

## **Regulations under Section 2701**

### **1. Statutory Overview**

Section 2701 provides that the value of certain retained interests in a corporation or partnership is disregarded in determining whether a transfer of an interest in such corporation or partnership to a member of the transferor's family is a gift and for purposes of valuing any such gift.<sup>1</sup> By its terms, Section 2701 may apply in the event of a transfer of an interest in a corporation or a partnership by an individual to her spouse, a lineal descendant of the transferor or her spouse, or the spouse of any such descendant if the transferor, her spouse, an ancestor of the transferor or the transferor's spouse, or the spouse of any such ancestor retains a senior distribution right in the entity (provided certain family members of the transferor control the entity) or a liquidation, put, call, or conversion right with respect to the entity.

Section 2701 specifies attribution rules for determining whether an individual holds an interest in an entity, attributing to an individual any interest held indirectly by such individual through a corporation, partnership, trust, or other entity.<sup>2</sup> It further provides that certain transactions – specifically, a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership – constitute transfers to which Section 2701 may apply.<sup>3</sup>

### **2. Impermissible Expansion of the Statutory Rules**

The rules regarding attribution and deemed transfers as set forth in the Treasury Regulations promulgated under Section 2701 do not reflect the best reading of Section 2701 and extend beyond the statutory rules.

#### **a. Attribution Rules**

In the case of equity interests held by an estate or trust, Section 2701 attributes the interests to an individual only if the equity interests are “held indirectly” by the individual through the estate or trust.<sup>4</sup> This statutory provision plainly suggests that property held by an estate or trust is attributable to an individual only in limited instances where the individual has a present interest in the property (for example, if the property is specifically bequeathed to an individual or, in the case of a trust, the individual has the right to withdraw the property) or where a grantor funds a trust which is includible in the grantor's estate). However, the attribution rules in the Treasury Regulations exceed this simple reading in several respects.

First, if an individual has a beneficial interest in an estate or trust and the individual's beneficial interest may, in the discretion of a fiduciary, be satisfied by an equity interest in a corporation or partnership, the individual beneficiary is deemed to own a portion of the equity interest, assuming the maximum exercise of discretion in favor of the beneficiary.<sup>5</sup> This is so

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<sup>1</sup> I.R.C. § 2701(a)(1).

<sup>2</sup> I.R.C. § 2701(e)(3).

<sup>3</sup> I.R.C. § 2701(e)(5).

<sup>4</sup> I.R.C. § 2701(e)(3).

<sup>5</sup> Treasury Regulation § 25.2701-6(a)(4).

even though the individual may never be entitled to receive a distribution of the underlying equity interest.

Second, if a trust owns an equity interest and an individual is treated as the owner of the trust under subpart E, part 1, subchapter J of the Code, the trust's equity interest is attributed to the deemed owner of the trust property.<sup>6</sup> This provision conflates ownership for income tax purposes with ownership for property law purposes. Indeed, in many cases, an individual treated as the owner of a trust for income tax purposes has no right to receive or acquire any portion of the trust property at any time.

### **b. Ordering Rules**

Because the attribution rules under the Treasury Regulation result in attribution beyond instances where an estate or trust merely holds an interest on behalf of an individual, they may result in a particular equity interest being attributed to more than one individual. Therefore, Treasury Regulation Section 25.2701-6 includes ordering rules for determining how an interest attributed to multiple individuals should be allocated. The ordering rules first attribute senior equity interests – that is, interests which would implicate Section 2701 if retained by the transferor, her spouse, or certain ancestors – to the transferor and such family members before they may be attributed to other individuals.<sup>7</sup> The rules invert the ordering assumption with respect to junior equity interests, first attributing them to the transferee in a particular transfer.<sup>8</sup> By doing so, the Treasury Regulation attributes equity interests to individuals in the most adverse manner possible for the transferor.

Further, the ordering rules suggest that a transfer by an individual of a pro rata portion of all of his or her interests in a corporation or partnership to a grantor trust (for income tax purposes) for the benefit of his or her descendants itself triggers the application of Section 2701. This is so because, under Section 2701, the transferor is treated as the owner of any senior equity interests transferred to the grantor trust, while the beneficiaries – in this case, the transferor's descendants – are treated as receiving the junior interests. Accordingly, this rule undermines the exception to the application of Section 2701 in the case of a transfer which proportionally reduces each class of equity interest held by the transferor and certain applicable family members, commonly known as the vertical slice exception.<sup>9</sup>

The ordering rules under the Treasury Regulation, which are required only due to the Treasury Regulation's expansive attribution rules, thereby may apply Section 2701 to instances where it otherwise would not apply by its terms or by the terms of exceptions provided under applicable regulations.

### **c. Deemed Transfers**

The expansive attribution rules also give way to additional deemed transfers which may implicate Section 2701. Because the Treasury Regulation attributes interests held in a grantor trust to the deemed owner of the trust for income tax purposes, the Treasury Regulation includes

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<sup>6</sup> Treasury Regulation § 25.2701-6(a)(4)(ii)(C).

<sup>7</sup> Treasury Regulation § 25.2701-6(a)(5)(i).

<sup>8</sup> Treasury Regulation § 25.2701-6(a)(5)(i)(ii).

<sup>9</sup> Treasury Regulation § 25.2701-1(c)(4).

a corollary provision treating the termination of grantor trust status as a transfer which may implicate Section 2701.<sup>10</sup> This provision may result in the application of Section 2701 even where an individual's beneficial interest in the underlying entity remains unchanged. This outcome differs significantly from what would constitute a deemed transfer under the statute, which limits deemed transfers to capital transactions involving a corporation or partnership which would shift beneficial interests among the owners thereof.<sup>11</sup>

### **3. Conclusion**

Treasury Regulation §§ 25.2701-1(b)(2)(C)(1), 25.2701-6(a)(4), and 25.2701-6(a)(5) do not reflect the best reading of Section 2701 and extend beyond the statute insofar as they would result in (i) the attribution of an equity interest held by an estate trust to an individual, except in instances where the individual has a present interest in the property or, in the case of an individual who settles a trust, where the trust is includible in her estate, (ii) the attribution of an equity interest held by an estate or trust being attributed to more than one individual, (iii) the attribution of an equity interest held by a grantor trust to its deemed owner for income tax purposes, or (iv) the termination of a trust's grantor trust status being treated as a transfer for purposes of Section 2701. Accordingly, we recommend that Treasury amend Treasury Regulation § 25.2701-6(a)(4) to limit the attribution of equity interests held by an estate or trust to individuals holding a present interest in the underlying property or, in the case of a trust, to the settlor of the trust in the event the trust is includible in the settlor's estate. We further recommend that Treasury Regulation § 25.2701-6(a)(4) be amended to attribute to any individual holding a present interest in a trust a pro rata share of all interests in a corporation or partnership held by such trust and revoke Treasury Regulation § 25.2701-6(a)(5). Finally, we recommend that Treasury revoke Treasury Regulation § 25.2701-1(b)(2)(C)(1).

## **Regulations under Section 2702**

### **1. Statutory Overview**

Section 2702 provides that the value of certain retained interests in a trust is disregarded in determining whether a transfer in trust to a member of the transferor's family is a gift and for purposes of valuing any such gift.<sup>12</sup> However, if an interest is a "qualified interest," the value of the retained interest is determined under Section 7520.<sup>13</sup> A "qualified interest," in turn, includes the right fixed amounts payable at least annually from a trust, commonly known as a qualified annuity interest or a qualified unitrust interest.<sup>14</sup> Further, Section 2702 enumerates certain exceptions to the general rule, including a transfer in trust of which the only property is a residence to be used as a personal residence by persons holding term interests in the trust, commonly known as a qualified personal residence trust, or a QPRT.<sup>15</sup>

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<sup>10</sup> Treasury Regulation § 25.2701-1(b)(2)(C)(1).

<sup>11</sup> I.R.C. § 2701(e)(5).

<sup>12</sup> I.R.C. § 2702(a)(1).

<sup>13</sup> I.R.C. § 2702(a)(2)(B).

<sup>14</sup> I.R.C. § 2702(b).

<sup>15</sup> I.R.C. § 2702(a)(3)(A)(ii).

## **2. Impermissible Expansion of the Statutory Rules**

Several regulations regarding qualified interests and QPRTs do not reflect the best reading of Section 2702 and extend beyond the statute.

### **a. Qualified Annuity and Unitrust Interests**

With respect to qualified annuity interests and qualified unitrust interests, the only statutory requirements are that the retained interest is a fixed amount and that the amount be payable at least annually. The rules promulgated under Section 2702 depart from these limited requirements in several respects. First, the regulations require that the trust instrument prohibit the commutation of the holder's interest for the interest to constitute a qualified interest.<sup>16</sup> Yet, the statute states only that the interest must be payable at least annually, meaning that payment cannot be deferred, but does not address prepayment. Second, with respect to trust created after September 20, 1999, the regulations prohibit the trustee of a trust from issuing a note, other debt instrument, option, or other similar financial instrument in satisfaction of the annuity or unitrust payment.<sup>17</sup> The preamble to the final regulations indicates that this rule is intended to prevent the effective deferral of the annuity payment.<sup>18</sup> However, there are more limited rules which would have the same effect. For instance, the regulation could have allowed for the payment of the annuity or unitrust amount via a note bearing interest at the rate required under Section 7520. This would ensure that the grantor receives the full value of the annuity or unitrust amount at the required time without foreclosing the use of debt instruments to pay the annuity, which is not expressly prohibited by the statute.

### **b. Qualified Personal Residence Trust**

Similarly, the statutory requirements for a trust to qualify as a QPRT are fairly limited. The statute requires only that the trust property consist only of a residence to be used as a personal residence by persons holding term interests in the trust. The regulations reach beyond a plain application of the statute by prohibiting the trust from selling or transferring the residence to the grantor of the trust or to the grantor's spouse during the term or at any period following the term if the trust is deemed to be owned by the grantor or the grantor's spouse.<sup>19</sup> This rule is intended to prevent the grantor from engaging in a "bait and switch" to take advantage of narrow exception for QPRTs to transfer assets other than a personal residence.<sup>20</sup> However, because Section 2702 does not require that the trust retain the personal residence initially transferred to the trust, the prohibition on transfers between the grantor or the grantor's spouse and the QPRT do not reflect the best reading of the statute and represent an expansion of the statutory rules.

## **3. Conclusion**

The Treasury Regulations promulgated under Section 2702 expand the statutory limitations on what constitutes a qualified annuity interest, qualified unitrust, or QPRT beyond a plain reading of the statute. Therefore, we recommend that Treasury amend Treasury Regulation

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<sup>16</sup> Treasury Regulation § 25.2702-3(d)(5).

<sup>17</sup> Treasury Regulation § 25.2702-3(d)(6).

<sup>18</sup> 65 FR 53587.

<sup>19</sup> Treasury Regulation § 25.2702-5(b).

<sup>20</sup> 61 FR 16623.

§ 25.2702-3(d)(5) to allow satisfaction of a qualified annuity interest or qualified unitrust interest by issuance of a promissory note or other similar instrument, provided the instrument has a fair market value equal to the value of the annuity or unitrust amount. We further recommend that Treasury revoke Treasury Regulation §§ and 25.2702-3(d)(6) and 25.2702-5(b).