

Part III - Administrative, Procedural, and Miscellaneous

Qualified Interests

Notice 2003-72

PURPOSE

This notice announces that the Internal Revenue Service will follow the Tax Court's decision in *Walton v. Commissioner*, 115 T.C. 589 (2000), holding that § 25.2702-3(e), Example 5, of the Gift Tax Regulations is invalid.

BACKGROUND

Section 2702 provides special rules for valuing gifts in trust when the donor or an applicable family member retains an interest in the trust. If the retained interest is not a qualified interest, the interest is valued at zero, and the amount of the gift is the entire value of the transferred property. If the retained interest is a qualified interest, the interest is valued under § 7520 using prescribed actuarial tables and interest rates, and the amount of the gift is the value of the transferred property reduced by the value of the retained interest. Under § 2702(b), a qualified interest is: (1) an interest that consists of a right to receive fixed amounts payable not less frequently than annually (a qualified annuity interest); (2) an interest that consists of a right, payable at least annually, to receive a fixed percentage of the net fair market value of the trust corpus determined annually (a qualified unitrust interest); and (3) a right to receive a noncontingent remainder interest if all other interests in the trust are qualified annuity or unitrust interests (a qualified remainder interest). Under § 25.2702-3(d)(3), the qualified annuity or unitrust interest must be payable, "for the life of the term holder, for a specified term of years, or for the shorter (but not longer) of those periods."

In Example 5 of § 25.2702-3(e), A transfers property to an irrevocable trust, retaining the right to receive a unitrust amount for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. The example concludes that A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust amount for 10 years or until A's prior death. However, the unitrust amount payable to A's estate if A dies within the term of the trust is not a qualified interest.

In *Walton v. Commissioner*, the Tax Court considered a situation similar to that presented in Example 5. In *Walton*, the grantor established a grantor retained annuity trust, pursuant to which the grantor was to receive an annuity for a term of 2 years. If the grantor died before the expiration of the 2-year term, the annuity was to be paid to the grantor's estate for the balance of the term. Upon expiration of the 2-year term, the trust corpus was to be distributed to a designated remainder beneficiary. After considering the legislative history and purpose of § 2702, the Court held that Example 5 is an unreasonable interpretation and invalid extension of § 2702. The Court concluded that a

retained annuity payable for a specified term of years to the grantor, or to the grantor's estate if the grantor dies prior to expiration of the term, is a qualified interest under § 2702 for the specified term of years.

IRS ACQUIESCENCE

The IRS acquiesces in the Tax Court's decision. Accordingly, in the fact situation presented in § 25.2702-3(e), Example 5, the Internal Revenue Service will treat the retained unitrust interest payable to A or A's estate as a qualified interest payable for a 10-year term. The regulations will be revised to conform to this notice.

DRAFTING INFORMATION

The principal author of this notice is Scott S. Landes of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Mr. Landes at (202) 622-3090 (not a toll-free call).