

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 1: 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 1, 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.

Step 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 interest were \$100,000, the Step 4 adjustment would have been a \$33,333 reduction for consideration received ((250/750) × \$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

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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—