gift of the remainder interest under section 2513. In 1993, A transfers A's term interest to D, A's other child, for no consideration. A is entitled to reduce A's aggregate taxable gifts on the transfer. Assume that A and S also split the subsequent gift to D, and that A dies one month after making the subsequent transfer of the term interest and S dies six months later. The gift of the term interest is included in A's gross estate under section 2035(d)(2). To the extent S's taxable gifts are reduced pursuant to section 2001(e), S is entitled to no reduction in aggregate or adjusted taxable gifts under this section.

*Example 6.* T transfers property to an irrevocable trust retaining the power to direct the distribution of trust income for 10 years among T's descendants in whatever shares T deems appropriate. On the expiration of the 10-year period, the trust corpus is to be paid in equal shares to T's children. T's transfer of the remainder interest is a completed gift. Because T's retained interest is not a qualified interest, it is valued at zero under § 25.2702–2(b)(1) and the amount of T's gift is the fair market value of the property transferred to the trust. The distribution of income each year is not a transfer of a retained interest in trust. Therefore, T is not entitled to reduce aggregate taxable gifts as a result of the distributions of income from the trust.

*Example 7.* The facts are the same as in *Example 6,* except that after 3 years T exercises the right to direct the distribution of trust income by assigning the right to the income

for the balance of the term to T's child, C. The exercise is a transfer of a retained interest in trust for purposes of this section. T is entitled to reduce aggregate taxable gifts by the lesser of the increase in taxable gifts resulting from the application of section 2702 to the initial transfer or the increase in taxable gifts resulting from the transfer of the retained interest in trust.

*Example 8.* In 1992, V purchases an income interest for 10 years in property in the same transaction or series of transactions in which G, V's child, purchases the remainder interest in the same property. V dies in 1997 still holding the term interest, the value of which is includible in V's gross estate under section 2033. V's estate would be entitled to a reduction in adjusted taxable gifts in the amount determined under paragraph (b) of this section.

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

### § 25.2702–7 Effective dates.

Except as provided in this section, §§ 25.2702–1 through 25.2702–6 apply as of January 28, 1992. With respect to transfers to which section 2702 applied made prior to January 28, 1992, taxpayers may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of the proposed regulations and the final regulations are considered a reasonable interpretation of the statutory provisions. The fourth through eighth sentences of § 25.2702–5(b)(1) and § 25.2702–5(c)(9) apply with respect to trusts created after May 16, 1996.

[T.D. 8395, 57 FR 4273, Feb. 4, 1992, as amended by T.D. 8743, 62 FR 66989, Dec. 23, 1997]

### § 25.2703–1 Property subject to restrictive arrangements.

(a) *Disregard of rights or restrictions*—(1) *In general.* For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), the value of any property is determined without regard to any right or restriction relating to the property.

(2) *Right or restriction.* For purposes of this section, right or restriction means—

(i) Any option, agreement, or other right to acquire or use the property at a price less than fair market value (determined without regard to the option, agreement, or right); or

(ii) Any restriction on the right to sell or use the property.

(3) *Agreements, etc. containing rights or restrictions.* A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement. A right or restriction may be implicit in the capital structure of an entity.

(4) *Qualified easements.* A perpetual restriction on the use of real property that qualified for a charitable deduction under either section 2522(d) or section 2055(f) of the Internal Revenue Code is not treated as a right or restriction.

(b) *Exceptions*—(1) *In general.* This section does not apply to any right or restriction satisfying the following three requirements—

(i) The right or restriction is a bona fide business arrangement;

(ii) The right or restriction is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth; and

(iii) At the time the right or restriction is created, the terms of the right or restriction are comparable to similar arrangements entered into by persons in an arm's length transaction.

(2) *Separate requirements.* Each of the three requirements described in paragraph (b)(1) of this section must be independently satisfied for a right or restriction to meet this exception. Thus, for example, the mere showing that a right or restriction is a bona fide business arrangement is not sufficient to establish that the right or restriction is not a device to transfer property for less than full and adequate consideration.

(3) *Exception for certain rights or restrictions.* A right or restriction is considered to meet each of the three requirements described in paragraph (b)(1) of this section if more than 50 percent by value of the property subject to the right or restriction is owned directly or indirectly (within the meaning of § 25.2701–6) by individuals who are not members of the transferor's family. In order to meet this exception, the property owned by those individuals must be subject to the right or restriction to the same extent

as the property owned by the transferor. For purposes of this section, members of the transferor's family include the persons described in § 25.2701–2(b)(5) and any other individual who is a natural object of the transferor's bounty. Any property held by a member of the transferor's family under the rules of § 25.2701–6 (without regard to § 25.2701–6(a)(5)) is treated as held only by a member of the transferor's family.

(4) *Similar arrangement*—(i) *In general.* A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length. A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business. This determination generally will entail consideration of such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted.

(ii) *Evidence of general business practice.* Evidence of general business practice is not met by showing isolated comparables. If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods. It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement. If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.

(5) *Multiple rights or restrictions.* If property is subject to more than one right or restriction described in paragraph (a)(2) of this section, the failure of a right or restriction to satisfy the requirements of paragraph (b)(1) of this section does not cause any other right or restriction to fail to satisfy those requirements if the right or restriction otherwise meets those requirements. Whether separate provisions are separate rights or restrictions, or are integral parts of a single right or restriction, depends on all the facts and circumstances.

(c) *Substantial modification of a right or restriction*—(1) *In general.* A right or restriction that is substantially modified is treated as a right or restriction created on the date of the modification. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a *de minimis* change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification. If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless it can be shown that updating would not have resulted in a substantial modification. The addition of any family member as a party to a right or restriction (including by reason of a transfer of property that subjects the transferee family member to a right or restriction with respect to the transferred property) is considered a substantial modification unless the addition is mandatory under the terms of the right or restriction or the added family member is assigned to a generation (determined under the rules of section 2651 of the Internal Revenue Code) no lower than the lowest generation occupied by individuals already party to the right or restriction).

(2) *Exceptions.* A substantial modification does not include—

(i) A modification required by the terms of a right or restriction;

(ii) A discretionary modification of an agreement conferring a right or restriction if the modification does not change the right or restriction;

(iii) A modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate; and

(iv) A modification that results in an option price that more closely approximates fair market value.

(d) *Examples.* The following examples illustrate the provisions of this section:

*Example 1.* T dies in 1992 owning title to Blackacre. In 1991, T and T's child entered into a lease with respect to Blackacre. At the time the lease was entered into, the terms of the lease were not comparable to leases of similar property entered into among unrelated parties. The lease is a restriction on the use of the property that is disregarded in valuing the property for Federal estate tax purposes.

*Example 2.* T and T's child, C, each own 50 percent of the outstanding stock of X corporation. T and C enter into an agreement in 1987 providing for the disposition of stock held by the first to die at the time of death. The agreement also provides certain restrictions with respect to lifetime transfers. In 1992, as permitted (but not required) under the agreement, T transfers one-half of T's stock to T's spouse, S. S becomes a party to the agreement between T and C by reason of the transfer. The transfer is the addition of a family member to the right or restriction. However, it is not a substantial modification of the right or restriction because the added family member would be assigned to a generation under section 2651 of the Internal Revenue Code no lower than the generation occupied by C.

*Example 3.* The facts are the same as in *Example 2.* In 1993, the agreement is amended to reflect a change in the company's name and a change of address for the company's registered agent. These changes are not a substantial modification of the agreement conferring the right or restriction because the right or restriction has not changed.

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

### § 25.2703–2 Effective date.

Section 25.2703–1 applies to any right or restriction created or substantially modified after October 8, 1990, and is effective as of January 28, 1992. With respect to transfers occurring prior to January 28, 1992, and for purposes of determining whether an event occurring prior to January 28, 1992 constitutes a substantial modification, taxpayers may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of the proposed regulations and the final regulations are considered a reasonable interpretation of the statutory provisions.

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

### § 25.2704–1 Lapse of certain rights.

(a) *Lapse treated as transfer*—(1) *In general.* The lapse of a voting right or a liquidation right in a corporation or partnership (an ''entity'') is a transfer by the individual directly or indirectly holding the right immediately prior to its lapse (the ''holder'') to the extent provided in paragraphs (b) and (c) of this section. This section applies only if the entity is controlled by the holder and members of the holder's family immediately before and after the lapse. The amount of the transfer is determined under paragraph (d) of this section. If the lapse of a voting right or a liquidation right occurs during the holder's lifetime, the lapse is a transfer by gift. If the lapse occurs at the holder's death, the lapse is a transfer includible in the holder's gross estate.

(2) *Definitions.* The following definitions apply for purposes of this section.

(i) *Control.* Control has the meaning given it in § 25.2701–2(b)(5).

(ii) *Member of the family.* Member of the family has the meaning given it in § 25.2702–2(a)(1).

(iii) *Directly or indirectly held.* An interest is directly or indirectly held only to the extent the value of the interest would have been includible in the gross estate of the individual if the individual had died immediately prior to the lapse.

(iv) *Voting right.* Voting right means a right to vote with respect to any matter of the entity. In the case of a partnership, the right of a general partner to participate in partnership management is a voting right. The right to compel the entity to acquire all or a portion of the holder's equity interest in the entity by reason of aggregate voting power is treated as a liquidation right and is not treated as a voting right.

(v) *Liquidation right.* Liquidation right means a right or ability to compel the entity to acquire all or a portion of the holder's equity interest in the entity, including by reason of aggregate voting power, whether or not its exercise would result in the complete liquidation of the entity.

(vi) *Subordinate.* Subordinate has the meaning given it in § 25.2701–3(a)(2)(iii).

(3) *Certain temporary lapses.* If a lapsed right may be restored only upon

the occurrence of a future event not within the control of the holder or members of the holder's family, the lapse is deemed to occur at the time the lapse becomes permanent with respect to the holder, *i.e.* either by a transfer of the interest or otherwise.

(4) *Source of right or lapse.* A voting right or a liquidation right may be conferred by and may lapse by reason of a State law, the corporate charter or by-laws, an agreement, or other means.

(b) *Lapse of voting right.* A lapse of a voting right occurs at the time a presently exercisable voting right is restricted or eliminated.

(c) *Lapse of liquidation right*—(1) *In general.* A lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated. Except as otherwise provided, a transfer of an interest that results in the lapse of a liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated. However, a transfer that results in the elimination of the transferor's right or ability to compel the entity to acquire an interest retained by the transferor that is subordinate to the transferred interest is a lapse of a liquidation right with respect to the subordinate interest.

(2) *Exceptions.* Section 2704(a) does not apply to the lapse of a liquidation right under the following circumstances.

(i) *Family cannot obtain liquidation value*—(A) *In general.* Section 2704(a) does not apply to the lapse of a liquidation right to the extent the holder (or the holder's estate) and members of the holder's family cannot immediately after the lapse liquidate an interest that the holder held directly or indirectly and could have liquidated prior to the lapse.

(B) *Ability to liquidate.* Whether an interest can be liquidated immediately after the lapse is determined under the State law generally applicable to the entity, as modified by the governing instruments of the entity, but without regard to any restriction described in section 2704(b). Thus, if, after any restriction described in section 2704(b) is disregarded, the remaining requirements for liquidation under the governing instruments are less restrictive than the State law that would apply in the absence of the governing instruments, the ability to liquidate is determined by reference to the governing instruments.

(ii) *Rights valued under section 2701.* Section 2704(a) does not apply to the lapse of a liquidation right previously valued under section 2701 to the extent necessary to prevent double taxation (taking into account any adjustment available under § 25.2701–5).

(iii) *Certain changes in State law.* Section 2704(a) does not apply to the lapse of a liquidation right that occurs solely by reason of a change in State law. For purposes of this paragraph, a change in the governing instrument of an entity is not a change in State law.

(d) *Amount of transfer.* The amount of the transfer is the excess, if any, of—

(1) The value of all interests in the entity owned by the holder immediately before the lapse (determined immediately after the lapse as if the lapsed right was nonlapsing); over

(2) The value of the interests described in the preceding paragraph immediately after the lapse (determined as if all such interests were held by one individual).

(e) *Application to similar rights.* [Reserved]

(f) *Examples.* The following examples illustrate the provisions of this section:

*Example 1.* Prior to D's death, D owned all the preferred stock of Corporation Y and D's children owned all the common stock. At that time, the preferred stock had 60 percent of the total voting power and the common stock had 40 percent. Under the corporate by-laws, the voting rights of the preferred stock terminated on D's death. The value of D's interest immediately prior to D's death (determined as if the voting rights were nonlapsing) was $100X. The value of that interest immediately after death would have been $90X if the voting rights had been nonlapsing. The decrease in value reflects the loss in value resulting from the death of D (whose involvement in Y was a key factor in Y's profitability). Section 2704(a) applies to the lapse of voting rights on D's death. D's gross estate includes an amount equal to the excess, if any, of $90X over the fair market value of the preferred stock determined after the lapse of the voting rights.

*Example 2.* Prior to D's death, D owned all the preferred stock of Corporation Y. The preferred stock and the common stock each

carried 50 percent of the total voting power of Y. D's children owned 40 percent of the common stock and unrelated parties own the remaining 60 percent. Under the corporate by-laws, the voting rights of the preferred stock terminate on D's death. Section 2704(a) does not apply to the lapse of D's voting rights because members of D's family do not control Y after the lapse.

*Example 3.* The by-laws of Corporation Y provide that the voting rights of any transferred shares of the single outstanding class of stock are reduced to ½ vote per share after the transfer but are fully restored to the transferred shares after 5 years. D owned 60 percent of the shares prior to death and members of D's family owned the balance. On D's death, D's shares pass to D's children and the voting rights are reduced pursuant to the by-laws. Section 2704(a) applies to the lapse of D's voting rights. D's gross estate includes an amount equal to the excess, if any, of the fair market value of D's stock (determined immediately after D's death as though the voting rights had not been reduced and would not be reduced) over the stock's fair market value immediately after D's death.

*Example 4.* D owns 84 percent of the single outstanding class of stock of Corporation Y. The by-laws require at least 70 percent of the vote to liquidate Y. D gives one-half of D's stock in equal shares to D's three children (14 percent to each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y, because the voting rights with respect to the corporation are not restricted or eliminated by reason of the transfer.

*Example 5.* D and D's two children, A and B, are partners in Partnership X. Each has a 3⅓ percent general partnership interest and a 30 percent limited partnership interest. Under State law, a general partner has the right to participate in partnership management. The partnership agreement provides that when a general partner withdraws or dies, X must redeem the general partnership interest for its liquidation value. Also, under the agreement any general partner can liquidate the partnership. A limited partner cannot liquidate the partnership and a limited partner's capital interest will be returned only when the partnership is liquidated. A deceased limited partner's interest continues as a limited partnership interest. D dies, leaving his limited partnership interest to D's spouse. Because of a general partner's right to dissolve the partnership, a limited partnership interest has a greater fair market value when held in conjunction with a general partnership interest than when held alone. Section 2704(a) applies to the lapse of D's liquidation right because after the lapse, members of D's family could liquidate D's limited partnership interest. D's gross estate includes an amount equal to the excess of the value of all D's interests in X immediately before D's death (determined immediately after D's death but as though the liquidation right had not lapsed and would not lapse) over the fair market value of all D's interests in X immediately after D's death.

*Example 6.* The facts are the same as in *Example 5,* except that under the partnership agreement D is the only general partner who holds a unilateral liquidation right. Assume further that the partnership agreement contains a restriction described in section 2704(b) that prevents D's family members from liquidating D's limited partnership interest immediately after D's death. Under State law, in the absence of the restriction in the partnership agreement, D's family members could liquidate the partnership. The restriction on the family's ability to liquidate is disregarded and the amount of D's gross estate is increased by reason of the lapse of D's liquidation right.

*Example 7.* D owns all the stock of Corporation X, consisting of 100 shares of non-voting preferred stock and 100 shares of voting common stock. Under the by-laws, X can only be liquidated with the consent of at least 80 percent of the voting shares. D transfers 30 shares of common stock to D's child. The transfer is not a lapse of a liquidation right with respect to the common stock because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated. The transfer is not a lapse of a liquidation right with respect to the retained preferred stock because the preferred stock is not subordinate to the transferred common stock.

*Example 8.* D owns all of the single class of stock of Corporation Y. D recapitalizes Y, exchanging D's common stock for voting common stock and non-voting, non-cumulative preferred stock. The preferred stock carries a right to put the stock for its par value at any time during the next 10 years. D transfers the common stock to D's grandchild in a transfer subject to section 2701. In determining the amount of D's gift under section 2701, D's retained put right is valued at zero. D's child, C, owns the preferred stock when the put right lapses. Section 2704(a) applies to the lapse, without regard to the application of section 2701, because the put right was not valued under section 2701 in the hands of C.

*Example 9.* A and A's two children are equal general and limited partners in Partnership Y. Under the partnership agreement, each general partner has a right to liquidate the partnership at any time. Under State law that would apply in the absence of contrary provisions in the partnership agreement, the death or incompetency of a general partner terminates the partnership. However, the partnership agreement provides that the partnership does not terminate on the incompetence or death of a general partner, but that an incompetent partner cannot exercise rights as a general partner during any

period of incompetency. A partner's full rights as general partner are restored if the partner regains competency. A becomes incompetent. The lapse of A's voting right on becoming incompetent is not subject to section 2704(a) because it may be restored to A in the future. However, if A dies while incompetent, a lapse subject to section 2704(a) is deemed to occur at that time because the lapsed right cannot thereafter be restored to A.

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

### § 25.2704–2 Transfers subject to applicable restrictions.

(a) *In general.* If an interest in a corporation or partnership (an ''entity'') is transferred to or for the benefit of a member of the transferor's family, any applicable restriction is disregarded in valuing the transferred interest. This section applies only if the transferor and members of the transferor's family control the entity immediately before the transfer. For the definition of control, see § 25.2701–2(b)(5). For the definition of member of the family, see § 25.2702–2(a)(1).

(b) *Applicable restriction defined.* An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction. A restriction is an applicable restriction only to the extent that either the restriction by its terms will lapse at any time after the transfer, or the transferor (or the transferor's estate) and any members of the transferor's family can remove the restriction immediately after the transfer. Ability to remove the restriction is determined by reference to the State law that would apply but for a more restrictive rule in the governing instruments of the entity. See § 25.2704–1(c)(1)(B) for a discussion of the term ''State law.'' An applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b) of the Internal Revenue Code, provided that for purposes of this section the term ''fiduciary of a trust'' as used in section 267(b) does not include a bank as defined in section 581 of the Internal Revenue Code. A restriction imposed or required to be imposed by Federal or State law is not an applicable restriction. An option, right to use property, or agreement that is subject to section 2703 is not an applicable restriction.

(c) *Effect of disregarding an applicable restriction.* If an applicable restriction is disregarded under this section, the transferred interest is valued as if the restriction does not exist and as if the rights of the transferor are determined under the State law that would apply but for the restriction. For example, an applicable restriction with respect to preferred stock will be disregarded in determining the amount of a transfer of common stock under section 2701.

(d) *Examples.* The following examples illustrate the provisions of this section:

*Example 1.* D owns a 76 percent interest and each of D's children, A and B, owns a 12 percent interest in General Partnership X. The partnership agreement requires the consent of all the partners to liquidate the partnership. Under the State law that would apply in the absence of the restriction in the partnership agreement, the consent of partners owning 70 percent of the total partnership interests would be required to liquidate X. On D's death, D's partnership interest passes to D's child, C. The requirement that all the partners consent to liquidation is an applicable restriction. Because A, B and C (all members of D's family), acting together after the transfer, can remove the restriction on liquidation, D's interest is valued without regard to the restriction; *i.e.*, as though D's interest is sufficient to liquidate the partnership.

*Example 2.* D owns all the preferred stock in Corporation X. The preferred stock carries a right to liquidate X that cannot be exercised until 1999. D's children, A and B, own all the common stock of X. The common stock is the only voting stock. In 1994, D transfers the preferred stock to D's child, A. The restriction on D's right to liquidate is an applicable restriction that is disregarded. Therefore, the preferred stock is valued as though the right to liquidate were presently exercisable.

*Example 3.* D owns 60 percent of the stock of Corporation X. The corporate by-laws provide that the corporation cannot be liquidated for 10 years after which time liquidation requires approval by 60 percent of the voting interests. In the absence of the provision in the by-laws, State law would require approval by 80 percent of the voting interests to liquidate X. D transfers the stock to a trust for the benefit of D's child, A, during the 10-year period. The 10-year restriction is an applicable restriction and is disregarded. Therefore, the value of the stock is determined as if the transferred block could currently liquidate X.

*Example 4.* D and D's children, A and B, are partners in Limited Partnership Y. Each has a 3.33 percent general partnership interest and a 30 percent limited partnership interest. Any general partner has the right to liquidate the partnership at any time. As part of a loan agreement with a lender who is related to D, each of the partners agree that the partnership may not be liquidated without the lender's consent while any portion of the loan remains outstanding. During the term of the loan agreement, D transfers one-half of both D's partnership interests to each of A and B. Because the lender is a related party, the requirement that the lender consent to liquidation is an applicable restriction and the transfers of D's interests are valued as if such consent were not required.

*Example 5.* D owns 60 percent of the preferred and 70 percent of the common stock in Corporation X. The remaining stock is owned by individuals unrelated to D. The preferred stock carries a put right that cannot be exercised until 1999. In 1995, D transfers the common stock to D's child in a transfer that is subject to section 2701. The restriction on D's right to liquidate is an applicable restriction that is disregarded in determining the amount of the gift under section 2701.

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

### § 25.2704–3 Effective date.

Section 25.2704–1 applies to lapses occurring after January 28, 1992, of rights created after October 8, 1990. Section 25.2704–2 applies to transfers occurring after January 28, 1992, of property subject to applicable restrictions created after October 8, 1990. In determining whether a voting right or a liquidation right has lapsed prior to that date, and for purposes of determining whether the lapse is subject to section 2704(a), taxpayers may rely on any reasonable interpretation of the statutory provisions. For transfers of interests occurring before January 28, 1992, taxpayers may rely on any reasonable interpretation of the statutory provisions in detemining whether a restriction is an applicable restriction that must be disregarded in determining the value of the transferred interest. For these purposes, the provisions of the proposed regulations and the final regulations are considered a reasonable interpretation of the statutory provisions.

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

## PROCEDURE AND ADMINISTRATION

### § 25.6001–1 Records required to be kept.

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

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

company shall file this statement direct with the internal revenue officer.

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

### § 25.6011–1 General requirement of return, statement, or list.

(a) *General rule.* Every person made liable for any tax imposed by Chapter 12 of the Code shall make such returns or statements as are required by the regulations in this part. The return or statement shall include therein the information required by the applicable regulations or forms.

(b) *Use of prescribed forms.* Copies of the forms prescribed by paragraph (b) of § 25.6001–1 and § 25.6019–1 may be obtained from district directors and directors of service centers. The fact that a person required to file a form has not been furnished with copies of a form will not excuse him from the making of a gift tax return, or from the furnishing of the evidence for which the forms are to be used. Application for a form should be made to the district director or director of a service center in ample time to enable the person whose duty it is to file the form to have the form prepared, verified, and filed on or before the date prescribed for the filing thereof.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7012, 34 FR 7691, May 15, 1969]

### § 25.6019–1 Persons required to file returns.

(a) *Gifts made after December 31, 1981.* Subject to section 2523(i)(2), an individual citizen or resident of the United States who in any calendar year beginning after December 31, 1981, makes any transfer by gift other than a transfer that, under section 2503 (b) or (e) (relating, respectively, to certain gifts of $10,000 per donee and the exclusion for payment of certain educational and medical expenses), is not included in the total amount of gifts for that year, or a transfer of an interest with respect to which a marital deduction is allowed for the value of the entire interest under section 2523 (other than a marital deduction allowed by reason of section 2523(f), regarding qualified terminable interest property for which a return must be filed in order to make the election under that section), must file a gift tax return on Form 709 for that calendar year.

(b) *Gifts made after December 31, 1976, and before January 1, 1982.* An individual citizen or resident of the United States who makes a transfer by gift within any calendar year beginning after December 31, 1976, and before January 1, 1982, must file a gift tax return on Form 709 for any calendar quarter in which the sum of the taxable gifts made during that calendar quarter, plus all other taxable gifts made during the year (for which a return has not yet been required to be filed), exceeds $25,000. If the aggregate transfers made in a calendar year after 1976 and before 1982 that must be reported do not exceed $25,000, only one return must be filed for the calendar year and it must be filed by the due date for a fourth quarter gift tax return (April 15).

(c) *Gifts made after December 31, 1970, and before January 1, 1977.* An individual citizen or resident of the United States who makes a transfer by gift within any calendar year beginning after December 31, 1970, and before January 1, 1977, must file a gift tax return on Form 709 for the calendar quarter in which any portion of the value of the gift, or any portion of the sum of the values of the gifts to such donee during that calendar year, is not excluded from the total amount of taxable gifts for that year, and must also make a return for any subsequent quarter within the same taxable year in which any additional gift is made to the same donee.

(d) *Gifts by nonresident alien donors.* The rules contained in paragraphs (a) through (c) of this section also apply to a nonresident not a citizen of the United States provided that, under section 2501(a)(1) and § 25.2511–3, the transfer is subject to the gift tax.

(e) *Miscellaneous provisions.* Only individuals are required to file returns and not trusts, estates, partnerships, or corporations. Duplicate copies of the return are not required to be filed. See §§ 25.6075–1 and 25.6091–1 for the time and place for filing the gift tax return. For delinquency penalties for failure to file or pay the tax, see section 6651 and § 301.6651–1 of this chapter (Procedure and Administration Regulations). For criminal penalties for failure to file a

return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

(f) *Return required even if no tax due.* The return is required even though, because of the deduction authorized by section 2522 (charitable deduction) or the unified credit under section 2505, no tax may be payable on the transfer.

(g) *Deceased donor.* If the donor dies before filing his return, the executor or administrator of his estate shall file the return. If the donor becomes legally incompetent before filing his return, his guardian or committee shall file the return.

(h) *Ratification of return.* The return shall not be made by an agent unless by reason of illness, absence, or nonresidence, the person liable for the return is unable to make it within the time prescribed. Mere convenience is not sufficient reason for authorizing an agent to make the return. If by reason of illness, absence or nonresidence, a return is made by an agent, the return must be ratified by the donor or other person liable for its filing within a reasonable time after such person becomes able to do so. If the return filed by the agent is not so ratified, it will not be considered the return required by the statute. Supplemental data may be submitted at the time of ratification. The ratification may be in the form of a statement, executed under the penalties of perjury and filed with the internal revenue officer with whom the return was filed, showing specifically that the return made by the agent has been carefully examined and that the person signing ratifies the return as the donor's. If a return is signed by an agent, a statement fully explaining the inability of the donor must accompany the return.

[T.D. 7238, 37 FR 28735, Dec. 29, 1972, as amended by T.D. 8522, 59 FR 9663, Mar. 1, 1994]

### § 25.6019–2 Returns required in case of consent under section 2513.

Except as otherwise provided in this section, the provisions of § 25.6019–1 (other than paragraph (d) of § 25.6019–1) apply with respect to the filing of a gift tax return or returns in the case of a husband and wife who consent (see § 25.2513–1) to the application of section 2513. If both spouses are (without regard to the provisions of section 2513) required under the provisions of § 25.6019–1 to file returns, returns must be filed by both spouses. If only one of the consenting spouses is (without regard to the provisions of section 2513) required under § 25.6019–1 to file a return, a return must be filed by that spouse. In the latter case if, after giving effect to the provisions of section 2513, the other spouse is considered to have made a gift not excluded from the total amount of such other spouse's gifts for the taxable year by reason of section 2503 (b) or (e) (relating, respectively, to certain gifts of $10,000 per donee and the exclusion for certain educational or medical expenses), a return must also be filed by such other spouse. Thus, if during a calendar year beginning after December 31, 1981, the first spouse made a gift of $18,000 to a child (the gift not being either a future interest in property or an amount excluded under section 2503(e)) and the other spouse made no gifts, only the first spouse is required to file a return for that calendar year. However, if the other spouse had made a gift in excess of $2,000 to the same child during the same calendar year or if the gift made by the first spouse had amounted to $21,000, each spouse would be required to file a return if the consent is signified as provided in section 2513.

[T.D. 8522, 59 FR 9664, Mar. 1, 1994]

### § 25.6019–3 Contents of return.

(a) *In general.* The return must set forth each gift made during the calendar year (or calendar quarter with respect to gifts made after December 31, 1970, and before January 1, 1982) that under sections 2511 through 2515 is to be included in computing taxable gifts; the deductions claimed and allowable under sections 2521 through 2524; and the taxable gifts made for each of the preceding reporting periods. (See § 25.2504–1.) In addition the return shall set forth the fair market value of all gifts not made in money, including gifts resulting from sales and exchanges of property made for less than full and adequate consideration in money or money's worth, giving, as of the date of the sale or exchange, both the fair market value of the property sold or exchanged and the fair market

value of the consideration received by the donor. If a donor contends that his retained power over property renders the gift incomplete (see § 25.2511–2) and hence not subject to tax as of the calendar quarter or calendar year of the initial transfer, the transaction should be disclosed in the return for the calendar quarter or calendar year of the initial transfer and evidence showing all relevant facts, including a copy of the instrument of transfer, shall be submitted with the return. The instructions printed on the return should be carefully followed. A certified or verified copy of each document required by the instructions printed on the return form shall be filed with the return. Any additional documents the donor may desire to submit may be submitted with the return.

(b) *Disclosure of transfers coming within provisions of section 2516.* Section 2516 provides that certain transfers of property pursuant to written property settlements between husband and wife are deemed to be transfers for full and adequate consideration in money or money's worth if divorce occurs within 2 years. In any case where a husband and wife enter into a written agreement of the type contemplated by section 2516 and the final decree of divorce is not granted on or before the due date for the filing of a gift tax return for the calendar year (or calendar quarter with respect to periods beginning after December 31, 1970, and ending before January 1, 1982) in which the agreement became effective (see § 25.6075–1), then, except to the extent § 25.6019–1 provides otherwise, the transfer must be disclosed by the transferor upon a gift tax return filed for the calendar year (or calendar quarter) in which the agreement becomes effective, and a copy of the agreement must be attached to the return. In addition, a certified copy of the final divorce decree shall be furnished the internal revenue officer with whom the return was filed not later than 60 days after the divorce is granted. Pending receipt of evidence that the final decree of divorce has been granted (but in no event for a period of more than 2 years from the effective date of the agreement), the transfer will tentatively be treated as made for a full and adequate consideration in money or money's worth.

[T.D. 7238, 37 FR 28736, Dec. 29, 1972, as amended by T.D. 8522, 59 FR 9664, Mar. 1, 1994]

### § 25.6019–4 Description of property listed on return.

The properties comprising the gifts made during the calendar year (or calendar quarter with respect to gifts made after December 31, 1970, and before January 1, 1982) must be listed on the return and described in a manner that they may be readily identified. Thus, there should be given for each parcel of real estate a legal description, its area, a short statement of the character of any improvements, and, if located in a city, the name of the street and number. Description of bonds shall include the number transferred, principal amount, name of obligor, date of maturity, rate of interest, date or dates on which interest is payable, series number where there is more than one issue, and the principal exchange upon which listed, or the principal business office of the obligor, if unlisted. Description of stocks shall include number of shares, whether common or preferred, and, if preferred, what issue thereof, par value, quotation at which returned, exact name of corporation, and, if the stock is unlisted, the location of the principal business office, the State in which incorporated and the date of incorporation, or if the stock is listed, the principal exchange upon which sold. Description of notes shall include name of maker, date on which given, date of maturity, amount of principal, amount of principal unpaid, rate of interest and whether simple or compound, and date to which interest has been paid. If the gift of property includes accrued income thereon to the date of the gift, the amount of such accrued income shall be separately set forth. Description of the seller's interest in land contracts transferred shall include name of buyer, date of contract, description of property, sale price, initial payment, amounts of installment payments, unpaid balance of principal, interest rate and date prior to gift to which interest has been paid. Description of life insurance policies

shall show the name of the insurer and the number of the policy. In describing an annuity, the name and address of the issuing company shall be given, or, if payable out of a trust or other fund, such a description as will fully identify the trust or fund. If the annuity is payable for a term of years, the duration of the term and the date on which it began shall be given, and if payable for the life of any person, the date of birth of that person shall be stated. Judgments shall be described by giving the title of the cause and the name of the court in which rendered, date of judgment, name and address of judgment debtor, amount of judgment, rate of interest to which subject, and by stating whether any payments have been made thereon, and, if so, when and in what amounts.

[T.D. 7238, 37 FR 28736, Dec. 29, 1972, as amended by T.D. 8522, 59 FR 9664, Mar. 1, 1994]

### § 25.6061–1 Signing of returns and other documents.

Any return, statement, or other document required to be made under any provision of Chapter 12 or Subtitle F of the Code or regulations prescribed thereunder with respect to any tax imposed by Chapter 12 of the Code shall be signed by the donor or other person required or duly authorized to sign in accordance with the regulations, forms, or instructions prescribed with respect to such return, statement, or other document. The person required or duly authorized to make the return may incur liability for the penalties provided for erroneous, false, or fraudulent returns. For criminal penalties see sections 7201, 7203, 7206, 7207, and 7269.

[T.D. 6600, 27 FR 4987, May 29, 1962]

### § 25.6065–1 Verification of returns.

(a) *Penalties of perjury*. If a return, statement, or other document made under the provisions of Chapter 12 or Subtitle F of the Code or the regulations thereunder with respect to any tax imposed by Chapter 12 of the Code, or the form and instructions issued with respect to such return, statement, or other document, requires that it shall contain or be verified by a written declaration that it is made under the penalties of perjury, it must be so verified by the person or persons required to sign such return, statement, or other document. In addition, any other statement or document submitted under any provision of Chapter 12 or Subtitle F of the Code or regulations thereunder with respect to any tax imposed by Chapter 12 of the Code may be required to contain or be verified by a written declaration that it is made under the penalties of perjury.

(b) *Oath*. Any return, statement, or other document required to be submitted under Chapter 12 or Subtitle F of the Code or regulations prescribed thereunder with respect to any tax imposed by Chapter 12 of the Code may be required to be verified by an oath.

[T.D. 6600, 27 FR 4987, May 29, 1962]

### § 25.6075–1 Returns, time for filing gift tax returns for gifts made after December 31, 1981.

(a) *In general*. Except as provided in paragraphs (b) (1) and (2) of this section, a return required to be filed under section 6019 for gifts made after December 31, 1981, must be filed on or before the 15th day of April following the close of the calendar year in which the gift was made.

(b) *Special rules*—(1) *Extensions*. Except as provided in paragraph (b)(2) of this section, if a taxpayer files an income tax return on the calendar year basis and the taxpayer is granted an extension of time for filing the return of income tax imposed by Subtitle A of the Internal Revenue Code, then such taxpayer shall also be deemed to have been granted an extension of time for filing the gift tax return under section 6019 for such calendar year equal to the extension of time granted for filing the income tax return. See section 6081 and the regulations thereunder for rules relating to extension of time for filing returns.

(2) *Death of donor*. Where a gift is made during the calendar year in which the donor dies, the time for filing the return made under section 6019 shall not be later than the time (including extensions) for filing the return made under section 6018 (relating to estate tax returns) with respect to such donor. In addition, 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 shall be 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 shall be on or before the 15th day of April following the close of the calendar year, unless an extension was granted for filing the gift tax return.

(c) Paragraphs (a) and (b) may be illustrated by the following examples.

*Example (1).* Donor makes a taxable gift on April 1, 1982, for which a return must be made under section 6019. Donor files the income tax return on the calendar year basis. The donor was granted a 4-month extension from April 15, 1983 to August 15, 1983, in which to file the 1982 income tax return. Under these circumstances, the donor is not required to file the gift tax return prior to August 15, 1983. See paragraph (b)(1) of this section.

*Example (2).* Donor makes a taxable gift on April 1, 1982, for which a return must be made under section 6019. The donor dies on May 1, 1982. Under these circumstances, since the due date for filing the estate tax return, February 1, 1983 (assuming an estate tax return under section 6018 was required to be filed), falls prior to the due date for the gift tax return (as specified in section 6075(b)(1)), the last day for filing the gift tax return is February 1, 1983. See paragraph (b)(2) of this section.

*Example (3).* The facts are the same as in example (2), except the donor dies on November 30, 1982. Although the estate tax return is due on or before August 30, 1983, the last day for filing the gift tax return is April 15, 1983. See paragraph (b) of this section.

*Example (4).* The facts are the same as in example (3), except that the executor receives a 4-month extension for filing the decedent's income tax return. Under these circumstances, the last day for filing the gift tax return is August 15, 1983. See paragraphs (b) (1) and (2) of this section.

*Example (5).* The facts are the same as in example (3), except that the donor-decedent receives an extension of 6 months for filing the gift tax return. See section 6081 and § 25.6081–1. Since section 6075(b)(3) and § 25.6075–2(b) provide that the time for filing the gift tax return made under section 6019 shall not be later than the time (including extensions) for filing the estate tax return made under section 6018, the last day for filing the gift tax return is August 30, 1983.

(d) See section 7503 and § 301.7503–1 concerning the timely filing of a return that falls due on a Saturday, Sunday or legal holiday. As to additions to the tax for failure to file the return within the prescribed time, see section 6651 and § 301.6651–1.

[T.D. 7910, 48 FR 40375, Sept. 7, 1983]

### § 25.6075–2 Returns; time for filing gift tax returns for gifts made after December 31, 1976, and before January 1, 1982.

(a) *Due date for filing quarterly gift tax returns.* (1) Except as provided in paragraph (b) of this section, a return required to be filed under section 6019 for the first, second, or third calendar quarter of any calendar year must be filed on or before the 15th day of the second month following the close of the calendar quarter in which the taxable gift was made.

(2) If a return is required to be filed under section 6019 for the fourth calendar quarter, then—

(i) For gifts made after December 31, 1976 and before January 1, 1979, the return must be filed on or before February 15th following the close of the fourth calendar quarter, or

(ii) For gifts made after December 31, 1978, and before January 1, 1982, the return must be filed on or before April 15th following the close of the fourth calendar quarter.

(b) *Special rule.* (1) If the total amount of taxable gifts (determined after the application of paragraph (c)(1) of this section, relating to split gifts) made by a person during a calendar quarter is $25,000 or less, the return required under section 6019 for that quarter must be filed on or before the date prescribed in paragraph (a)(1) of this section for filing the return for gifts made in the first subsequent calendar quarter (unless the first subsequent calendar quarter is the fourth calendar quarter in which case see paragraph (b)(2) of this section) in the calendar year in which the sum of—

(i) The taxable gifts made during such subsequent calendar quarter, plus

(ii) All other taxable gifts made in prior quarters of the calendar year for

which no return has yet been required to be filed,

exceeds $25,000. The return must include transfers by gift (as required by section 6019 and the regulations under that section) made during such subsequent and prior quarters of the calendar year for which no return has yet been required to be filed and identify in which quarter such transfers were made. The return must meet all the requirements for a separate return as if a separate return had been made for each quarter in which a transfer by gift was made. This return will be treated as a separate return for each of the quarters identified on the return.

(2) If a return is not required to be filed under paragraph (b)(1) of this section, then—

(i) For gifts made after December 31, 1976 and before January 1, 1979, the return must be filed on or before February 15th following the close of the fourth calendar quarter, or

(ii) For gifts made after December 31, 1978, and before January 1, 1982, the return must be filed on or before April 15th following the close of the fourth calendar quarter.

The return must include all transfers by gift (as required under section 6019 and the regulations under that section) made during the calendar year for which no return has yet been required to be filed and identify in which quarter such transfers were made. The return must meet all the requirements for a separate return as if a separate return had been made for each quarter in which a transfer by gift was made. This return will be treated as a separate return for each of the quarters identified on the return.

(3) Under section 6075(b)(3), any extension of time granted a taxpayer for filing the return of income taxes imposed by Subtitle A for any taxable year which is a calendar year shall be treated as an extension of time granted the taxpayer for filing any return under section 6019 which is due (under paragraphs (a)(2)(ii) and (b)(2)(ii) of this section) on or before April 15th following the close of the fourth calendar quarter. See also section 6081 and § 25.6081–1 for other rules relating to extensions of time for filing returns.

(4) See section 7503 and § 301.7503–1 for the due date of a return that falls on a Saturday, Sunday, or a legal holiday. As to additions to the tax for failure to file the return within the prescribed time, see section 6651 and § 301.6651–1.

(c) *Effect of section 2513.* (1) In determining whether taxable gifts made during any calendar quarter exceed $25,000, and in determining whether taxable gifts made in the current calendar quarter and the preceding calendar quarters of the calendar year for which no return has yet been required to be filed exceed $25,000, the effect of section 2513 is not taken into account for any gifts made in the current or previous quarters for which a return is now being filed unless an irrevocable consent was made by either spouse on a return that was required to be filed prior to the due date of the current return. See § 25.2513–3 for the rules relating to when a consent becomes irrevocable.

(2) Paragraph (c)(1) of this section may be illustrated by the following examples:

*Example (1).* During the first quarter of 1980 A made taxable gifts of $17,000 ($20,000 − $3,000 annual exclusion under section 2503(b)) to D. During the second quarter A made another taxable gift of $10,000 to D. A's taxable gifts for the first two quarters are $27,000. Therefore, A is required to file a return for the first and second quarters on or before August 15, 1980. On that return A's wife, B, consented to the application of section 2513 (relating to split gifts) for the second quarter. Even though A split the second quarter gift with his wife, A's return is nevertheless required to be filed on or before August 15, 1980 because in determining whether taxable gifts exceed $25,000, the effect of section 2513 is only taken into account for the quarter in which an irrevocable consent was made on a return required to be filed before August 15, 1980.

*Example (2).* Assume the same facts as in Example (1). In addition, during the third quarter A made another taxable gift of $20,000 to D, and B made a taxable gift of $24,000 to D. B is required to file a return reporting the taxable gifts made during the second and third quarters on or before November 15, 1980 because B's total taxable gifts exceed $25,000 (second quarter gifts after taking section 2513 into account=½ ($10,000) − $3,000 (annual exclusion under section 2503(b))=$2,000 plus a $24,000 gift in the third quarter). Even if A and B had consented to the application of section 2513 for

the third quarter, B's return would nevertheless be due on or before November 15, 1980, because an irrevocable consent was not made on a return that was required to be filed prior to November 15, 1980. However, the effect of section 2513 is taken into account for the second quarter because an irrevocable consent was made on a return that was required to be filed prior to November 15, 1980.

*Example (3).* During the first quarter of 1980 A made taxable gifts of $27,000 to F ($30,000 − $3,000 annual exclusion under section 2503(b)). A is required to file a return on or before May 15, 1980. A fails to file a return until August 1, 1980. On that return B, A's spouse, consented to the application of section 2513. The consent on that return is irrevocable under § 25.2513–3. During the second quarter B made taxable gifts of $14,000 to F. A and B made no other gifts during 1980. B has made total taxable gifts of $26,000 ($12,000 for the first quarter and $14,000 for the second quarter). Therefore, B is required to file a return on or before August 15, 1980. Even if A and B had consented to the application of section 2513 for the second quarter, B's return is nevertheless due on or before August 15, 1980. Assuming no other gifts were made during the year, A's return reporting the second quarter split gift would be due on or before April 15, 1981.

*Example (4).* During the first quarter of 1980 A made taxable gifts of $20,000 to G. B, A's spouse, files a gift tax return on June 15, 1980 reporting that gift and both A and B signify their consent to the application of section 2513 on that return. In determining whether either spouse has exceeded the $25,000 amount for the remainder of 1980, the effect of section 2513 will be taken into account for the transfer by gift made in the first quarter.

(d) *Nonresident not citizens of the United States.* In the case of a donor who is a nonresident not a citizen of the United States, paragraphs (a) and (b) of this section shall be applied by substituting ''$12,500'' for ''$25,000'' each place it appears. For rules relating to whether certain residents of possessions are considered nonresidents not citizens of the United States, see section 2501(c) and § 25.2501–1(d).

(e) *Effective date.* This section is effective for gifts made after December 31, 1976, and before January 1, 1982.

[T.D. 7757, 46 FR 6929, Jan. 22, 1981. Redesignated and amended by T.D. 7910, 48 FR 40375, Sept. 7, 1983]

### § 25.6081–1 Extension of time for filing returns.

It is important that the donor file on or before the due date a return as nearly complete and final as it is possible for him to prepare. However, the district director or director of the service center is authorized to grant a reasonable extension of time for filing returns. Applications for extensions of time for filing gift tax returns must contain a full recital of the causes for delay. Except as provided in paragraph (b) of § 301.6091–1 (relating to hand-carried documents), such application shall be made to the internal revenue officer with whom such return is required to be filed. Except in the case of donors who are abroad, no extension for filing gift tax returns may be granted for more than 6 months. An extension of time for filing a return does not operate to extend the time for payment of the tax or any part thereof, unless so specified in the extension. For extensions of time for payment of tax, see § 25.6161–1. No extension of time for filing a return may be granted unless the application is received by such internal revenue officer before the expiration of the time within which the return must otherwise be filed. The application should, when possible, be made sufficiently early to permit the internal revenue officer to consider the matter and reply before what otherwise would be the due date of the return.

[T.D. 7012, 34 FR 7692, May 15, 1969]

### § 25.6091–1 Place for filing returns and other documents.

(a) *In general.* If the donor is a resident of the United States, the gift tax return required by section 6019 shall be filed with the district director for the district in which the legal residence or principal place of business of the donor is located. If the donor is a nonresident (whether or not a citizen), and his principal place of business is located in an internal revenue district, the gift tax return shall be filed with the district director for the internal revenue district in which the donor's principal place of business is located.

(b) *Returns filed with service centers.* Notwithstanding paragraph (a) of this section, unless a return is filed by hand carrying, whenever instructions applicable to gift tax returns provide that

the returns be filed with a service center, the returns must be so filed in accordance with the instructions. Returns which are filed by hand carrying shall be filed with the district director (or with any person assigned the administrative supervision of an area, zone, or local office constituting a permanent post of duty within the internal revenue district of such director) in accordance with paragraph (a) of this section.

(c) *Returns of certain nonresidents.* If the donor is a nonresident (whether or not a citizen), and he does not have a principal place of business which is located in an internal revenue district, the gift tax return required by section 6019, whether or not such return is made by hand carrying, shall be filed with the Internal Revenue Service Center, Philadelphia, Pennsylvania, or the Director of International Operations, Washington, DC, depending upon the place designated on the return form or in the instructions issued with respect to such form.

(Secs. 6091, 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7012, 34 FR 7692, May 15, 1969, as amended by T.D. 7238, 37 FR 28737, Dec. 29, 1972; 39 FR 797, Jan. 3, 1974; T.D. 7495, 42 FR 33726, July 1, 1977]

### § 25.6091–2 Exceptional cases.

Notwithstanding the provisions of § 25.6091–1 the Commissioner may permit the filing of the gift tax return required by section 6019 in any internal revenue district.

[T.D. 6600, 27 FR 4987, May 29, 1962]

### § 25.6151–1 Time and place for paying tax shown on return.

The tax shown on the gift tax return is to be paid by the donor at the time and place fixed for filing the return (determined without regard to any extension of time for filing the return), unless the time for paying the tax is extended in accordance with the provisions of section 6161. However, for provisions relating to certain cases in which the time for paying the gift tax is postponed by reason of an individual serving in, or in support of, the Armed Forces of the United States in a combat zone, see section 7508. For provisions relating to the time and place for filing the return, see §§ 25.6075–1 and 25.6091–1.

### § 25.6161–1 Extension of time for paying tax or deficiency.

(a) *In general*—(1) *Tax shown on return.* A reasonable extension of time to pay the amount of tax shown on the return may be granted by the district director at the request of the donor. The period of such extension shall not be in excess of six months from the date fixed for the payment of the tax, except that if the taxpayer is abroad the period of extension may be in excess of six months.

(2) *Deficiency.* The time for payment of any amount determined as a deficiency in respect of tax imposed by Chapter 12 of the Code, or for payment of any part thereof may be extended by the district director at the request of the donor for a period not to exceed 18 months from the date fixed for the payment of the deficiency, as shown on the notice and demand from the district director, and, in exceptional cases, for a further period not in excess of 12 months. No extension of time for the payment of a deficiency shall be granted if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

(3) *Extension of time for filing distinguished.* The granting of an extension of time for filing a return does not operate to extend the time for the payment of the tax or any part thereof, unless so specified in the extension.

(b) *Undue hardship required for extension.* An extension of the time for payment shall be granted only upon a satisfactory showing that payment on the due date of the amount with respect to which the extension is desired will result in an undue hardship. The extension will not be granted upon a general statement of hardship. The term ''undue hardship'' means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, loss due to the sale of property at a sacrifice price, will result to the donor from making payment on the due date of the amount with respect to which the extension is desired.

If a market exists, the sale of the property at the current market price is not ordinarily considered as resulting in an undue hardship.

(c) *Application for extension.* An application for an extension of the time for payment of the tax shown on the return, or for the payment of any amount determined as a deficiency, shall be in writing and shall be accompanied by evidence showing the undue hardship that would result to the donor if the extension were refused. The application shall also be accompanied by a statement of the assets and liabilities of the donor and an itemized statement showing all receipts and disbursements for each of the 3 months immediately preceding the due date of the amount to which the application relates. The application, with supporting documents, must be filed with the applicable district director referred to in paragraph (a) of § 25.6091–1 regardless of whether the return is to be filed with, or the tax is to be paid to, such district director on or before the date prescribed for payment of the amount with respect to which the extension is desired. The application will be examined by the district director, and within 30 days, if possible, will be denied, granted, or tentatively granted subject to certain conditions of which the donor will be notified. If an additional extension is desired, the request therefor must be made to the district director on or before the expiration of the period for which the prior extension is granted.

(d) *Payment pursuant to extension.* If an extension of time for payment is granted, the amount the time for payment of which is so extended shall be paid on or before the expiration of the period of the extension without the necessity of notice and demand from the district director. The granting of an extension of the time for payment of the tax or deficiency does not relieve the donor from liability for the payment of interest thereon during the period of the extension. See section 6601 and § 301.6601–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7012, 34 FR 7692, May 15, 1969]

### § 25.6165–1 Bonds where time to pay tax or deficiency has been extended.

If an extension of time for payment of tax or deficiency is granted under section 6161, the district director may, if he deems it necessary, require a bond for the payment of the amount in respect of which the extension is granted in accordance with the terms of the extension. However, such bond shall not exceed double the amount with respect to which the extension is granted. For provisions relating to form of bonds, see the regulations under section 7101 contained in part 301 of this chapter (Regulations on Procedure and Administration).

[T.D. 6600, 27 FR 4987, May 29, 1962]

### § 25.6321–1 Lien for taxes.

For regulations concerning the lien for taxes, see § 301.6321–1 of this chapter (Regulations on Procedure and Administration).

### § 25.6323–1 Validity and priority against certain persons.

For regulations concerning the validity of the lien imposed by section 6321 against certain persons, see §§ 301.6323(a)–1 through 301.6323(i)–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 7429, 41 FR 35498, Aug. 23, 1976]

### § 25.6324–1 Special lien for gift tax.

For regulations concerning the special lien for the gift tax, see § 301.6324–1 of this chapter (Regulations on Procedure and Administration).

### § 25.6601–1 Interest on underpayment, nonpayment, or extensions of time for payment, of tax.

For regulations concerning interest on underpayment, nonpayment, or extensions of time for payment of tax, see § 301.6601–1 of this chapter (Regulations on Procedure and Administration).

### § 25.6905–1 Discharge of executor from personal liability for decedent's income and gift taxes.

For regulations concerning the discharge of an executor from personal liability for a decedent's income and gift

taxes, see § 301.6905–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 7238, 37 FR 28738, Dec. 29, 1972]

### § 25.7101–1 Form of bonds.

For provisions relating to form of bonds, see the regulations under section 7101 contained in part 301 of this chapter (Regulations on Procedure and Administration).

[T.D. 6600, 27 FR 4987, May 29, 1962]

## GENERAL ACTUARIAL VALUATIONS

SOURCE: Sections 25.7520–1 through 25.7520–4 appear at T.D. 8540, 59 FR 30177, June 10, 1994, unless otherwise noted.

### § 25.7520–1 Valuation of annuities, unitrust interests, interests for life or term of years, and remainder or reversionary interests.

(a) *General actuarial valuations.* (1) Except as otherwise provided in this section and in § 25.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances), in the case of gifts made after April 30, 1989, the fair market value of annuities, interests for life or for a term of years (including unitrust interests), remainders, and reversions is their present value determined under this section. See § 20.2031–7(d) (and, for certain prior periods, § 20.2031–7A) of this chapter, Estate Tax Regulations, for the computation of the value of annuities, unitrust interests, life estates, terms of years, remainders, and reversions, other than interests described in paragraphs (a)(2) and (a)(3) of this section.

(2) In the case of a gift to a beneficiary of a pooled income fund after April 30, 1989, see § 1.642(c)–6(e) (or, for certain prior periods, § 1.642(c)–6A) of this chapter (Income Tax Regulations) with respect to the valuation of the remainder interest.

(3) In the case of a gift to a beneficiary of a charitable remainder annuity trust after April 30, 1989, see § 1.664–2 of this chapter with respect to the valuation of the remainder interest. See § 1.664–4 (or, for certain prior periods, § 1.664–4A) of this chapter (Income Tax Regulations) with respect to the valuation of the remainder interest in property transferred to a charitable remainder unitrust.

(b) *Components of valuation*—(1) *Interest rate component*—(i) *Section 7520 Interest rate.* The section 7520 interest rate is the rate of return, rounded to the nearest two-tenths of one percent, that is equal to 120 percent of the applicable Federal mid-term rate, compounded annually, for purposes of section 1274(d)(1), for the month in which the valuation date falls. In rounding the rate to the nearest two-tenths of a percent, any rate that is midway between one two-tenths of a percent and another is rounded up to the higher of those two rates. For example, if 120 percent of the applicable Federal mid-term rate is 10.30, the section 7520 interest rate component is 10.4. The section 7520 interest rate is published monthly by the Internal Revenue Service in the Internal Revenue Bulletin (See § 601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Valuation date.* Generally, the valuation date is the date on which the gift is made. For gift tax purposes, the valuation date is the date on which the gift is complete under § 25.2511–2. For special rules in the case of charitable transfers, see § 25.7520–2.

(2) *Mortality component.* The mortality component reflects the mortality data most recently available from the United States census. As new mortality data becomes available after each decennial census, the mortality component described in this section will be revised periodically and the revised mortality component tables will be published in the regulations at that time. For gifts with valuation dates after April 30, 1989, the mortality component table (Table 80CNSMT) is contained in § 20.2031–7(d) of this chapter (Estate Tax Regulations). See § 20.2031–7A of this chapter for mortality component tables applicable to gifts before May 1, 1989.

(c) *Tables.* The present value on the valuation date of an annuity, life estate, term of years, remainder, or reversion is computed by using the section 7520 interest rate component that is described in paragraph (b)(1) of this section and the mortality component that is described in paragraph (b)(2) of

this section. Actuarial factors for determining these present values are included in tables in these regulations and in publications by the Internal Revenue Service. If a special factor is required in order to value an interest, the Internal Revenue Service will furnish the factor upon a request for a ruling. The request for a ruling must be accompanied by a recitation of the facts, including the date of birth for each measuring life and copies of relevant instruments. A request for a ruling must comply with the instructions for requesting a ruling published periodically in the Internal Revenue Bulletin (see Rev. Proc. 94–1, 1994–1 I.R.B. 10, and subsequent updates, and §§ 601.201 and 601.601(d)(2)(ii)(*b*) of this chapter) and include payment of the required user fee.

(1) *Regulation sections containing tables with interest rates between 4.2 and 14 percent.* Section 1.642(c)–6(e)(4) of this chapter contains Table S used for determining the present value of a single life remainder interest in a pooled income fund as defined in § 1.642(c)–5 of this chapter (Income Tax Regulations). Section 1.664–4(e)(6) of this chapter contains Table D (actuarial factors used in determining the present value of a remainder interest postponed for a term of years), Table U(1) (actuarial factors for one life), and Table F (payout factors) used in determining the present value of a remainder interest in a charitable remainder unitrust as defined in § 1.664–3 of this chapter. Section 20.2031–7(d)(6) of this chapter (Estate Tax Regulations) contains Table S (actuarial factors for one life), Table B (actuarial factors used in determining the present value of an interest for a term of years), Table K (annuity end-of-interval adjustment factors), Table J (term certain annuity beginning-of-interval adjustment factors), and Table 80CNSMT (mortality components) used in determining the present value of annuities, life estates, remainders, and reversions. The regulations will be revised periodically to include new mortality component tables and new tables of factors.

(2) *Internal Revenue Service publications containing tables with interest rates between 2.2 and 26 percent.* The following documents (except for Publication 1459) have been published for sale by the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402:

(i) Internal Revenue Service Publication 1457, ''Actuarial Values, Alpha Volume,'' (8/89). This publication includes tables of valuation factors, as well as examples that show how to compute other valuation factors, for determining the present value of annuities, life estates, terms of years, remainders, and reversions, measured by one or two lives. These factors may also be used in the valuation of interests in a charitable remainder annuity trust as defined in § 1.664–2 of this chapter (Income Tax Regulations) and a pooled income fund as defined in § 1.642(c)–5.

(ii) Internal Revenue Service Publication 1458, ''Actuarial Values, Beta Volume,'' (8/89). This publication includes term certain tables and tables of one and two life valuation factors for determining the present value of remainder interests in a charitable remainder unitrust as defined in § 1.664–3 of this chapter.

(iii) Internal Revenue Service Publication 1459, ''Actuarial Values, Gamma Volume,'' (8–89) is no longer available for purchase from the Superintendent of Documents. However, it may be obtained by requesting a copy from: CC:DOM:CORP:T:R (IRS Publication 1459), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. This publication includes tables for computing depreciation adjustment factors. See § 1.170A–12 of this chapter (Income Tax Regulations).

(d) *Effective date.* This section is effective as of May 1, 1989.

### § 25.7520–2 Valuation of charitable interests.

(a) *In general*—(1) *Valuation.* Except as otherwise provided in this section and in § 25.7520–3 (relating to exceptions to the use of prescribed tables under certain circumstances), the fair market value of annuities, interests for life or for a term for years, remainders, and reversions for which a gift tax charitable deduction is allowable is the present value of such interests determined under § 25.7520–1.

(2) *Prior-month election rule.* If any part of the property interest transferred qualifies for a gift tax charitable deduction under section 2522, the donor may elect to compute the present value of the interest transferred by use of the section 7520 interest rate for the month during which the gift is made or the section 7520 interest rate for either of the 2 months preceding the month during which the gift is made. Paragraph (b) of this section explains how a prior-month election is made. The interest rate for the month so elected is the applicable section 7520 interest rate. If the actuarial factor for either or both of the 2 months preceding the month during which the gift is made is based on a mortality experience that is different from the mortality experience at the date of the gift and if the donor elects to use the section 7520 rate for a prior month with the different mortality experience, the donor must use the actuarial factor derived from the mortality experience in effect during the month of the section 7520 rate elected. All actuarial computations relating to the gift must be made by applying the interest rate component and the mortality component of the month elected by the donor.

(3) *Gifts of more than one interest in the same property.* If a donor makes a gift of more than one interest in the same property at the same time, the donor must, for purposes of valuing the gifts, use the same interest rate and mortality components for the gift of each interest in the property. If the donor has made gifts of more than one interest in the same property at different times, the donor must determine the value of the gift by the use of the interest rate component and mortality component in effect during the month of that gift or, if applicable under paragraph (a)(2) of this section, either of the two months preceding the month of the gift.

(4) *Information required with tax return.* The following information must be attached to the gift tax return (or to the amended return) if the donor claims a charitable deduction for the present value of a temporary or remainder interest in property—

(i) A complete description of the interest that is transferred, including a copy of the instrument of transfer;

(ii) The valuation date of the transfer;

(iii) The names and identification numbers of the beneficiaries of the transferred interest;

(iv) The names and birthdates of any measuring lives, a description of any relevant terminal illness condition of any measuring life, and (if applicable) an explanation of how any terminal illness condition was taken into account in valuing the interest; and

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

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

(b) *Election of interest rate component*—(1) *Time for making election.* A taxpayer makes a prior-month election under paragraph (a)(2) of this section by attaching the information described in paragraph (b)(2) of this section to the donor's gift tax return or to an amended return for that year that is filed within 24 months after the later of the date the original return for the year was filed or the due date for filing the return.

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

(3) *Revocability.* The prior-month election may be revoked by filing an amended return within 24 months after the later of the date the original return of tax for that year was filed or the due date for filing the return. The revocation must be filed in the place referred to in paragraph (a)(5) of this section.

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

**§ 25.7520–3 Limitation on the application of section 7520.**

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

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

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

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

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

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

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

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

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

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

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

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

(B) An *ordinary income interest* is the right to receive the income from or the use of property during one or more measuring lives or for some other defined period. A standard section 7520 income factor for an ordinary income interest represents the present worth of the right to receive the use of $1.00 for a defined period, using the interest rate prescribed under section 7520 for the appropriate month. However, in the case of certain gifts made after October 8, 1990, if the donor does not retain a qualified annuity, unitrust, or reversionary interest, the value of any interest retained by the donor is considered to be zero if the remainder beneficiary is a member of the donor's family. See § 25.2702–2.

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

(ii) *Certain restricted beneficial interests.* A *restricted beneficial interest* is an annuity, income, remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances. In general, a standard section 7520 annuity, income, or remainder factor may

not be used to value a restricted beneficial interest. However, a special section 7520 annuity, income, or remainder factor may be used to value a restricted beneficial interest under some circumstances. See paragraphs (b)(2)(v) *Example 5* and (b)(4) of this section, which illustrate situations in which special section 7520 actuarial factors are needed to take into account limitations on beneficial interests. See § 25.7520–1(c) for requesting a special factor from the Internal Revenue Service.

(iii) *Other beneficial interests.* If, under the provisions of this paragraph (b), the interest rate and mortality components prescribed under section 7520 are not applicable in determining the value of any annuity, income, remainder, or reversionary interest, the actual fair market value of the interest (determined without regard to section 7520) is based on all of the facts and circumstances if and to the extent permitted by the Internal Revenue Code provision applicable to the property interest.

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

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

other specified period of time, the interest rate component prescribed under section 7520 and § 1.7520–1 of this chapter may not be used unless, during the specified period, the effect of the trust, will or other governing instrument is to provide the beneficiary with that degree of use, possession, and enjoyment of the property during the term of interest that applicable state law accords to a person who is unqualifiedly designated as a life tenant or term holder for a similar period of time.

(B) *Diversions of income and corpus.* A standard section 7520 income factor for an ordinary income interest may not be used to value an income interest or similar interest in property for a term of years, or for one or more measuring lives, if—

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

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

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

(iv) *Pooled income fund interests.* In general, pooled income funds are created and administered to achieve a special rate of return. A beneficial interest in a pooled income fund is not ordinarily valued using a standard section 7520 income or remainder interest factor. The present value of a beneficial interest in a pooled income fund is determined according to rules and special remainder factors prescribed in § 1.642(c)-6 of this chapter and, when applicable, the rules set forth under paragraph (b)(3) of this section if the individual who is the measuring life is terminally ill at the time of the transfer.

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

*Example 1. Unproductive property.* The donor transfers corporation stock to a trust under the terms of which all of the trust income is payable to A for life. Considering the applicable federal rate under section 7520 and the appropriate life estate factor for a person A's age, the value of A's income interest, if valued under this section, would be $10,000. After A's death, the trust is to terminate and the trust property is to be distributed to B. The trust specifically authorizes, but does not require, the trustee to retain the shares of stock. The corporation has paid no dividends on this stock during the past 5 years, and there is no indication that this policy will change in the near future. Under applicable state law, the corporation is considered to be a sound investment that satisfies fiduciary standards. The facts and circumstances, including applicable state law, indicate that the income beneficiary would not have the legal right to compel the trustee to make the trust corpus productive in conformity with the requirements for a lifetime trust income interest under applicable local law. Therefore, the life income interest in this case is considered nonproductive. Consequently, A's income interest may not be valued actuarially under this section.

*Example 2. Beneficiary's right to make trust productive.* The facts are the same as in *Example 1,* except that the trustee is not specifically authorized to retain the shares of corporation stock. Further, the terms of the trust specifically provide that the life income beneficiary may require the trustee to

make the trust corpus productive consistent with income yield standards for trusts under applicable state law. Under that law, the minimum rate of income that a productive trust may produce is substantially below the section 7520 interest rate on the valuation date. In this case, because A, the income beneficiary, has the right to compel the trustee to make the trust productive for purposes of applicable local law during A's lifetime, the income interest is considered an ordinary income interest for purposes of this paragraph, and the standard section 7520 life income factor may be used to determine the value of A's income interest. However, in the case of gifts made after October 8, 1990, if the donor was the life income beneficiary, the value of the income interest would be considered to be zero in this situation. See § 25.2702–2.

*Example 3. Annuity trust funded with unproductive property.* The donor, who is age 60, transfers corporation stock worth $1,000,000 to a trust. The trust will pay a 6 percent ($60,000 per year) annuity in cash or other property to the donor for 10 years or until the donor's prior death. Upon the termination of the trust, the trust property is to be distributed to the donor's child. The section 7520 rate for the month of the transfer is 8.2 percent. The corporation has paid no dividends on the stock during the past 5 years, and there is no indication that this policy will change in the near future. Under applicable state law, the corporation is considered to be a sound investment that satisfies fiduciary standards. Therefore, the trust's sole investment in this corporation is not expected to adversely affect the interest of either the annuity beneficiary or the remainder beneficiary. Considering the 6 percent annuity payout rate and the 8.2 percent section 7520 interest rate, the trust corpus is considered sufficient to pay this annuity for the entire 10-year term of the trust, or even indefinitely. The trust specifically authorizes, but does not require, the trustee to retain the shares of stock. Although it appears that neither beneficiary would be able to compel the trustee to make the trust corpus produce investment income, the annuity interest in this case is considered to be an ordinary annuity interest, and a section 7520 annuity factor may be used to determine the present value of the annuity. In this case, the section 7520 annuity factor would represent the right to receive $1.00 per year for a term of 10 years or the prior death of a person age 60.

*Example 4. Unitrust funded with unproductive property.* The facts are the same as in *Example 3*, except that the donor has retained a unitrust interest equal to 7 percent of the value of the trust property, valued as of the beginning of each year. Although the trust corpus is nonincome-producing, the present value of the donor's retained unitrust interest may be determined by using the section 7520 unitrust factor for a term of years or a prior death.

*Example 5. Eroding corpus in an annuity trust.* (i) The donor, who is age 60 and in normal health, transfers property worth $1,000,000 to a trust. The trust will pay a 10 percent ($100,000 per year) annuity to a charitable organization for the life of the donor, payable annually, and the remainder will be distributed to the donor's child. The section 7520 rate for the month of the transfer is 6.8 percent. First, it is necessary to determine whether the annuity may exhaust the corpus before all annuity payments are made. Because it is assumed that any measuring life may survive until age 110, any life annuity could require payments until the measuring life reaches age 110. Based on a section 7520 interest rate of 6.8 percent, the determination of whether the annuity may exhaust the corpus before the annuity payments are made is computed as follows:

| | |
|---|---|
| Age to which life annuity may continue | 110 |
| Less: Age of measuring life at date of transfer | 60 |
| Number of years annuity may continue | 50 |
| Annual annuity payment | $100,000.00 |
| Times: Table B annuity factor for 50 years | 14.1577 |
| Present value of term certain annuity | 1,415,770.00 |

(ii) Since the present value of an annuity for a term of 50 years exceeds the corpus, the annuity may exhaust the trust before all payments are made. Consequently, the annuity must be valued as an annuity payable for a term of years or until the prior death of the annuitant, with the term of years determined by when the fund will be exhausted by the annuity payments.

(iii) Using factors based on Table 80CNSMT at 6.8 percent, it is determined that the fund will be sufficient to make 17 annual payments, but not to make the entire 18th payment. Specifically, the initial corpus will be able to make payments of $67,287.26 per year for 17 years plus payments of $32,712.74 per year for 18 years. The annuity is valued by adding the value of the two separate temporary annuities.

(iv) Based on Table H of Publication 1457 (a copy of this publication may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402), the present value of an annuity of $67,287.26 per year payable for 17 years or until the prior death of a person aged 60 is $579,484.61 ($67,287.26 × 8.6121). The present value of an annuity of $32,712.74 per year payable for 18 years or until the prior death of a person aged 60 is $287,731.45 ($32,712.74 × 8.7957). Thus, the present value of the charitable annuity interest is $867,216.06 ($579,484.61 + $287,731.45).

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

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

*Example. Terminal illness.* The donor transfers property worth $1,000,000 to a child in exchange for the child's promise to pay the donor $103,000 per year for the donor's life. The donor is age 60 but has been diagnosed with an incurable illness and has at least a 50 percent probability of dying within 1 year. The section 7520 interest rate for the month of the transfer is 10.6 percent, and the standard annuity factor at that interest rate for a person age 60 in normal health is 7.4230. Thus, if the donor were not terminally ill, the present value of the annuity would be $764,569 ($103,000 × 7.4230). Assuming the presumption provided in paragraph (b)(3) of this section does not apply, because there is at least a 50 percent probability that the donor will die within 1 year, the standard section 7520 annuity factor may not be used to determine the present value of the donor's annuity interest. Instead, a special section 7520 annuity factor must be computed that takes into account the projection of the donor's actual life expectancy.

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

(c) *Effective date.* Section 25.7520–3(a) is effective as of May 1, 1989. The provisions of paragraph (b) of this section are effective with respect to gifts made after December 13, 1995.

[T.D. 8540, 59 FR 30177, June 10, 1994, as amended by T.D. 8630, 60 FR 63919, Dec. 13, 1995]

### § 25.7520–4 Transitional rules.

(a) *Reliance.* If the valuation date is after April 30, 1989, and before June 10, 1994, a donor can rely on Notice 89–24, 1989–1 C.B. 660, or Notice 89–60, 1989–1 C.B. 700 (See § 601.601(d)(2)(ii)(*b*) of this chapter), in valuing the transferred interest.

(b) *Transfers in 1989.* If a donor transferred an interest in property by gift after December 31, 1988, and before May 1, 1989, retaining an interest in the same property and, after April 30, 1989, and before January 1, 1990, transferred the retained interest in the property, the donor may, at the donor's option, value the transfer of the retained interest under either § 25.2512–5(d) or § 25.2512–5A(d).

(c) *Effective date.* This section is effective as of May 1, 1989.

## PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

Sec.

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AUTHORITY: 26 U.S.C. 7805 and 26 U.S.C. 2663.

Section 26.2632–1 also issued under 26 U.S.C. 2632 and 2663.

Section 26.2642–4 also issued under 26 U.S.C. 2632 and 2663.

Section 26.2662–1 also issued under 26 U.S.C. 2662.

Section 26.2663–2 also issued under 26 U.S.C. 2632 and 2663.

SOURCE: T.D. 8644, 60 FR 66903, Dec. 27, 1995, unless otherwise noted.

## § 26.2600–1 Table of contents.

This section lists the captions that appear in the regulations under sections 2601 through 2663.

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*§ 26.2663–2 Application of chapter 13 to transfers by nonresidents not citizens of the United States.*

(a) In general.
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## 26.2601–1 Effective dates.

(a) *Transfers subject to the generation-skipping transfer tax*—(1) *In general.* Except as otherwise provided in this section, the provisions of chapter 13 of the Internal Revenue Code of 1986 (Code) apply to any generation-skipping transfer (as defined in section 2611) made after October 22, 1986.

(2) *Certain transfers treated as if made after October 22, 1986.* Solely for purposes of chapter 13, an inter vivos transfer is treated as if it were made on October 23, 1986, if it was—

(i) Subject to chapter 12 (regardless of whether a tax was actually incurred or paid); and

(ii) Made after September 25, 1985, but before October 23, 1986. For purposes of this paragraph, the value of the property transferred shall be the value of the property on the date the property was transferred.

(3) *Certain trust events treated as if occurring after October 22, 1986.* For purposes of chapter 13, if an inter vivos transfer is made to a trust after September 25, 1985, but before October 23, 1986, any subsequent distribution from the trust or termination of an interest in the trust that occurred before October 23, 1986, is treated as occurring immediately after the deemed transfer on October 23, 1986. If more than one distribution or termination occurs with

respect to a trust, the events are treated as if they occurred on October 23, 1986, in the same order as they occurred. See paragraph (b)(1)(iv)(B) of this section for rules determining the portion of distributions and terminations subject to tax under chapter 13. This paragraph (a)(3) does not apply to transfers to trusts not subject to chapter 13 by reason of the transition rules in paragraphs (b) (2) and (3) of this section. The provisions of this paragraph (a)(3) do not apply in determining the value of the property under chapter 13.

(4) *Example.* The following example illustrates the principle that paragraph (a)(2) of this section is not applicable to transfers under a revocable trust that became irrevocable by reason of the transferor's death after September 25, 1985, but before October 23, 1986:

*Example.* T created a revocable trust on September 30, 1985, that became irrevocable when T died on October 10, 1986. Although the trust terminated in favor of a grandchild of T, the transfer to the grandchild is not treated as occurring on October 23, 1986, pursuant to paragraph (a)(2) of this section because it is not an inter vivos transfer subject to chapter 12. The transfer is not subject to chapter 13 because it is in the nature of a testamentary transfer that occurred prior to October 23, 1986.

(b) *Exceptions*—(1) *Irrevocable trusts*—(i) *In general.* The provisions of chapter 13 do not apply to any generation-skipping transfer under a trust (as defined in section 2652(b)) that was irrevocable on September 25, 1985. The rule of the preceding sentence does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985. See paragraph (b)(1)(iv) of this section for rules for determining the portion of the trust that is subject to the provisions of chapter 13.

(ii) *Irrevocable trust defined*—(A) *In general.* Unless otherwise provided in either paragraph (b)(1)(ii) (B) or (C) of this section, any trust (as defined in section 2652(b)) in existence on September 25, 1985, is considered an irrevocable trust.

(B) *Property includible in the gross estate under section 2038.* For purposes of this chapter a trust is not an irrevocable trust to the extent that, on September 25, 1985, the settlor held a power with respect to such trust that would have caused the value of the trust to be included in the settlor's gross estate for Federal estate tax purposes by reason of section 2038 (without regard to powers relinquished before September 25, 1985) if the settlor had died on September 25, 1985. A trust is considered subject to a power on September 25, 1985, even though the exercise of the power was subject to the precedent giving of notice, or even though the exercise could take effect only on the expiration of a stated period, whether or not on or before September 25, 1985, notice had been given or the power had been exercised. A trust is not considered subject to a power if the power is, by its terms, exercisable only on the occurrence of an event or contingency not subject to the settlor's control (other than the death of the settlor) and if the event or contingency had not in fact taken place on September 25, 1985.

(C) *Property includible in the gross estate under section 2042.* A policy of insurance on an individual's life that is treated as a trust under section 2652(b) is not considered an irrevocable trust to the extent that, on September 25, 1985, the insured possessed any incident of ownership (as defined in §20.2042–1(c) of this chapter, and without regard to any incidents of ownership relinquished before September 25, 1985), that would have caused the value of the trust, (i.e., the insurance proceeds) to be included in the insured's gross estate for Federal estate tax purposes by reason of section 2042, if the insured had died on September 25, 1985.

(D) *Examples.* The following examples illustrate the application of this paragraph (b)(1):

EXAMPLE 1. *Section 2038 applicable.* On September 25, 1985, T, the settlor of a trust that was created before September 25, 1985, held a testamentary power to add new beneficiaries to the trust. T held no other powers over any portion of the trust. The testamentary power held by T would have caused the trust to be included in T's gross estate under section 2038 if T had died on September 25, 1985. Therefore, the trust is not an irrevocable trust for purposes of this section.

EXAMPLE 2. *Section 2038 not applicable when power held by a person other than settlor.* On September 25, 1985, S, the spouse of the settlor of a trust in existence on that date, had

an annual right to withdraw a portion of the principal of the trust. The trust was otherwise irrevocable on that date. Because the power was not held by the settlor of the trust, it is not a power described in section 2038. Thus, the trust is considered an irrevocable trust for purposes of this section.

EXAMPLE 3. *Section 2038 not applicable.* In 1984, T created a trust and retained the right to expand the class of remaindermen to include any of T's afterborn grandchildren. As of September 25, 1985, all of T's grandchildren were named remaindermen of the trust. Since the exercise of T's power was dependent on there being afterborn grandchildren who were not members of the class of remaindermen, a contingency that did not exist on September 25, 1985, the trust is not considered subject to the power on September 25, 1985, and is an irrevocable trust for purposes of this section. The result is not changed even if grandchildren are born after September 25, 1985, whether or not T exercises the power to expand the class of remaindermen.

EXAMPLE 4. *Section 2042 applicable.* On September 25, 1985, T purchased an insurance policy on T's own life and designated child, C, and grandchild, GC, as the beneficiaries. T retained the power to obtain from the insurer a loan against the surrender value of the policy. T's insurance policy is a trust (as defined in section 2652(b)) for chapter 13 purposes. The trust is not considered an irrevocable trust because, on September 25, 1985, T possessed an incident of ownership that would have caused the value of the policy to be included in T's gross estate under section 2042 if T had died on that date.

EXAMPLE 5. *Trust partially irrevocable.* In 1984, T created a trust naming T's grandchildren as the income and remainder beneficiaries. T retained the power to revoke the trust as to one-half of the principal at any time prior to T's death. T retained no other powers over the trust principal. T did not die before September 25, 1985, and did not exercise or release the power before that date. The half of the trust not subject to T's power to revoke is an irrevocable trust for purposes of this section.

(iii) *Trust containing qualified terminable interest property*—(A) *In general.* For purposes of chapter 13, a trust described in paragraph (b)(1)(ii) of this section that holds qualified terminable interest property by reason of an election under section 2056(b)(7) or section 2523(f) (made either on, before or after September 25, 1985) is treated in the same manner as if the decedent spouse or the donor spouse (as the case may be) had made an election under section 2652(a)(3). Thus, transfers from such trusts are not subject to chapter 13, and the decedent spouse or the donor spouse (as the case may be) is treated as the transferor of such property. The rule of this paragraph (b)(1)(iii) does not apply to that portion of the trust that is subject to chapter 13 by reason of an addition to the trust occurring after September 25, 1985. See §26.2652–2(a) for rules where an election under section 2652(a)(3) is made. See §26.2652–2(c) for rules where a portion of a trust is subject to an election under section 2652(a)(3).

(B) *Examples.* The following examples illustrate the application of this paragraph (b)(1)(iii):

EXAMPLE 1. *QTIP election made after September 25, 1985.* On March 28, 1985, T established a trust. The trust instrument provided that the trustee must distribute all income annually to T's spouse, S, during S's life. Upon S's death, the remainder is to be distributed to GC, the grandchild of T and S. On April 15, 1986, T elected under section 2523(f) to treat the property in the trust as qualified terminable interest property. On December 1, 1987, S died and soon thereafter the trust assets were distributed to GC. Because the trust was irrevocable on September 25, 1985, the transfer to GC is not subject to tax under chapter 13. T is treated as the transferor with respect to the transfer of the trust assets to GC in the same manner as if T had made an election under section 2652(a)(3) to reverse the effect of the section 2523(f) election for chapter 13 purposes.

EXAMPLE 2. *Section 2652(a)(3) election deemed to have been made.* Assume the same facts as in *Example 1,* except the trust instrument provides that after S's death all income is to be paid annually to C, the child of T and S. Upon C's death, the remainder is to be distributed to GC. C died on October 1, 1992, and soon thereafter the trust assets are distributed to GC. Because the trust was irrevocable on September 25, 1985, the termination of C's interest is not subject to chapter 13.

(iv) *Additions to irrevocable trusts*—(A) *In general.* If an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by reason of paragraph (b)(1) of this section, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to chapter 13 (the non-chapter 13 portion)

and a portion subject to chapter 13 (the chapter 13 portion), each with a separate inclusion ratio (as defined in section 2642(a)). The non-chapter 13 portion represents the value of the assets of the trust as it existed on September 25, 1985. The applicable fraction (as defined in section 2642(a)(2)) for the non-chapter 13 portion is deemed to be 1 and the inclusion ratio for such portion is 0. The chapter 13 portion of the trust represents the value of all additions made to the trust after September 25, 1985. The inclusion ratio for the chapter 13 portion is determined under section 2642. This paragraph (b)(1)(iv)(A) requires separate portions of one trust only for purposes of determining inclusion ratios. For purposes of chapter 13, a constructive addition under paragraph (b)(1)(v) of this section is treated as an addition. See paragraph (b)(4) of this section for exceptions to the additions rule of this paragraph (b)(1)(iv). See §26.2654–1(a)(2) for rules treating additions to a trust by an individual other than the initial transferor as a separate trust for purposes of chapter 13.

(B) *Terminations of interests in and distributions from trusts.* Where a termination or distribution described in section 2612 occurs with respect to a trust to which an addition has been made, the portion of such termination or distribution allocable to the chapter 13 portion is determined by reference to the allocation fraction, as defined in paragraph (b)(1)(iv)(C) of this section. In the case of a termination described in section 2612(a) with respect to a trust, the portion of such termination that is subject to chapter 13 is the product of the allocation fraction and the value of the trust (to the extent of the terminated interest therein). In the case of a distribution described in section 2612(b) from a trust, the portion of such distribution that is subject to chapter 13 is the product of the allocation fraction and the value of the property distributed.

(C) *Allocation fraction—(1) In general.* The allocation fraction allocates appreciation and accumulated income between the chapter 13 and non-chapter 13 portions of a trust. The numerator of the allocation fraction is the amount of the addition (valued as of the date the addition is made), determined without regard to whether any part of the transfer is subject to tax under chapter 11 or chapter 12, but reduced by the amount of any Federal or state estate or gift tax imposed and subsequently paid by the recipient trust with respect to the addition. The denominator of the allocation fraction is the total value of the entire trust immediately after the addition. For purposes of this paragraph (b)(1)(iv)(C), the total value of the entire trust is the fair market value of the property held in trust (determined under the rules of section 2031), reduced by any amount attributable to or paid by the trust and attributable to the transfer to the trust that is similar to an amount that would be allowable as a deduction under section 2053 if the addition had occurred at the death of the transferor, and further reduced by the same amount that the numerator was reduced to reflect Federal or state estate or gift tax incurred by and subsequently paid by the recipient trust with respect to the addition. Where there is more than one addition to principal after September 25, 1985, the portion of the trust subject to chapter 13 after each such addition is determined pursuant to a revised fraction. In each case, the numerator of the revised fraction is the sum of the value of the chapter 13 portion of the trust immediately before the latest addition, and the amount of the latest addition. The denominator of the revised fraction is the total value of the entire trust immediately after the addition. If the transfer to the trust is a generation-skipping transfer, the numerator and denominator are reduced by the amount of the generation-skipping transfer tax, if any, that is imposed by chapter 13 on the transfer and actually recovered from the trust. The allocation fraction is rounded off to five decimal places (.00001).

(*2*) *Examples.* The following examples illustrate the application of paragraph (b)(1)(iv) of this section. In each of the examples, assume that the recipient trust does not pay any Federal or state transfer tax by reason of the addition.

EXAMPLE 1. *Post September 25, 1985, addition to trust.* (i) On August 16, 1980, T established

an irrevocable trust. Under the trust instrument, the trustee is required to distribute the entire income annually to T's child, C, for life, then to T's grandchild, GC, for life. Upon GC's death, the remainder is to be paid to GC's issue. On October 1, 1986, when the total value of the entire trust is $400,000, T transfers $100,000 to the trust. The allocation fraction is computed as follows:

$$\frac{\text{Value of addition}}{\text{Total value of trust}} = \frac{\$100{,}000}{\$400{,}000 + \$100{,}000} = .2$$

(ii) Thus, immediately after the transfer, 20 percent of the value of future generation-skipping transfers under the trust will be subject to chapter 13.

EXAMPLE 2. *Effect of expenses.* Assume the same facts as in *Example 1,* except immediately prior to the transfer on October 1, 1986, the fair market value of the individual assets in the trust totaled $400,000. Also, assume that the trust had accrued and unpaid debts, expenses, and taxes totaling $300,000. Assume further that the entire $300,000 represented amounts that would be deductible under section 2053 if the trust were includible in the transferor's gross estate. The numerator of the allocation fraction is $100,000 and the denominator of the allocation fraction is $200,000 (($400,000 − $300,000)+$100,000). Thus, the allocation fraction is .5 ($100,000/$200,000) and 50 percent of the value of future generation-skipping transfers will be subject to chapter 13.

EXAMPLE 3. *Multiple additions.* (i) Assume the same facts as in *Example 1,* except on January 30, 1988, when the total value of the entire trust is $600,000, T transfers an additional $40,000 to the trust. Before the transfer, the value of the portion of the trust that was attributable to the prior addition was $120,000 ($600,000×.2). The new allocation fraction is computed as follows:

$$\frac{\text{Total value of additions}}{\text{Total value of trust}} = \frac{\$120{,}000 + \$40{,}000}{\$600{,}000 + \$40{,}000} = \frac{\$160{,}000}{\$640{,}000} = .25$$

(ii) Thus, immediately after the transfer, 25 percent of the value of future generation-skipping transfers under the trust will be subject to chapter 13.

EXAMPLE 4. *Allocation fraction at time of generation-skipping transfer.* Assume the same facts as in *Example 3,* except on March 1, 1989, when the value of the trust is $800,000, C dies. A generation-skipping transfer occurs at C's death because of the termination of C's life estate. Therefore, $200,000 ($800,000×.25) is subject to tax under chapter 13.

(v) *Constructive additions*—(A) *Powers of Appointment.* Except as provided in paragraph (b)(1)(v)(B) of this section, where any portion of a trust remains in the trust after the post-September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under chapter 11 or chapter 12. See § 26.2652–1 for rules for determining the identity of the transferor of property for purposes of chapter 13.

(B) *Special rule for certain powers of appointment.* The release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in section 2041(b)) is not treated as an addition to a trust if—

(*1*) Such power of appointment was created in an irrevocable trust that is not subject to chapter 13 under paragraph (b)(1) of this section; and

(*2*) In the case of an exercise, the power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or

power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years plus, if necessary, a reasonable period of gestation (the perpetuities period). For purposes of this paragraph (b)(1)(v)(B)(*2*), the exercise of a power of appointment that validly postpones or suspends the vesting, absolute ownership or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date of creation of the trust) will not be considered an exercise that postpones or suspends vesting, absolute ownership or the power of alienation beyond the perpetuities period. If a power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

(C) *Constructive addition if liability is not paid out of trust principal.* Where a trust described in paragraph (b)(1) of this section is relieved of any liability properly payable out of the assets of such trust, the person or entity who actually satisfies the liability is considered to have made a constructive addition to the trust in an amount equal to the liability. The constructive addition occurs when the trust is relieved of liability (e.g., when the right of recovery is no longer enforceable). But see § 26.2652–1(a)(3) for rules involving the application of section 2207A in the case of an election under section 2652(a)(3).

(D) *Examples.* The following examples illustrate the application of this paragraph (b)(1)(v):

EXAMPLE 1. *Lapse of a power of appointment.* On June 19, 1980, T established an irrevocable trust with a corpus of $500,000. The trust instrument provides that the trustee shall distribute the entire income from the trust annually to T's spouse, S, during S's life. At S's death, the remainder is to be distributed to T and S's grandchild, GC. T also gave S a general power of appointment over one-half of the trust assets. On December 21, 1989, when the value of the trust corpus is $1,500,000, S died without having exercised the general power of appointment. The value of one-half of the trust corpus, $750,000 ($1,500,000 × .5) is included in S's gross estate under section 2041(a) and is subject to tax under Chapter 11. Because the value of one-half of the trust corpus is subject to tax under Chapter 11 with respect to S's estate, S is treated as the transferor of that property for purposes of Chapter 13 (see section 2652(a)(1)(A)). For purposes of the generation-skipping transfer tax, the lapse of S's power of appointment is treated as if $750,000 ($1,500,000 × .5) had been distributed to S and then transferred back to the trust. Thus, S is considered to have added $750,000 ($1,500,000 × .5) to the trust at the date of S's death. Because this constructive addition occurred after September 25, 1985, 50 percent of the corpus of the trust became subject to Chapter 13 at S's death.

EXAMPLE 2. *Multiple actual additions.* On June 19, 1980, T established an irrevocable trust with a principal of $500,000. The trust instrument provides that the trustee shall distribute the entire income from the trust annually to T's spouse, S, during S's life. At S's death, the remainder is to be distributed to GC, the grandchild of T and S. On October 1, 1985, when the trust assets were valued at $800,000, T added $200,000 to the trust. After the transfer on October 1, 1985, the allocation fraction was .2 ($200,000/$1,000,000). On December 21, 1989, when the value of the trust principal is $1,000,000, T adds $1,000,000 to the trust. After this addition, the new allocation fraction is 0.6 ($1,200,000/$2,000,000). The numerator of the fraction is the value of that portion of trust assets that were subject to chapter 13 immediately prior to the addition (by reason of the first addition), $200,000 (.2 × $1,000,000), plus the value of the second transfer, $1,000,000, which equals $1,200,000. The denominator of the fraction, $2,000,000, is the total value of the trust assets immediately after the second transfer. Thus, 60 percent of the principal of the trust becomes subject to chapter 13.

EXAMPLE 3. *Entire portion of trust subject to lapsed power is treated as an addition.* On September 25, 1985, B possessed a general power of appointment over the assets of an irrevocable trust that had been created by T in 1980. Under the terms of the trust, B's power lapsed on July 20, 1987. For Federal gift tax purposes, B is treated as making a gift of ninety-five percent (100%—5%) of the value of the principal (see section 2514). However, because the entire trust was subject to the power of appointment, 100 percent (that portion of the trust subject to the power) of the assets of the trust are treated as a constructive addition. Thus, the entire amount of all generation-skipping transfers occurring pursuant to the trust instrument after July 20, 1987, are subject to chapter 13.

EXAMPLE 4. *Exercise of power of appointment in favor of another trust.* On March 1, 1985, T established an irrevocable trust as defined in paragraph (b)(1)(ii) of this section. Under the terms of the trust instrument, the trustee is required to distribute the entire income annually to T's child, C, for life, then to T's grandchild, GC, for life. GC has the power to appoint any or all of the trust assets to

Trust 2 which is an irrevocable trust (as defined in paragraph (b)(1)(ii) of this section) that was established on August 1, 1985. The terms of Trust 2's governing instrument provide that the trustee shall pay income to T's great grandchild, GGC, for life. Upon GGC's death, the remainder is to be paid to GGC's issue. GGC was alive on March 1, 1985, when Trust 1 was created. C died on April 1, 1986. On July 1, 1987, GC exercised the power of appointment. The exercise of GC's power does not subject future transfers from Trust 2 to tax under chapter 13 because the exercise of the power in favor of Trust 2 does not suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date of creation of Trust 1, extending beyond the life of GGC (a beneficiary under Trust 2 who was in being at the date of creation of Trust 1) plus a period of 21 years. The result would be the same if Trust 2 had been created after the effective date of chapter 13.

EXAMPLE 5. *Exercise of power of appointment in favor of another trust.* Assume the same facts as in *Example 4,* except that GGC was born on March 28, 1986. The valid exercise of GC's power in favor of Trust 2 causes the principal of Trust 1 to be subject to chapter 13, because GGC was not born until after the creation of Trust 1. Thus, such exercise may suspend the vesting, absolute ownership, or power of alienation of an interest in the trust principal for a period, measured from the date of creation of Trust 1, extending beyond the life of GGC (a beneficiary under Trust 2 who was not a life in being at the date of creation of Trust 1).

EXAMPLE 6. *Extension for the longer of two periods.* Prior to the effective date of chapter 13, GP established an irrevocable trust under which the trust income was to be paid to GP's child, C, for life. C was given a testamentary power to appoint the remainder in further trust for the benefit of C's issue. In default of C's exercise of the power, the remainder was to pass to charity. C died on February 3, 1995, survived by a child who was alive when GP established the trust. C exercised the power in a manner that validly extends the trust in favor of C's issue until the latter of May 15, 2064 (80 years from the date the trust was created), or the death of C's child plus 21 years. C's exercise of the power is a constructive addition to the trust because the exercise may extend the trust for a period longer than the permissible periods of either the life of C's child (a life in being at the creation of the trust) plus 21 years or a term not more than 90 years measured from the creation of the trust. On the other hand, if C's exercise of the power could extend the trust based only on the life of C's child plus 21 years or only for a term of 80 years from the creation of the trust (but not the later of the two periods) then the exercise of the power would not have been a constructive addition to the trust.

EXAMPLE 7. *Extension for the longer of two periods.* The facts are the same as in *Example 6* except local law provides that the effect of C's exercise is to extend the term of the trust until May 15, 2064, whether or not C's child predeceases that date by more than 21 years. C's exercise is not a constructive addition to the trust because C exercised the power in a manner that cannot postpone or suspend vesting, absolute ownership, or power of alienation for a term of years that will exceed 90 years. The result would be the same if the effect of C's exercise is either to extend the term of the trust until 21 years after the death of C's child or to extend the term of the trust until the first to occur of May 15, 2064 or 21 years after the death of C's child.

(vi) *Appreciation and income.* Except to the extent that the provisions of paragraphs (b)(1)(iv) and (v) of this section allocate subsequent appreciation and accumulated income between the original trust and additions thereto, appreciation in the value of the trust and undistributed income added thereto are not considered an addition to the principal of a trust.

(2) *Transition rule for wills or revocable trusts executed before October 22, 1986*—(i) *In general.* The provisions of chapter 13 do not apply to any generation-skipping transfer under a will or revocable trust executed before October 22, 1986, provided that—

(A) The document in existence on October 21, 1986, is not amended at any time after October 21, 1986, in any respect which results in the creation of, or an increase in the amount of, a generation-skipping transfer;

(B) In the case of a revocable trust, no addition is made to the revocable trust after October 21, 1986, that results in the creation of, or an increase in the amount of, a generation-skipping transfer; and

(C) The decedent dies before January 1, 1987.

(ii) *Revocable trust defined.* For purposes of this section, the term *revocable trust* means any trust (as defined in section 2652(b)) except to the extent that, on October 22, 1986, the trust—

(A) Was an irrevocable trust described in paragraph (b)(1) of this section; or

(B) Would have been an irrevocable trust described in paragraph (b)(1) of

this section had it not been created or become irrevocable after September 25, 1985, and before October 22, 1986.

(iii) *Will or revocable trust containing qualified terminable interest property.* The rules contained in paragraph (b)(1)(iii) of this section apply to any will or revocable trust within the scope of the transition rule of this paragraph (b)(2).

(iv) *Amendments to will or revocable trust.* For purposes of this paragraph (b)(2), an amendment to a will or a revocable trust in existence on October 21, 1986, is not considered to result in the creation of, or an increase in the amount of, a generation-skipping transfer where the amendment is—

(A) Basically administrative or clarifying in nature and only incidentally increases the amount transferred; or

(B) Designed to ensure that an existing bequest or transfer qualifies for the applicable marital or charitable deduction for estate, gift, or generation-skipping transfer tax purposes and only incidentally increases the amount transferred to a skip person or to a generation-skipping trust.

(v) *Creation of, or increase in the amount of, a GST.* In determining whether a particular amendment to a will or revocable trust creates, or increases the amount of, a generation-skipping transfer for purposes of this paragraph (b)(2), the effect of the instrument(s) in existence on October 21, 1986, is measured against the effect of the instrument(s) in existence on the date of death of the decedent or on the date of any prior generation-skipping transfer. If the effect of an amendment cannot be immediately determined, it is deemed to create, or increase the amount of, a generation-skipping transfer until a determination can be made.

(vi) *Additions to revocable trusts.* Any addition made after October 21, 1986, but before the death of the settlor, to a revocable trust subjects all subsequent generation-skipping transfers under the trust to the provisions of chapter 13. Any addition made to a revocable trust after the death of the settlor (if the settlor dies before January 1, 1987) is treated as an addition to an irrevocable trust. See paragraph (b)(1)(v) of this section for rules involving constructive additions to trusts. See paragraph (b)(1)(v)(B) of this section for rules providing that certain transfers to trusts are not treated as additions for purposes of this section.

(vii) *Examples.* The following examples illustrate the application of paragraph (b)(2)(iv) of this section:

(A) *Facts applicable to Examples 1 through 5.* In each of *Examples 1* through *5* assume that T executed a will prior to October 22, 1986, and that T dies on December 31, 1986.

EXAMPLE 1. *Administrative change.* On November 1, 1986, T executes a codicil to T's will removing one of the co-executors named in the will. Although the codicil may have the effect of lowering administrative costs and thus increasing the amount transferred, it is considered administrative in nature and thus does not cause generation-skipping transfers under the will to be subject to chapter 13.

EXAMPLE 2. *Effect of amendment not immediately determinable.* On November 1, 1986, T executes a codicil to T's will revoking a bequest of $100,000 to C, a non-skip person (as defined under section 2613(b)) and causing that amount to be added to a residuary trust held for a skip person. The amendment is deemed to increase the amount of a generation-skipping transfer and prevents any transfers under the will from qualifying under paragraph (b)(2)(i) of this section. If, however, C dies before T and under local law the property would have been added to the residue in any event because the bequest would have lapsed, the codicil is not considered an amendment that increases the amount of a generation-skipping transfer.

EXAMPLE 3. *Refund of tax paid because of amendment.* T's will provided that an amount equal to the maximum allowable marital deduction would pass to T's spouse with the residue of the estate passing to a trust established for the benefit of skip persons. On October 23, 1986, the will is amended to provide that the marital share passing to T's spouse shall be the lesser of the maximum allowable marital deduction or the minimum amount that will result in no estate tax liability for T's estate. The amendment may increase the amount of a generation-skipping transfer. Therefore, any generation-skipping transfers under the will are subject to tax under chapter 13. If it becomes apparent that the amendment does not increase the amount of a generation-skipping transfer, a claim for refund may be filed with respect to any generation-skipping transfer tax that was paid within the period set forth in section 6511. For example, it would become apparent that the amendment did not result in an increase

in the residue if it is subsequently determined that the maximum marital deduction and the minimum amount that will result in no estate tax liability are equal in amount.

EXAMPLE 4. *An amendment that increases a generation-skipping transfer causes complete loss of exempt status.* T's will provided for the creation of two trusts for the benefit of skip persons. On November 1, 1986, T executed a codicil to the will specifically increasing the amount of a generation-skipping transfer under the will. All transfers made pursuant to the will or either of the trusts created thereunder are precluded from qualifying under the transition rule of paragraph (b)(2)(i) of this section and are subject to tax under chapter 13.

EXAMPLE 5. *Corrective action effective.* Assume that T in *Example 4* later executes a second codicil deleting the increase to the generation-skipping transfer. Because the provision increasing a generation-skipping transfer does not become effective, it is not considered an amendment to a will in existence on October 22, 1986.

(B) *Facts applicable to Examples 6 through 9.* T created a trust on September 30, 1985, in which T retained the power to revoke the transfer at any time prior to T's death. The trust provided that, upon the death of T, the income was to be paid to T's spouse, W, for life and then to A, B, and C, the children of T's sibling, S, in equal shares for life, with one-third of the principal to be distributed per stirpes to each child's surviving issue upon the death of the child. The trustee has the power to make discretionary distributions of trust principal to T's sibling, S.

EXAMPLE 6. *Amendment that affects only a person who is not a skip person.* A became disabled, and T modified the trust on December 1, 1986, to increase A's share of the income. Since the amendment does not result in the creation of, or increase in the amount of, a generation-skipping transfer, transfers pursuant to the trust are not subject to chapter 13.

EXAMPLE 7. *Amendment increasing skip person's share.* Assume that A, B, and C are the grandchildren of S rather than the children (and thus are skip persons as defined in section 2613). T's amendment of the trust increasing A's share of the income subjects the trust to the provisions of chapter 13 because the amendment increases the amount of the generation-skipping transfers to be made to A.

EXAMPLE 8. *Amendment that adds a skip person.* Assume that T amends the trust to add T's grandchild, D, as an income beneficiary. The trust will be subject to the provisions of chapter 13 because the amendment creates a generation-skipping transfer.

EXAMPLE 9. *Refund of tax paid during interim period when effect of amendment is not determinable.* Assume that T amends the trust to provide that the issue of S are to take a one-fourth share of the principal per stirpes upon S's death. Because the distribution to be made upon S's death may involve skip persons, the amendment is considered an amendment that creates or increases the amount of a generation-skipping transfer until a determination can be made. Accordingly, any distributions from (or terminations of interests in) such trust are subject to chapter 13 until it is determined that no skip person has been added to the trust. At that time, a claim for refund may be filed within the period set forth in section 6511 with respect to any generation-skipping transfer tax that was paid.

(3) *Transition rule in the case of mental incompetency*—(i) *In general.* If an individual was under a mental disability to change the disposition of his or her property continuously from October 22, 1986, until the date of his or her death, the provisions of chapter 13 do not apply to any generation-skipping transfer—

(A) Under a trust (as defined in section 2652(b)) to the extent such trust consists of property, or the proceeds of property, the value of which was included in the gross estate of the individual (other than property transferred by or on behalf of the individual during the individual's life after October 22, 1986); or

(B) Which is a direct skip (other than a direct skip from a trust) that occurs by reason of the death of the individual.

(ii) *Mental disability defined.* For purposes of this paragraph (b)(2), *the term mental disability* means mental incompetence to execute an instrument governing the disposition of the individual's property, whether or not there was an adjudication of incompetence and regardless of whether there has been an appointment of a guardian, fiduciary, or other person charged with either the care of the individual or the care of the individual's property.

(iii)(A) *Decedent who has not been adjudged mentally incompetent.* If there has not been a court adjudication that the decedent was mentally incompetent on or before October 22, 1986, the executor must file, with Form 706, either—

(*1*) A certification from a qualified physician stating that the decedent was—

(*i*) Mentally incompetent at all times on and after October 22, 1986; and

(*ii*) Did not regain competence to modify or revoke the terms of the trust or will prior to his or her death; or

(*2*) Sufficient other evidence demonstrating that the decedent was mentally incompetent at all times on and after October 22, 1986, as well as a statement explaining why no certification is available from a physician; and

(*3*) Any judgement or decree relating to the decedent's incompetency that was made after October 22, 1986.

(B) Such items in paragraphs (b)(3)(iii)(A)(*1*), (*2*), and (*3*) of this section will be considered relevant, but not determinative, in establishing the decedent's state of competency.

(iv) *Decedent who has been adjudged mentally incompetent.* If the decedent has been adjudged mentally incompetent on or before October 22, 1986, a copy of the judgment or decree, and any modification thereof, must be filed with the Form 706.

(v) *Rule applies even if another person has power to change trust terms.* In the case of a transfer from a trust, this paragraph (b)(3) applies even though a person charged with the care of the decedent or the decedent's property has the power to revoke or modify the terms of the trust, provided that the power is not exercised after October 22, 1986, in a manner that creates, or increases the amount of, a generation-skipping transfer. See paragraph (b)(2)(iv) of this section for rules concerning amendments that create or increase the amount of a generation-skipping transfer.

(vi) *Example.* The following example illustrates the application of paragraph (b)(3)(v) of this section:

EXAMPLE. T was mentally incompetent on October 22, 1986, and remained so until death in 1993. Prior to becoming incompetent, T created a revocable generation-skipping trust that was includible in T's gross estate. Prior to October 22, 1986, the appropriate court issued an order under which P, who was thereby charged with the care of T's property, had the power to modify or revoke the revocable trust. Although P exercised the power after October 22, 1986, and while T was incompetent, the power was not exercised in a manner that created, or increased the amount of, a generation-skipping transfer. Thus, the existence and exercise of P's power did not cause the trust to lose its exempt status under paragraph (b)(3) of this section. The result would be the same if the court order was issued after October 22, 1986.

(4) *Exceptions to additions rule*—(i) *In general.* Any addition to a trust made pursuant to an instrument or arrangement covered by the transition rules in paragraph (b) (1), (2) or (3) of this section is not treated as an addition for purposes of this section. Moreover, any property transferred inter vivos to a trust is not treated as an addition if the same property would have been added to the trust pursuant to an instrument covered by the transition rules in paragraph (b) (2) or (3) of this section.

(ii) *Examples.* The following examples illustrate the application of paragraph (b)(4)(i) of this section:

EXAMPLE 1. *Addition pursuant to terms of exempt instrument.* On December 31, 1980, T created an irrevocable trust having a principal of $100,000. Under the terms of the trust, the principal was to be held for the benefit of T's grandchild, GC. Pursuant to the terms of T's will, a document entitled to relief under the transition rule of paragraph (b)(2) of this section, the residue of the estate was paid to the trust. Because the addition to the trust was paid pursuant to the terms of an instrument (T's will) that is not subject to the provisions of chapter 13 because of paragraph (b)(2) of this section, the payment to the trust is not considered an addition to the principal of the trust. Thus, distributions to or for the benefit of GC, are not subject to the provisions of chapter 13.

EXAMPLE 2. *Property transferred inter vivos that would have been transferred to the same trust by the transferor's will.* T is the grantor of a trust that was irrevocable on September 25, 1985. T's will, which was executed before October 22, 1986, and not amended thereafter, provides that, upon T's death, the entire estate will pour over into T's trust. On October 1, 1985, T transfers $100,000 to the trust. While T's will otherwise qualifies for relief under the transition rule in paragraph (b)(2) of this section, the transition rule is not applicable unless T dies prior to January 1, 1987. Thus, if T dies after December 31, 1986, the transfer is treated as an addition to the trust for purposes of any distribution made from the trust after the transfer to the trust on October 1, 1985. If T dies before January 1, 1987, the entire trust (as well as any distributions from or terminations of interests in

the trust prior to T's death) is exempt, under paragraph (b)(2) of this section, from chapter 13 because the $100,000 would have been added to the trust under a will that would have qualified under paragraph (b)(2) of this section. In either case, for any generation-skipping transfers made after the transfer to the trust on October 1, 1985, but before T's death, the $100,000 is treated as an addition to the trust and a proportionate amount of the trust is subject to chapter 13.

EXAMPLE 3. *Pour over to a revocable trust.* T and S are the settlors of separate revocable trusts with equal values. Both trusts were established for the benefit of skip persons (as defined in section 2613). S dies on December 1, 1985, and under the provisions of S's trust, the principal pours over into T's trust. If T dies before January 1, 1987, the entire trust is excluded under paragraph (b)(2) of this section from the operation of chapter 13. If T dies after December 31, 1986, the entire trust is subject to the generation-skipping transfer tax provisions because T's trust is not a trust described in paragraph (b)(1) or (2) of this section. In the latter case, the fact that S died before January 1, 1987, is irrelevant because the principal of S's trust was added to a trust that never qualified under the transition rules of paragraph (b)(1) or (2) of this section.

EXAMPLE 4. *Pour over to exempt trust.* Assume the same facts as in *Example 3,* except upon the death of S on December 1, 1985, S's trust continues as an irrevocable trust and that the principal of T's trust is to be paid over upon T's death to S's trust. Again, if T dies before January 1, 1987, S's entire trust falls within the provisions of paragraph (b)(2) of this section. However, if T dies after December 31, 1986, the pour-over is considered an addition to the trust. Therefore, S's trust is not a trust excluded under paragraph (b)(2) of this section because an addition is made to the trust.

EXAMPLE 5. *Lapse of a general power of appointment.* S, the spouse of the settlor of an irrevocable trust that was created in 1980, had, on September 25, 1985, a general power of appointment over the trust assets. The trust provides that should S fail to exercise the power of appointment the property is to remain in the trust. On October 21, 1986, S executed a will under which S failed to exercise the power of appointment. If S dies before January 1, 1987, without having exercised the power in a manner which results in the creation of, or increase in the amount of, a generation-skipping transfer (or amended the will in a manner that results in the creation of, or increase in the amount of, a generation-skipping transfer), transfers pursuant to the trust or the will are not subject to chapter 13 because the trust is an irrevocable trust and the will qualifies under paragraph (b)(2) of this section.

EXAMPLE 6. *Lapse of general power of appointment held by intestate decedent.* Assume the same facts as in *Example 5,* except on October 22, 1986, S did not have a will and that S dies after that date. Upon S's death, or upon the prior exercise or release of the power, the value of the entire trust is treated as having been distributed to S, and S is treated as having made an addition to the trust in the amount of the entire principal. Any distribution or termination pursuant to the trust occurring after S's death is subject to chapter 13. It is immaterial whether S's death occurs before January 1, 1987, since paragraph (b)(2) of this section is only applicable where a will or revocable trust was executed before October 22, 1986.

(c) *Additional effective dates.* Except as otherwise provided, the regulations under §§ 26.2611–1, 26.2612–1, 26.2613–1, 26.2632–1, 26.2641–1, 26.2642–1, 26.2642–2, 26.2642–3, 26.2642–4, 26.2642–5, 26.2652–1, 26.2652–2, 26.2653–1, 26.2654–1, 26.2663–1, and 26.2663–2 are effective with respect to generation-skipping transfers as defined in § 26.2611–1 made on or after December 27, 1995. However, taxpayers may, at their option, rely on these regulations in the case of generation-skipping transfers made, and trusts that became irrevocable, after December 23, 1992, and before December 27, 1995.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29653, June 12, 1996, as amended at 61 FR 43656, Aug. 26, 1996]

### § 26.2611–1 Generation-skipping transfer defined.

A generation-skipping transfer (GST) is an event that is either a direct skip, a taxable distribution, or a taxable termination. See § 26.2612–1 for the definition of these terms. The determination as to whether an event is a GST is made by reference to the most recent transfer subject to the estate or gift tax. See § 26.2652–1(a)(2) for determining whether a transfer is subject to Federal estate or gift tax.

### § 26.2612–1 Definitions.

(a) *Direct skip*—(1) *In general.* A direct skip is a transfer to a skip person that is subject to Federal estate or gift tax. If property is transferred to a trust, the transfer is a direct skip only if the trust is a skip person. Only one direct skip occurs when a single transfer of property skips two or more generations. See paragraph (d) of this section

for the definition of skip person. See § 26.2652–1(b) for the definition of trust. See § 26.2632–1(c)(4) for the time that a direct skip occurs if the transferred property is subject to an estate tax inclusion period.

(2) *Special rule for certain lineal descendants*—(i) In *general.* Solely for the purpose of determining whether a transfer to or for the benefit of a lineal descendant of the transferor, the transferor's spouse, or a former spouse of the transferor is a direct skip, the generation assignment of the descendant is determined by disregarding the generation of a predeceased individual who was both an ancestor of the descendant and a lineal descendant of the transferor, the transferor's spouse, or a former spouse of the transferor (a predeceased child). If a transfer to a trust would be a direct skip but for this paragraph, any generation assignment determined under this paragraph continues to apply in determining whether any subsequent distribution from (or termination of an interest in) the portion of the trust attributable to that transfer is a GST. A living descendant who dies no later than 90 days after the subject transfer is treated as having predeceased the transferor to the extent that either the governing instrument or applicable local law provides that such individual shall be treated as predeceasing the transferor. Except as provided in this paragraph (a)(2), a living descendant is not treated as a predeceased child solely by reason of applicable local law; e.g., an individual is not treated as a predeceased child solely because state law treats an individual executing a disclaimer as having predeceased the transferor of the disclaimed property. See § 26.2652–1(a)(1) for the definition of *transferor.* See paragraph (e) of this section for the definition of *interest in trust.*

(ii) *Special rule.* If a transferor makes an addition to an existing trust after the death of an individual described in paragraph (a)(2)(i) of this section (so that the lineal descendant would be assigned to a higher generation by reason of that death), the additional property is treated as being held in a separate trust for purposes of chapter 13 and the provisions of § 26.2654–1(a)(2) apply as if the portions of the single trust had separate transferors. Subsequent additions are treated as additions to the appropriate portion of the single trust.

(b) *Taxable termination*—(1) *In general.* Except as otherwise provided in this paragraph (b), a taxable termination is a termination (occurring for any reason) of an interest in trust unless—

(i) A transfer subject to Federal estate or gift tax occurs with respect to the property held in the trust at the time of the termination;

(ii) Immediately after the termination, a person who is not a skip person has an interest in the trust; or

(iii) At no time after the termination may a distribution, other than a distribution the probability of which occurring is so remote as to be negligible (including a distribution at the termination of the trust) be made from the trust to a skip person. For this purpose, the probability that a distribution will occur is so remote as to be negligible only if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the distribution will occur.

(2) *Partial termination.* If a distribution of a portion of trust property is made to a skip person by reason of a termination occurring on the death of a lineal descendant of the transferor, the termination is a taxable termination with respect to the distributed property.

(3) *Simultaneous terminations.* A simultaneous termination of two or more interests creates only one taxable termination.

(c) *Taxable distribution*—(1) *In general.* A taxable distribution is a distribution of income or principal from a trust to a skip person unless the distribution is a taxable termination or a direct skip. If any portion of GST tax (including penalties and interest thereon) imposed on a distributee is paid from the distributing trust, the payment is an additional taxable distribution to the distributee. For purposes of chapter 13, the additional distribution is treated as having been made on the last day of the calendar year in which the original taxable distribution is made. If Federal estate or gift tax is imposed on any individual with respect to an interest in property held by a trust, the interest in

property is treated as having been distributed to the individual to the extent that the value of the interest is subject to Federal estate or gift tax. See § 26.2652–1(a)(6) *Example 5,* regarding the treatment of the lapse of a power of appointment as a transfer to a trust.

(2) *Look-through rule not to apply.* Solely for purposes of determining whether any transfer from a trust to another trust is a taxable distribution, the rules of section 2651(e)(2) do not apply. If the transferring trust and the recipient trust have the same transferor, see § 26.2642–4(a) (1) and (2) for rules for recomputing the applicable fraction of the recipient trust.

(d) *Skip person.* A skip person is—

(1) An individual assigned to a generation more than one generation below that of the transferor (determined under the rules of section 2651); or

(2) A trust if—

(i) All interests in the trust are held by skip persons; or

(ii) No person holds an interest in the trust and no distributions, other than a distribution the probability of which occurring is so remote as to be negligible (including distributions at the termination of the trust), may be made after the transfer to a person other than a skip person. For this purpose, the probability that a distribution will occur is so remote as to be negligible only if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the distribution will occur.

(e) *Interest in trust*—(1) *In general.* An interest in trust is an interest in property held in trust as defined in section 2652(c) and these regulations. An interest in trust exists if a person—

(i) Has a present right to receive trust principal or income;

(ii) Is a permissible current recipient of trust principal or income and is not described in section 2055(a); or

(iii) Is described in section 2055(a) and the trust is a charitable remainder annuity trust or unitrust (as defined in section 664(d)) or a pooled income fund (as defined in section 642(c)(5)).

(2) *Exceptions*—(i) *Support obligations.* In general, an individual has a present right to receive trust income or principal if trust income or principal may be used to satisfy the individual's support obligations. However, an individual does not have an interest in a trust merely because a support obligation of that individual may be satisfied by a distribution that is either within the discretion of a fiduciary or pursuant to provisions of local law substantially equivalent to the Uniform Gifts (Transfers) to Minors Act.

(ii) *Certain interests disregarded.* An interest which is used primarily to postpone or avoid the GST tax is disregarded for purposes of chapter 13. An interest is considered as used primarily to postpone or avoid the GST tax if a significant purpose for the creation of the interest is to postpone or avoid the tax.

(3) *Disclaimers.* An interest does not exist to the extent it is disclaimed pursuant to a disclaimer that constitutes a qualified disclaimer under section 2518.

(f) *Examples.* The following examples illustrate the provisions of this section. Unless stated otherwise, paragraph (a)(2) of this section, which assigns descendants to a higher generation when there is a predeceased ancestor, does not apply.

EXAMPLE 1. *Direct skip.* T gratuitously conveys Blackacre to T's grandchild. Because the transfer is a transfer to a skip person of property subject to Federal gift tax, it is a direct skip.

EXAMPLE 2. *Direct skip of more than one generation.* T gratuitously conveys Blackacre to T's great-grandchild. The transfer is a direct skip. Only one GST tax is imposed on the direct skip although two generations are skipped by the transfer.

EXAMPLE 3. *Withdrawal power in trust.* T transfers $50,000 to a new trust providing that trust income is to be paid to T's child, C, for life and, on C's death, the trust principal is to be paid to T's descendants. Under the terms of the trust, T grants four grandchildren the right to withdraw $10,000 from the trust for a 60 day period following the transfer. Since C, who is not a skip person, has an interest in the trust, the trust is not a skip person. T's transfer to the trust is not a direct skip.

EXAMPLE 4. *Taxable termination.* T establishes an irrevocable trust under which the income is to be paid to T's child, C, for life. On the death of C, the trust principal is to be paid to T's grandchild, GC. Since C has an interest in the trust, the trust is not a skip person and the transfer to the trust is not a

direct skip. If C dies survived by GC, a taxable termination occurs at C's death because C's interest in the trust terminates and thereafter the trust property is held by a skip person who occupies a lower generation than C.

EXAMPLE 5. *Direct skip of property held in trust.* T establishes a testamentary trust under which the income is to be paid to T's surviving spouse, S, for life and the remainder is to be paid to a grandchild of T and S. T's executor elects to treat the trust as qualified terminable interest property under section 2056(b)(7). The transfer to the trust is not a direct skip because S, a person who is not a skip person, holds a present right to receive income from the trust. Upon S's death, the trust property is included in S's gross estate under section 2044 and passes directly to a skip person. The GST occurring at that time is a direct skip because it is a transfer subject to chapter 11. The fact that the interest created by T is terminated at S's death is immaterial because S becomes the transferor at the time of the transfer subject to chapter 11.

EXAMPLE 6. *Predeceased ancestor exception.* T establishes an irrevocable trust providing that trust income is to be paid to T's grandchild, GC, for 5 years. At the end of the 5-year period, the trust is to terminate and the principal is to be distributed to GC. T's child, C, a parent of GC, is deceased at the time T establishes the trust. Therefore, GC is treated as a child of T rather than as a grandchild. As a result, GC is not a skip person, and the initial transfer to the trust is not a direct skip. Similarly, distributions to GC during the term of the trust and at the termination of the trust will not be GSTs.

EXAMPLE 7. *Predeceased ancestor exception not applicable.* The facts are the same as in *Example 6*, except the trust income is to be paid to T's spouse, S, during the first two years of the trust. Since S has an interest in the trust, the trust is not a skip person and the transfer by T is not a direct skip. Since the transfer is not a direct skip, the predeceased ancestor rule does not apply and GC is not treated as the child of T. A taxable termination occurs at the expiration of S's interest.

EXAMPLE 8. *Taxable termination.* T establishes an irrevocable trust for the benefit of T's child, C, T's grandchild, GC, and T's great-grandchild, GGC. Under the terms of the trust, income and principal may be distributed to any or all of the living beneficiaries at the discretion of the trustee. Upon the death of the second beneficiary to die, the trust principal is to be paid to the survivor. C dies first. A taxable termination occurs at that time because, immediately after C's interest terminates, all interests in the trust are held by skip persons (GC and GGC).

EXAMPLE 9. *Taxable termination resulting from distribution.* The facts are the same as in *Example 8*, except twenty years after C's death the trustee exercises its discretionary power and distributes the entire principal to GGC. The distribution results in a taxable termination because GC's interest in the trust terminates as a result of the distribution of the entire trust property to GGC, a skip person. The result would be the same if the trustee retained sufficient funds to pay the GST tax due by reason of the taxable termination, as well as any expenses of winding up the trust.

EXAMPLE 10. *Simultaneous termination of interests of more than one beneficiary.* T establishes an irrevocable trust for the benefit of T's child, C, T's grandchild, GC, and T's great-grandchild, GGC. Under the terms of the trust, income and principal may be distributed to any or all of the living beneficiaries at the discretion of the trustee. Upon the death of C, the trust property is to be distributed to GGC if then living. If C is survived by both GC and GGC, both C's and GC's interests in the trust will terminate on C's death. However, because both interests will terminate at the same time and as a result of one event, only one taxable termination occurs.

EXAMPLE 11. *Partial taxable termination.* T creates an irrevocable trust providing that trust income is to be paid to T's children, A and B, in such proportions as the trustee determines for their joint lives. On the death of the first child to die, one-half of the trust principal is to be paid to T's then living grandchildren. The balance of the trust principal is to be paid to T's grandchildren on the death of the survivor of A and B. If A predeceases B, the distribution occurring on the termination of A's interest in the trust is a taxable termination and not a taxable distribution. It is a taxable termination because the distribution is a distribution of a portion of the trust that occurs as a result of the death of A, a lineal descendant of T. It is immaterial that a portion of the trust continues and that B, a person other than a skip person, thereafter holds an interest in the trust.

EXAMPLE 12. *Taxable distribution.* T establishes an irrevocable trust under which the trust income is payable to T's child, C, for life. When T's grandchild, GC, attains 35 years of age, GC is to receive one-half of the principal. The remaining one-half of the principal is to be distributed to GC on C's death. Assume that C survives until GC attains age 35. When the trustee distributes one-half of the principal to GC on GC's 35th birthday, the distribution is a taxable distribution because it is a distribution to a skip person and is neither a taxable termination nor a direct skip.

EXAMPLE 13. *Exercise of withdrawal right as taxable distribution.* The facts are the same as

in *Example 12*, except GC holds a continuing right to withdraw trust principal and after one year GC withdraws $10,000. The withdrawal by GC is not a taxable termination because the withdrawal does not terminate C's interest in the trust. The withdrawal by GC is a taxable distribution to GC.

EXAMPLE 14. *Interest in trust.* T establishes an irrevocable trust under which the income is to be paid to T's child, C, for life. On the death of C, the trust principal is to be paid to T's grandchild, GC. Because C has a present right to receive income from the trust, C has an interest in the trust. Because GC cannot currently receive distributions from the trust, GC does not have an interest in the trust.

EXAMPLE 15. *Support obligation.* T establishes an irrevocable trust for the benefit of T's grandchild, GC. The trustee has discretion to distribute property for GC's support without regard to the duty or ability of GC's parent, C, to support GC. Because GC is a permissible current recipient of trust property, GC has an interest in the trust. C does not have an interest in the trust because the potential use of the trust property to satisfy C's support obligation is within the discretion of a fiduciary. C would be treated as having an interest in the trust if the trustee was required to distribute trust property for GC's support.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29653, June 12, 1996]

### § 26.2613–1 Skip person.

For the definition of *skip person* see § 26.2612–1(d).

### § 26.2632–1 Allocation of GST exemption.

(a) *General rule.* Except as otherwise provided in this section, an individual or the individual's executor may allocate the individual's $1 million GST exemption at any time from the date of the transfer through the date for filing the individual's Federal estate tax return (including any extensions for filing that have been actually granted). If no estate tax return is required to be filed, the GST exemption may be allocated at any time through the date a Federal estate tax return would be due if a return were required to be filed (including any extensions actually granted). If property is held in trust, the allocation of GST exemption is made to the entire trust rather than to specific trust assets. If a transfer is a direct skip to a trust, the allocation of GST exemption to the transferred property is also treated as an allocation of GST exemption to the trust for purposes of future GSTs with respect to the trust by the same transferor.

(b) *Lifetime allocations*—(1) *Automatic allocation to direct skips*—(i) *In general.* If a direct skip occurs during the transferor's lifetime, the transferor's GST exemption not previously allocated (unused GST exemption) is automatically allocated to the transferred property (but not in excess of the fair market value of the property on the date of the transfer). The transferor may prevent the automatic allocation of GST exemption by describing on a timely-filed United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709) the transfer and the extent to which the automatic allocation is not to apply. In addition, a timely-filed Form 709 accompanied by payment of the GST tax (as shown on the return with respect to the direct skip) is sufficient to prevent an automatic allocation of GST exemption with respect to the transferred property. See paragraph (c)(4) of this section for special rules in the case of direct skips treated as occurring at the termination of an estate tax inclusion period.

(ii) *Time for filing Form 709.* A Form 709 is timely filed if it is filed on or before the date required for reporting the transfer if it were a taxable gift (i.e., the date prescribed by section 6075(b), including any extensions to file actually granted (the due date)). Except as provided in paragraph (b)(1)(iii) of this section, the automatic allocation of GST exemption (or the election to prevent the allocation, if made) is irrevocable after the due date. An automatic allocation of GST exemption is effective as of the date of the transfer to which it relates. Except as provided above, a Form 709 need not be filed to report an automatic allocation.

(iii) *Transitional rule.* An election to prevent an automatic allocation of GST exemption filed on or before January 26, 1996, becomes irrevocable on July 24, 1996.

(2) *Allocation to other transfers*—(i) *In general.* An allocation of GST exemption to property transferred during the transferor's lifetime, other than in a direct skip, is made on Form 709. The allocation must clearly identify the

trust to which the allocation is being made, the amount of GST exemption allocated to it, and if the allocation is late or if an inclusion ratio greater than zero is claimed, the value of the trust assets at the effective date of the allocation. See paragraph (b)(2)(ii) of this section. The allocation should also state the inclusion ratio of the trust after the allocation. Except as otherwise provided in this paragraph, an allocation of GST exemption may be made by a formula; e.g., the allocation may be expressed in terms of the amount necessary to produce an inclusion ratio of zero. However, formula allocations made with respect to charitable lead annuity trusts are not valid except to the extent they are dependent on values as finally determined for Federal estate or gift tax purposes. With respect to a timely allocation, an allocation of GST exemption becomes irrevocable after the due date of the return. Except as provided in § 26.2642–3 (relating to charitable lead annuity trusts), an allocation of GST exemption to a trust is void to the extent the amount allocated exceeds the amount necessary to obtain an inclusion ratio of zero with respect to the trust. See § 26.2642–1 for the definition of inclusion ratio. An allocation is also void if the allocation is made with respect to a trust that has no GST potential with respect to the transferor making the allocation, at the time of the allocation. For this purpose, a trust has GST potential even if the possibility of a GST is so remote as to be negligible.

(ii) *Effective date of allocation*—(A) *In general.* (*1*) Except as otherwise provided, an allocation of GST exemption is effective as of the date of any transfer as to which the Form 709 on which it is made is a timely filed return (a timely allocation). If more than one timely allocation is made, the earlier allocation is modified only if the later allocation clearly identifies the transfer and the nature and extent of the modification. Except as provided in paragraph (d)(1) of this section, an allocation to a trust made on a Form 709 filed after the due date for reporting a transfer to the trust (a late allocation) is effective on the date the Form 709 is filed and is deemed to precede in point of time any taxable event occurring on such date. For purposes of this paragraph (b)(2)(ii), the Form 709 is deemed filed on the date it is postmarked to the Internal Revenue Service Center. See § 26.2642–2 regarding the effect of a late allocation in determining the inclusion ratio, etc. See paragraph (c)(1) of this section regarding allocation of GST exemption to property subject to an estate tax inclusion period. If it is unclear whether an allocation of GST exemption on a Form 709 is a late or a timely allocation to a trust, the allocation is effective in the following order—

(*i*) To any transfer to the trust disclosed on the return as to which the return is a timely return;

(*ii*) As a late allocation; and

(*iii*) To any transfer to the trust not disclosed on the return as to which the return would be a timely return.

(*2*) A late allocation to a trust may be made on a Form 709 that is timely filed with respect to another transfer. A late allocation is irrevocable when made.

(B) *Amount of allocation.* If other transfers exist with respect to which GST exemption could be allocated under paragraphs (b)(2)(ii)(A)(*1*) (*ii*) and (*iii*), any GST exemption allocated under paragraph (b)(2)(ii)(A)(*1*)(*i*) of this section is allocated in an amount equal to the value of the transferred property as reported on the Form 709. Thus, if the GST exemption allocated on the Form 709 exceeds the value of the transfers reported on that return that have generation-skipping potential, the initial allocation under paragraph (b)(2)(ii)(A)(*1*)(*i*) of this section is in the amount of the value of those transfers as reported on that return. Any remaining amount of GST exemption allocated on that return is then allocated pursuant to paragraphs (b)(2)(ii)(A)(*1*) (*ii*) and (*iii*) of this section, notwithstanding any subsequent upward adjustment in value of the transfers reported on the return.

(iii) *Examples.* The following examples illustrate the provisions of this paragraph (b):

EXAMPLE 1. *Modification of allocation of GST exemption.* T transfers $100,000 to an irrevocable generation-skipping trust on December 1, 1996. The transfer to the trust is not a direct skip. The date prescribed for filing the

gift tax return reporting the taxable gift is April 15, 1997. On February 10, 1997, T files a Form 709 allocating $50,000 of GST exemption to the trust. On April 10 of the same year, T files an amended Form 709 allocating $100,000 of GST exemption to the trust in a manner that clearly indicates the intention to modify and supersede the prior allocation with respect to the 1996 transfer. The allocation made on the April 10 return supersedes the prior allocation because it is made on a timely-filed Form 709 that clearly identifies the trust and the nature and extent of the modification of GST exemption allocation. The allocation of $100,000 of GST exemption to the trust is effective as of December 1, 1996. The result would be the same if the amended Form 709 decreased the amount of the GST exemption allocated to the trust.

EXAMPLE 2. *Modification of allocation of GST exemption.* The facts are the same as in *Example 1,* except on July 10, 1997, T files a Form 709 attempting to reduce the earlier allocation. The return is not a timely-filed return. The $100,000 GST exemption allocated to the trust, as amended on April 10, 1997, remains in effect because an allocation, once made, is irrevocable and may not be modified after the last date on which a timely-filed Form 709 can be filed.

EXAMPLE 3. *Effective date of late allocation of GST exemption.* T transfers $100,000 to an irrevocable generation-skipping trust on December 1, 1996. The transfer to the trust is not a direct skip. The date prescribed for filing the gift tax return reporting the taxable gift is April 15, 1997. On December 1, 1997, T files a Form 709 and allocates $50,000 to the trust. The allocation is effective as of December 1, 1997.

EXAMPLE 4. *Effective date of late allocation of GST exemption.* T transfers $100,000 to a generation-skipping trust on December 1, 1996, in a transfer that is not a direct skip. T does not make an allocation of GST exemption on a timely-filed Form 709. On July 1, 1997, the trustee makes a taxable distribution from the trust to T's grandchild in the amount of $30,000. Immediately prior to the distribution, the value of the trust assets was $150,000. On the same date, T allocates GST exemption to the trust in the amount of $50,000. The allocation of GST exemption on the date of the transfer is treated as preceding in point of time the taxable distribution. At the time of the GST, the trust has an inclusion ratio of .6667 (1 − (50,000/150,000)).

EXAMPLE 5. *Automatic allocation to split-gift direct skip.* On May 15, 1996, T transfers $50,000 to a trust in a direct skip. T does not file a timely gift tax return electing out of the automatic allocation. On April 30, 1998, T and T's spouse, S, file an initial gift tax return for 1996 on which they consent, pursuant to section 2513, to have the gift treated as if one-half had been made by each. As a result of the election under section 2513, which is retroactive to the date of T's transfer, T and S are each treated as the transferor of one-half of the property transferred in the direct skip. Thus, $25,000 of T's unused GST exemption and $25,000 of S's unused GST exemption is automatically allocated to the trust. Both allocations are effective on and after the date that T made the transfer.

(c) *Special rules during an estate tax inclusion period*—(1) *In general.* An allocation of GST exemption (including an automatic allocation) to property subject to an estate tax inclusion period (ETIP) that is made prior to termination of the ETIP cannot be revoked, but becomes effective no earlier than the date of any termination of the ETIP with respect to the trust. Where an allocation has not been made prior to the termination of the ETIP, an allocation is effective at the termination of the ETIP during the transferor's lifetime if made by the due date for filing a Form 709 that would apply to a taxable gift occurring at the time the ETIP terminates (timely ETIP return). An allocation is effective in the case of the termination of the ETIP on the death of the transferor as provided in paragraph (d) of this section. If any part of a trust is subject to an ETIP, the entire trust is subject to the ETIP. See § 26.2642–1(b)(2) for rules determining the inclusion ratio applicable in the case of GSTs during an ETIP.

(2) *Estate tax inclusion period defined*—(i) *In general.* An ETIP is the period during which, should death occur, the value of transferred property would be includible (other than by reason of section 2035) in the gross estate of—

(A) The transferor; or

(B) The spouse of the transferor.

(ii) *Exceptions*—(A) For purposes of paragraph (c)(2) of this section, the value of transferred property is not considered as being subject to inclusion in the gross estate of the transferor or the spouse of the transferor if the possibility that the property will be included is so remote as to be negligible. A possibility is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the property will be included in the gross estate.

(B) For purposes of paragraph (c)(2) of this section, the value of transferred

property is not considered as being subject to inclusion in the gross estate of the spouse of the transferor, if the spouse possesses with respect to any transfer to the trust, a right to withdraw no more than the greater of $5,000 or 5 percent of the trust corpus, and such withdrawal right terminates no later than 60 days after the transfer to the trust.

(C) The rules of this paragraph (c)(2) do not apply to qualified terminable interest property with respect to which the special election under § 26.2652–2 has been made.

(3) *Termination of an ETIP.* An ETIP terminates on the first to occur of—

(i) The death of the transferor;

(ii) The time at which no portion of the property is includible in the transferor's gross estate (other than by reason of section 2035) or, in the case of an individual who is a transferor solely by reason of an election under section 2513, the time at which no portion would be includible in the gross estate of the individual's spouse (other than by reason of section 2035);

(iii) The time of a GST, but only with respect to the property involved in the GST; or

(iv) In the case of an ETIP arising by reason of an interest or power held by the transferor's spouse under subsection (c)(2)(i)(B) of this section, at the first to occur of—

(A) The death of the spouse; or

(B) The time at which no portion of the property would be includible in the spouse's gross estate (other than by reason of section 2035).

(4) *Treatment of direct skips.* If property transferred to a skip person is subject to an ETIP, the direct skip is treated as occurring on the termination of the ETIP.

(5) *Examples.* The following examples illustrate the rules of this section as they apply to the termination of an ETIP during the lifetime of the transferor. In each example assume that T transfers $100,000 to an irrevocable trust:

EXAMPLE 1. *Allocation of GST exemption during ETIP.* The trust instrument provides that trust income is to be paid to T for 9 years or until T's prior death. The trust principal is to be paid to T's grandchild on the termination of T's income interest. If T dies within the 9-year period, the value of the trust principal is includible in T's gross estate under section 2036(a). Thus, the trust is subject to an ETIP. T files a timely Form 709 reporting the transfer and allocating $100,000 of GST exemption to the trust. The allocation of GST exemption to the trust is not effective until the termination of the ETIP.

EXAMPLE 2. *Effect of prior allocation on termination of ETIP.* The facts are the same as in *Example 1,* except the trustee has the power to invade trust principal on behalf of T's grandchild, GC, during the term of T's income interest. In year 4, when the value of the trust is $200,000, the trustee distributes $15,000 to GC. The distribution is a taxable distribution. The ETIP with respect to the property distributed to GC terminates at the time of the taxable distribution. See paragraph (c)(3)(iii) of this section. Solely for purposes of determining the trust's inclusion ratio with respect to the taxable distribution, the prior $100,000 allocation of GST exemption (as well as any additional allocation made on a timely ETIP return) is effective immediately prior to the taxable distribution. See § 26.2642–1(b)(2). The trust's inclusion ratio with respect to the taxable distribution is therefore .50 (1 − (100,000/200,000)).

EXAMPLE 3. *Split-gift transfers subject to ETIP.* The trust instrument provides that trust income is to be paid to T for 9 years or until T's prior death. The trust principal is to be paid to T's grandchild on the termination of T's income interest. T files a timely Form 709 reporting the transfer. T's spouse, S, consents to have the gift treated as made one-half by S under section 2513. Because S is treated as transferring one-half of the property to T's grandchild, S becomes the transferor of one-half of the trust for purposes of chapter 13. Because the value of the trust would be includible in T's gross estate if T died immediately after the transfer, S's transfer is subject to an ETIP. If S should die prior to the termination of the trust, S's executor may allocate S's GST exemption to the trust, but only to the portion of the trust for which S is treated as the transferor. However, the allocation does not become effective until the earlier of the expiration of T's income interest or T's death.

EXAMPLE 4. *Transfer of retained interest as ETIP termination.* The trust instrument provides that trust income is to be paid to T for 9 years or until T's prior death. The trust principal is to be paid to T's grandchild on the termination of T's income interest. Four years after the initial transfer, T transfers the income interest to T's sibling. The ETIP with respect to the trust terminates on T's transfer of the income interest because, after the transfer, the trust property would not be includible in T's gross estate (other than by reason of section 2035) if T died at that time.

(d) *Allocations after the transferor's death*—(1) *Allocation by executor.* Except

as otherwise provided in this paragraph (d), an allocation of a decedent's unused GST exemption by the executor of the decedent's estate is made on the appropriate United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706 or Form 706NA) filed on or before the date prescribed for filing the return by section 6075(a) (including any extensions actually granted (the due date)). An allocation of GST exemption with respect to property included in the gross estate of a decedent is effective as of the date of death. A timely allocation of GST exemption by an executor with respect to a lifetime transfer of property that is not included in the transferor's gross estate is made on a Form 709. A late allocation of GST exemption by an executor, other than an allocation that is deemed to be made under section 2632(b)(1), with respect to a lifetime transfer of property is made on Form 706, Form 706NA or Form 709 (filed on or before the due date of the transferor's estate tax return) and is effective as of the date the allocation is filed. An allocation of GST exemption to a trust (whether or not funded at the time the Form 706 or Form 706NA is filed) is effective if the notice of allocation clearly identifies the trust and the amount of the decedent's GST exemption allocated to the trust. An executor may allocate the decedent's GST exemption by use of a formula. For purposes of this section, an allocation is void if the allocation is made for a trust that has no GST potential with respect to the transferor for whom the allocation is being made, as of the date of the transferor's death. For this purpose, a trust has GST potential even if the possibility of a GST is so remote as to be negligible.

(2) *Automatic allocation after death*. A decedent's unused GST exemption is automatically allocated on the due date for filing Form 706 or Form 706NA to the extent not otherwise allocated by the decedent's executor on or before that date. The automatic allocation occurs whether or not a return is actually required to be filed. Unused GST exemption is allocated pro rata (subject to the rules of § 26.2642–2(b)), on the basis of the value of the property as finally determined for purposes of chapter 11 (chapter 11 value), first to direct skips treated as occurring at the transferor's death. The balance, if any, of unused GST exemption is allocated pro rata (subject to the rules of § 26.2642–2(b)) on the basis of the chapter 11 value of the nonexempt portion of the trust property (or in the case of trusts that are not included in the gross estate, on the basis of the date of death value of the trust) to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made. The automatic allocation of GST exemption is irrevocable, and an allocation made by the executor after the automatic allocation is made is ineffective. No automatic allocation of GST exemption is made to a trust that will have a new transferor with respect to the entire trust prior to the occurrence of any GST with respect to the trust. In addition, no automatic allocation of GST exemption is made to a trust if, during the nine month period ending immediately after the death of the transferor—

(i) No GST has occurred with respect to the trust; and

(ii) At the end of such period no future GST can occur with respect to the trust.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996]

### § 26.2641–1 Applicable rate of tax.

The rate of tax applicable to any GST (applicable rate) is determined by multiplying the maximum Federal estate tax rate in effect at the time of the GST by the inclusion ratio (as defined in § 26.2642–1). For this purpose, the maximum Federal estate tax rate is the maximum rate set forth under section 2001(c) (without regard to section 2001(c)(2)).

### § 26.2642–1 Inclusion ratio.

(a) *In general.* Except as otherwise provided in this section, the inclusion ratio is determined by subtracting the applicable fraction (rounded to the nearest one-thousandth (.001)) from 1. In rounding the applicable fraction to the nearest one-thousandth, any amount that is midway between one

one-thousandth and another one-thousandth is rounded up to the higher of those two amounts.

(b) *Numerator of applicable fraction*—(1) *In general.* Except as otherwise provided in this paragraph (b), and in §§ 26.2642–3 (providing a special rule for charitable lead annuity trusts) and 26.2642–4 (providing rules for the redetermination of the applicable fraction), the numerator of the applicable fraction is the amount of GST exemption allocated to the trust (or to the transferred property in the case of a direct skip not in trust).

(2) *GSTs occurring during an ETIP*—(i) *In general.* For purposes of determining the inclusion ratio with respect to a taxable termination or a taxable distribution that occurs during an ETIP, the numerator of the applicable fraction is the sum of—

(A) The GST exemption previously allocated to the trust (including any allocation made to the trust prior to any taxable termination or distribution) reduced (but not below zero) by the nontax amount of any prior GSTs with respect to the trust; and

(B) Any GST exemption allocated to the trust on a timely ETIP return filed after the termination of the ETIP. See § 26.2632–1(c)(5) *Example 2.*

(ii) *Nontax amount of a prior GST.* (*1*) The nontax amount of a prior GST with respect to the trust is the amount of the GST multiplied by the applicable fraction attributable to the trust at the time of the prior GST.

(*2*) For rules regarding the allocation of GST exemption to property during an ETIP, see § 26.2632–1(c).

(c) *Denominator of applicable fraction*—(1) *In general.* Except as otherwise provided in this paragraph (c) and in §§ 26.2642–3 and 26.2642–4, the denominator of the applicable fraction is the value of the property transferred to the trust (or transferred in a direct skip not in trust) (as determined under § 26.2642–2) reduced by the sum of—

(i) Any Federal estate tax and any State death tax incurred by reason of the transfer that is chargeable to the trust and is actually recovered from the trust;

(ii) The amount of any charitable deduction allowed under section 2055, 2106, or 2522 with respect to the transfer; and

(iii) In the case of a direct skip, the value of the portion of the transfer that is a nontaxable gift. See paragraph (c)(3) of this section for the definition of nontaxable gift.

(2) *Zero denominator.* If the denominator of the applicable fraction is zero, the inclusion ratio is zero.

(3) *Nontaxable gifts.* Generally, for purposes of chapter 13, a transfer is a nontaxable gift to the extent the transfer is excluded from taxable gifts by reason of section 2503(b) (after application of section 2513) or section 2503(e). However, a transfer to a trust for the benefit of an individual is not a nontaxable gift for purposes of this section unless—

(i) Trust principal or income may, during the individual's lifetime, be distributed only to or for the benefit of the individual; and

(ii) The assets of the trust will be includible in the gross estate of the individual if the individual dies before the trust terminates.

(d) *Examples.* The following examples illustrate the provisions of this section. See § 26.2652–2(d) *Examples 2* and *3* for illustrations of the computation of the inclusion ratio where the special (reverse QTIP) election may be applicable.

EXAMPLE 1. *Computation of the inclusion ratio.* T transfers $100,000 to a newly-created irrevocable trust providing that income is to be accumulated for 10 years. At the end of 10 years, the accumulated income is to be distributed to T's child, C, and the trust principal is to be paid to T's grandchild. T allocates $40,000 of T's GST exemption to the trust on a timely-filed gift tax return. The applicable fraction with respect to the trust is .40 ($40,000 (the amount of GST exemption allocated to the trust) over $100,000 (the value of the property transferred to the trust)). The inclusion ratio is .60 (1 − .40). If the maximum Federal estate tax rate is 55 percent at the time of a GST, the rate of tax applicable to the transfer (applicable rate) will be .333 (55 percent (the maximum estate tax rate) × .60 (the inclusion ratio)).

EXAMPLE 2. *Gift entirely nontaxable.* On December 1, 1996, T transfers $10,000 to an irrevocable trust for the benefit of T's grandchild, GC. GC possesses a right to withdraw any contributions to the trust such that the entire transfer qualifies for the annual exclusion under section 2503(b). Under the terms of the trust, the income is to be paid to GC

for 10 years or until GC's prior death. Upon the expiration of GC's income interest, the trust principal is payable to GC or GC's estate. The transfer to the trust is a direct skip. T made no prior gifts to or for the benefit of GC during 1996. The entire $10,000 transfer is a nontaxable transfer. For purposes of computing the tax on the direct skip, the denominator of the applicable fraction is zero, and thus, the inclusion ratio is zero.

EXAMPLE 3. *Gift nontaxable in part.* T transfers $12,000 to an irrevocable trust for the benefit of T's grandchild, GC. Under the terms of the trust, the income is to be paid to GC for 10 years or until GC's prior death. Upon the expiration of GC's income interest, the trust principal is payable to GC or GC's estate. Further, GC has the right to withdraw $10,000 of any contribution to the trust such that $10,000 of the transfer qualifies for the annual exclusion under section 2503(b). The amount of the nontaxable transfer is $10,000. Solely for purposes of computing the tax on the direct skip, T's transfer is divided into two portions. One portion is equal to the amount of the nontaxable transfer ($10,000) and has a zero inclusion ratio; the other portion is $2,000 ($12,000 − $10,000). With respect to the $2,000 portion, the denominator of the applicable fraction is $2,000. Assuming that T has sufficient GST exemption available, the numerator of the applicable fraction is $2,000 (unless T elects to have the automatic allocation provisions not apply). Thus, assuming T does not elect to have the automatic allocation not apply, the applicable fraction is one ($2,000/$2,000 = 1) and the inclusion ratio is zero (1 − 1 = 0).

EXAMPLE 4. *Gift nontaxable in part.* Assume the same facts as in *Example 3,* except T files a timely Form 709 electing that the automatic allocation of GST exemption not apply to the $12,000 transferred in the direct skip. T's transfer is divided into two portions, a $10,000 portion with a zero inclusion ratio and a $2,000 portion with an applicable fraction of zero (0/$2,000 = 0) and an inclusion ratio of one (1 − 0 = 1).

### § 26.2642–2 Valuation.

(a) *Lifetime transfers*—(1) *In general.* For purposes of determining the denominator of the applicable fraction, the value of property transferred during life is its fair market value on the effective date of the allocation of GST exemption. In the case of a timely allocation under § 26.2632–1(b)(2)(ii), the denominator of the applicable fraction is the fair market value of the property as finally determined for purposes of chapter 12.

(2) *Special rule for late allocations during life.* If a transferor makes a late allocation of GST exemption to a trust, the value of the property transferred to the trust is the fair market value of the trust assets determined on the effective date of the allocation of GST exemption. Except as otherwise provided in this paragraph (a)(2), if a transferor makes a late allocation of GST exemption to a trust, the transferor may, solely for purposes of determining the fair market value of the trust assets, elect to treat the allocation as having been made on the first day of the month during which the late allocation is made (valuation date). An election under this paragraph (a)(2) is not effective with respect to a life insurance policy or a trust holding a life insurance policy, if the insured individual has died. An allocation subject to the election contained in this paragraph (a)(2) is not effective until it is actually filed with the Internal Revenue Service. The election is made by stating on the Form 709 on which the allocation is made—

(i) That the election is being made;

(ii) The applicable valuation date; and

(iii) The fair market value of the trust assets on the valuation date.

(b) *Transfers at death*—(1) *In general.* Except as provided in paragraphs (b) (2) and (3) of this section, in determining the denominator of the applicable fraction, the value of property included in the decedent's gross estate is its value for purposes of chapter 11. In the case of qualified real property with respect to which the election under section 2032A is made, the value of the property is the value determined under section 2032A provided the recapture agreement described in section 2032A(d)(2) filed with the Internal Revenue Service specifically provides for the signatories' consent to the imposition of, and personal liability for, additional GST tax in the event an additional estate tax is imposed under section 2032A(c). See § 26.2642–4(a)(4). If the recapture agreement does not contain these provisions, the value of qualified real property as to which the election under section 2032A is made is the fair market value of the property determined without regard to the provisions of section 2032A.

(2) *Special rule for pecuniary payments*—(i) *In general.* If a pecuniary payment is satisfied with cash, the denominator of the applicable fraction is the pecuniary amount. If property other than cash is used to satisfy a pecuniary payment, the denominator of the applicable fraction is the pecuniary amount only if payment must be made with property on the basis of the value of the property on—

(A) The date of distribution; or

(B) A date other than the date of distribution, but only if the pecuniary payment must be satisfied on a basis that fairly reflects net appreciation and depreciation (occurring between the valuation date and the date of distribution) in all of the assets from which the distribution could have been made.

(ii) *Other pecuniary amounts payable in kind.* The denominator of the applicable fraction with respect to any property used to satisfy any other pecuniary payment payable in kind is the date of distribution value of the property.

(3) *Special rule for residual transfers after payment of a pecuniary payment*—(i) *In general.* Except as otherwise provided in this paragraph (b)(3), the denominator of the applicable fraction with respect to a residual transfer of property after the satisfaction of a pecuniary payment is the estate tax value of the assets available to satisfy the pecuniary payment reduced, if the pecuniary payment carries appropriate interest (as defined in paragraph (b)(4) of this section), by the pecuniary amount. The denominator of the applicable fraction with respect to a residual transfer of property after the satisfaction of a pecuniary payment that does not carry appropriate interest is the estate tax value of the assets available to satisfy the pecuniary payment reduced by the present value of the pecuniary payment. For purposes of this paragraph (b)(3)(i), the present value of the pecuniary payment is determined by using—

(A) The interest rate applicable under section 7520 at the death of the transferor; and

(B) The period between the date of the transferor's death and the date the pecuniary amount is paid.

(ii) *Special rule for residual transfers after pecuniary payments payable in kind.* The denominator of the applicable fraction with respect to any residual transfer after satisfaction of a pecuniary payment payable in kind is the date of distribution value of the property distributed in satisfaction of the residual transfer, unless the pecuniary payment must be satisfied on the basis of the value of the property on—

(A) The date of distribution; or

(B) A date other than the date of distribution, but only if the pecuniary payment must be satisfied on a basis that fairly reflects net appreciation and depreciation (occurring between the valuation date and the date of distribution) in all of the assets from which the distribution could have been made.

(4) *Appropriate interest*—(i) *In general.* For purposes of this section and § 26.2654–1 (relating to certain trusts treated as separate trusts), appropriate interest means that interest must be payable from the date of death of the transferor (or from the date specified under applicable State law requiring the payment of interest) to the date of payment at a rate—

(A) At least equal to—

(*1*) The statutory rate of interest, if any, applicable to pecuniary bequests under the law of the State whose law governs the administration of the estate or trust; or

(*2*) If no such rate is indicated under applicable State law, 80 percent of the rate that is applicable under section 7520 at the death of the transferor; and

(B) Not in excess of the greater of—

(*1*) The statutory rate of interest, if any, applicable to pecuniary bequests under the law of the State whose law governs the administration of the trust; or

(*2*) 120 percent of the rate that is applicable under section 7520 at the death of the transferor.

(ii) *Pecuniary payments deemed to carry appropriate interest.* For purposes of this paragraph (b)(4), if a pecuniary payment does not carry appropriate interest, the pecuniary payment is considered to carry appropriate interest to the extent—

(A) The entire payment is made or property is irrevocably set aside to satisfy the entire pecuniary payment within 15 months of the transferor's death; or

(B) The governing instrument or applicable local law specifically requires the executor or trustee to allocate to the pecuniary payment a pro rata share of the income earned by the fund from which the pecuniary payment is to be made between the date of death of the transferor and the date of payment. For purposes of paragraph (b)(4)(ii)(A) of this section, property is irrevocably set aside if it is segregated and held in a separate account pending distribution.

(c) *Examples.* The following examples illustrate the provisions of this section:

EXAMPLE 1. *T transfers $100,000 to a newly-created irrevocable trust on December 15, 1996.* The trust provides that income is to be paid to T's child for 10 years. At the end of the 10-year period, the trust principal is to be paid to T's grandchild. T does not allocate any GST exemption to the trust on the gift tax return reporting the transfer. On November 15, 1997, T files a Form 709 allocating $50,000 of GST exemption to the trust. Because the allocation was made on a late filed return, the value of the property transferred to the trust is determined on the date the allocation is filed (unless an election is made pursuant to paragraph (a)(2) of this section to value the trust property as of the first day of the month in which the allocation document is filed with the Internal Revenue Service). On November 15, 1997, the value of the trust property is $150,000. Effective as of November 15, 1997, the applicable fraction with respect to the trust is .333 ($50,000 (the amount of GST exemption allocated to the trust) over $150,000 (the value of the trust principal on the effective date of the GST exemption allocation)), and the inclusion ratio is .667 (1.0 − .333).

EXAMPLE 2. The facts are the same as in *Example 1,* except the value of the trust property is $80,000 on November 15, 1997. The applicable fraction is .625 ($50,000 over $80,000) and the inclusion ratio is .375 (1.0 − .625).

EXAMPLE 3. T transfers $100,000 to a newly-created irrevocable trust on December 15, 1996. The trust provides that income is to be paid to T's child for 10 years. At the end of the 10-year period, the trust principal is to be paid to T's grandchild. T does not allocate any GST exemption to the trust on the gift tax return reporting the transfer. On November 15, 1997, T files a Form 709 allocating $50,000 of GST exemption to the trust. T elects to value the trust principal on the first day of the month in which the allocation is made pursuant to the election provided in paragraph (a)(2) of this section. Because the late allocation is made in November, the value of the trust is determined as of November 1, 1997.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996]

### § 26.2642–3 Special rule for charitable lead annuity trusts.

(a) *In general.* In determining the applicable fraction with respect to a charitable lead annuity trust—

(1) The numerator is the adjusted generation-skipping transfer tax exemption (adjusted GST exemption); and

(2) The denominator is the value of all property in the trust immediately after the termination of the charitable lead annuity.

(b) *Adjusted GST exemption defined.* The adjusted GST exemption is the amount of GST exemption allocated to the trust increased by an amount equal to the interest that would accrue if an amount equal to the allocated GST exemption were invested at the rate used to determine the amount of the estate or gift tax charitable deduction, compounded annually, for the actual period of the charitable lead annuity. If a late allocation is made to a charitable lead annuity trust, the adjusted GST exemption is the amount of GST exemption allocated to the trust increased by the interest that would accrue if invested at such rate for the period beginning on the date of the late allocation and extending for the balance of the actual period of the charitable lead annuity. The amount of GST exemption allocated to a charitable lead annuity trust is not reduced even though it is ultimately determined that the allocation of a lesser amount of GST exemption would have resulted in an inclusion ratio of zero. For purposes of chapter 13, a charitable lead annuity trust is any trust providing an interest in the form of a guaranteed annuity described in § 25.2522(c)-3(c)(2)(vi) of this chapter for which the transferor is allowed a charitable deduction for Federal estate or gift tax purposes.

(c) *Example.* The following example illustrates the provisions of this section:

EXAMPLE. T creates a charitable lead annuity trust for a 10-year term with the remainder payable to T's grandchild. T timely allocates an amount of GST exemption to the trust which T expects will ultimately result in a zero inclusion ratio. However, at the end of the charitable lead interest, because the property has not appreciated to the extent T anticipated, the numerator of the applicable fraction is greater than the denominator. The inclusion ratio for the trust is zero. No portion of the GST exemption allocated to the trust is restored to T or to T's estate.

**§ 26.2642–4 Redetermination of applicable fraction.**

(a) *In general.* The applicable fraction for a trust is redetermined whenever additional exemption is allocated to the trust or when certain changes occur with respect to the principal of the trust. Except as otherwise provided in this paragraph (a), the numerator of the redetermined applicable fraction is the sum of the amount of GST exemption currently being allocated to the trust (if any) plus the value of the nontax portion of the trust, and the denominator of the redetermined applicable fraction is the value of the trust principal immediately after the event occurs. The nontax portion of a trust is determined by multiplying the value of the trust assets, determined immediately prior to the event, by the then applicable fraction.

(1) *Multiple transfers to a single trust.* If property is added to an existing trust, the denominator of the redetermined applicable fraction is the value of the trust immediately after the addition reduced as provided in § 26.2642–1(c).

(2) *Consolidation of separate trusts.* If separate trusts created by one transferor are consolidated, a single applicable fraction for the consolidated trust is determined. The numerator of the redetermined applicable fraction is the sum of the nontax portions of each trust immediately prior to the consolidation.

(3) *Property included in transferor's gross estate.* If the value of property held in a trust created by the transferor, with respect to which an allocation was made at a time that the trust was not subject to an ETIP, is included in the transferor's gross estate, the applicable fraction is redetermined if additional GST exemption is allocated to the property. The numerator of the redetermined applicable fraction is an amount equal to the nontax portion of the property immediately after the death of the transferor increased by the amount of GST exemption allocated by the executor of the transferor's estate to the trust. If additional GST exemption is not allocated to the trust, then, except as provided in this paragraph (a)(3), the applicable fraction immediately before death is not changed, if the trust was not subject to an ETIP at the time GST exemption was allocated to the trust. In any event, the denominator of the applicable fraction is reduced to reflect any federal or state, estate or inheritance taxes paid from the trust.

(4) *Imposition of recapture tax under section 2032A*—(i) If an additional estate tax is imposed under section 2032A and if the section 2032A election was effective (under § 26.2642–2(b)) for purposes of the GST tax, the applicable fraction with respect to the property is redetermined as of the date of death of the transferor. In making the redetermination, any available GST exemption not allocated at the death of the transferor (or at a prior recapture event) is automatically allocated to the property. The denominator of the applicable fraction is the fair market value of the property at the date of the transferor's death reduced as provided in § 26.2642–1(c) and further reduced by the amount of the additional GST tax actually recovered from the trust.

(ii) The GST tax imposed with respect to any taxable termination, taxable distribution, or direct skip occurring prior to the recapture event is recomputed based on the applicable fraction as redetermined. Any additional GST tax as recomputed is due and payable on the date that is six months after the event that causes the imposition of the additional estate tax under section 2032A. The additional GST tax is remitted with Form 706–A and is reported by attaching a statement to Form 706–A showing the computation of the additional GST tax.

(iii) The applicable fraction, as redetermined under this section, is also used in determining any GST tax imposed with respect to GSTs occurring after the date of the recapture event.

(b) *Examples.* The following examples illustrate the principles of this section:

EXAMPLE 1. *Allocation of additional exemption.* T transfers $200,000 to an irrevocable trust under which the income is payable to T's child, C, for life. Upon the termination of the trust, the remainder is payable to T's grandchild, GC. At a time when no ETIP exists with respect to the trust property, T makes a timely allocation of $100,000 of GST exemption, resulting in an inclusion ratio of .50. Subsequently, when the entire trust property is valued at $500,000, T allocates an additional $100,000 of T's unused GST exemption to the trust. The inclusion ratio of the trust is recomputed at that time. The numerator of the applicable fraction is $350,000 ($250,000 (the nontax portion as of the date of the allocation) plus $100,000 (the GST exemption currently being allocated)). The denominator is $500,000 (the date of allocation fair market value of the trust). The inclusion ratio is .30 (1 − .70).

EXAMPLE 2. *Multiple transfers to a trust, allocation both timely and late.* On December 10, 1993, T transfers $10,000 to an irrevocable trust that does not satisfy the requirements of section 2642(c)(2). T makes identical transfers to the trust on December 10, 1994, 1995, 1996, and on January 15, 1997. Immediately after the transfer on January 15, 1997, the value of the trust principal is $40,000. On January 14, 1998, when the value of the trust principal is $50,000, T allocates $30,000 of GST exemption to the trust. T discloses the 1997 transfer on the Form 709 filed on January 14, 1998. Thus, T's allocation is a timely allocation with respect to the transfer in 1997, $10,000 of the allocation is effective as of the date of that transfer, and, on and after January 15, 1997, the inclusion ratio of the trust is .75 (1 − ($10,000/$40,000)). The balance of the allocation is a late allocation with respect to prior transfers to the trust and is effective as of January 14, 1998. In redetermining the inclusion ratio as of that date, the numerator of the redetermined applicable fraction is $32,500 ($12,500 (.25 × $50,000), the nontax portion of the trust on January 14, 1998) plus $20,000 (the amount of GST exemption allocated late to the trust). The denominator of the new applicable fraction is $50,000 (the value of the trust principal at the time of the late allocation).

EXAMPLE 3. *Excess allocation.* (i) T creates an irrevocable trust for the benefit of T's child and grandchild in 1996 transferring $50,000 to the trust on the date of creation. T allocates no GST exemption to the trust on the Form 709 reporting the transfer. On July 1, 1997 (when the value of the trust property is $60,000), T transfers an additional $40,000 to the trust.

(ii) On April 15, 1998, when the value of the trust is $150,000, T files a Form 709 reporting the 1997 transfer and allocating $150,000 of GST exemption to the trust. The allocation is a timely allocation of $40,000 with respect to the 1997 transfer and is effective as of that date. Thus, the applicable fraction for the trust as of July 1, 1997 is .40 ($40,000/$100,000 ($40,000 + $60,000)).

(iii) The allocation is also a late allocation of $90,000, the amount necessary to attain a zero inclusion ratio on April 15, 1998, computed as follows: $60,000 (the nontax portion immediately prior to the allocation (.40 × $150,000)) plus $90,000 (the additional allocation necessary to produce a zero inclusion ratio based on a denominator of $150,000)/ $150,000 equals one and, thus, an inclusion ratio of zero. The balance of the allocation, $20,000 ($150,000 less the timely allocation of $40,000 less the late allocation of $90,000) is void.

EXAMPLE 4. *Undisclosed transfer.* (i) The facts are the same as in Example 3, except that on February 1, 1998 (when the value of the trust is $150,000), T transfers an additional $50,000 to the trust and the value of the entire trust corpus on April 15, 1998 is $220,000. The Form 709 filed on April 15, 1998 does not disclose the 1998 transfer. Under the rule in § 26.2632–1(b)(2)(ii), the allocation is effective first as a timely allocation to the 1997 transfer; second, as a late allocation to the trust as of April 15, 1998; and, finally as a timely allocation to the February 1, 1998 transfer. As of April 15, 1998, $55,000, a pro rata portion of the trust assets, is considered to be the property transferred to the trust on February 1, 1998 (($50,000/$200,000) × $220,000). The balance of the trust, $165,000, represents prior transfers to the trust.

(ii) As in EXAMPLE 3, the allocation is a timely allocation as to the 1997 transfer (and the applicable fraction as of July 1, 1997 is .40) and a late allocation as of 1998. The amount of the late allocation is $99,000, computed as follows: (.40 × $165,000 plus $99,000)/ $165,000 = one.

(iii) The balance of the allocation, $11,000 ($150,000 less the timely allocation of $40,000 less the late allocation of $99,000) is a timely allocation as of February 1, 1998. The applicable fraction with respect to the trust, as of February 1, 1998, is .355, computed as follows: $60,000 (the nontax portion of the trust immediately prior to the February 1, 1998 transfer (.40 × $150,000)) plus $11,000 (the amount of the timely allocation to the 1998 transfer)/$200,000 (the value of the trust on February 1, 1998, after the transfer on that date) = $71,000/$200,000 = .355.

(iv) The applicable fraction with respect to the trust, as of April 15, 1998, is .805 computed as follows: $78,100 (the nontax portion immediately prior to the allocation (.355 × $220,000)) plus $99,000 (the amount of the late allocation)/ $220,000 = $177,100/$220,000 = .805.

EXAMPLE 5. *Redetermination of inclusion ratio on ETIP termination.* (i) T transfers

$100,000 to an irrevocable trust. The trust instrument provides that trust income is to be paid to T for 9 years or until T's prior death. The trust principal is to be paid to T's grandchild, GC, on the termination of T's income interest. The trustee has the power to invade trust principal for the benefit of GC during the term of T's income interest. The trust is subject to an ETIP while T holds the retained income interest. T files a timely Form 709 reporting the transfer and allocates $100,000 of GST exemption to the trust. In year 4, when the value of the trust is $200,000, the trustee distributes $15,000 to GC. The distribution is a taxable distribution. Because of the existence of the ETIP, the inclusion ratio with respect to the taxable distribution is determined immediately prior to the occurrence of the GST. Thus, the inclusion ratio applicable to the year 4 GST is .50 (1 − ($100,000/$200,000)).

(ii) In year 5, when the value of the trust is again $200,000, the trustee distributes another $15,000 to GC. Because the trust is still subject to the ETIP in year 5, the inclusion ratio with respect to the year 5 GST is again computed immediately prior to the GST. In computing the new inclusion ratio, the numerator of the applicable fraction is reduced by the nontax portion of prior GSTs occurring during the ETIP. Thus, the numerator of the applicable fraction with respect to the GST in year 5 is $92,500 ($100,000 − (.50 × $15,000)) and the inclusion ratio applicable with respect to the GST in year 5 is .537 (1 − ($92,500/$200,000) = .463). Any additional GST exemption allocated on a timely ETIP return with respect to the GST in year 5 is effective immediately prior to the transfer.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996]

### § 26.2642–5 Finality of inclusion ratio.

(a) *Direct skips.* The inclusion ratio applicable to a direct skip becomes final when no additional GST tax (including additional GST tax payable as a result of a cessation, etc. of qualified use under section 2032A(c)) may be assessed with respect to the direct skip.

(b) *Other GSTs.* With respect to taxable distributions and taxable terminations, the inclusion ratio for a trust becomes final, on the later of—

(1) The expiration of the period for assessment with respect to the first GST tax return filed using that inclusion ratio (unless the trust is subject to an election under section 2032A in which case the applicable date under this subsection is the expiration of the period of assessment of any additional GST tax due as a result of a cessation, etc. of qualified use under section 2032A); or

(2) The expiration of the period for assessment of Federal estate tax with respect to the estate of the transferor. For purposes of this paragraph (b)(2), if an estate tax return is not required to be filed, the period for assessment is determined as if a return were required to be filed and as if the return were timely filed within the period prescribed by section 6075(a).

[T.D. 8644, 60 FR 66903, Dec. 27, 1995, as amended at 61 FR 43656, Aug. 26, 1996]

### § 26.2652–1 Transferor defined; other definitions.

(a) *Transferor defined*—(1) *In general.* Except as otherwise provided in paragraph (a)(3) of this section, the individual with respect to whom property was most recently subject to Federal estate or gift tax is the transferor of that property for purposes of chapter 13. An individual is treated as transferring any property with respect to which the individual is the transferor. Thus, an individual may be a transferor even though there is no transfer of property under local law at the time the Federal estate or gift tax applies. For purposes of this paragraph, a surviving spouse is the transferor of a qualified domestic trust created by the deceased spouse that is included in the surviving spouse's gross estate, provided the trust is not subject to the election described in § 26.2652–2 (reverse QTIP election). A surviving spouse is also the transferor of a qualified domestic trust created by the surviving spouse pursuant to section 2056(d)(2)(B).

(2) *Transfers subject to Federal estate or gift tax.* For purposes of this chapter, a transfer is subject to Federal gift tax if a gift tax is imposed under section 2501(a) (without regard to exemptions, exclusions, deductions, and credits). A transfer is subject to Federal estate tax if the value of the property is includible in the decedent's gross estate as determined under section 2031 or section 2103.

(3) *Special rule for certain QTIP trusts.* Solely for purposes of chapter 13, if a transferor of qualified terminable interest property (QTIP) elects under § 26.2652–2(a) to treat the property as if

the QTIP election had not been made (reverse QTIP election), the identity of the transferor of the property is determined without regard to the application of sections 2044, 2207A, and 2519.

(4) *Split-gift transfers.* In the case of a transfer with respect to which the donor's spouse makes an election under section 2513 to treat the gift as made one-half by the spouse, the electing spouse is treated as the transferor of one-half of the entire value of the property transferred by the donor, regardless of the interest the electing spouse is actually deemed to have transferred under section 2513. The donor is treated as the transferor of one-half of the value of the entire property. See § 26.2632–1(c)(5) *Example 3,* regarding allocation of GST exemption with respect to split-gift transfers subject to an ETIP.

(5) *Examples.* The following examples illustrate the principles of this paragraph (a):

EXAMPLE 1. *Identity of transferor.* T transfers $100,000 to a trust for the sole benefit of T's grandchild. The transfer is subject to Federal gift tax because a gift tax is imposed under section 2501(a) (without regard to exemptions, exclusions, deductions, and credits). Thus, for purposes of chapter 13, T is the transferor of the $100,000. It is immaterial that a portion of the transfer is excluded from the total amount of T's taxable gift by reason of section 2503(b).

EXAMPLE 2. *Gift splitting and identity of transferor.* The facts are the same as in EXAMPLE 1, except T's spouse, S, consents under section 2513 to split the gift with T. For purposes of chapter 13, S and T are each treated as a transferor of $50,000 to the trust.

EXAMPLE 3. *Change of transferor on subsequent transfer tax event.* T transfers $100,000 to a trust providing that all the net trust income is to be paid to T's spouse, S, for S's lifetime. T elects under section 2523(f) to treat the transfer as a transfer of qualified terminable interest property, and T does not make the reverse QTIP election under section 2652(a)(3). On S's death, the trust property is included in S's gross estate under section 2044. Thus, S becomes the transferor at the time of S's death.

EXAMPLE 4. *Effect of transfer of an interest in trust on identity of the transferor.* T transfers $100,000 to a trust providing that all of the net income is to be paid to T's child, C, for C's lifetime. At C's death, the trust property is to be paid to T's grandchild. C transfers the income interest to X, an unrelated party, in a transfer that is a completed transfer for Federal gift tax purposes. Because C's transfer is a transfer of a term interest in the trust that does not affect the rights of other parties with respect to the trust property, T remains the transferor with respect to the trust.

EXAMPLE 5. *Effect of lapse of withdrawal right on identity of transferor.* T transfers $10,000 to a new trust providing that the trust income is to be paid to T's child, C, for C's life and, on the death of C, the trust principal is to be paid to T's grandchild, GC. The trustee has discretion to distribute principal for GC's benefit during C's lifetime. C has a right to withdraw $10,000 from the trust for a 60-day period following the transfer. Thereafter, the power lapses. C does not exercise the withdrawal right. The transfer by T is subject to Federal gift tax because a gift tax is imposed under section 2501(a) (without regard to exemptions, exclusions, deductions, and credits) and, thus, T is treated as having transferred the entire $10,000 to the trust. On the lapse of the withdrawal right, C becomes a transferor to the extent C is treated as having made a completed transfer for purposes of chapter 12. Therefore, except to the extent that the amount with respect to which the power of withdrawal lapses exceeds the greater of $5,000 or 5% of the value of the trust property, T remains the transferor of the trust property for purposes of chapter 13.

EXAMPLE 6. *Effect of reverse QTIP election on identity of the transferor.* T establishes a testamentary trust having a principal of $500,000. Under the terms of the trust, all trust income is payable to T's surviving spouse, S, during S's lifetime. T's executor makes an election to treat the trust property as qualified terminable interest property and also makes the reverse QTIP election. For purposes of chapter 13, T is the transferor with respect to the trust. On S's death, the then full fair market value of the trust is includible in S's gross estate under section 2044. However, because of the reverse QTIP election, S does not become the transferor with respect to the trust; T continues to be the transferor.

EXAMPLE 7. *Effect of reverse QTIP election on constructive additions.* The facts are the same as in Example 6, except the inclusion of the QTIP trust in S's gross estate increased the Federal estate tax liability of S's estate by $200,000. The estate does not exercise the right of recovery from the trust granted under section 2207A. Under local law, the beneficiaries of S's residuary estate (which bears all estate taxes under the will) could compel the executor to exercise the right of recovery but do not do so. Solely for purposes of chapter 13, the beneficiaries of the residuary estate are not treated as having made an addition to the trust by reason of their failure to exercise their right of recovery. Because of the reverse QTIP election, for GST purposes, the trust property is not

treated as includible in S's gross estate and, under those circumstances, no right of recovery exists.

EXAMPLE 8. *Effect of reverse QTIP election on constructive additions.* S, the surviving spouse of T, dies testate. At the time of S's death, S was the beneficiary of a trust with respect to which T's executor made a QTIP election under section 2056(b)(7). Thus, the trust is includible in S's gross estate under section 2044. T's executor also made the reverse QTIP election with respect to the trust. S's will provides that all death taxes payable with respect to the trust are payable from S's residuary estate. Since the transferor of the property is determined without regard to section 2044 and section 2207A, S is not treated as making a constructive addition to the trust by reason of the tax apportionment clause in S's will.

EXAMPLE 9. *Split-gift transfers.* T transfers $100,000 to an inter vivos trust that provides T with an annuity payable for ten years or until T's prior death. The annuity satisfies the definition of a qualified interest under section 2702(b). When the trust terminates, the corpus is to be paid to T's grandchild, GC. T's spouse, S, consents under section 2513 to have the gift treated as made one-half by S. Under section 2513, only the actuarial value of the gift to GC is eligible to be treated as made one-half by S. However, because S is treated as the donor of one-half of the gift to GC, S becomes the transferor of one-half of the entire trust ($50,000) for purposes of Chapter 13.

(b) *Trust defined*—(1) *In general.* A trust includes any arrangement (other than an estate) that has substantially the same effect as a trust. Thus, for example, arrangements involving life estates and remainders, estates for years, and insurance and annuity contracts are trusts. Generally, a transfer as to which the identity of the transferee is contingent upon the occurrence of an event is a transfer in trust; however, a transfer of property included in the transferor's gross estate, as to which the identity of the transferee is contingent upon an event that must occur within 6 months of the transferor's death, is not considered a transfer in trust solely by reason of the existence of the contingency.

(2) *Examples.* The following examples illustrate the provisions of this paragraph (b):

EXAMPLE 1. *Uniform gifts to minors transfers.* T transfers cash to an account in the name of T's child, C, as custodian for C's child, GC (who is a minor), under a state statute substantially similar to the Uniform Gifts to Minors Act. For purposes of chapter 13, the transfer to the custodial account is treated as a transfer to a trust.

EXAMPLE 2. *Contingent transfers.* T bequeaths $200,000 to T's child, C, provided that if C does not survive T by more than 6 months, the bequest is payable to T's grandchild, GC. C dies 4 months after T. The bequest is not a transfer in trust because the contingency that determines the recipient of the bequest must occur within 6 months of T's death. The bequest to GC is a direct skip.

EXAMPLE 3. *Contingent transfers.* The facts are the same as in Example 2, except C must survive T by 18 months to take the bequest. The bequest is a transfer in trust for purposes of chapter 13, and the death of C is a taxable termination.

(c) *Trustee defined.* The trustee of a trust is the person designated as trustee under local law or, if no such person is so designated, the person in actual or constructive possession of property held in trust.

(d) *Executor defined.* For purposes of chapter 13, the executor is the executor or administrator of the decedent's estate. However, if no executor or administrator is appointed, qualified or acting within the United States, the executor is the fiduciary who is primarily responsible for payment of the decedent's debts and expenses. If there is no such executor, administrator or fiduciary, the executor is the person in actual or constructive possession of the largest portion of the value of the decedent's gross estate.

(e) *Interest in trust.* See § 26.2612–1(e) for the definition of *interest in trust.*

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996, as amended by T.D. 8720, 62 FR 27498, May 20, 1997]

### § 26.2652–2 Special election for qualified terminable interest property.

(a) *In general.* If an election is made to treat property as qualified terminable interest property (QTIP) under section 2523(f) or section 2056(b)(7), the person making the election may, for purposes of chapter 13, elect to treat the property as if the QTIP election had not been made (reverse QTIP election). An election under this section is irrevocable. An election under this section is not effective unless it is made with respect to all of the property in the trust to which the QTIP election applies. See, however, § 26.2654–1(b)(1). Property that qualifies for a deduction

under section 2056(b)(5) is not eligible for the election under this section.

(b) *Time and manner of making election.* An election under this section is made on the return on which the QTIP election is made. If a protective QTIP election is made, no election under this section is effective unless a protective reverse QTIP election is also made.

(c) *Transitional rule.* If a reverse QTIP election is made with respect to a trust prior to December 27, 1995, and GST exemption has been allocated to that trust, the transferor (or the transferor's executor) may elect to treat the trust as two separate trusts, one of which has a zero inclusion ratio by reason of the transferor's GST exemption previously allocated to the trust. The separate trust with the zero inclusion ratio consists of that fractional share of the value of the entire trust equal to the value of the nontax portion of the trust under § 26.2642–4(a). The reverse QTIP election is treated as applying only to the trust with the zero inclusion ratio. An election under this paragraph (c) is made by attaching a statement to a copy of the return on which the reverse QTIP election was made under section 2652(a)(3). The statement must indicate that an election is being made to treat the trust as two separate trusts and must identify the values of the two separate trusts. The statement is to be filed in the same place in which the original return was filed and must be filed before June 24, 1996. A trust subject to the election described in this paragraph is treated as a trust that was created by two transferors. See § 26.2654–1(a)(2) for special rules involving trusts with multiple transferors.

(d) *Examples.* The following examples illustrate the provisions of this section:

EXAMPLE 1. *Special (reverse QTIP) election under section 2652(a)(3).* T transfers $1,000,000 to a trust providing that all trust income is to be paid to T's spouse, S, for S's lifetime. On S's death, the trust principal is payable to GC, a grandchild of S and T. T elects to treat all of the transfer as a transfer of QTIP and also makes the reverse QTIP election for all of the property. Because of the reverse QTIP election, T continues to be treated as the transferor of the property after S's death for purposes of chapter 13. A taxable termination rather than a direct skip occurs on S's death.

EXAMPLE 2. *Election under transition rule.* In 1994, T died leaving $4 million in trust for the benefit of T's surviving spouse, S. On January 16, 1995, T's executor filed T's Form 706 on which the executor elects to treat the entire trust as qualified terminable interest property. The executor also makes a reverse QTIP election. The reverse QTIP election is effective with respect to the entire trust even though T's executor could allocate only $1 million of GST exemption to the trust. T's executor may elect to treat the trust as two separate trusts, one having a value of 25% of the value of the single trust and an inclusion ratio of zero, but only if the election is made prior to June 24, 1996. If the executor makes the transitional election, the other separate trust, having a value of 75% of the value of the single trust and an inclusion ratio of one, is not treated as subject to the reverse QTIP election.

EXAMPLE 3. *Denominator of the applicable fraction of QTIP trust.* T bequeaths $1,500,000 to a trust in which T's surviving spouse, S, receives an income interest for life. Upon the death of S, the property is to remain in trust for the benefit of C, the child of T and S. Upon C's death, the trust is to terminate and the trust property paid to the descendants of C. The bequest qualifies for the estate tax marital deduction under section 2056(b)(7) as QTIP. The executor does not make the reverse QTIP election under section 2652(a)(3). As a result, S becomes the transferor of the trust at S's death when the value of the property in the QTIP trust is included in S's gross estate under section 2044. For purposes of computing the applicable fraction with respect to the QTIP trust upon S's death, the denominator of the fraction is reduced by any Federal estate tax (whether imposed under section 2001, 2101 or 2056A(b)) and State death tax attributable to the trust property that is actually recovered from the trust.

## § 26.2653–1 Taxation of multiple skips.

(a) *General rule.* If property is held in trust immediately after a GST, solely for purposes of determining whether future events involve a skip person, the transferor is thereafter deemed to occupy the generation immediately above the highest generation of any person holding an interest in the trust immediately after the transfer. If no person holds an interest in the trust immediately after the GST, the transferor is treated as occupying the generation above the highest generation of any person in existence at the time of the GST who then occupies the highest generation level of any person who may subsequently hold an interest in

the trust. See § 26.2612–1(e) for rules determining when a person has an interest in property held in trust.

(b) *Examples.* The following examples illustrate the provisions of this section:

EXAMPLE 1. *T transfers property to an irrevocable trust for the benefit of T's grandchild, GC, and great-grandchild, GGC.* During GC's life, the trust income may be distributed to GC and GGC in the trustee's absolute discretion. At GC's death, the trust property passes to GGC. Both GC and GGC have an interest in the trust for purposes of chapter 13. The transfer by T to the trust is a direct skip, and the property is held in trust immediately after the transfer. After the direct skip, the transferor is treated as being one generation above GC, the highest generation individual having an interest in the trust. Therefore, GC is no longer a skip person and distributions to GC are not taxable distributions. However, because GGC occupies a generation that is two generations below the deemed generation of T, GGC is a skip person and distributions of trust income to GGC are taxable distributions.

EXAMPLE 2. T transfers property to an irrevocable trust providing that the income is to be paid to T's child, C, for life. At C's death, the trust income is to be accumulated for 10 years and added to principal. At the end of the 10-year accumulation period, the trust income is to be paid to T's grandchild, GC, for life. Upon GC's death, the trust property is to be paid to T's great-grandchild, GGC, or to GGC's estate. A GST occurs at C's death. Immediately after C's death and during the 10-year accumulation period, no person has an interest in the trust within the meaning of section 2652(c) and § 26.2612–1(e) because no one can receive current distributions of income or principal. Immediately after C's death, T is treated as occupying the generation above the generation of GC (the trust beneficiary in existence at the time of the GST who then occupies the highest generation level of any person who may subsequently hold an interest in the trust). Thus, subsequent income distributions to GC are not taxable distributions.

### § 26.2654–1 Certain trusts treated as separate trusts.

(a) *Single trust treated as separate trusts*—(1) *Substantially separate and independent shares*—(i) *In general.* If a single trust consists solely of substantially separate and independent shares for different beneficiaries, the share attributable to each beneficiary (or group of beneficiaries) is treated as a separate trust for purposes of chapter 13. The phrase ''substantially separate and independent shares'' generally has the same meaning as provided in § 1.663(c)–3 of this chapter. However, a portion of a trust is not a separate share unless such share exists from and at all times after the creation of the trust. For purposes of this paragraph (a)(1), a trust is treated as created at the date of death of the grantor if the trust is includible in its entirety in the grantor's gross estate for Federal estate tax purposes. Further, treatment of a single trust as separate trusts under this paragraph (a)(1) does not permit treatment of those portions as separate trusts for purposes of filing returns and payment of tax or for purposes of computing any other tax imposed under the Internal Revenue Code. Also, additions to, and distributions from, such trusts are allocated pro rata among the separate trusts, unless the governing instrument expressly provides otherwise.

(ii) *Certain pecuniary amounts.* For purposes of this section, if a person holds the current right to receive a mandatory (i.e., nondiscretionary and noncontingent) payment of a pecuniary amount at the death of the transferor from an inter vivos trust that is includible in the transferor's gross estate, or a testamentary trust, the pecuniary amount is a separate and independent share if—

(A) The trustee is required to pay appropriate interest (as defined in § 26.2642–2(b)(4)(i) and (ii)) to the person; and

(B) If the pecuniary amount is payable in kind on the basis of value other than the date of distribution value of the assets, the trustee is required to allocate assets to the pecuniary payment in a manner that fairly reflects net appreciation or depreciation in the value of the assets in the fund available to pay the pecuniary amount measured from the valuation date to the date of payment.

(2) *Multiple transferors with respect to single trust*—(i) *In general.* If there is more than one transferor with respect to a trust, the portions of the trust attributable to the different transferors are treated as separate trusts for purposes of chapter 13. Treatment of a single trust as separate trusts under this paragraph (a)(2) does not permit treatment of those portions as separate

trusts for purposes of filing returns and payment of tax or for purposes of computing any other tax imposed under the Internal Revenue Code. Also, additions to, and distributions from, such trusts are allocated pro rata among the separate trusts unless otherwise expressly provided in the governing instrument.

(ii) *Addition by a transferor.* If an individual makes an addition to a trust of which the individual is not the sole transferor, the portion of the single trust attributable to each separate trust is determined by multiplying the fair market value of the single trust immediately after the contribution by a fraction. The numerator of the fraction is the value of the separate trust immediately after the contribution. The denominator of the fraction is the fair market value of all the property in the single trust immediately after the transfer.

(3) *Severance of a single trust.* A single trust treated as separate trusts under paragraphs (a)(1) or (2) of this section may be divided at any time into separate trusts to reflect that treatment. For this purpose, the rules of paragraph (b)(1)(ii)(C) of this section apply with respect to the severance and funding of the severed trusts.

(4) *Allocation of exemption*—(i) *In general.* With respect to a separate share treated as a separate trust under paragraph (a)(1) or (2) of this section, an individual's GST exemption is allocated to the separate trust. See § 26.2632–1 for rules concerning the allocation of GST exemption.

(ii) *Automatic allocation to direct skips.* If the transfer is a direct skip to a trust that occurs during the transferor's lifetime and is treated as a transfer to separate trusts under paragraphs (a)(1) or (a)(2) of this section, the transferor's GST exemption not previously allocated is automatically allocated on a pro rata basis among the separate trusts. The transferor may prevent an automatic allocation of GST exemption to a separate share of a single trust by describing on a timely-filed United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709) the transfer and the extent to which the automatic allocation is not to apply to a particular share. See § 26.2632–1(b) for rules for avoiding the automatic allocation of GST exemption.

(5) *Examples.* The following examples illustrate the principles of this section (a):

EXAMPLE 1. *Separate shares as separate trusts.* T transfers $100,000 to a trust under which income is to be paid in equal shares for 10 years to T's child, C, and T's grandchild, GC (or their respective estates). The trust does not permit distributions of principal during the term of the trust. At the end of the 10-year term, the trust principal is to be distributed to C and GC in equal shares. The shares of C and GC in the trust are separate and independent and, therefore, are treated as separate trusts. The result would not be the same if the trust permitted distributions of principal unless the distributions could only be made from a one-half separate share of the initial trust principal and the distributee's future rights with respect to the trust are correspondingly reduced. T may allocate part of T's GST exemption under section 2632(a) to the share held for the benefit of GC.

EXAMPLE 2. *Separate share rule inapplicable.* The facts are the same as in *Example 1,* except the trustee holds the discretionary power to distribute the income in any proportion between C and GC during the last year of the trust. The shares of C and GC in the trust are not separate and independent shares throughout the entire term of the trust and, therefore, are not treated as separate trusts for purposes of chapter 13.

EXAMPLE 3. *Pecuniary payment as separate share.* T creates a lifetime revocable trust providing that on T's death $500,000 is payable to T's spouse, S, with the balance of the principal to be held for the benefit of T's grandchildren. The value of the trust is includible in T's gross estate upon T's death. Under the terms of the trust, the payment to S is required to be made in cash, and under local law S is entitled to receive interest on the payment at an annual rate of 6 percent, commencing immediately upon T's death. For purposes of chapter 13, the trust is treated as created at T's death, and the $500,000 payable to S from the trust is treated as a separate share. The result would be the same if the payment to S could be satisfied using noncash assets at their value on the date of distribution. Further, the result would be the same if the decedent's probate estate poured over to the revocable trust on the decedent's death and was then distributed in accordance with the terms of the trust.

EXAMPLE 4. *Pecuniary payment not treated as separate share.* The facts are the same as in *Example 3,* except the bequest to S is to be paid in noncash assets valued at their values as finally determined for Federal estate tax

purposes. Neither the trust instrument nor local law requires that the assets distributed in satisfaction of the bequest fairly reflect net appreciation or depreciation in all the assets from which the bequest may be funded. S's $500,000 bequest is not treated as a separate share and the trust is treated as a single trust for purposes of chapter 13.

EXAMPLE 5. *Multiple transferors to single trust.* A transfers $100,000 to an irrevocable generation-skipping trust; B simultaneously transfers $50,000 to the same trust. As of the time of the transfers, the single trust is treated as two trusts for purposes of chapter 13. Because A contributed ⅔ of the value of the initial corpus, ⅔ of the single trust principal is treated as a separate trust created by A. Similarly, because B contributed ⅓ of the value of the initial corpus, ⅓ of the single trust is treated as a separate trust created by B. A or B may allocate their GST exemption under section 2632(a) to the respective separate trusts.

EXAMPLE 6. *Additional contributions.* A transfers $100,000 to an irrevocable generation-skipping trust; B simultaneously transfers $50,000 to the same trust. When the value of the single trust has increased to $180,000, A contributes an additional $60,000 to the trust. At the time of the additional contribution, the portion of the single trust attributable to each grantor's separate trust must be redetermined. The portion of the single trust attributable to A's separate trust immediately after the contribution is ¾ (((2/3 × $180,000) + $60,000)/$240,000). The portion attributable to B's separate trust after A's addition is ¼.

EXAMPLE 7. *Distributions from a separate share.* The facts are the same as in *Example 6,* except that, after A's second contribution, $50,000 is distributed to a beneficiary of the trust. Absent a provision in the trust instrument that charges the distribution against the contribution of either A or B, ¾ of the distribution is treated as made from the separate trust of which A is the transferor and 1/4 from the separate trust of which B is the transferor.

EXAMPLE 8. *Separate share rule inapplicable.* T creates an irrevocable trust that provides the trustee with the discretionary power to distribute income or corpus to T's children and grandchildren. The trust provides that, when T's youngest child reaches age 21, the trust will be divided into separate shares, one share for each child of T. The income from a respective child's share will be paid to the child during the child's life with the remainder passing to such child's children (grandchildren of T). The separate shares that come into existence when the youngest child reaches age 21 will not be recognized as separate trusts for purposes of Chapter 13 because the shares did not exist from and at all times after the creation of the trust. Any allocation of GST exemption to the trust either before or after T's youngest child reaches age 21 will apply with respect to the entire trust. Thus, the inclusion ratio will be the same with respect to any distribution from the trust or the separate shares. The result would be the same if the trust instrument provided that the trust was to be divided into separate trusts when T's youngest child reached age 21.

(b) *Division of a trust included in the gross estate*—(1) *In general.* The severance of a trust that is included in the transferor's gross estate (or created under the transferor's will) into two or more trusts is recognized for purposes of chapter 13 if—

(i) The trust is severed pursuant to a direction in the governing instrument providing that the trust is to be divided upon the death of the transferor; or

(ii) The governing instrument does not require or otherwise direct severance but the trust is severed pursuant to discretionary authority granted either under the governing instrument or under local law; and

(A) The terms of the new trusts provide in the aggregate for the same succession of interests and beneficiaries as are provided in the original trust;

(B) The severance occurs (or a reformation proceeding, if required, is commenced) prior to the date prescribed for filing the Federal estate tax return (including extensions actually granted) for the estate of the transferor; and

(C) Either—

(*1*) The new trusts are severed on a fractional basis. If severed on a fractional basis, the separate trusts need not be funded with a pro rata portion of each asset held by the undivided trust. The trusts may be funded on a nonpro rata basis provided funding is based on either the fair market value of the assets on the date of funding or in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding; or

(*2*) If the severance is required (by the terms of the governing instrument) to be made on the basis of a pecuniary amount, the pecuniary payment is satisfied in a manner that would meet the requirements of paragraph (a)(1)(ii) of

this section if it were paid to an individual.

(2) *Special rule.* If a court order severing the trust has not been issued at the time the Federal estate tax return is filed, the executor must indicate on a statement attached to the return that a proceeding has been commenced to sever the trust and describe the manner in which the trust is proposed to be severed. A copy of the petition or other instrument used to commence the proceeding must also be attached to the return. If the governing instrument of a trust or local law authorizes the severance of the trust, a severance pursuant to that authorization is treated as meeting the requirement of paragraph (b)(1)(ii)(B) of this section if the executor indicates on the Federal estate tax return that separate trusts will be created (or funded) and clearly sets forth the manner in which the trust is to be severed and the separate trusts funded.

(3) *Allocation of exemption.* An individual's GST exemption under §2632 may be allocated to the separate trusts created pursuant to this section at the discretion of the executor or trustee.

(4) *Examples.* The following examples illustrate the provisions of this section (b):

EXAMPLE 1. *Severance of single trust.* T's will establishes a testamentary trust providing that income is to be paid to T's spouse for life. At the spouse's death, one-half of the corpus is to be paid to T's child, C, or C's estate (if C fails to survive the spouse) and one-half of the corpus is to be paid to T's grandchild, GC, or GC's estate (if GC fails to survive the spouse). If the requirements of paragraph (b) of this section are otherwise satisfied, T's executor may divide the testamentary trust equally into two separate trusts, one trust providing an income interest to spouse for life with remainder to C, and the other trust with an income interest to spouse for life with remainder to GC. Furthermore, if the requirements of paragraph (b) of this section are satisfied, the executor or trustee may further divide the trust for the benefit of GC. GST exemption may be allocated to any of the divided trusts.

EXAMPLE 2. *Severance of revocable trust.* T creates an inter vivos revocable trust providing that, at T's death and after payment of all taxes and administration expenses, the remaining corpus will be divided into two trusts. One trust, for the benefit of T's spouse, is to be funded with the smallest amount that, if qualifying for the marital deduction, will reduce the estate tax to zero. The other trust, for the benefit of T's descendants, is to be funded with the balance of the revocable trust corpus. The trust corpus is includible in T's gross estate. Each trust is recognized as a separate trust for purposes of chapter 13.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996, as amended at 61 FR 43656, Aug. 26, 1996]

### 26.2662–1 Generation-skipping transfer tax return requirements.

(a) *In general.* Chapter 13 imposes a tax on generation-skipping transfers (as defined in section 2611). The requirements relating to the return of tax depend on the type of generation-skipping transfer involved. This section contains rules for filing the required tax return. Paragraph (c)(2) of this section provides special rules concerning the return requirements for generation-skipping transfers pursuant to certain trust arrangements (as defined in paragraph (c)(2)(ii) of this section), such as life insurance policies and annuities.

(b) *Form of return*—(1) *Taxable distributions.* Form 706GS(D) must be filed in accordance with its instructions for any taxable distribution (as defined in section 2612(b)). The trust involved in a transfer described in the preceding sentence must file Form 706GS(D–1) in accordance with its instructions. A copy of Form 706GS(D–1) shall be sent to each distributee.

(2) *Taxable terminations.* Form 706GS(T) must be filed in accordance with its instructions for any taxable termination (as defined in section 2612(a)).

(3) *Direct skip*—(i) *Inter vivos direct skips.* Form 709 must be filed in accordance with its instructions for any direct skip (as defined in section 2612(c)) that is subject to chapter 12 and occurs during the life of the transferor.

(ii) *Direct skips occurring at death*—(A) *In general.* Form 706 or Form 706NA must be filed in accordance with its instructions for any direct skips (as defined in section 2612(c)) that are subject to chapter 11 and occur at the death of the decedent.

(B) *Direct skips payable from a trust.* Schedule R–1 of Form 706 must be filed in accordance with its instructions for

any direct skip from a trust if such direct skip is subject to chapter 11. See paragraph (c)(2) of this section for special rules relating to the person liable for tax and required to make the return under certain circumstances.

(c) *Person liable for tax and required to make return*—(1) *In general.* Except as otherwise provided in this section, the following person is liable for the tax imposed by section 2601 and must make the required tax return—

(i) The transferee in a taxable distribution (as defined in section 2612(b));

(ii) The trustee in the case of a taxable termination (as defined in section 2612(a));

(iii) The transferor (as defined in section 2652(a)(1)(B)) in the case of an inter vivos direct skip (as defined in section 2612(c));

(iv) The trustee in the case of a direct skip from a trust or with respect to property that continues to be held in trust; or

(v) The executor in the case of a direct skip (other than a direct skip described in paragraph (c)(1)(iv) of this section) if the transfer is subject to chapter 11. See paragraph (c)(2) of this section for special rules relating to direct skips to or from certain trust arrangements (as defined in paragraph (c)(2)(ii) of this section).

(2) *Special rule for direct skips occurring at death with respect to property held in trust arrangements*—(i) *In general.* In the case of certain property held in a trust arrangement (as defined in paragraph (c)(2)(ii) of this section) at the date of death of the transferor, the person who is required to make the return and who is liable for the tax imposed by chapter 13 is determined under paragraphs (c)(2)(iii) and (iv) of this section.

(ii) *Trust arrangement defined.* For purposes of this section, the term *trust arrangement* includes any arrangement (other than an estate) which, although not an explicit trust, has the same effect as an explicit trust. For purposes of this section, the term ''explicit trust'' means a trust described in § 301.7701–4(a).

(iii) *Executor's liability in the case of transfers with respect to decedents dying on or after June 24, 1996 if the transfer is less than $250,000.* In the case of a direct skip occurring at death, the executor of the decedent's estate is liable for the tax imposed on that direct skip by chapter 13 and is required to file Form 706 or Form 706NA (and not Schedule R–1 of Form 706) if, at the date of the decedent's death—

(A) The property involved in the direct skip is held in a trust arrangement; and

(B) The total value of the property involved in direct skips with respect to the trustee of that trust arrangement is less than $250,000.

(iv) *Executor's liability in the case of transfers with respect to decedents dying prior to June 24, 1996 if the transfer is less than $100,000.* In the case of a direct skip occurring at death with respect to a decedent dying prior to June 24, 1996, the rule in paragraph (c)(2)(iii) of this section that imposes liability upon the executor applies only if the property involved in the direct skip with respect to the trustee of the trust arrangement, in the aggregate, is less than $100,000.

(v) *Executor's right of recovery.* In cases where the rules of paragraphs (c)(2)(iii) and (iv) of this section impose liability for the generation-skipping transfer tax on the executor, the executor is entitled to recover from the trustee (if the property continues to be held in trust) or from the recipient of the property (in the case of a transfer from a trust), the generation-skipping transfer tax attributable to the transfer.

(vi) *Examples.* The following examples illustrate the application of this paragraph (c)(2) with respect to decedents dying on or after June 24, 1996:

EXAMPLE 1. *Insurance proceeds less than $250,000.* On August 1, 1997, T, the insured under an insurance policy, died. The proceeds ($200,000) were includible in T's gross estate for Federal estate tax purposes. T's grandchild, GC, was named the sole beneficiary of the policy. The insurance policy is treated as a trust under section 2652(b)(1), and the payment of the proceeds to GC is a transfer from a trust for purposes of chapter 13. Therefore, the payment of the proceeds to GC is a direct skip. Since the proceeds from the policy ($200,000) are less than $250,000, the executor is liable for the tax imposed by chapter 13 and is required to file Form 706.

EXAMPLE 2. *Aggregate insurance proceeds of $250,000 or more.* Assume the same facts as in Example 1, except T is the insured under two

insurance policies issued by the same insurance company. The proceeds ($150,000) from each policy are includible in T's gross estate for Federal estate tax purposes. T's grandchild, GC1, was named the sole beneficiary of Policy 1, and T's other grandchild, GC2, was named the sole beneficiary of Policy 2. GC1 and GC2 are skip persons (as defined in section 2613). Therefore, the payments of the proceeds are direct skips. Since the total value of the policies ($300,000) exceeds $250,000, the insurance company is liable for the tax imposed by chapter 13 and is required to file Schedule R–1 of Form 706.

EXAMPLE 3. *Insurance proceeds of $250,000 or more held by insurance company.* On August 1, 1997, T, the insured under an insurance policy, dies. The policy provides that the insurance company shall make monthly payments of $750 to GC, T's grandchild, for life with the remainder payable to T's great grandchild, GGC. The face value of the policy is $300,000. Since the proceeds continue to be held by the insurance company (the trustee), the proceeds are treated as if they were transferred to a trust for purposes of chapter 13. The trust is a skip person (as defined in section 2613(a)(2)) and the transfer is a direct skip. Since the total value of the policy ($300,000) exceeds $250,000, the insurance company is liable for the tax imposed by chapter 13 and is required to file Schedule R–1 of Form 706.

EXAMPLE 4. *Insurance proceeds less than $250,000 held by insurance company.* Assume the same facts as in Example 3, except the policy provides that the insurance company shall make monthly payments of $500 to GC and that the face value of the policy is $200,000. The transfer is a transfer to a trust for purposes of chapter 13. However, since the total value of the policy ($200,000) is less than $250,000, the executor is liable for the tax imposed by chapter 13 and is required to file Form 706.

EXAMPLE 5. On August 1, 1997, A, the insured under a life insurance policy, dies. The insurance proceeds on A's life that are payable under policies issued by Company X are in the aggregate amount of $200,000 and are includible in A's gross estate. Because the proceeds are includible in A's gross estate, the generation-skipping transfer that occurs upon A's death, if any, will be a direct skip rather than a taxable distribution or a taxable termination. Accordingly, because the aggregate amount of insurance proceeds with respect to Company X is less than $250,000, Company X may pay the proceeds without regard to whether the beneficiary is a skip person in relation to the decedent-transferor.

(3) *Limitation on personal liability of trustee.* Except as provided in paragraph (c)(3)(iii) of this section, a trustee is not personally liable for any increases in the tax imposed by section 2601 which is attributable to the fact that—

(i) A transfer is made to the trust during the life of the transferor for which a gift tax return is not filed; or

(ii) The inclusion ratio with respect to the trust, determined by reference to the transferor's gift tax return, is erroneous, the actual inclusion ratio being greater than the reported inclusion ratio.

(iii) This paragraph (c)(3) does not apply if the trustee has or is deemed to have knowledge of facts sufficient to reasonably conclude that a gift tax return was required to be filed or that the inclusion ratio is erroneous. A trustee is deemed to have knowledge of such facts if the trustee's agent, employee, partner, or co-trustee has knowledge of such facts.

(4) *Exceptions*—(i) *Legal or mental incapacity.* If a distributee is legally or mentally incapable of making a return, the return may be made for the distributee by the distributee's guardian or, if no guardian has been appointed, by a person charged with the care of the distributee's person or property.

(ii) *Returns made by fiduciaries.* See section 6012(b) for a fiduciary's responsibilities regarding the returns of decedents, returns of persons under a disability, returns of estates and trusts, and returns made by joint fiduciaries.

(d) *Time and manner of filing return*—(1) *In general.* Forms 706, 706NA, 706GS(D), 706GS(D–1), 706GS(T), 709, and Schedule R–1 of Form 706 must be filed with the Internal Revenue Service office with which an estate or gift tax return of the transferor must be filed. The return shall be filed—

(i) *Direct skip.* In the case of a direct skip, on or before the date on which an estate or gift tax return is required to be filed with respect to the transfer (see section 6075(b)(3)); and

(ii) *Other transfers.* In all other cases, on or before the 15th day of the 4th month after the close of the calendar year in which such transfer occurs. See paragraph (d)(2) of this section for an exception to this rule when an election is made under section 2624(c) to value property included in certain taxable terminations in accordance with section 2032.

(2) *Exception for alternative valuation of taxable termination.* In the case of a taxable termination with respect to which an election is made under section 2624(c) to value property in accordance with section 2032, a Form 706GS(T) must be filed on or before the 15th day of the 4th month after the close of the calendar year in which the taxable termination occurred, or on or before the 10th month following the month in which the death that resulted in the taxable termination occurred, whichever is later.

(e) *Place for filing returns.* See section 6091 for the place for filing any return, declaration, statement, or other document, or copies thereof, required by chapter 13.

(f) *Lien on property.* The liens imposed under sections 6324, 6324A, and 6324B are applicable with respect to the tax imposed under chapter 13. Thus, a lien under section 6324 is imposed in the amount of the tax imposed by section 2601 on all property transferred in a generation-skipping transfer until the tax is fully paid or becomes uncollectible by reason of lapse of time. The lien attaches at the time of the generation-skipping transfer and is in addition to the lien for taxes under section 6321.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996]

### § 26.2663–1 Recapture tax under section 2032A.

See § 26.2642–4(a)(4) for rules relating to the recomputation of the applicable fraction and the imposition of additional GST tax, if additional estate tax is imposed under section 2032A.

### § 26.2663–2 Application of chapter 13 to transfers by nonresidents not citizens of the United States.

(a) *In general.* This section provides rules for applying chapter 13 of the Internal Revenue Code to transfers by a transferor who is a nonresident not a citizen of the United States (NRA transferor). For purposes of this section, an individual is a resident or citizen of the United States if that individual is a resident or citizen of the United States under the rules of chapter 11 or 12 of the Internal Revenue Code, as the case may be. Every NRA transferor is allowed a GST exemption of $1,000,000. See § 26.2632–1 regarding the allocation of the exemption.

(b) *Transfers subject to chapter 13*—(1) *Direct skips.* A transfer by a NRA transferor is a direct skip subject to chapter 13 only to the extent that the transfer is subject to the Federal estate or gift tax within the meaning of § 26.2652–1(a)(2). See § 26.2612–1(a) for the definition of direct skip.

(2) *Taxable distributions and taxable terminations.* Chapter 13 applies to a taxable distribution or a taxable termination to the extent that the initial transfer of property to the trust by a NRA transferor, whether during life or at death, was subject to the Federal estate or gift tax within the meaning of § 26.2652–1(a)(2). See § 26.2612–1(b) for the definition of a taxable termination and § 26.2612–1(c) for the definition of a taxable distribution.

(c) *Trusts funded in part with property subject to chapter 13 and in part with property not subject to chapter 13*—(1) *In general.* If a single trust created by a NRA transferor is in part subject to chapter 13 under the rules of paragraph (b) of this section and in part not subject to chapter 13, the applicable fraction with respect to the trust is determined as of the date of the transfer, except as provided in paragraph (c)(3) of this section.

(i) *Numerator of applicable fraction.* The numerator of the applicable fraction is the sum of the amount of GST exemption allocated to the trust (if any) plus the value of the nontax portion of the trust.

(ii) *Denominator of applicable fraction.* The denominator of the applicable fraction is the value of the property transferred to the trust reduced as provided in § 26.2642–1(c).

(2) *Nontax portion of the trust.* The nontax portion of a trust is a fraction, the numerator of which is the value of property not subject to chapter 13 determined as of the date of the initial completed transfer to the trust, and the denominator of which is the value of the entire trust. For example, T, a NRA transferor, transfers property that has a value of $1,000 to a generation-skipping trust. Of the property transferred to the trust, property having a value of $200 is subject to chapter

13 and property having a value of $800 is not subject to chapter 13. The nontax portion is .8 ($800 (the value of the property not subject to chapter 13) over $1,000 (the total value of the property transferred to the trust)).

(3) *Special rule with respect to the estate tax inclusion period.* For purposes of this section, the provisions of § 26.2632–1(c), providing rules applicable in the case of an estate tax inclusion period (ETIP), apply only if the property transferred by the NRA transferor is subsequently included in the transferor's gross estate. If the property is not subsequently included in the gross estate, then the nontax portion of the trust and the applicable fraction are determined as of the date of the initial transfer. If the property is subsequently included in the gross estate, then the nontax portion and the applicable fraction are determined as of the date of death.

(d) *Examples.* The following examples illustrate the provisions of this section. In each example T, a NRA, is the transferor; C is T's child; and GC is C's child and a grandchild of T:

EXAMPLE 1. *Direct transfer to skip person.* T transfers property to GC in a transfer that is subject to Federal gift tax under chapter 12 within the meaning of § 26.2652–1(a)(2). At the time of the transfer, C and GC are NRAs. T's transfer is subject to chapter 13 because the transfer is subject to gift tax under chapter 12.

EXAMPLE 2. *Transfers of both U.S. and foreign situs property.* (i) T's will established a testamentary trust for the benefit of C and GC. The trust was funded with stock in a publicly traded U.S. corporation having a value on the date of T's death of $100,000, and property not situated in the United States (and therefore not subject to estate tax) having a value on the date of T's death of $400,000.

(ii) On a timely filed estate tax return (Form 706NA), the executor of T's estate allocates $50,000 of GST exemption under section 2632(a) to the trust. The numerator of the applicable fraction is $450,000, the sum of $50,000 (the amount of exemption allocated to the trust) plus $400,000 (the value of the nontax portion of the trust (4/5 x $500,000)). The denominator is $500,000. Hence, the applicable fraction with respect to the trust is .9 ($450,000/$500,000), and the inclusion ratio is .1 (1 - 9/10).

EXAMPLE 3. *Inter vivos transfer of U.S. and foreign situs property to a trust and a timely allocation of GST exemption.* T establishes a trust providing that trust income is payable to T's child for life and the remainder is to be paid to T's grandchild. T transfers property to the trust that has a value of $100,000 and is subject to chapter 13. T also transfers property to the trust that has a value of $300,000 but is not subject to chapter 13. T allocates $100,000 of exemption to the trust on a timely filed United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709). The applicable fraction with respect to the trust is 1, determined as follows: $300,000 (the value of the nontax portion of the trust) plus $100,000 (the exemption allocated to the trust)/ $400,000 (the total value of the property transferred to the trust).

EXAMPLE 4. *Inter vivos transfer of U.S. and foreign situs property to a trust and a late allocation of GST exemption.* (i) In 1996, T transfers $500,000 of property to an inter vivos trust the terms of which provide that income is payable to C, for life, with the remainder to GC. The property transferred to the trust consists of property subject to chapter 13 that has a value of $400,000 on the date of the transfer and property not subject to chapter 13 that has a value of $100,000. T does not allocate GST exemption to the trust. On the transfer date, the nontax portion of the trust is .2 ($100,000/$500,000) and the applicable fraction is also .2 determined as follows: $100,000 (the value of the nontax portion of the trust)/$500,000 (the value of the property transferred to the trust).

(ii) In 1999, when the value of the trust is $800,000, T allocates $100,000 of GST exemption to the trust. The applicable fraction of the trust must be recomputed. The numerator of the applicable fraction is $260,000 ($100,000 (the amount of GST exemption allocated to the trust)) plus $160,000 (the value of the nontax portion of the trust as of the date of allocation (.2 x $800,000)). The denominator of the applicable fraction is $800,000. Accordingly, the applicable fraction with respect to the trust after the allocation is .325 ($260,000/$800,000) and the inclusion ratio is .675 (1 - .325).

EXAMPLE 5. *Taxable termination.* The facts are the same as in Example 4 except that, in 2006, when the value of the property is $1,200,000, C dies and the trust corpus is distributed to GC. The termination is a taxable termination. If no further GST exemption has been allocated to the trust, the applicable fraction remains .325 and the inclusion ratio remains .675.

EXAMPLE 6. *Estate Tax Inclusion Period.* (i) T transferred property to an inter vivos trust the terms of which provided T with an annuity payable for 10 years or until T's prior death. The annuity satisfies the definition of a qualified interest under section 2702(b). The trust also provided that, at the end of the trust term, the remainder will pass to GC or GC's estate. The property transferred to the

trust consisted of property subject to chapter 13 that has a value of $100,000 and property not subject to chapter 13 that has a value of $400,000. T allocated $100,000 of GST exemption to the trust. If T dies within the 10 year period, the value of the trust principal will be subject to inclusion in T's gross estate to the extent provided in sections 2103 and 2104(b). Accordingly, the ETIP rule under paragraph (c)(3) of this section applies.

(ii) In year 6 of the trust term, T died. At T's death, the trust corpus had a value of $800,000, and $500,000 was includible in T's gross estate as provided in sections 2103 and 2104(b). Thus, $500,000 of the trust corpus is subject to chapter 13 and $300,000 is not subject to chapter 13. The $100,000 GST exemption allocation is effective as of T's date of death. Also, the nontax portion of the trust and the applicable fraction are determined as of T's date of death. In this case, the nontax portion of the trust is .375, determined as follows: $300,000 (the value of the trust not subject to chapter 13)/$800,000 (the value of the trust). The numerator of the applicable fraction is $400,000, determined as follows: $100,000 (GST exemption previously allocated to the trust) plus $300,000 (the value of the nontax portion of the trust). The denominator of the applicable fraction is $800,000. Thus, the applicable fraction with respect to the trust is .50, unless additional exemption is allocated to the trust by T's executor or the automatic allocation rules of §26.2632–1(d)(2) apply.

EXAMPLE 7. The facts are the same as in *Example 6* except that T survives the termination date of T's retained annuity and the trust corpus is distributed to GC. Since the trust was not included in T's gross estate, the ETIP rules do not apply. Accordingly, the nontax portion of the trust and the applicable fraction are determined as of the date of the transfer to the trust. The nontax portion of the trust is .80 ($400,000/$500,000). The numerator of the applicable fraction is $500,000 determined as follows: $100,000 (GST exemption allocated to the trust) plus $400,000 (the value of the nontax portion of the trust). Accordingly, the applicable fraction is 1, and the inclusion ratio is zero.

(e) *Transitional rule for allocations for transfers made before December 27, 1995.* If an NRA made a GST (inter vivos or testamentary) after December 23, 1992, and before December 27, 1995 that is subject to chapter 13 (within the meaning of §26.2663–2), the NRA will be treated as having made a timely allocation of GST exemption to the transfer in a calendar year in the order prescribed in section 2632(c). Thus, a NRA's unused GST exemption will initially be treated as allocated to any direct skips made during the calendar year and then to any trusts with respect to which the NRA made transfers during the same calendar year and from which a taxable distribution or a taxable termination may occur. Allocations within the above categories are made in the order in which the transfers occur. Allocations among simultaneous transfers within the same category are made pursuant to the principles of section 2632(c)(2). This transitional allocation rule will not apply if the NRA transferor, or the executor of the NRA's estate, as the case may be, elected to have an automatic allocation of GST exemption not apply by describing on a timely-filed Form 709 for the year of the transfer, or a timely filed Form 706NA, the details of the transfer and the extent to which the allocation was not to apply.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996]

## PARTS 28–29 [RESERVED]