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(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 prop-

erty. 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").