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

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

(7) *Qualified annuity interest.* Qualified annuity interest means an interest that meets all the requirements of § 25.2702–3(b) and (d).

(8) *Qualified unitrust interest.* Qualified unitrust interest means an interest that meets all the requirements of § 25.2702–3(c) and (d).

(9) *Qualified remainder interest.* Qualified remainder interest means an interest that meets all the requirements of § 25.2702–3(f).

(10) *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.

(2) The following facts apply for *Examples 6 through 8* (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 6. 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 7. 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 8. 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).

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§ 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 at least annually. A right of withdrawal, whether or not cumulative, is not a qualified annuity interest. Issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount.

(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) *Period for payment of annuity amount.* The annuity amount may be payable based on either the anniversary date of the creation of the trust or the taxable year of the trust. In either situation, the annuity amount may be paid annually or more frequently, such as semi-annually, quarterly, or monthly. If the payment is made based on the anniversary date, proration of the annuity amount is required only if the last period during which the annuity is payable to the grantor is a period of less than 12 months. If the payment is made based on the taxable year, proration of the annuity amount is required for each short taxable year of the trust during the grantor's term. The prorated amount is the annual annuity amount multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

(4) *Payment of the annuity amount in certain circumstances.* An annuity amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days after the anniversary date. An annuity amount payable based on the taxable year of the trust may be paid after the