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[Code Sec. 2702]

Special valuation rules for transfers in trust.

This is in response to your memorandum dated January 5, 1995, and prior correspondence on behalf of Taxpayers concerning the application of section 2702 of the Internal Revenue Code.

The facts, as submitted, indicate that Taxpayer A has agreed to participate as a limited partner in Venture, a Florida limited partnership created to construct and operate a commercial facility solely with equity contributed by the partners; i.e., without acquisition or construction financing. None of the other investors in Venture are related to Taxpayers.

Taxpayer A, Taxpayer B (Taxpayer A's child), other individuals related to Taxpayer A, and certain trusts for the benefit of individuals related to Taxpayer A, propose to create Family Entity (a Florida general partnership) to acquire the limited partnership interest in Venture. The acquisition of two of the Family Entity interests, representing 35.33 percent of the investment, will involve substantially identical joint purchase agreements [agreements.]

One agreement involving Taxpayer A and Daughter (another of A's children) will involve a 28 percent interest in Family Entity. Taxpayer A and Daughter will each provide from their independent funds that portion of the purchase price corresponding to his or her actuarial interest as determined under § 7520. Daughter possesses independent wealth substantially in excess of that necessary to purchase the remainder interest.

Taxpayer A and his wife, in contemplation of this investment, have created three trusts for the benefit of Taxpayer B's issue. Taxpayer B and those trusts will enter into the second agreement involving a 7.33 percent interest in Family Entity. Substantially all of the corpus of the trusts will be used to acquire the remainder interest.

The governing instrument of Family Entity provides for priority annual distributions to each interest holder on or before February 15 of each year equal to nine percent of the initial cash contribution of that interest holder, but only to the extent such distributions are not prohibited by applicable law and only to the extent funds are available. The instrument also requires additional distributions from any "distributable cash" in excess of that needed to make the priority distributions. The term "distributable cash" essentially refers to cash flow less certain reserves.

If Family Entity is unable in any year to distribute an amount equal to nine percent of the initial contribution to the interest holders, the governing instrument requires that Family Entity issue notes, payable on demand, bearing a market rate of interest in lieu of the undistributed portion of such payment.

Other provisions of the governing instrument applicable to the interests subject to the agreements provide that:

1) The interests may not be sold during the life of the life tenant;

2) The Family Entity is to continue in existence at least until the death of the last to die of Taxpayers A and B;

3) No additional capital contribution will be required of Taxpayer A or Taxpayer B; and

4) Any payment required to be made by Taxpayer A or Taxpayer B to a creditor of the entity is to be treated as a loan to the entity to be repaid out of the first available proceeds, with interest to be paid at the prime rate determined by a specified regional bank.

In addition, the governing instrument requires that loss allocations that would result in a negative balance in the capital account of the interests subject to the joint purchase agreement are to be allocated to interests other than those subject to the agreements.

Under the terms of their respective agreements, Taxpayer A and Taxpayer B are designated as life tenants and, thus, will be entitled to receive any distributions made by Family Entity with respect to the interests subject to the agreements.

Taxpayers propose that the agreements will be effective on February 1, 1995. Their respective agreements will provide that, on January 31, Taxpayer A and Taxpayer B will be entitled to receive, with respect to each preceding 12 months, payments equal to the greater of nine percent of the total initial purchase price or the aggregate distributions made by Family Entity with respect to the interest during such preceding period. In the event Family Entity issues a demand note in lieu of the nine percent payment contemplated by the agreement, the owner of the remainder interest under each agreement agrees to promptly execute and deliver a full recourse written guarantee of payment.

Each agreement further provides that no other persons will be entitled to receive distributions during the life tenant's life. Special rules in each agreement require appropriate adjustments in the case of incorrect valuation or in the event of a payment with respect to a period of less than one year. Commutation of the life tenant's interest is specifically prohibited.

You request the following rulings.

1. The interest to be acquired by Taxpayer A as life tenant under the agreement will be a qualified annuity interest under § 2702 the value of which is determined under § 7520 for federal gift tax purposes.

2. The interest to be acquired by Taxpayer B as life tenant under the agreement will be a qualified annuity interest under § 2702 the value of which is determined under § 7520 for federal gift tax purposes.

3. The interest to be acquired by Taxpayer A as life tenant under the agreement will not be included in Taxpayer A's gross estate for under § 2036 solely by reason of the agreement.

4. The interest to be acquired by Taxpayer B as life tenant under the agreement will not be included in Taxpayer B's gross estate for under § 2036 solely by reason of the agreement.

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2511 provides that the tax imposed by § 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2702 provides the method for valuing a gift in trust when the gift is to or for the benefit of a member of the transferor's family and the donor or an applicable family member retains an interest in the gifted property. Section 2702(a)(2) provides that, in general, the value of any retained interest that is not a qualified interest shall be treated as being zero. The value of any retained interest that is a qualified interest shall be determined under § 7520.

Section 2702(c)(1) provides that the transfer of an interest in property with respect to which there are one or more term interests shall be treated as the transfer of an interest in a trust. Section 2702(c)(2) provides that, if two or more members of the same family acquire interests in such property (property described in paragraph (1)) in the same transaction (or a series of related transactions), the person acquiring the term interest in such property is treated as having acquired the entire property and then transferred to the other persons the interests actually acquired by them in the transaction. Such transfer shall be treated as made in exchange for the consideration, if any, provided by such persons for the acquisition of their interests in the property.

Section 25.2702-1(b) of the Gift Tax Regulations provides that, if § 2702 applies, the amount of the gift is determined by subtracting the interest retained by the transferor or any applicable family member from the value of the transferred property. If the retained interest is not a qualified interest, and, thus, is valued at zero, the amount of the gift is the entire value of the property. If the retained interest is a qualified interest, then the value of the gift will be the fair market value of the property transferred to the trust less the value of the qualified interest.

Section 25.2702-2(a)(5) provides that a qualified interest includes a qualified annuity interest. A qualified annuity interest is an interest that meets all the requirements of § 25.2702-3(b) and (d).

Among other requirements, under § 25.2702-3(b), a qualified annuity interest must be an irrevocable right to receive a fixed amount payable at least annually. A fixed amount means either 1) a stated dollar amount payable periodically, but not less frequently than annually, but only to the extent that the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year, or 2) 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 that the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year. The governing instrument must prohibit additional contributions after the establishment of the trust.

Section 25.2702-3(b) also provides that the annuity amount must be payable to or for the benefit of the holder of the annuity interest for each taxable year of the term. A payment with respect to any taxable year may be made after the close of such taxable year provided the payment is made 1) within the 12-month period and 2) no later than the date by which the trustee is required to file the federal income tax return of the trust for the taxable year without regard to extensions.

The regulations also provide that, the governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iv) of the

Income Tax Regulations relating to the computation of the annuity amount in the case of short taxable years and the last taxable year of the term. Section 1.664-2(a)(1)(iv) provides that in the case of a short taxable year and the year of termination of the trust, the annuity amount shall be prorated on a daily basis for the number of days making up the short taxable year or the period from the beginning of the taxable year to the date of termination of the trust. However, an instrument is deemed to meet these short taxable year requirements if it provides that the fixed amount or a pro-rata portion thereof must be payable for the final period of the annuity interest.

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) (relating to the qualification of charitable remainder annuity trusts) providing for any incorrect determination of the fair market value of the property in the trust. Section 1.664-2(a)(1)(iii) provides that, if the market value is incorrectly determined by the fiduciary, the governing instrument must provide that the trust shall pay to the recipient (in the case of an undervaluation) or be repaid by the recipient (in the case of an overvaluation) an amount equal to the difference between the amount which the trust should have paid the recipient if the correct value were used and the amount which the trust actually paid the recipient.

Section 25.2702-3(b) specifically states that a right of withdrawal, whether or not cumulative, is not a qualified annuity interest.

Section 25.2702-3(d) provides additional requirements applicable to qualified annuity interests. In general, to be a qualified annuity interest, an interest must be a qualified annuity interest in every respect. The governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity interest during the term of the qualified interest. The governing instrument must fix the term of the annuity interest. This term must be for the life of the term holder, for a specified term of years, or for the shorter, but not the longer, of those periods. The governing instrument must prohibit commutation (prepayment) of the interest of the term holder.

Section 2033 provides that the value of a decedent's gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2036(a) provides, in part, that the value of the gross estate shall include the value of property to the extent of any interest therein of which the decedent has at any time made a transfer (except for full and adequate consideration in money or money's worth) by trust or otherwise, under which the decedent has retained for life or for any similar period the possession for enjoyment of, or the right to the income from, the property.

However, if the decedent at no time held any interest in property other than a life interest, which terminates at the decedent's death, no portion of the value of the property is includible in the decedent's gross estate as property in which the decedent had an interest or as the subject of a transfer with a retained life estate. See Rev. Rul. 66-86, 1986-1 C.B. 216.

Similarly, if a decedent has transferred property to another in return for a promise to make periodic payments to the transferor for the transferor's lifetime, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent under § 2036. In these cases, the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made. See Rev. Rul. 77-193, 1977-1 C.B. 273, and cases cited therein.

Section 2043(a) provides that if any one of the transfers, trusts, etc. enumerated in §§ 2035 to 2038 is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for and adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.

In the present case, several members of the same family are acquiring interests in Family Entity in the same transaction. In transactions that are part of that transaction, yet separate and distinct therefrom, family members are acquiring interests in property in which there are term interests. With respect to those separate transactions, § 2702 requires that Taxpayer A be treated as having acquired the entire 28 percent interest in which he has a term interest and then having transferred the remainder interest in that 28 percent interest in trust to Daughter. Similarly, § 2702 requires that Taxpayer B be treated as acquiring the 7.33 percent interest and transferring the remainder interest in that interest in trust to the trusts created for Taxpayer B's issue.

Analysis of the facts indicates that Family Entity functions as a solely as a conduit channeling cash flow from Venture to the members of the family. In any year when Venture fails to generate cash flow equal to nine percent of the initial contributions, Family Entity will issue demand notes to the various interest holders entitled to payment. Those notes can only be satisfied out of future cash flow that is distributable to the interest holder in any event. Thus, the notes, standing alone, represent nothing more than a cumulative right of withdrawal of assets otherwise distributable to the interest holder.

The terms of each agreement provide that:

1) The life tenant is to receive on an annual basis, nine percent of the total amount contributed with respect to the interest subject to the agreement;

2) The first payment will be made within twelve months of the deemed transfer to the trust; and

3) In the event that a note is distributed to the life tenant, the remainderman will guarantee payment of the note, on demand, with full recourse to the independent assets of the remaindermen.

In addition, other terms in the agreement satisfy the remaining requirements of §§ 25.2702-3(b) and (d) of the regulations.

Ruling requests 1 and 2:

Based on the above we conclude that:

1) Because Daughter has sufficient independent wealth to provide assurance that Taxpayer A will be entitled to receive the entire series of annuity payments without regard to the success of Venture, the notes, if issued, will not be considered a mere right of withdrawal of trust assets and, thus, the interest to be acquired by Taxpayer A as life tenant under the agreement will be a qualified annuity interest under § 2702, the value of which is determined under § 7520 for federal gift tax purposes.

2. Because Trusts are entities holding no assets other than the remainder interest, the obligation to make the payments is satisfiable solely out of the underlying property and its earnings. Thus, the interest retained by Taxpayer B under the agreement, being limited to the earnings and cash flow of Venture, will not be a qualified annuity interest under § 2702.

Ruling requests 3 and 4:

Taxpayer's representative argues that the acquisition of the life estate and remainder interests in the 28 and 7.33 percent interests should be viewed as a "joint purchase", wherein Taxpayers independently acquired their interests as "life tenants" while the remaindermen separately acquired their interest. Under this scenario, they argue, neither Taxpayer A nor Taxpayer B can be said to have made a transfer of property in which they retained an interest that would cause inclusion in the value of their gross estate under § 2036.

We disagree. It is clear from even a cursory examination of the terms of these agreements that the respective interests of the Taxpayers differ substantially from a typical life tenant/remainderman situation. It would be unusual, for example, for the life tenant to receive distributions that represent a return of capital. Similarly, it would be unusual for the remainderman to pledge his or her independent assets to assure that the return payable to the life tenant attained the anticipated level.

We think the better analysis is that each taxpayer has made a transfer of property in a transaction under which that Taxpayer has retained the right to receive periodic payments for the transferor's lifetime.

Under Rev. Rul. 77-193, supra, it is apparent that these payments do not represent a retained interest in the transferred property so as to include the property in the estate of the transferor (under § 2036) so long as the promise is a personal obligation of the transferee, the obligation is not satisfiable solely out of the underlying property and its earnings, and the size of the payments is not determined by the size of the actual income from the underlying property at the time the payments are made.

Based on the above, and with reference solely to the terms of the agreements, we conclude:

3. Because Daughter holds sufficient personal wealth to satisfy her potential personal liability for the payments to Taxpayer A, and because neither the size nor the obligation to make those payments relates to the performance of the underlying property, the interest to be acquired by Taxpayer A as life tenant under the agreement will not be included in Taxpayer A's gross estate for under § 2036 solely by reason of the agreement.

4. Because Trusts are entities holding no assets other than the remainder interest, the obli-

gation to make the payments is satisfiable solely out of the underlying property and its earnings. Thus, the interest retained by Taxpayer B under the agreement, being limited to the earnings and cash flow of Venture, will cause the inclusion of the value represented by the 7.33 percent interest to be includible in Taxpayer B's gross estate under § 2036 (reduced pursuant to § 2043, by the amount of consideration furnished by Trusts at the time of the purchase).

Except as we have specifically ruled, we express no opinion as to tax consequences of the proposed transaction under §.§. 2036, 2039, or any other provisions of the Code.

This ruling is based on the facts and applicable law in effect on the date of this letter. If there is a change in material fact or law (local or federal), the ruling will have no force or effect. If Taxpayer is in doubt whether there has been a change in material fact or law, a request for reconsideration of this ruling should be submitted to this office.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

A copy of this letter should be attached to any gift, estate or transfer tax returns, that you may file relating to these matters.

Sincerely yours, Assistant Chief Counsel (Passthroughs and Special Industries), By Lee A. Dunn, Acting Chief, Branch 4.

LTR 9515040, January 17, 1995

Symbol: CP:E:EP:T:3

Uniform Issue List No.: 6704.01-00

[Code Sec. 6704]

Failure to keep records necessary to meet reporting requirements under Section 6047(d) (See also 6047); Liability for penalty.

This is in response to the request for a ruling dated September 3, 1993, as supplemented and amended by letters dated January 27, 1994, March 25, 1994, May 20, 1994, May 27, 1994, July 21, 1994, and August 26, 1994, submitted by Employer A, concerning the penalties under sections 6652(e), 6704, 6721, and 6722 of the Internal Revenue Code and the liability for withholding under section 3405(d) of the Code. Employer A is the sponsor, administrator, trustee and payor of distributions for Plan X, which is a defined contribution plan intended to qualify under section 401(a) of the Code. The plan year is the calendar year.

For each plan year through 1989 Plan X provided for the creation of class year accounts. Under Plan X class year accounts matured and were distributable at the option of participants two years after the end of the plan year for which the contributions were made. At the maturity of a class year, a participant had three options: (1) to withdraw all employee contributions and earnings attributable to the class year, (2) to withdraw all employee contributions and earnings and all matching Employer A contributions and earnings attributable to the class year and (3) to make no withdrawal. Plan X did not provide for class years after 1989. Approximately 50 to 60 percent of the eligible participants elected to receive class year distributions during the years Plan X provided for class year distributions.

In the event a participant elected not to withdraw a matured class year, the employee contributions and employer contributions and the respective earnings attributable to each were added to the participant's deferred account. The cumulative totals of employee contributions and earnings and employer contributions and earnings in the deferred account were augmented by the totals of such contributions and earnings in the class year account and all record of the class year disappeared. The contributions remained in the deferred account until withdrawn under other Plan X options.

Historically, Plan X has accounted for employee contributions on a multiple contract basis because prior to 1979 Plan X was unaware that it was required to be treated as a single contract rather than a number of separate contracts. Under the multiple contract approach, for reporting purposes an employee could offset only employee contributions attributable to the class year with respect to which the distribution was made. No reductions were made with respect to a participant's contributions to the Plan except those attributable to the class year that was withdrawn. For plan recordkeeping purposes all contributions and earnings attributable to a participant's class year withdrawal were deleted from the participant's account upon withdrawal of the class year.

Similarly, if a participant took a distribution other than a class year distribution (such as a withdrawal of all supplemental contributions and the earnings thereon), the participant's employee contributions account, with respect to any other after-tax employee contributions, such as employee basic contributions, would not be reduced.