

- (d) Taxpayer election.
  - (1) In general.
  - (2) Limitation not applicable.
  - (3) Time and manner of election.
  - (4) Example.

§ 25.2701-5 *Adjustments to mitigate double taxation.*

- (a) Reduction of transfer tax base.
  - (1) In general.
  - (2) Federal gift tax modification.
  - (3) Federal estate tax modification.
  - (4) Section 2701 interest.
- (b) Amount of reduction.
  - (c) Duplicated amount.
    - (1) In general.
  - (2) Transfer tax value—in general.
  - (3) Special transfer tax value rules.
  - (d) Examples.
- (e) Computation of reduction if initial transfer is split under section 2513.
  - (1) In general.
  - (2) Transfers during joint lives.
  - (3) Transfers at or after death of either spouse.
- (f) Examples.
- (g) Double taxation otherwise avoided.
- (h) Effective date.

§ 25.2701-6 *Indirect holding of interests.*

- (a) In general.
  - (1) Attribution to individuals.
  - (2) Corporations.
  - (3) Partnerships.
  - (4) Estates, trusts, and other entities.
  - (5) Multiple attribution.
- (b) Examples.

§ 25.2701-7 *Separate interests.*

§ 25.2701-8 *Effective dates.*

[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).

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