

§ 12.210 [Corrected and Amended]

30. In § 12.210(a) the phrase "pay reparation award" is revised to read "pay a reparation award".

31. In § 12.210(b)(4) "respondent's violations, which" is revised to read "respondent's violations, the amount of punitive damages, if any, for which respondent is liable to complainant, which" and "\$10,000," is revised to read "\$30,000," both times that it appears.

§ 12.314 [Amended]

32. In § 12.314(b)(4) "violations, and the amount," is revised to read "violations, the amount of punitive damages if warranted, and the amount,"

§ 12.315 [Amended]

33. In the heading of § 12.315 "\$10,000," is revised to read "\$30,000."

34. In § 12.315 "\$10,000," is revised to read "\$30,000," both times that it appears.

§ 12.404 [Corrected]

35. In § 12.404 the phrase "of proceeding on appeal of review before" is revised to read "of proceedings on appeal before".

§ 12.408 [Corrected]

36. The heading of § 12.408 is revised to read "Delegation of authority to the Deputy General Counsel for Opinions."

37. In the first sentence of § 12.408 revise the phrase "Chief of the Opinions Section" to read "Deputy General Counsel for Opinions".

38. In § 12.408(b) revise the phrase "Chief of the Opinions Section" to read "Deputy General Counsel for Opinions". Issued by Order of the Commission.

Dated: February 23, 1994.

Jean A. Webb,

Secretary of the Commission.

[FR Doc. 94-4574 Filed 2-29-94; 8:45 am]

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DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food and Drug Administration

21 CFR Part 450

[Docket No. 89N-0440]

Antibiotic Drugs; New Tests and Specifications for Doxorubicin Hydrochloride and Its Dosage Forms

AGENCY: Food and Drug Administration, HHS.

ACTION: Final rule.

SUMMARY: The Food and Drug Administration (FDA) is amending the

antibiotic drug regulations by revising the accepted standards for doxorubicin hydrochloride bulk and its dosage forms to reflect advances in analytic chemistry and improvements in the manufacturing technology of this antibiotic drug. These actions are being taken at the request of a manufacturer and will provide better quality control of this product.

DATES: Effective March 1, 1994; written comments, notice of participation, and request for a hearing by March 31, 1994; data, information, and analyses to justify a hearing by May 2, 1994.

ADDRESSES: Submit written comments to the Dockets Management Branch (HFA-305), Food and Drug Administration, rm. 1-23, 12420 Parklawn Dr., Rockville, MD 20857.

FOR FURTHER INFORMATION CONTACT: Peter A. Dionne, Center for Drug Evaluation and Research (HFD-520), Food and Drug Administration, 5600 Fishers Lane, Rockville, MD 20857, 301-443-0335.

SUPPLEMENTARY INFORMATION:

I. Background

In the Federal Register of May 3, 1990 (55 FR 18617), FDA proposed to amend the antibiotic drug regulations for doxorubicin hydrochloride bulk and its dosage forms to reflect the significant improvement in the extraction and chromatographic separation methods since the original promulgation of regulations for doxorubicin hydrochloride in 1976. This improvement in manufacturing technology and analytical testing methodology has resulted in the production of highly purified drug substances and finished dosage forms.

Specifically, FDA proposed to amend the regulations for doxorubicin hydrochloride bulk to: (1) Revise the doxorubicin hydrochloride content limits from 900 to 1,100 micrograms per milligram ($\mu\text{g}/\text{mg}$) on the anhydrous basis to 970 to 1,020 $\mu\text{g}/\text{mg}$ on the anhydrous and solvent-free basis; (2) revise the high-pressure liquid chromatography (HPLC) test currently specified for determining the content of doxorubicin hydrochloride; (3) revise the pH range limits from a range of 3.8 to 6.5 to a range of 4.0 to 5.5; (4) add a total solvent residue test with an upper limit of not more than 2.5 percent; (5) add a chromatographic purity test with a total impurity specification of not more than 3.0 percent; (6) delete the microbiological agar diffusion assay for determining microbiological activity; and (7) revise the solution used for the disposition of waste material from synthetic detergent to dilute sodium hypochlorite.

FDA also proposed to amend the regulations for doxorubicin hydrochloride for injection to: (1) Revise the HPLC test currently specified for determining the content of doxorubicin hydrochloride; (2) revise the pH range limits from a range of 3.8 to 6.5 to a range of 4.5 to 6.5; (3) add a provision to the product description permitting the product to contain methylparaben; (4) replace the pyrogen test with the U.S. Pharmacopeia (U.S.P.) Bacterial Endotoxin Test with an upper limit of not more than 2.2 U.S.P. endotoxin units/mg of doxorubicin hydrochloride; (5) delete the microbiological activity specification for the doxorubicin hydrochloride used in making the product; (6) delete the depressor substances test for the product and add the depressor substances specification for the doxorubicin hydrochloride used in making the product; and (7) revise the solution used for the disposition of waste material from synthetic detergent to dilute sodium hypochlorite.

FDA also proposed to amend the regulation for doxorubicin hydrochloride injection to: (1) Revise the HPLC test currently specified for determining the content of doxorubicin hydrochloride; (2) replace the pyrogen test with the U.S.P. Bacterial Endotoxin Test with an upper limit of not more than 2.2 U.S.P. endotoxin units/mg of doxorubicin hydrochloride; (3) delete the microbiological activity specification for the doxorubicin hydrochloride used in making the product; and (4) revise the solution used for the disposition of waste material from synthetic detergent to dilute sodium hypochlorite.

Interested persons were given until July 2, 1990, to submit written comments on this proposal and until June 4, 1990, to submit requests for an informal conference. One comment was received from the manufacturer requesting the proposed changes. This comment involved the description of the preparation of the resolution test solution and the system suitability requirements for the new HPLC method. The manufacturer requested that the preparation method in U.S.P. XXII, supp. I, be used and that the system suitability requirements be those in U.S.P. XXII, supp. I.

FDA believes that both the method in the proposal and the U.S.P. method of preparation for the resolution test solution give satisfactory production of doxorubicinone and, therefore, will present both methods in this final rule. FDA believes that the term "asymmetry factor" is the correct one because measurements are being made on both sides of the HPLC peak and not just the

tailoring side. This final rule will, therefore, use the term "asymmetry factor" and will not be the same as the U.S.P., which uses the term "tailoring factor." To be consistent with the U.S.P., however, this final rule will use limits of not less than 0.7 and not more than 1.2 instead of not less than 0.9 and not more than 1.2 that were proposed. FDA also believes that column efficiency should be stated as absolute column efficiency (h_p) and not as theoretical plates (n), because the number of theoretical plates varies with the length and particle size of the packing in the column. If the column is packed with 10-micrometer (μ m) particles and is 25 centimeters (cm) long, then a column efficiency of not greater than 10.0 is equivalent to 2,500 theoretical plates which is close to the 2,250 plates stated in the U.S.P. The efficiency of the column, which will be stated in the final rule as absolute column efficiency (h_p), is satisfactory if it is not greater than 10.0, equivalent to 2,500 theoretical plates for a 25-cm column of 10- μ m particles. To be consistent with the U.S.P., the proposed resolution of not less than 8.0 between the peaks of doxorubicin and doxorubicinone has been changed in the final rule to not less than 5.5.

II. Environmental Impact

The agency has determined under 21 CFR 25.24(c)(6) that this action is of a type that does not individually or cumulatively have a significant effect on the human environment. Therefore, neither an environmental assessment nor an environmental impact statement is required.

III. Economic Impact

The agency has considered the economic impact of this final rule and has determined that it does not require a regulatory flexibility analysis, as defined in the Regulatory Flexibility Act (Pub. L. 96-354). Specifically, the final rule would impose an insubstantial amendment to existing requirements and would refine existing technical provisions without imposing more stringent requirements. Accordingly, the agency certifies that this rulemaking will not have a significant economic impact on a substantial number of small entities.

IV. Submitting Comments and Filing Objections

Any person who will be adversely affected by this regulation may file objections to it and request a hearing. Reasonable grounds for the hearing must be shown. Any person who decides to seek a hearing must file (1)

on or before March 31, 1994, a written notice of participation and request for a hearing, and (2) on or before May 2, 1994, the data, information, and analyses on which the person relies to justify a hearing, as specified in 21 CFR 314.300. A request for a hearing may not rest upon mere allegations or denials, but must set forth specific facts showing that there is a genuine and substantial issue of fact that requires a hearing. If it conclusively appears from the face of the data, information, and factual analyses in the request for a hearing that no genuine and substantial issue of fact precludes the action taken by this order, or if a request for a hearing is not made in the required format or with the required analyses, the Commissioner of Food and Drugs will enter summary judgment against the person(s) who request(s) the hearing, making findings and conclusions and denying a hearing. All submissions must be filed in three copies, identified with the docket number appearing in the heading of this document and filed with the Dockets Management Branch (address above).

The procedures and requirements governing this document, a notice of participation and request for a hearing, a submission of data, information, and analyses to justify a hearing, other comments, and grant or denial of a hearing are contained in 21 CFR 314.300.

All submissions under this document, except for data and information prohibited from public disclosure under 21 U.S.C. 331(j) or 18 U.S.C. 1905, may be seen in the Dockets Management Branch (address above) between 9 a.m. and 4 p.m., Monday through Friday.

List of Subjects in 21 CFR Part 450

Antibiotics.

Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs, 21 CFR part 450 is amended as follows:

PART 450—ANTITUMOR ANTIBIOTIC DRUGS

1. The authority citation for 21 CFR part 450 continues to read as follows:

Authority: Sec. 507 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 357).

2. Section 450.24 is amended by revising paragraphs (a)(1)(i), (a)(1)(ii), and (a)(1)(v); by adding new paragraph (a)(1)(viii); by revising paragraph (a)(3)(i), the last sentence in the introductory text of paragraph (b), paragraphs (b)(1) and (b)(2); and by adding new paragraph (b)(8) to read as follows:

§ 450.24 Doxorubicin hydrochloride.

(a) * * *

(1) * * *

(i) Its doxorubicin hydrochloride content is not less than 970 micrograms and not more than 1,020 micrograms of doxorubicin hydrochloride per milligram on the anhydrous and solvent free basis.

(ii) Its total solvent residue (as acetone and alcohol) is not more than 2.5 percent.

* * * * *

(v) The pH of an aqueous solution containing 5 milligrams per milliliter is not less than 4.0 and not more than 5.5.

* * * * *

(viii) The total of any impurities detected by high-pressure liquid chromatography assay is not more than 3.0 percent.

* * * * *

(3) * * *

(i) Results of tests and assays on the batch for doxorubicin hydrochloride content, solvent residue, depressor substances, moisture, pH, crystallinity, identity, and total impurities.

* * * * *

(b) * * * Dispose of all waste material by dilution with large volumes of dilute sodium hypochlorite (bleach) solution.

(1) *Doxorubicin hydrochloride content (high-performance liquid chromatography).* Proceed as directed in § 436.216 of this chapter, using ambient temperature, an ultraviolet detection system operating at a wavelength of 254 nanometers, a 4.6-millimeter X 25-centimeter column packed with microparticulate (5 to 10 micrometers in diameter) packing material, such as trimethylsilane chemically bonded to porous silica, a flow rate of not more than 2.0 milliliters per minute, and a known injection volume of between 10 and 20 microliters. Mobile phase, working standard and sample solutions, resolution test solution, system suitability requirements, and calculations are as follows:

(i) *Mobile phase.* Prepare a suitable mixture of water, acetonitrile, methanol, and phosphoric acid (540:290:170:2). Dissolve 1 gram of sodium lauryl sulfate in 1,000 milliliters of this solution, adjust with 2N sodium hydroxide to a pH of 3.6±0.1. Filter through a suitable filter capable of removing particulate matter to 0.5 micron in diameter. Degas the mobile phase just prior to its introduction into the chromatograph.

(ii) *Preparation of working standard, sample, and resolution test solutions—*(A) *Working standard solution.* Dissolve an accurately weighed quantity of doxorubicin hydrochloride working

standard in mobile phase to obtain a solution having a known concentration of 0.1 milligram of doxorubicin hydrochloride per milliliter.

(B) *Sample solution.* Transfer approximately 20 milligrams of sample, accurately weighed, to a 200-milliliter volumetric flask, add mobile phase to volume, and mix. This yields a solution containing 0.1 milligram of doxorubicin hydrochloride per milliliter (estimated).

(C) *Resolution test solution.* Use either of the following preparation methods:

(1) To 2 milliliters of a 1.0 milligram per milliliter solution of doxorubicin hydrochloride, add 20 microliters of 1N hydrochloric acid. Hold for 30 minutes at 95 °C in an oil bath.

(2) Dissolve about 10 milligrams of doxorubicin hydrochloride in 5 milliliters of water, add 5 milliliters of phosphoric acid, and allow to stand for about 30 minutes. Adjust with 2N

sodium hydroxide (about 37 milliliters) to a pH of 2.6±0.1, add 15 milliliters of acetonitrile and 10 milliliters of methanol, mix, and filter. (Note: Portions of this solution may be frozen until needed, then thawed and mixed before use.)

(3) The procedures in paragraphs (b)(1)(ii)(C)(1) and (b)(1)(ii)(C)(2) of this section generate doxorubicinone, the aglycone of doxorubicin. Use this solution to determine the resolution requirement for the chromatographic system.

(iii) *System suitability requirements—*(A) *Asymmetry factor.* The asymmetry factor (A_s) for the doxorubicin peak measured at a point 5 percent of the peak height is not less than 0.7 and not more than 1.2.

(B) *Efficiency of the column.* The absolute column efficiency (h) is satisfactory if it is not greater than 10.0,

equivalent to 2,500 theoretical plates for a 25-centimeter column of 10-micrometer particles.

(C) *Resolution.* The resolution (R) between the peaks of doxorubicin and doxorubicinone (generated in situ) is satisfactory if it is not less than 5.5.

(D) *Capacity factor.* The capacity factor (k) for doxorubicin is satisfactory if it is in the range between 1.0 and 5.0.

(E) *Coefficient of variation.* The coefficient of variation (relative standard of deviation in percent) of 5 replicate injections is satisfactory if it is not more than 1.0 percent. If the system suitability parameters have been met, then proceed as described in § 436.216(b) of this chapter.

(iv) *Calculations.* Calculate the micrograms of doxorubicin hydrochloride per milligram of sample as follows:

$$\text{Micrograms of doxorubicin hydrochloride per milligram} = \frac{A_U \times P_S \times 100}{A_S \times C_U \times (100 - m - X)}$$

where:

A_U = Area of the doxorubicin hydrochloride peak in the chromatogram of the sample (at a retention time equal to that observed for the standard);

A_S = Area of the doxorubicin hydrochloride peak in the chromatogram of the doxorubicin hydrochloride working standard;

P_S = Doxorubicin hydrochloride activity in the doxorubicin hydrochloride working standard solution in micrograms per milliliter;

C_U = Milligrams of the sample per milliliter of sample solution;

m = Percent moisture content of the sample; and

X = Percent solvent residue determined as directed in paragraph (b)(2) of this section.

(2) *Residue solvent (as acetone and alcohol)—*(i) *Standard preparation.* Transfer to a 100-milliliter volumetric flask about 200 milligrams of acetone, 300 milligrams of dehydrated alcohol, and 1,000 milligrams of dioxane, each accurately weighed, and mix. Dilute with water to volume, and mix. Transfer 5.0 milliliters of the resulting solution to a 50-milliliter volumetric flask, dilute with water to volume, and mix. This solution contains about 0.2 milligram of acetone, 0.3 milligram of alcohol, and 1 milligram of dioxane per milliliter.

(ii) *Solvent.* Transfer about 100 milligrams of dioxane, accurately weighed to a 100-milliliter volumetric

flask, dilute with water to volume, and mix.

(iii) *Test preparation.* Dissolve about 200 milligrams of doxorubicin hydrochloride sample in 3.0 milliliters of solvent.

(iv) *Chromatographic system (see United States Pharmacopeia (U.S.P.) Chromatography (621)).* The gas chromatograph is equipped with a flame-ionization detector and a 4-millimeter X 2-meter column packed with 8-percent liquid phase G16 (see U.S.P. Chromatographic Reagents—Phases) on 100- to 120-mesh support S1AB (potassium hydroxide-washed) (see U.S.P. Chromatographic Reagents—Supports). The column is maintained at about 60 °C, and helium is used as the carrier gas. Adjust the column temperature and carrier gas flow rate so that dioxane elutes in about 6 minutes. Chromatograph the standard preparation, and record the peak responses as directed under procedure; the resolution (R) between adjacent peaks is not less than 2.0; the relative standard deviations of the ratios of the peak responses of the acetone and dioxane peaks and of the alcohol and dioxane peaks for replicate injections is not more than 4.0 percent; and the tailing factor for the alcohol peak is not more than 1.5.

(v) *Procedure.* (Note: Use peak areas where peak responses are indicated.)

Separately inject equal volumes (about 1 microliter) of the standard preparation and the test preparation into the chromatograph, record the chromatograms, and measure the responses for the major peaks. The relative retention times are about 0.2 for acetone, 0.5 for alcohol, and 1.0 for dioxane. Calculate the percentage, by weight, of acetone and alcohol, respectively, in the sample as follows:

$$X = \text{Percent acetone or alcohol} = 100(C_A/C_D)(D_U/W_U)(R_U/R_S)$$

where:

C_A = Concentration of acetone or alcohol in the standard preparation in milligrams per milliliter;

C_D = Concentration of dioxane in the standard preparation in milligrams per milliliter;

D_U = Total quantity of dioxane in the test preparation, in milligrams;

W_U = Quantity of doxorubicin hydrochloride taken to prepare the test preparation, in milligrams;

R_U = Response ratio of the analyte peak (acetone or alcohol) to the dioxane peak obtained from the test preparation; and

R_S = Response ratio of the analyte peak (acetone or alcohol) to the dioxane peak obtained from the standard preparation.

The total of acetone and alcohol is not greater than 2.5 percent. Use the result obtained to calculate the doxorubicin hydrochloride content of the sample on the solvent-free basis.

* * * * *

(8) *Chromatographic purity.* Proceed as directed in paragraph (b)(1) of this section, except prepare the sample solution by dissolving the sample to be tested in mobile phase to obtain a solution containing approximately 0.5 milligram of doxorubicin hydrochloride per milliliter. Calculate the percentage of impurities as follows:

$$\frac{\text{Percent total impurities}}{100} = \frac{(100 S)/(S + r)}{100}$$

where:

S = The sum of the responses of the minor component peaks; and

r = The response of the major doxorubicin hydrochloride peak.

The total related impurities detected is not more than 2.0 percent.

3. Section 450.224a is amended by revising paragraphs (a)(1), (a)(3)(i)(a), (a)(3)(i)(b), the last sentence in the introductory text of paragraph (b), paragraphs (b)(1) and (b)(3); and by removing and reserving paragraph (b)(4) to read as follows:

§ 450.224a Doxorubicin hydrochloride for injection.

(a) *Requirements for certification—(1) Standards of identity, strength, quality, and purity.* Doxorubicin hydrochloride for injection is a freeze-dried powder whose components are doxorubicin hydrochloride and lactose. It may also contain methylparaben. Its doxorubicin hydrochloride content is satisfactory if it is not less than 90 percent and not more than 115 percent of the number of milligrams of doxorubicin hydrochloride that it is represented to contain. It is sterile. It contains not more than 2.2 U.S.P. endotoxin units per milligram of doxorubicin hydrochloride. Its moisture content is not more than 4.0 percent. When reconstituted as directed in the labeling, its pH is not less than 4.5 and not more than 6.5. It passes the identity test. The doxorubicin hydrochloride used conforms to the standards prescribed by § 450.24(a)(1).

(3) * * *

(i) * * *

(a) The doxorubicin hydrochloride used in making the batch for doxorubicin hydrochloride content, residue solvents, depressor substances, moisture, pH, crystallinity, identity, and total related impurities.

(b) The batch for doxorubicin hydrochloride content, sterility, bacterial endotoxins, moisture, pH, and identity.

(b) * * * Dispose of all waste material by dilution with large volumes of sodium hypochlorite (bleach) solution.

(1) *Doxorubicin hydrochloride content (high-performance liquid chromatography).* Proceed as directed in § 450.24(b)(1), preparing the sample solution and calculating the doxorubicin hydrochloride content as follows:

(i) *Sample solution.* Prepare the sample solution by rinsing the contents of the vial into an appropriate sized volumetric flask with sufficient mobile phase to obtain a concentration of 0.1 milligram of doxorubicin hydrochloride per milliliter (estimated).

(ii) *Calculations.* Calculate the doxorubicin hydrochloride content per vial as follows:

$$\frac{\text{Milligrams of doxorubicin hydrochloride per vial}}{100} = \frac{A_U \times P_S \times d}{A_S \times 1,000}$$

where:

A_U = Area of the doxorubicin hydrochloride peak in the chromatogram of the sample (at a retention time equal to that observed for the standard);

A_S = Area of the doxorubicin hydrochloride peak in the chromatogram of the doxorubicin hydrochloride working standard;

P_S = Doxorubicin hydrochloride activity in the doxorubicin hydrochloride working standard solution in micrograms per milliliter; and

d = Dilution factor of the sample.

(3) *Bacterial endotoxins.* Proceed as directed in the United States Pharmacopeia (U.S.P.) Bacterial Endotoxin Test, using a solution of doxorubicin hydrochloride for injection containing 1.1 milligrams of doxorubicin hydrochloride per milliliter. The specimen under test contains not more than 2.2 U.S.P. endotoxin units per milligram of doxorubicin hydrochloride.

(4) [Reserved]

4. Section 450.224b is amended by revising paragraphs (a)(1), (a)(3)(i)(A), (a)(3)(i)(B), the last sentence in the introductory text of paragraph (b), and paragraph (b)(1); by removing and reserving paragraph (b)(2); and by revising paragraph (b)(4) to read as follows:

§ 450.224b Doxorubicin hydrochloride injection.

(a) *Requirements for certification—(1) Standards of identity, strength, quality, and purity.* Doxorubicin hydrochloride

injection is an aqueous solution of doxorubicin hydrochloride in an isotonic diluent. Each milliliter contains doxorubicin hydrochloride equivalent to 2 milligrams of doxorubicin hydrochloride. Its doxorubicin hydrochloride content is satisfactory if it is not less than 90 percent and not more than 115 percent of the number of milligrams it is represented to contain. It is sterile. It contains not more than 2.2 U.S.P. endotoxin units per milligram of doxorubicin hydrochloride. Its pH is not less than 2.5 and not more than 3.5. It passes the identity test. The doxorubicin hydrochloride used conforms to the standards prescribed by § 450.24(a)(1).

(3) * * *

(i) * * *

(A) The doxorubicin hydrochloride used in making the batch for doxorubicin hydrochloride content, residue solvents, depressor substances, moisture, pH, crystallinity, identity, and total related impurities.

(B) The batch for doxorubicin hydrochloride content, sterility, bacterial endotoxins, pH, and identity.

(b) * * * Dispose of all waste material by dilution with large volumes of sodium hypochlorite (bleach) solution.

(1) *Doxorubicin hydrochloride content (high-performance liquid chromatography).* Proceed as directed in § 450.24(b)(1), preparing the sample solution and calculating the doxorubicin hydrochloride content as follows:

(i) *Sample solution.* Dilute an accurately measured volume of sample equivalent to not less than 2 milligrams of doxorubicin hydrochloride, quantitatively with mobile phase to obtain a solution containing 0.1 milligram of doxorubicin hydrochloride per milliliter (estimated).

(ii) *Calculations.* Calculate the milligrams of doxorubicin hydrochloride per milliliter of sample as follows:

$$\frac{\text{Milligrams of doxorubicin hydrochloride per milliliter}}{100} = \frac{A_U \times P_S \times d}{A_S \times 1,000}$$

where:

A_U = Area of the doxorubicin hydrochloride peak in the chromatogram of the sample (at a retention time equal to that observed for the standard);

A_3 = Area of the doxorubicin hydrochloride peak in the chromatogram of the doxorubicin hydrochloride working standard;

P_3 = Doxorubicin hydrochloride activity in the doxorubicin hydrochloride working standard solution in micrograms per milliliter; and

d = Dilution factor of the sample.

(2) [Reserved]

* * * * *

(4) *Bacterial endotoxins.* Proceed as directed in the United States Pharmacopeia (U.S.P.) Bacterial Endotoxin Test, using a test solution prepared by diluting doxorubicin hydrochloride injection with sterile water for injection to obtain a concentration of 1.1 milligrams of doxorubicin hydrochloride per milliliter. The specimen under test contains not more than 2.2 U.S.P. endotoxin units per milligram of doxorubicin hydrochloride.

* * * * *

Dated: February 18, 1994.

Albert Rothschild,

Acting Director, Office of Compliance, Center for Drug Evaluation and Research.

[FR Doc. 94-4518 Filed 2-28-94; 8:45 am]

BILLING CODE 4160-01-F

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 20, 22, 25, and 602

[TD 8522]

RIN 1545-AC67

Estate and Gift Tax Marital Deduction

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations relating to the estate tax and gift tax marital deduction. Changes to the applicable tax law were made by the Tax Reform Act of 1976, the Revenue Act of 1978, the Economic Recovery Tax Act of 1981, the Technical Corrections Act of 1982, the Deficit Reduction Act of 1984, the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, the Omnibus Budget Reconciliation Act of 1989, and the Energy Policy Act of 1992. These regulations will provide the public with the guidance needed to comply with those Acts.

EFFECTIVE DATE: March 1, 1994.

FOR FURTHER INFORMATION CONTACT: Susan Hurwitz, (202) 622-3090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information requirement contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-0015. The estimated annual burden per respondent varies from .1 to .5 hours depending on individual circumstances, with an estimated average of .25 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attention: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

On May 21, 1984, the IRS published in the *Federal Register* proposed amendments to the Estate and Gift Tax Regulations (26 CFR part 20 and part 25) under sections 2044, 2056, 2207A, 2519, 2523, and 6019 of the Internal Revenue Code (Code) (49 FR 21350). Conforming changes were proposed for regulations under other sections of the Code. The amendments implement and provide guidance with respect to sections 2044, 2056, 2207A, 2519, 2523, and 6019 which were added or amended by the Tax Reform Act of 1976, the Revenue Act of 1978, the Economic Recovery Tax Act of 1981, and the Technical Corrections Act of 1982. This project finalizes those amendments. Additionally, revisions have been made in the final regulations to reflect certain statutory changes made since the publication of the proposed regulations by the Deficit Reduction Act of 1984, the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, the Omnibus Budget Reconciliation Act of 1989, and the Energy Policy Act of 1992. Written comments responding to the Notice of Proposed Rulemaking were received. No public hearing was requested and none was held. After consideration of all of the comments regarding the proposed amendments, those amendments are adopted by this Treasury decision with revisions in response to those comments. The significant comments and revisions are described below.

Explanation of Provisions

In response to comments, § 20.2044-1(b), as proposed, has been revised to include a reference to section 6166. Therefore, property included in the surviving spouse's gross estate under section 2044 is treated as passing from such spouse's estate upon such spouse's later death for purposes of determining whether the estate is eligible to pay the estate tax liability in installments under section 6166.

In response to comments, § 20.2044-1(c), as proposed, has been revised to include guidance for taxpayers on the evidence that is required in order to rebut the presumption that property in which the surviving spouse had a qualifying income interest for life was deducted by the first decedent's estate under section 2056(b)(7) or by the donor spouse under section 2523(f) in determining the prior decedent's estate or gift tax liability.

Several changes were made in the final regulations regarding the definition of the term "specific portion" as used in sections 2056(b)(5), 2056(b)(7), 2523(e) and 2523(f). In general, a spousal interest qualifies for the marital deduction under section 2056(b)(5) or section 2523(e) if the spouse receives an income interest with respect to the entire interest in property or a "specific portion" of the entire interest, coupled with a general power of appointment over the entire corpus or a "specific portion" of the entire corpus. Similarly, an interest is eligible for the qualified terminable interest property (QTIP) election under section 2056(b)(7) or section 2523(f) if the spouse receives an income interest in the entire interest or a "specific portion" of the interest. Under §§ 20.2056(b)-5(c) and 25.2523(e)-1(c), in order to constitute a right to income in, or power over, a specific portion of property, the right or power must relate to a fraction or percentage share of the property.

However, in *Northeastern Pennsylvania National Bank and Trust Co. v. United States*, 387 U.S. 213 (1967), the United States Supreme Court held that, for purposes of section 2056(b)(5), a right to receive a specified periodic payment (e.g., \$24,000 per year) from a trust also constitutes a right to receive the income from a specific portion of the trust corpus; i.e., the pecuniary amount of corpus that, based on the assumed rate of return used in the regulations, would generate the periodic payment. In reaching this conclusion, the Court invalidated § 20.2056(b)-5(c) to the extent it precluded characterization of a specific

periodic payment as a right to income from a specific portion of trust corpus.

In *Estate of Alexander v. Commissioner*, 82 T.C. 34 (1984), *aff'd without opinion* (4th Cir. 1985), the Tax Court held that a power of appointment over a pecuniary amount of trust corpus constituted a power of appointment over a "specific portion" of the trust property thus qualifying the property for the marital deduction under section 2056(b)(5). The Tax Court felt compelled to reach this decision in view of the Supreme Court's decision in *Northeastern Pennsylvania National Bank*, which applied the term in the context of the requisite spousal income interest.

The proposed regulations provided amendments to the definition of the term "specific portion" under §§ 20.2056(b)-5(c) and 25.2523(e)-1 with respect to the requisite spousal income interest that conform to the Court's decision in *Northeastern Pennsylvania National Bank*. In addition, §§ 20.2056(b)-7(c) and 25.2523(f)-1(c), and illustrative examples, adopted the *Northeastern Pennsylvania National Bank* rule with respect to interests within the purview of section 2056(b)(7) or section 2523(f).

However, section 1941 of the Energy Policy Act of 1992, Public Law 102-486, amended section 2056(b) and section 2523 (e) and (f) to limit the term "specific portion" such that it references a portion determined only on a fractional or percentage basis. The amendments are generally effective in the case of estates of decedents dying after October 24, 1992 (the date of enactment) and to gifts made after that date, subject to certain transitional rules. The legislative history underlying the amendments provides that no inference should be drawn from the legislation regarding the law prior to enactment. H.R. Rep. No. 1018, 102nd Cong. 2d Sess. 432 (1992).

The definition in the proposed regulations of "specific portion" as a fractional or percentage interest has been adopted. However, for estates coming within the purview of the transitional rule of Public Law 102-486 the definition of specific portion in the final regulations adopts the proposed amendments to §§ 20.2056(b)-5 and 25.2523(e)-1, which reflect the decision in *Northeastern Pennsylvania National Bank*. The corresponding proposed amendments to §§ 20.2056(b)-7 and 25.2523(f)-1 (and pertinent portions of the proposed amendments to §§ 20.2044-1 and 25.2519-1) have also been retained in the final regulations. In addition, the IRS recognizes that *Estate of Alexander* reflects the law prior to

enactment of Public Law 102-486, with respect to interests within the purview of sections 2056(b)(5) and 2523(e) and the final regulations also incorporate this decision, subject to the Public Law 102-486 effective date and transitional rules.

The IRS recognizes that some aspects of the 1992 legislation should be the subject of separate proposed regulations under section 2056(b)(7). For example, the IRS invites comments on the application of the Energy Policy Act of 1992 to the treatment of annuities as described in the last sentence of section 2056(b)(7)(B)(ii). Send comments to: CC:DOM:CORP:T:R, room 5528, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044.

In response to comments, *Example 4* of § 20.2056(b)-5(c)(5) has been revised to eliminate the reference to the office building in the facts. The example, as revised, focuses on the definition of "specific portion" under section 2056(b)(5) and the amount deductible under the facts presented. A similar revision was made to *Example 4* of § 25.2523(e)-1(c)(5) which contains similar facts.

In response to comments, § 20.2056(b)-7(b)(3), as proposed, has been revised to clarify that an executor who is appointed, qualified and acting within the United States, within the meaning of section 2203, is responsible for making the QTIP election, even with respect to property that is not in the executor's possession, such as an inter vivos trust established by the decedent. If there is no executor appointed, the person in actual or constructive possession of the qualifying income interest property may make the election.

Paragraph (c) of § 20.2056(b)-7, has been added, in response to comments, to provide limited circumstances under which a protective QTIP election is recognized for estate tax purposes. In general, the protective election will be recognized only if, at the time the return is filed, a bona fide issue is presented the resolution of which is uncertain at the time the federal estate tax return is filed, that concerns whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive. Because of changes made to Schedule M of Form 706, it was deemed unnecessary to provide for a protective election for a trust that fails to meet the requirements of section 2056(b)(5). The availability of a protective gift tax QTIP election was considered but rejected because of the perceived absence of a need for such an election.

Section 20.2056(b)-7(d)(3) retains the position of the proposed regulations that an income interest does not qualify as a qualifying income interest for life if the income interest is contingent on the executor's election of QTIP treatment; for example, if the spouse is entitled to trust income only if the executor makes the QTIP election with respect to the trust. This issue has been the subject of recent litigation. Although the Tax Court has agreed with the position of the proposed regulations, the Eighth Circuit and the Fifth Circuit have reversed the Tax Court on this issue. *Estate of Robertson v. Commissioner*, No. 93-2488 (8th Cir. February 4, 1994), *rev'g* 98 T.C. 678 (1992); *Estate of Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992), *rev'g* 97 T.C. 327 (1991). See also, *Estate of Spencer v. Commissioner*, T.C. Memo 1992-579, *appeal docketed*, No. 93-1997 (6th Cir. July 26, 1993). In *Estate of Robertson* and *Estate of Clayton*, the appellate courts found that under section 2056(b)(7)(B), qualified terminable interest property is defined *inter alia* as property for which an election is made. Thus, qualification of property as qualified terminable interest property is always contingent on the executor's election. Qualification for the marital deduction is determined as of the time of death. The IRS continues to believe, consistent with the conclusion reached by the Tax Court, that if the substantive rights and interests the spouse receives in trust property are dependent on the executor's post-death exercise of discretionary authority, the rights and interests received by the spouse cannot properly be characterized as qualifying as of the time of death, nor can the rights and interests received by the spouse be characterized as passing from the decedent to the spouse, as required under section 2056(a). The appellate courts take the position that the statutory language supports the allowance of the marital deduction if the receipt of the requisite substantive rights and interests is contingent on making the election. This is inconsistent with the fundamental principle that qualification of an interest in property for the marital deduction is determined as of the date of death. Accordingly, the Service believes that the statute does not authorize a grant of discretion to the executor to create substantive rights in the spouse, and the final regulations reflect this position.

Example (14) of § 20.2056(b)-7(e), as proposed, has not been adopted. This example illustrated that an annuity purchased by an executor pursuant to a directive of the decedent qualifies as

qualified terminable interest property under section 2056(b)(7). The example was in conflict with section 2056(b)(1)(C), which provides that a marital deduction is not allowed with respect to any terminable interest (i.e., any interest that will terminate or fail on the occurrence of a specified event, or due to lapse of time) if the interest is to be acquired by the executor for the surviving spouse pursuant to the directions of the decedent (e.g., a will direction to purchase an annuity for the spouse.) Section 2056(b)(7), which provides an exception allowing a deduction for terminable interests described in section 2056(b)(1)(A), does not provide an exception for interests described in section 2056(b)(1)(C). Section 20.2056(b)-7(c) of the final regulations reflects this fact.

Section 2056(b)(7)(C), added to the Code by the Technical and Miscellaneous Revenue Act of 1988, and amended by the Omnibus Budget Reconciliation Act of 1989, provides for an automatic section 2056(b)(7) election (and deduction) in the case of an annuity includible in the decedent's gross estate under section 2039, where only the surviving spouse has the right to receive payments before the death of the surviving spouse. With respect to the gift tax, the qualification of a spouse's interest in a joint and survivor annuity that is the subject of a gift under section 2511 is now governed by section 2523(f)(6), also added by TAMRA in 1988. This section provides for an automatic election if only the donor and the donor's spouse have a right to receive payments prior to the death of the last spouse to die. Rules governing the application of section 2056(b)(7)(C), as well as section 2523(f)(6), will be prescribed under regulations to be proposed under those sections at a later date.

Example 10 of § 20.2056(b)-7(e), as proposed, considered the treatment of a spousal annuity payable from a decedent's individual retirement account. In response to comments, this example has been retained as an illustration of an interest that qualifies as a qualifying income interest for life under section 2056(b)(7)(B)(ii), without regard to section 2056(b)(7)(C). However, the IRS recognizes that the arrangement described in the example may also qualify, at least in part, for the automatic election and deduction under section 2056(b)(7)(C), and this question will be considered in regulations to be proposed under that section at a later date.

Section 20.2056(b)-7(b), as proposed, provided that a marital trust that qualifies under section 2056(b)(7) may

be divided into separate trusts to reflect a partial election with respect to the trust. This provision has been clarified to specify that the severance of the trust must occur no later than the termination of the period of estate administration. Further, the provision has been clarified to indicate that although the severed trusts must be funded based on fair market values on the date of division, the trusts need not be funded with a pro rata portion of each asset. Example 4 of § 20.2056(b)-7(h) has been added to illustrate this provision.

Section 20.2056(b)-8, as proposed, has been revised to provide that a charitable remainder trust described in section 664 may qualify for a marital deduction under section 2056(b)(7) in situations where the surviving spouse is not the only noncharitable beneficiary of the charitable remainder trust (e.g., where the trust provides for a successive life beneficiary on the spouse's death). However, in view of the enactment of section 1941 of The Energy Policy Act of 1992 (discussed above), this provision is limited in application to those estates not subject to the 1992 amendments to the Code. A similar change (with similar limitations) was made to § 25.2523(g)-1, as proposed, providing that a charitable remainder trust in which the donor's spouse is a noncharitable beneficiary can qualify as qualified terminable interest property under section 2523(f), even if the trust fails to qualify under section 2523(g) (because, for example, the donor and the donor's spouse are not the only noncharitable beneficiaries of the trust.)

The IRS requests comments on whether the unitrust or annuity interest in a charitable remainder trust described in sections 664(d)(1) or (d)(2) qualifies as a qualifying income interest for life in view of the 1992 amendments. See, e.g., the last sentence of section 2056(b)(7)(B)(ii).

Sections 20.2056(b)-9 and 25.2523(h)-1 have been added to reflect the addition of sections 2056(b)(9) and 2523(h) (denial of double deduction) to the Code by the Technical Corrections Act of 1982.

Sections 20.2056(c)-1A and 20.2056(c)-2A, as proposed, have not been adopted by the final regulations. These sections contained comprehensive rules for computing the amount of the allowable estate tax marital deduction in the case of estates of decedents dying in 1977 through 1981. In general, the allowable marital deduction applicable to these estates was limited in amount to the greater of \$250,000 or one-half of the adjusted gross estate. The section, as proposed, also contained rules promulgated under

the transitional rules accompanying section 2002(d)(1) of the Tax Reform Act of 1976 (which increased the limitation on the allowable marital deduction to the greater of \$250,000 or one-half of the adjusted gross estate), and the transitional rule under section 403(e) of the Economic Recovery Tax Act of 1981 (which enacted the unlimited marital deduction).

In general, the comprehensive rules discussing the computation of the amount of the marital deduction under the statutory changes enacted in 1976 will only apply to the estates of decedents who died in 1977 through 1981 and, in some cases, estates of decedents dying after 1981 if the decedent's will was executed prior to 1982. In view of the limited continuing applicability of these rules, they have not been adopted by the final regulations. Similarly, the transitional rules primarily involved estates of decedents dying after 1981 under wills or other testamentary instruments executed prior to 1982. Many of the issues involving the application of these transitional rules have been settled by litigation. See, e.g., *Estate of Niesen v. Commissioner*, 865 F.2d 162 (8th Cir. 1988); *Estate of Levitt v. Commissioner*, 95 T.C. 289 (1990); *Estate of Christmas v. Commissioner*, 91 T.C. 769 (1988). Accordingly, the proposed regulations discussing these rules have also not been adopted. A short reference to these rules has been added to § 20.2056(a)-1 of the regulations.

Section 22.2056-1 is removed, since this temporary regulation (which considered the requirements for a partial QTIP election) has been incorporated into the final regulations contained in this document.

Section 25.2519-1(c), as proposed, discussed the amount of the gift under section 2519 if the surviving spouse transfers all or a part of the spouse's income interest in property subject to a QTIP election under either section 2056(b)(7) or section 2523(f). Under section 2207A(b), the spouse has a right to recover from the persons receiving the transferred property any gift tax imposed on the transfer. Section 25.2519-1(a), as proposed, provided that in determining the amount of the gift under section 2519, the value of the transfer is reduced by the amount of the gift tax reimbursement. That is, the section 2519 gift was proposed to be treated as a "net gift." See, e.g., Rev. Rul. 75-72, 1975-1 C.B. 310. However, the section 2207A(b) reimbursement provision could be viewed as shifting the liability for the gift tax imposed on the transfer to the persons receiving the property. Arguably, payment by those

persons of a gift tax for which they are liable under the statute should not reduce the amount of the transfer for gift tax purposes, or otherwise result in net gift treatment. See, e.g., Rev. Rul. 80-111, 1980-1 C.B. 208. Accordingly, the reference in § 25.2519-1(c), treating the transfer as a net gift, has been deleted. The IRS anticipates that the issue regarding net gift treatment will be the subject of subsequent proposed regulations and specifically requests comments on this issue.

Section 25.2519-1(a) and Examples 4 and 5 of § 25.2519-1(g) have been revised to reflect the application of section 2702 as added to the Code by the Revenue Reconciliation Act of 1990.

Section 25.2523(f)-1(b)(4), as proposed, discussed the manner and time for making the gift tax qualified terminable interest property election. That section has been revised in the final regulations in order to reflect the changes made to section 2523(f)(4)(A) by the Tax Reform Act of 1986. Under section 2523(f)(4)(A), as amended, the gift tax election is to be made on or before the date prescribed by section 6075(b) for filing a gift tax return (including extensions authorized under section 6075(b)(2), relating to automatic extensions of time for filing a gift tax return where the taxpayer is granted an extension of time to file the income tax return.) The section, as proposed, has also been revised to permit QTIP elections to be made on returns for which extensions have been granted pursuant to section 6081(a) of the Code.

Comments have been received suggesting that an inter vivos transfer in trust where the donor retains an income interest and the spouse receives the right to trust income on the termination of the donor's preceding life income interest should qualify as qualified terminable interest property under section 2523(f). These comments were rejected. In general, the statute requires that the spouse must be entitled to receive the trust income for the spouse's life. An income interest that commences at some time in the future, if the spouse survives until that time, is not payable to the spouse for life as required by the statute. Further, if such an interest were allowed to qualify under section 2523(f), it is problematical whether, in the event the donee spouse predeceased the donor spouse, the IRS could sustain inclusion of the trust corpus in the gross estate of the donee spouse under section 2044 (or sustain treating the assignment of the spouse's interest as a disposition under section 2519), since, as noted above, it is questionable whether such an interest constitutes a qualifying income interest for life. Accordingly, § 25.2523(f)-1(c)(2)

has been added to clarify that, in order to constitute a qualifying income interest for life, the spouse must receive the immediate right to receive the income from the property.

Examples 9, 10, and 11 of § 25.2523(f)-1(f) have been added, illustrating the application of section 2523(f)(5) and § 25.2523(f)-1(d). Under these sections, where the donor spouse retains an interest in a trust subject to a section 2523(f) QTIP election (e.g., the trust provides an income interest to the spouse for life, then to the donor for life, with remainder to children), the trust corpus is not subject to inclusion in the donor's gross estate under section 2036 (by virtue of the retained life estate) if the donor predeceases the spouse. Further, any transfer of the retained interest during the donor's lifetime prior to the death of the donee spouse is not subject to gift tax. However, under section 2523(f)(5)(B), this exclusion rule does not apply if, prior to the donor's death (or the transfer of the interest), the property is included in the donee spouse's gross estate under section 2044 or is treated as a gift by the donee spouse under section 2519. The examples clarify, *inter alia*, that if the property is included in the donee spouse's gross estate (or is subject to a gift tax under section 2519), the donee spouse is treated as the transferor of the property for estate and gift tax purposes. Accordingly, on the subsequent death of the donor spouse, the donor is not treated as the transferor of the property in which the donor possesses an income interest. In such circumstances, notwithstanding section 2523(f)(5)(B), the property is not includible in the donor's gross estate under section 2036. However, the property could be subject to inclusion in the donor's gross estate under another applicable section of the Code, the application of which is not dependent on the donor's status as a transferor of the property. For example, if the donee spouse's estate made an election under section 2056(b)(7) with respect to the property, then the property would be includible in the donor spouse's gross estate under section 2044 (a so-called lifetime reverse QTIP trust).

Sections 20.2056(a)-1(a), 20.2056(b)-7(e), 25.2523(a)-1(a), 25.2523(a)-1(c) and 25.6019-1, as proposed, have been revised to refer to the changes made by the Technical and Miscellaneous Revenue Act of 1988 and the Omnibus Budget Reconciliation Act of 1989, in regard to the availability of the estate tax marital deduction where the surviving spouse is not a United States citizen and the gift tax marital deduction where the

donee spouse is not a United States citizen.

Several minor clarifying amendments have been made to the text and the examples in the proposed regulations to better describe the intent and scope of those provisions.

Effective Dates

Except as specifically provided in §§ 20.2044-2, 20.2056(b)-5(c)(3)(ii) and (iii), 20.2056(b)-7(e)(5), 20.2056(b)-8(b), 25.2519-2, 25.2523(e)-1(c)(3), 25.2523(f)-1(c)(3) and 25.2523(g)-1(b), these regulations are effective in the case of estates of decedents dying after March 1, 1994, and to gifts made after that date. With respect to estates of decedents dying on or before March 1, 1994, or gifts made on or before that date, taxpayers may rely on any reasonable interpretation of the statutory provisions. For this purpose, the proposed regulations published in the Federal Register on May 21, 1984 (49 FR 21350) are considered a reasonable interpretation of the statutory provisions.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required.

Drafting Information

The principal author of these regulations is Susan Hurwitz of the Office of Chief Counsel, Internal Revenue Service. Other personnel from the IRS and Treasury Department participated in developing these regulations.

List of Subjects

26 CFR Part 20

Estate tax, Reporting and recordkeeping requirements.

26 CFR Part 22

Estate tax, Reporting and recordkeeping requirements.

26 CFR Part 25

Gift taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 20, 22, 25, and 602 are amended as follows:

PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Paragraph 1. The authority citation for part 20 is revised to read as follows:

Authority: 26 U.S.C. 7805.

Section 20.2031-7 also issued under 26 U.S.C. 170(f)(4) and 26 U.S.C. 642(c)(5).

Section 20.2031-10 also issued under 26 U.S.C. 170(f)(4) and 26 U.S.C. 642(c)(5).

Section 20.2032-1 also issued under 26 U.S.C. 170(f)(4) and 26 U.S.C. 642(c)(5).

Section 20.2055-2 also issued under 26 U.S.C. 170(f)(4) and 26 U.S.C. 642(c)(5).

Section 20.2204-1 also issued under 26 U.S.C. 6324A(a).

Section 20.2204-3 also issued under 26 U.S.C. 6324A(a).

Section 20.6324A-1 also issued under 26 U.S.C. 6324A(a).

Section 20.6324B-1 also issued under 26 U.S.C. 6324B.

Par. 1a. The authority citations immediately following §§ 20.2031-7, 20.2031-10, 20.2032-1, 20.2055-2, 20.2204-1, 20.2204-3, 20.6324A-1 and 20.6324B-1 are removed.

§ 20.0-1 [Amended]

Par. 2. In § 20.0-1(b)(1), the last sentence is amended by removing the reference "20.2056(e)-3" and adding "20.2056(d)-1" in its place.

Par. 3. Section 20.2012-1 is amended as follows:

a. In paragraph (a), the first sentence is revised to read as set forth below.

b. In paragraph (d)(2)(ii), the fourth and fifth sentences are removed.

c. Paragraph (d)(3) is removed.

§ 20.2012-1 Credit for gift tax.

(a) *In general.* With respect to gifts made before 1977, a credit is allowed under section 2012 against the Federal estate tax for gift tax paid under chapter 12 of the Internal Revenue Code, or corresponding provisions of prior law, on a gift by the decedent of property subsequently included in the decedent's gross estate. * * *

Par. 4. Section 20.2013-4, paragraph (b)(3)(ii) is amended by removing the second sentence.

Par. 5. Section 20.2014-3 is amended as follows:

a. The concluding text of paragraph (b) immediately following paragraph

(b)(2) is revised to read as set forth below.

b. Paragraph (c), *Example (3)(ii)*, second sentence, is revised to read as set forth below.

§ 20.2014-3 Second limitation.

* * *

(b) * * *

Any reduction described in paragraph (b)(1) or (b)(2) of this section on account of the marital deduction must proportionately take into account, if applicable, the limitation on the aggregate amount of the marital deduction contained in § 20.2056(a)-1(c). See § 20.2014-3(c), *Example 3*.

(c) * * *

Example 3. * * *

(ii) * * * Assume that the limitation imposed by section 2056(c), as in effect before 1982, is applicable so that the aggregate allowable marital deduction is limited to one-half the adjusted gross estate, or \$400,000 (which is 50 percent of \$800,000). * * *

* * *

Par. 6. Section 20.2044-1 is redesignated § 20.2045-1 and new §§ 20.2044-1 and 20.2044-2 are added to read as follows:

§ 20.2044-1 Certain property for which marital deduction was previously allowed.

(a) *In general.* Section 2044 generally provides for the inclusion in the gross estate of property in which the decedent had a qualifying income interest for life and for which a deduction was allowed under section 2056(b)(7) or 2523(f). The value of the property included in the gross estate under section 2044 is not reduced by the amount of any section 2503(b) exclusion that applied to the transfer creating the interest. See section 2207A, regarding the right of recovery against the persons receiving the property that is applicable in certain cases.

(b) *Passed from.* For purposes of section 1014 and chapters 11 and 13 of subtitle B of the Internal Revenue Code, property included in a decedent's gross estate under section 2044 is considered to have been acquired from or to have passed from the decedent to the person receiving the property upon the decedent's death. Thus, for example, the property is treated as passing from the decedent for purposes of determining the availability of the charitable deduction under section 2055, the marital deduction under section 2056, and special use valuation under section 2032A. In addition, the tax imposed on property includible under section 2044 is eligible for the installment payment of estate tax under section 6166.

(c) *Presumption.* Unless established to the contrary, section 2044 applies to the entire value of the trust at the surviving spouse's death. If a marital deduction is taken on either the estate or gift tax return with respect to the transfer which created the qualifying income interest, it is presumed that the deduction was allowed for purposes of section 2044. To avoid the inclusion of property in the decedent-spouse's gross estate under this section, the executor of the spouse's estate must establish that a deduction was not taken for the transfer which created the qualifying income interest. For example, to establish that a deduction was not taken, the executor may produce a copy of the estate or gift tax return filed with respect to the transfer by the first spouse or the first spouse's estate establishing that no deduction was taken under section 2523(f) or section 2056(b)(7). In addition, the executor may establish that no return was filed on the original transfer by the decedent because the value of the first spouse's gross estate was below the threshold requirement for filing under section 6018. Similarly, the executor could establish that the transfer creating the decedent's qualifying income interest for life was made before the effective date of section 2056(b)(7) or section 2523(f).

(d) *Amount included—(1) In general.* The amount included under this section is the value of the entire interest in which the decedent had a qualifying income interest for life, determined as of the date of the decedent's death (or the alternate valuation date, if applicable). If, in connection with the transfer of property that created the decedent's qualifying income interest for life, a deduction was allowed under section 2056(b)(7) or section 2523(f) for less than the entire interest in the property (i.e., for a fractional or percentage share of the entire interest in the transferred property), the amount includible in the decedent's gross estate under this section is equal to the fair market value of the entire interest in the property on the date of the decedent's death (or the alternate valuation date, if applicable) multiplied by the fractional or percentage share of the interest for which the deduction was taken.

(2) *Inclusion of income.* If any income from the property for the period between the date of the transfer creating the decedent-spouse's interest and the date of the decedent-spouse's death has not been distributed before the decedent-spouse's death, the undistributed income is included in the decedent-spouse's gross estate under this section to the extent that the income is not so included under any

other section of the Internal Revenue Code.

(3) *Reduction of includible share in certain cases.* If only a fractional or percentage share is includible under this section, the includible share is appropriately reduced if—

(i) The decedent-spouse's interest was in a trust and distributions of principal were made to the spouse during the spouse's lifetime;

(ii) The trust provides that the distributions are to be made from the qualified terminable interest share of the trust; and

(iii) The executor of the decedent-spouse's estate can establish the reduction in that share based on the fair market value of the trust assets at the time of each distribution.

(4) *Interest in previously severed trust.* If the decedent-spouse's interest was in a trust consisting of only qualified terminable interest property and the trust was severed (in compliance with § 20.2056(b)-7(b) or § 25.2523(f)-1(b) of this chapter) from a trust that, after the severance, held only property that was not qualified terminable interest property, only the value of the property in the severed portion of the trust is includible in the decedent-spouse's gross estate.

(e) *Examples.* The following examples illustrate the principles in paragraphs (a) through (d) of this section, where the decedent, D, was survived by spouse, S.

Example 1. Inclusion of trust subject to election. Under D's will, assets valued at \$800,000 in D's gross estate (net of debts, expenses and other charges, including death taxes, payable from the property) passed in trust with income payable to S for life. Upon S's death, the trust principal is to be distributed to D's children. D's executor elected under section 2056(b)(7) to treat the entire trust property as qualified terminable interest property and claimed a marital deduction of \$800,000. S made no disposition of the income interest during S's lifetime under section 2519. On the date of S's death, the fair market value of the trust property was \$740,000. S's executor did not elect the alternate valuation date. The amount included in S's gross estate pursuant to section 2044 is \$740,000.

Example 2. Inclusion of trust subject to partial election. The facts are the same as in Example 1, except that D's executor elected under section 2056(b)(7) with respect to only 50 percent of the value of the trust (\$400,000). Consequently, only the equivalent portion of the trust is included in S's gross estate; i.e., \$370,000 (50 percent of \$740,000).

Example 3. Spouse receives qualifying income interest in a fraction of trust income. Under D's will, assets valued at \$800,000 in D's gross estate (net of debts, expenses and other charges, including death taxes, payable from the property) passed in trust with 20 percent of the trust income payable to S for

S's life. The will provides that the trust principal is to be distributed to D's children upon S's death. D's executor elected to deduct, pursuant to section 2056(b)(7), 50 percent of the amount for which the election could be made; i.e., \$80,000 (50 percent of 20 percent of \$800,000). Consequently, on the death of S, only the equivalent portion of the trust is included in S's gross estate; i.e., \$74,000 (50 percent of 20 percent of \$740,000).

Example 4. Distribution of corpus during spouse's lifetime. The facts are the same as in Example 3, except that S was entitled to receive all the trust income but the executor of D's estate elected under section 2056(b)(7) with respect to only 50 percent of the value of the trust (\$400,000). Pursuant to authority in the will, the trustee made a discretionary distribution of \$100,000 of principal to S in 1995 and charged the entire distribution to the qualified terminable interest share. Immediately prior to the distribution, the fair market value of the trust property was \$1,100,000 and the qualified terminable interest portion of the trust was 50 percent. Immediately after the distribution, the qualified terminable interest portion of the trust was 45 percent (\$450,000 divided by \$1,000,000). Provided S's executor can establish the relevant facts, the amount included in S's gross estate is \$333,000 (45 percent of \$740,000).

Example 5. Spouse assigns a portion of income interest during life. Under D's will, assets valued at \$800,000 in D's gross estate (net of debts, expenses and other charges, including death taxes, payable from the property) passed in trust with all the income payable to S, for S's life. The will provides that the trust principal is to be distributed to D's children upon S's death. D's executor elected under section 2056(b)(7) to treat the entire trust property as qualified terminable interest property and claimed a marital deduction of \$800,000. During the term of the trust, S transfers to C the right to 40 percent of the income from the trust for S's life. Because S is treated as transferring the entire remainder interest in the trust corpus under section 2519 (as well as 40 percent of the income interest under section 2511), no part of the trust is includible in S's gross estate under section 2044. However, if S retains until death an income interest in 60 percent of the trust corpus (which corpus is treated pursuant to section 2519 as having been transferred by S for both gift and estate tax purposes), 60 percent of the property will be includible in S's gross estate under section 2036(a) and a corresponding adjustment is made in S's adjusted taxable gifts.

Example 6. Inter vivos trust subject to election under section 2523(f). D transferred \$800,000 to a trust providing that trust income is to be paid annually to S, for S's life. The trust provides that upon S's death, \$100,000 of principal is to be paid to X charity and the remaining principal distributed to D's children. D elected to treat all of the property transferred to the trust as qualified terminable interest property under section 2523(f). At the time of S's death, the fair market value of the trust is \$1,000,000. S's executor does not elect the alternate valuation date. The amount included in S's

gross estate is \$1,000,000; i.e., the fair market value at S's death of the entire trust property. The \$100,000 that passes to X charity on S's death is treated as a transfer by S to X charity for purposes of section 2055. Therefore, S's estate is allowed a charitable deduction for the \$100,000 transferred from the trust to the charity to the same extent that a deduction would be allowed by section 2055 for a bequest by S to X charity.

Example 7. Spousal interest in the form of an annuity. D died prior to October 24, 1992, the effective date of the Energy Policy Act of 1992 (Pub. L. 102-486). See § 20.2056(b)-7(e). Under D's will, assets valued at \$500,000 in D's gross estate (net of debts, expenses and other charges, including death taxes, payable from the property) passed in trust pursuant to which an annuity of \$20,000 a year was payable to S for S's life. Trust income not paid to S as an annuity is to be accumulated in the trust and may not be distributed during S's lifetime. D's estate deducted \$200,000 under section 2056(b)(7) and § 20.2056(b)-7(e)(2). S did not assign any portion of S's interest during S's life. At the time of S's death, the value of the trust property is \$800,000. S's executor does not elect the alternate valuation date. The amount included in S's gross estate pursuant to section 2044 is \$320,000 $(\$200,000 / \$500,000) \times \$800,000$.

§ 20.2044-2 Effective dates.

Except as specifically provided in Example 7 of § 20.2044-1(e), the provisions of § 20.2044-1 are effective with respect to estates of a decedent-spouse dying after March 1, 1994. With respect to estates of decedent-spouses dying on or before such date, taxpayers may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of § 20.2044-1 (as well as project LR-211-76, 1984-1 C.B., page 598, see § 601.601(d)(2)(ii)(b) of this chapter), are considered a reasonable interpretation of the statutory provisions.

Par. 7. Section 20.2055-6 is added to read as follows:

§ 20.2055-6 Disallowance of double deduction in the case of qualified terminable interest property.

No deduction is allowed from the decedent's gross estate under section 2055 for property with respect to which a deduction is allowed by reason of section 2056(b)(7). See section 2056(b)(9) and § 20.2056(b)-9.

Par. 8. Section 20.2056-0 is added to read as follows:

§ 20.2056-0 Table of contents.

This section lists the captions that appear in the regulations under §§ 20.2056(a)-1 through 20.2056(d)-2.

§ 20.2056(a)-1 Marital deduction; in general.

(a) In general.

(b) Requirements for marital deduction.

- (1) In general.
- (2) Burden of establishing requisite facts.

(c) Marital deduction; limitation on aggregate deductions.

- (1) Estates of decedents dying before 1977.
- (2) Estates of decedents dying after December 31, 1976, and before January 1, 1982.
- (3) Estates of decedents dying after December 31, 1981.

§ 20.2056(a)-2 Marital deduction; deductible interests and nondeductible interests.

- (a) In general.
- (b) Deductible interests.

§ 20.2056(b)-1 Marital deduction; limitation in case of life estate or other "terminable interest."

- (a) In general.
- (b) Terminable interests.
- (c) Nondeductible terminable interests.
- (d) Exceptions.
- (e) Miscellaneous principles.
- (f) Direction to acquire a terminable interest.
- (g) Examples.

§ 20.2056(b)-2 Marital deduction; interest in unidentified assets.

- (a) In general.
- (b) Application of section 2056(b)(2).
- (c) Interest nondeductible if circumstances present.
- (d) Example.

§ 20.2056(b)-3 Marital deduction; interest of spouse conditioned on survival for limited period.

- (a) In general.
- (b) Six months' survival.
- (c) Common disaster.
- (d) Examples.

§ 20.2056(b)-4 Marital deduction; valuation of interest passing to surviving spouse.

- (a) In general.
- (b) Property interest subject to an encumbrance or obligation.
- (c) Effect of death taxes.
- (d) Remainder interests.

§ 20.2056(b)-5 Marital deduction; life estate with power of appointment in surviving spouse.

- (a) In general.
- (b) Specific portion; deductible amount.
- (c) Meaning of specific portion.
- (1) In general.
- (2) Fraction or percentage share.
- (3) Special rule in the case of estates of decedents dying on or before October 24, 1992, and certain decedents dying after October 24, 1992, with wills or

revocable trusts executed on or prior to that date.

- (4) Local law.
- (5) Examples.
- (d) Meaning of entire interest.
- (e) Application of local law.
- (f) Right to income.
- (g) Power of appointment in surviving spouse.
- (h) Requirement of survival for a limited period.
- (i) Existence of power in another.

§ 20.2056(b)-6 Marital deduction; life insurance or annuity payments with power of appointment in surviving spouse.

- (a) In general.
- (b) Specific portion; deductible interest.
- (c) Applicable principles.
- (d) Payments of installments or interest.
- (e) Powers of appointment.

§ 20.2056(b)-7 Election with respect to life estate for surviving spouse.

- (a) In general.
- (b) Qualified terminable interest property.
- (1) In general.
- (2) Property for which an election may be made.
- (3) Persons permitted to make the election.
- (4) Manner and time of making the election.
- (c) Protective elections.
- (1) In general.
- (2) Protective election irrevocable.
- (d) Qualifying income interest for life.
- (1) In general.
- (2) Entitled for life to all income.
- (3) Contingent income interests.
- (4) Income between last distribution date and spouse's date of death.
- (5) Pooled income funds.
- (6) Power to distribute principal to spouse.
- (e) Annuities payable from trusts in the case of estates of decedents dying on or before October 24, 1992, and certain decedents dying after October 24, 1992, with wills or revocable trusts executed on or prior to that date.

(1) In general.

- (2) Deductible interest.
- (3) Distributions permissible only to surviving spouse.
- (4) Applicable interest rate.
- (5) Effective dates.
- (f) Joint and survivor annuities.

[Reserved]

§ 20.2056(b)-8 Special rule for charitable remainder trusts.

- (a) In general.
- (1) Surviving spouse only noncharitable beneficiary.

- (2) Interest for life or term of years.
- (3) Payment of state death taxes.
- (b) Charitable trusts where surviving spouse is not the only noncharitable beneficiary.

§ 20.2056(b)-9 Denial of double deduction.

§ 20.2056(b)-10 Effective dates.

§ 20.2056(c)-1 Marital deduction; definition of passed from the decedent.

- (a) In general.
- (b) Expectant interest in property under community property laws.

§ 20.2056(c)-2 Marital deduction; definition of "passed from the decedent to his surviving spouse."

- (a) In general.
- (b) Examples.
- (c) Effect of election by surviving spouse.
- (d) Will contests.
- (e) Survivorship.

§ 20.2056(c)-3 Marital deduction; definition of passed from the decedent to a person other than his surviving spouse.

§ 20.2056(d)-1 Marital deduction; effect of disclaimers of post-December 31, 1976 transfers.

- (a) Disclaimer by a surviving spouse.
- (b) Disclaimer by a person other than a surviving spouse.

§ 20.2056(d)-2 Marital deduction; effect of disclaimers of pre-January 1, 1977 transfers.

- (a) Disclaimers by a surviving spouse.
- (b) Disclaimer by a person other than a surviving spouse.
- (1) Decedents dying after October 3, 1966, and before January 1, 1977.
- (2) Decedents dying after September 30, 1963, and before October 4, 1966.
- (3) Decedents dying before October 4, 1966.

Par. 9. Section 20.2056(a)-1 is revised to read as follows:

§ 20.2056(a)-1 Marital deduction; in general.

(a) *In general.* A deduction is allowed under section 2056 from the gross estate of a decedent for the value of any property interest which passes from the decedent to the decedent's surviving spouse if the interest is a *deductible interest* as defined in § 20.2056(a)-2. With respect to decedents dying in certain years, a deduction is allowed under section 2056 only to the extent that the total of the deductible interests does not exceed the applicable limitations set forth in paragraph (c) of this section. The deduction allowed under section 2056 is referred to as the *marital deduction*. See also sections 2056(d) and 2056A for special rules applicable in the case of decedents

dying after November 10, 1988, if the decedent's surviving spouse is not a citizen of the United States at the time of the decedent's death. In such cases, the marital deduction may not be allowed unless the property passes to a qualified domestic trust as described in section 2056A(a).

(b) *Requirements for marital deduction*—(1) *In general*. To obtain the marital deduction with respect to any property interest, the executor must establish the following facts—

(i) The decedent was survived by a spouse (see § 20.2056(c)-2(e));

(ii) The property interest passed from the decedent to the spouse (see §§ 20.2056(b)-5 through 20.2056(b)-8 and 20.2056(c)-1 through 20.2056(c)-3);

(iii) The property interest is a deductible interest (see § 20.2056(a)-2); and

(iv) The value of the property interest (see § 20.2056(b)-4).

(2) *Burden of establishing requisite facts*. The executor must provide the facts relating to any applicable limitation on the amount of the allowable marital deduction under § 20.2056(a)-1(c), and must submit proof necessary to establish any fact required under paragraph (b)(1), including any evidence requested by the district director.

(c) *Marital deduction; limitation on aggregate deductions*—(1) *Estates of decedents dying before 1977*. In the case of estates of decedents dying before January 1, 1977, the marital deduction is limited to one-half of the value of the adjusted gross estate, as that term was defined under section 2056(c)(2) prior to repeal by the Economic Recovery Tax Act of 1981.

(2) *Estates of decedents dying after December 31, 1976, and before January 1, 1982*—Except as provided in § 2002(d)(1) of the Tax Reform Act of 1976 (Pub. L. 94-455), in the case of decedents dying after December 31, 1976, and before January 1, 1982, the marital deduction is limited to the greater of—

(i) \$250,000; or

(ii) One-half of the value of the decedent's adjusted gross estate, adjusted for inter vivos gifts to the spouse as prescribed by section 2056(c)(1)(B) prior to repeal by the Economic Recovery Tax Act of 1981 (Pub. L. 97-34).

(3) *Estates of decedents dying after December 31, 1981*. In the case of estates of decedents dying after December 31, 1981, the marital deduction is limited as prescribed in paragraph (c)(2) of this section if the provisions of § 403(e)(3) of Pub. L. 97-34 are satisfied.

Par. 10. Section 20.2056(a)-2 is amended as follows:

a. In paragraph (a), a paragraph heading is added and the last sentence is revised.

b. In paragraph (b), a paragraph heading is added.

c. The additions and revisions read as follows:

§ 20.2056(a)-2 Marital deduction; deductible interests and nondeductible interests.

(a) *In general*. * * * Subject to any applicable limitations set forth in § 20.2056(a)-1(c), the amount of the marital deduction is the aggregate value of the deductible interests.

(b) *Deductible interests*. * * *

Par. 11. Section 20.2056(b)-1 is amended as follows:

a. Paragraphs (d)(2) and (d)(3) are revised.

b. Paragraphs (d)(4) and (d)(5) are added.

c. Paragraph (e)(4) is revised.

d. In paragraph (g), the introductory text is revised.

e. The revisions and additions read as follows:

§ 20.2056(b)-1 Marital deduction; limitation in case of life estate or other terminable interest.

* * * * *

(d) * * *

(2) It is a right to income for life with a general power of appointment, meeting the requirements set forth in § 20.2056(b)-5;

(3) It consists of life insurance or annuity payments held by the insurer with a general power of appointment in the spouse, meeting the requirements set forth in § 20.2056(b)-6;

(4) It is qualified terminable interest property, meeting the requirements set forth in § 20.2056(b)-7; or

(5) It is an interest in a qualified charitable remainder trust in which the spouse is the only noncharitable beneficiary, meeting the requirements set forth in § 20.2056(b)-8.

(e) * * *

(4) The terms *passed from the decedent*, *passed from the decedent to his surviving spouse* and *passed from the decedent to a person other than his surviving spouse* are defined in §§ 20.2056(c)-1 through 20.2056(c)-3.

* * * * *

(g) *Examples*. The application of this section may be illustrated by the following examples. In each example, it is assumed that the executor made no election under section 2056(b)(7) (even if under the specific facts the election would have been available), that any

property interest passing from the decedent to a person other than the surviving spouse passed for less than full and adequate consideration in money or money's worth, and that section 2056(b)(8) is inapplicable.

* * * * *

Par. 12. In § 20.2056(b)-2, headings are added to paragraphs (a) through (d) to read as follows:

§ 20.2056(b)-2 Marital deduction; interest in unidentified assets.

(a) *In general*. * * *

(b) *Application of section 2056(b)(2)*.

* * * * *

(c) *Interest nondeductible if circumstances present*. * * *

(d) *Example*. * * *

* * * * *

§ 20.2056(b)-4 [Amended]

Par. 13. In § 20.2056(b)-4, paragraph (b) is amended by removing the fifth sentence.

Par. 14. Section 20.2056(b)-5 is amended as follows:

a. Paragraph (c) is revised to read as set forth below.

b. The heading and first sentence of paragraph (d) are revised to read as set forth below.

§ 20.2056(b)-5 Marital deduction; life estate with power of appointment in surviving spouse.

* * * * *

(c) *Meaning of specific portion*—(1) *In general*. Except as provided in paragraphs (c)(2) and (c)(3) of this section, a partial interest in property is not treated as a specific portion of the entire interest. In addition, any specific portion of an entire interest in property is nondeductible to the extent the specific portion is subject to invasion for the benefit of any person other than the surviving spouse, except in the case of a deduction allowable under section 2056(b)(5), relating to the exercise of a general power of appointment by the surviving spouse.

(2) *Fraction or percentage share*. Under section 2056(b)(10), a partial interest in property is treated as a specific portion of the entire interest if the rights of the surviving spouse in income, and the required rights as to the power described in § 20.2056(b)-5(a), constitute a fractional or percentage share of the entire property interest, so that the surviving spouse's interest reflects its proportionate share of the increase or decrease in the value of the entire property interest to which the income rights and the power relate. Thus, if the spouse's right to income and the spouse's power extend to a

specified fraction or percentage of the property, or the equivalent, the interest is in a specific portion of the property. In accordance with paragraph (b) of this section, if the spouse has the right to receive the income from a specific portion of the trust property (after applying paragraph (c)(3) of this section) but has a power of appointment over a different specific portion of the property (after applying paragraph (c)(3) of this section), the marital deduction is limited to the lesser specific portion.

(3) *Special rule in the case of estates of decedents dying on or before October 24, 1992, and certain decedents dying after October 24, 1992, with wills or revocable trusts executed on or prior to that date.*

(i) In the case of estates of decedents within the purview of the effective date and transitional rules contained in paragraphs (c)(3) (ii) and (iii) of this section:

(A) A specific sum payable annually, or at more frequent intervals, out of the property and its income that is not limited by the income of the property is treated as the right to receive the income from a specific portion of the property. The specific portion, for purposes of paragraph (c)(2) of this section, is the portion of the property that, assuming the interest rate generally applicable for the valuation of annuities at the time of the decedent's death, would produce income equal to such payments. However, a pecuniary amount payable annually to a surviving spouse is not treated as a right to the income from a specific portion of the trust property for purposes of this paragraph (c)(3)(i)(A) if any person other than the surviving spouse may receive, during the surviving spouse's lifetime, any distribution of the property. To determine the applicable interest rate for valuing annuities, see sections 2031 and 7520 and the regulations under those sections.

(B) The right to appoint a pecuniary amount out of a larger fund (or trust corpus) is considered the right to appoint a specific portion of such fund or trust for purposes of paragraph (c)(2) in an amount equal to such pecuniary amount.

(ii) The rules contained in paragraphs (c)(3)(i) (A) and (B) of this section apply with respect to estates of decedents dying on or before October 24, 1992.

(iii) The rules contained in paragraphs (c)(3)(i) (A) and (B) of this section apply in the case of decedents dying after October 24, 1992, if property passes to the spouse pursuant to a will or revocable trust agreement executed on or before October 24, 1992, and either—

(A) On that date, the decedent was under a mental disability to change the disposition of the property and did not regain competence to dispose of such property before the date of death; or

(B) The decedent dies prior to October 24, 1995.

(iv) Notwithstanding paragraph (c)(3)(iii) of this section, paragraphs (c)(3)(i) (A) and (B) of this section do not apply if the will or revocable trust is amended after October 24, 1992, in any respect that increases the amount of the transfer qualifying for the marital deduction or alters the terms by which the interest so passes to the surviving spouse of the decedent.

(4) *Local law.* A partial interest in property is treated as a specific portion of the entire interest if it is shown that the surviving spouse has rights under local law that are identical to those the surviving spouse would have acquired had the partial interest been expressed in terms satisfying the requirements of paragraph (c)(2) (or paragraph (c)(3) if applicable) of this section.

(5) *Examples.* The following examples illustrate the application of paragraphs (a) through (c)(4) of this section:

Example 1. Spouse entitled to the lesser of an annuity or a fraction of trust income. The decedent, D, died prior to October 24, 1992. D bequeathed in trust 500 identical shares of X company stock, valued for estate tax purposes at \$500,000. The trust provides that during the lifetime of D's spouse, S, the trustee is to pay annually to S the lesser of one-half of the trust income or \$20,000. Any trust income not paid to S is to be accumulated in the trust and may not be distributed during S's lifetime. S has a testamentary general power of appointment over the entire trust principal. The applicable interest rate for valuing annuities as of D's date of death under section 7520 is 10 percent. For purposes of paragraphs (a) through (c) of this section, S is treated as receiving all of the income from the lesser of—

(i) One half of the stock (\$250,000); or
(ii) \$20,000, the specific portion of the stock which, as determined in accordance with § 20.2056(b)-5(c)(3)(i)(A), would produce annual income of \$20,000 (20,000/10). Accordingly, the marital deduction is limited to \$200,000 (200,000/500,000 or 2/5 of the value of the trust).

Example 2. Spouse possesses power and income interest over different specific portions of trust. The facts are the same as in Example 1 except that S's testamentary general power of appointment is exercisable over only 1/4 of the trust principal. Consequently, under section 2056(b)(5), the marital deduction is allowable only for the value of 1/4 of the trust (\$125,000); i.e., the lesser of the value of the portion with respect to which S is deemed to be entitled to all of the income (1/4 of the trust or \$125,000), or the value of the portion with respect to which S possesses the requisite power of appointment (1/4 of the trust or \$125,000).

Example 3. Power of appointment over pecuniary amount. The decedent, D, died prior to October 24, 1992. D bequeathed property valued at \$400,000 for estate tax purposes in trust. The trustee is to pay annually to D's spouse, S, one-fourth of the trust income. Any trust income not paid to S is to be accumulated in the trust and may not be distributed during S's lifetime. The will gives S a testamentary general power of appointment over the sum of \$160,000. Because D died prior to October 24, 1992, S's power of appointment over \$160,000 is treated as a power of appointment over a specific portion of the entire trust interest. The marital deduction allowable under section 2056(b)(5) is limited to \$100,000; that is, the lesser of—

(1) The value of the trust corpus (\$400,000);
(2) The value of the trust corpus over which S has a power of appointment (\$160,000); or
(3) That specific portion of the trust with respect to which S is entitled to all the income (\$100,000).

Example 4. Power of appointment over shares of stock constitutes a power over a specific portion. Under D's will, 250 shares of Y company stock were bequeathed in trust pursuant to which all trust income was payable annually to S, D's spouse, for life. S was given a testamentary general power of appointment over 100 shares of stock. The trust provides that if the trustee sells the Y company stock, S's general power of appointment is exercisable with respect to the sale proceeds or the property in which the proceeds are reinvested. Because the amount of property represented by a single share of stock would be altered if the corporation split its stock, issued stock dividends, made a distribution of capital, etc., a power to appoint 100 shares at the time of S's death is not necessarily a power to appoint the entire interest that the 100 shares represented on the date of D's death. If it is shown that, under local law, S has a general power to appoint not only the 100 shares designated by D but also 100/250 of any distributions by the corporation that are included in trust principal, the requirements of paragraph (c)(2) of this section are satisfied and S is treated as having a general power to appoint 100/250 of the entire interest in the 250 shares. In that case, the marital deduction is limited to 40 percent of the trust principal. If local law does not give S that power, the 100 shares would not constitute a specific portion under § 20.2056(b)-5(c) (including § 20.2056(b)-5(c)(3)(i)(B)). The nature of the asset is such that a change in the capitalization of the corporation could cause an alteration in the original value represented by the shares at the time of D's death and, thus, it does not represent a specific portion of the trust.

(d) *Meaning of entire interest.* Because a marital deduction is allowed for each separate qualifying interest in property passing from the decedent to the decedent's surviving spouse (subject to any applicable limitations in § 20.2056(a)-(c)), for purposes of paragraphs (a) and (b) of this section,

each property interest with respect to which the surviving spouse received any rights is considered separately in determining whether the surviving spouse's rights extend to the entire interest or to a specific portion of the entire interest. * * *

* * *
Par. 15. Sections 20.2056(b)-7 through 20.2056(b)-10 are added to read as follows:

§ 20.2056(b)-7 Election with respect to life estate for surviving spouse.

(a) *In general.* Subject to section 2056(d), a marital deduction is allowed under section 2056(b)(7) with respect to estates of decedents dying after December 31, 1981, for qualified terminable interest property as defined in paragraph (b) of this section. All of the property for which a deduction is allowed under this paragraph (a) is treated as passing to the surviving spouse (for purposes of § 20.2056(a)-1), and no part of the property is treated as passing to any person other than the surviving spouse (for purposes of § 20.2056(b)-1).

(b) *Qualified terminable interest property—(1) In general.* Section 2056(b)(7)(B)(i) provides the definition of *qualified terminable interest property*.

(i) Terminable interests described in section 2056(b)(1)(C) cannot qualify as qualified terminable interest property. Thus, if the decedent directs the executor to purchase a terminable interest with estate assets, the terminable interest acquired will not qualify as qualified terminable interest property.

(ii) For purposes of section 2056(b)(7)(B)(i), the term *property* generally means the *entire interest in property* (within the meaning of § 20.2056(b)-5(d)) or a *specific portion of the entire interest* (within the meaning of § 20.2056(b)-5(c)).

(2) *Property for which an election may be made—(i) In general.* The election may relate to all or any part of property that meets the requirements of section 2056(b)(7)(B)(i), provided that any partial election must be made with respect to a fractional or percentage share of the property so that the elective portion reflects its proportionate share of the increase or decrease in value of the entire property for purposes of applying sections 2044 or 2519. The fraction or percentage may be defined by formula.

(ii) *Division of trusts—(A) In general.* A trust may be divided into separate trusts to reflect a partial election that has been made, or is to be made, if authorized under the governing instrument or otherwise permissible

under local law. Any such division must be accomplished no later than the end of the period of estate administration. If, at the time of the filing of the estate tax return, the trust has not yet been divided, the intent to divide the trust must be unequivocally signified on the estate tax return.

(B) *Manner of dividing and funding trust.* The division of the trust must be done on a fractional or percentage basis to reflect the partial election. However, the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust.

(C) *Local law.* A trust may be divided only if the fiduciary is required, either by applicable local law or by the express or implied provisions of the governing instrument, to divide the trust on the basis of the fair market value of the assets of the trust at the time of the division.

(3) *Persons permitted to make the election.* The election referred to in section 2056(b)(7)(B)(i)(III) must be made by the executor that is appointed, qualified, and acting within the United States, within the meaning of section 2203, regardless of whether the property with respect to which the election is to be made is in the executor's possession. If there is no executor appointed, qualified, and acting within the United States, the election may be made by any person with respect to property in the actual or constructive possession of that person and may also be made by that person with respect to other property not in the actual or constructive possession of that person if the person in actual or constructive possession of such other property does not make the election. For example, in the absence of an appointed executor, the trustee of an *intervivos* trust (that is included in the gross estate of the decedent) can make the election.

(4) *Manner and time of making the election—(i) In general.* The election referred to in section 2056(b)(7)(B)(i)(III) and (v) is made on the return of tax imposed by section 2001 (or section 2101). For purposes of this paragraph, the term *return of tax imposed by section 2001* means the last estate tax return filed by the executor on or before the due date of the return, including extensions or, if a timely return is not filed, the first estate tax return filed by the executor after the due date.

(ii) *Election irrevocable.* The election, once made, is irrevocable, provided that an election may be revoked or modified on a subsequent return filed on or before the due date of the return, including extensions actually granted. If an executor appointed under local law has made an election on the return of tax

imposed by section 2001 (or section 2101) with respect to one or more properties, no subsequent election may be made with respect to other properties included in the gross estate after the return of tax imposed by section 2001 is filed. An election under section 2056(b)(7)(B)(v) is separate from any elections made under section 2056(a)(3).

(c) *Protective elections—(1) In general.* A protective election may be made to treat property as qualified terminable interest property only if, at the time the federal estate tax return is filed, the executor of the decedent's estate reasonably believes that there is a bona fide issue that concerns whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive, i.e., whether property that is includible is eligible for the qualified terminable interest property election. The protective election must identify either the specific asset, group of assets, or trust to which the election applies and the specific basis for the protective election.

(2) *Protective election irrevocable.* The protective election, once made on the return of tax imposed by section 2001, cannot be revoked. For example, if a protective election is made on the basis that a bona fide question exists regarding the inclusion of a trust corpus in the gross estate and it is later determined that the trust corpus is so includible, the protective election becomes effective with respect to the trust corpus and cannot thereafter be revoked.

(d) *Qualifying income interest for life—(1) In general.* Section 2056(b)(7)(B)(ii) provides the definition of *qualifying income interest for life*. For purposes of section 2056(b)(7)(B)(ii)(II), the surviving spouse is included within the prohibited class of powerholders referred to therein.

(2) *Entitled for life to all income.* The principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.

(3) *Contingent income interests.* An income interest granted for a term of years, or a life estate subject to termination upon the occurrence of a specified event (e.g., remarriage), is not a qualifying income interest for life. In addition, an income interest (or life estate) that is contingent upon the executor's election under section

2056(b)(7)(B)(v) is not a qualifying income interest for life, regardless of whether the election is actually made.

(4) *Income between last distribution date and date of spouse's death.* An income interest does not fail to constitute a qualifying income interest for life solely because income between the last distribution date and the date of the surviving spouse's death is not required to be distributed to the surviving spouse or to the estate of the surviving spouse. See § 20.2044-1 relating to the inclusion of such undistributed income in the gross estate of the surviving spouse.

(5) *Pooled income funds.* An income interest in a pooled income fund described in section 642(c)(5) constitutes a qualifying income interest for life for purposes of section 2056(b)(7)(B)(ii).

(6) *Power to distribute principal to spouse.* An income interest in a trust will not fail to constitute a qualifying income interest for life solely because the trustee has a power to distribute principal to or for the benefit of the surviving spouse. The fact that property distributed to a surviving spouse may be transferred by the spouse to another person does not result in a failure to satisfy the requirement of section 2056(b)(7)(B)(ii)(II). However, if the surviving spouse is legally bound to transfer the distributed property to another person without full and adequate consideration in money or money's worth, the requirement of section 2056(b)(7)(B)(ii)(II) is not satisfied.

(e) *Annuities payable from trusts in the case of estates of decedents dying on or before October 24, 1992, and certain decedents dying after October 24, 1992, with wills or revocable trusts executed on or prior to that date—(1) In general.* In the case of estates of decedents within the purview of the effective date and transitional rules contained in § 20.2056(b)-7(e)(5), a surviving spouse's lifetime annuity interest payable from a trust or other group of assets passing from the decedent is treated as a qualifying income interest for life for purposes of section 2056(b)(7)(B)(ii).

(2) *Deductible interest.* The deductible interest, for purposes of § 20.2056(a)-2(b), is the specific portion of the property that, assuming the applicable interest rate for valuing annuities, would produce income equal to the minimum amount payable annually to the surviving spouse. If, based on the applicable interest rate, the entire property from which the annuity may be satisfied is insufficient to produce income equal to the minimum annual

payment, the value of the deductible interest is the entire value of the property. The value of the deductible interest may not exceed the value of the property from which the annuity is payable. If the annual payment may increase, the increased amount is not taken into account in valuing the deductible interest.

(3) *Distributions permissible only to surviving spouse.* An annuity interest is not treated as a qualifying income interest for life for purposes of section 2056(b)(7)(B)(ii) if any person other than the surviving spouse may receive, during the surviving spouse's lifetime, any distribution of the property or its income (including any distribution under an annuity contract) from which the annuity is payable.

(4) *Applicable interest rate.* To determine the applicable interest rate for valuing annuities, see sections 2031 and 7520 and the regulations under those sections.

(5) *Effective dates.* (i) The rules contained in § 20.2056(b)-7(e) apply with respect to estates of decedents dying on or before October 24, 1992.

(ii) The rules contained in § 20.2056(b)-7(e) apply in the case of decedents dying after October 24, 1992, if property passes to the spouse pursuant to a will or revocable trust executed on or before October 24, 1992, and either—

(A) On that date, the decedent was under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of death; or

(B) The decedent dies prior to October 24, 1995.

(iii) Notwithstanding the foregoing, the rules contained in § 20.2056(b)-7(e) do not apply if the will or revocable trust is amended after October 24, 1992, in any respect that increases the amount of the transfer qualifying for the marital deduction or alters the terms by which the interest so passes to the surviving spouse.

(f) *Joint and survivor annuities.* [Reserved]

(g) *Application of local law.* The provisions of local law are taken into account in determining whether the conditions of section 2056(b)(7)(B)(ii)(I) are satisfied. For example, silence of a trust instrument as to the frequency of payment is not regarded as a failure to satisfy the requirement that the income must be payable to the surviving spouse annually or more frequently unless applicable local law permits payments less frequently.

(h) *Examples.* The following examples illustrate the application of paragraphs

(a) through (g) of this section. In each example, it is assumed that the decedent, D, was survived by S, D's spouse and that, unless stated otherwise, S is not the trustee of any trust established for S's benefit.

Example 1. Life estate in residence. D owned a personal residence valued at \$250,000 for estate tax purposes. Under D's will, the exclusive and unrestricted right to use the residence (including the right to continue to occupy the property as a personal residence or to rent the property and receive the income) passes to S for life. At S's death, the property passes to D's children. Under applicable local law, S must consent to any sale of the property. If the executor elects to treat all of the personal residence as qualified terminable interest property, the deductible interest is \$250,000, the value of the residence for estate tax purposes.

Example 2. Power to make property productive. D's will established a trust funded with property valued for estate tax purposes at \$500,000. The assets include both income producing assets and non-productive assets. S was given the power, exercisable annually, to require distribution of all of the trust income to herself. No trust property may be distributed during S's lifetime to any person other than S. Applicable local law permits S to require that the trustee either make the trust property productive or sell the property and reinvest in productive property within a reasonable time after D's death. If the executor elects to treat all of the trust as qualified terminable interest property, the deductible interest is \$500,000. If the executor elects to treat only 20 percent of the trust as qualified terminable interest property, the deductible interest is \$100,000, i.e., 20 percent of \$500,000.

Example 3. Power of distribution over fraction of trust income. The facts are the same as in Example 2 except that S is given the right exercisable annually for S's lifetime to require distribution to herself of only 50 percent of the trust income for life. The remaining trust income is to be accumulated or distributed among S and the decedent's children in the trustee's discretion. The maximum amount that D's executor may elect to treat as qualified terminable interest property is \$250,000; i.e., the estate tax value of the trust (\$500,000) multiplied by the percentage of the trust in which S has a qualifying income interest for life (50 percent). If D's executor elects to treat only 20 percent of the portion of the trust in which S has a qualifying income interest as qualified terminable interest property, the deductible interest is \$50,000, i.e., 20 percent of \$250,000.

Example 4. Power to distribute trust corpus to other beneficiaries. D's will established a trust providing that S is entitled to receive at least annually all the trust income. The trustee is given the power to use annually during S's lifetime \$5,000 from the trust for the maintenance and support of S's minor child, C. Any such distribution does not necessarily relieve S of S's obligation to support and maintain C. S does not have a qualifying income interest for life in any portion of the trust because the bequest fails

to satisfy the condition that no person have a power, other than a power the exercise of which takes effect only at or after S's death, to appoint any part of the property to any person other than S. The trust would also be nondeductible under section 2056(b)(7) if S, rather than the trustee, held the power to appoint a portion of the principal to C. However, in the latter case, if S made a qualified disclaimer (within the meaning of section 2518) of the power to appoint to C, the trust could qualify for the marital deduction pursuant to section 2056(b)(7), assuming that the power is personal to S and S's disclaimer terminates the power. Similarly, in either case, if C made a qualified disclaimer of C's right to receive distributions from the trust, the trust would qualify under section 2056(b)(7), assuming that C's disclaimer effectively negates the trustee's power under local law.

Example 5. Spouse's income interest terminable on remarriage. D's will established a trust providing that all of the trust income is payable at least annually to S for S's lifetime, provided that, if S remarries, S's interest in the trust will pass to X. The trust is not deductible under section 2056(b)(7). S's income interest is not a qualifying income interest for life because it is not for life but, rather, is terminable upon S's remarriage.

Example 6. Spouse's income interest contingent on executor's election. D's will established a trust providing that S is entitled to receive the income from that portion of the trust that the executor elects to treat as qualified terminable interest property. S does not have a qualifying income interest for life in any portion of the trust because the income interest is contingent upon the executor's election. Accordingly, the executor cannot elect qualified terminable interest treatment for any portion of the trust. If the decedent's will gives the surviving spouse a qualifying income interest for life in a specific portion of the trust (such as the minimum portion of the trust that is necessary to reduce the Federal estate tax to zero) and the interest is not contingent on the executor's election, the executor can elect qualified terminable interest treatment for the specified portion of the trust.

Example 7. Formula partial election. D's will established a trust funded with the residue of D's estate. Trust income is to be paid annually to S for life, and the principal is to be distributed to D's children upon S's death. S has the power to require that all the trust property be made productive. There is no power to distribute trust property during S's lifetime to any person other than S. D's executor elects to deduct a fractional share of the residuary estate under section 2056(b)(7). The election specifies that the numerator of the fraction is the amount of deduction necessary to reduce the Federal estate tax to zero (taking into account final estate tax values) and the denominator of the fraction is the final estate tax value of the residuary estate (taking into account any specific bequests or liabilities of the estate paid out of the residuary estate). The formula election is of a fractional share. The value of the share qualifies for the marital deduction even though the executor's determinations to

claim administration expenses as estate or income tax deductions and the final estate tax values will affect the size of the fractional share.

Example 8. Formula partial election. The facts are the same as in Example 7 except that, rather than defining a fraction, the executor's formula states: "I elect to treat as qualified terminable interest property that portion of the residuary trust, up to 100 percent, necessary to reduce the Federal estate tax to zero, after taking into account the available unified credit, final estate tax values and any liabilities and specific bequests paid from the residuary estate." The formula election is of a fractional share. The share is equivalent to the fractional share determined in Example 7.

Example 9. Severance of QTIP trust. D's will established a trust funded with the residue of D's estate. Trust income is to be paid annually to S for life, and the principal is to be distributed to D's children upon S's death. S has the power to require that all of the trust property be made productive. There is no power to distribute trust property during S's lifetime to any person other than S. D's will authorizes the executor to make the election under section 2056(b)(7) only with respect to the minimum amount of property necessary to reduce estate taxes on D's estate to zero, authorizes the executor to divide the residuary estate into two separate trusts to reflect the election, and authorizes the executor to charge any payment of principal to S to the qualified terminable interest trust. S is the sole beneficiary of both trusts during S's lifetime. The authorizations in the will do not adversely affect the allowance of the marital deduction. Only the property remaining in the marital deduction trust, after payment of principal to S, is subject to inclusion in S's gross estate under section 2044 or subject to gift tax under section 2519.

Example 10. Payments to spouse from individual retirement account. S is the life beneficiary of sixteen remaining annual installments payable from D's individual retirement account. The terms of the account provide for the payment of the account balance in nineteen annual installments that commenced when D reached age 70½. Each installment is equal to all the income earned on the remaining principal in the account plus a share of the remaining principal equal to 1/19 in the first year, 1/18 in the second year, 1/17 in the third year, etc. Under the terms of the account, S has no right to withdraw any other amounts from the account. Any payments remaining after S's death pass to D's children. S's interest in the account qualifies as a qualifying income interest for life under section 2056(b)(7)(B)(ii), without regard to the provisions of section 2056(b)(7)(C).

Example 11. Spouse's interest in trust in the form of an annuity. D died prior to October 24, 1992. D's will established a trust funded with income producing property valued at \$500,000 for estate tax purposes. The trustee is required by the trust instrument to pay \$20,000 a year to S for life. Trust income in excess of the annuity amount is to be accumulated in the trust and may not be distributed during S's lifetime.

S's lifetime annuity interest is treated as a qualifying income interest for life. If the executor elects to treat the entire portion of the trust in which S has a qualifying income interest as qualified terminable interest property, the value of the deductible interest is (assuming that 10 percent is the applicable interest rate under section 7520 for valuing annuities on the appropriate valuation date) \$200,000, because that amount would yield an income to S of \$20,000 a year.

Example 12. Value of spouse's annuity exceeds value of trust corpus. The facts are the same as in Example 11 except that the trustee is required to pay S \$70,000 a year for life. If the executor elects to treat the entire portion of the trust in which S has a qualifying income interest as qualified terminable interest property, the value of the deductible interest is \$500,000, which is the lesser of the entire value of the property (\$500,000), or the amount of property that (assuming a 10 percent interest rate) would yield an income to S of \$70,000 a year (\$700,000).

Example 13. Pooled income fund. D's will provides for a bequest of \$200,000 to a pooled income fund described in section 642(c)(5), designating S as the income beneficiary for life. If D's executor elects to treat the entire \$200,000 as qualified terminable interest property, the deductible interest is \$200,000.

Example 14. Funding severed QTIP trusts. D's will established a trust satisfying the requirements of section 2056(b)(7). Pursuant to the authority in D's will and § 20.2056(b)-7(b)(2)(ii), D's executor indicates on the Federal estate tax return that an election under section 2056(b)(7) is being made with respect to 50 percent of the trust, and that the trust will subsequently be divided to reflect the partial election on the basis of the fair market value of the property at the time of the division. D's executor funds the trust at the end of the period of estate administration. At that time, the property available to fund the trusts consists of 100 shares of X Corporation stock with a current value of \$400,000 and 200 shares of Y Corporation stock with a current value of \$400,000. D may fund each trust with the stock of either or both corporations, in any combination, provided that the aggregate value of the stock allocated to each trust is \$400,000.

§ 20.2056(b)-8 Special rule for charitable remainder trusts.

(a) *In general*—(1) *Surviving spouse only noncharitable beneficiary.* With respect to estates of decedents dying after December 31, 1981, subject to section 2056(d), if the surviving spouse of the decedent is the only noncharitable beneficiary of a charitable remainder annuity trust or a charitable remainder unitrust described in section 664 (qualified charitable remainder trust), section 2056(b)(1) does not apply to the interest in the trust that is transferred to the surviving spouse. Thus, the value of the annuity or unitrust interest passing to the spouse qualifies for a marital deduction under

section 2056(b)(8) and the value of the remainder interest qualifies for a charitable deduction under section 2055. If an interest in property qualifies for a marital deduction under section 2056(b)(8), no election may be made with respect to the property under section 2056(b)(7). For purposes of this section, the term *non-charitable beneficiary* means any beneficiary of the qualified charitable remainder trust other than an organization described in section 170(c).

(2) *Interest for life or term of years.* The surviving spouse's interest need not be an interest for life to qualify for a marital deduction under section 2056(b)(8). However, for purposes of section 664, an annuity or unitrust interest payable to the spouse for a term of years cannot be payable for a term that exceeds 20 years.

(3) *Payment of state death taxes.* A deduction is allowed under section 2056(b)(8) even if the transfer to the surviving spouse is conditioned on the spouse's payment of state death taxes, if any, attributable to the qualified charitable remainder trust. See § 20.2056(b)-4(c) for the effect of such a condition on the amount of the deduction allowable.

(b) *Charitable remainder trusts where the surviving spouse is not the only noncharitable beneficiary.* In the case of a charitable remainder trust where the decedent's spouse is not the only noncharitable beneficiary (for example, where the noncharitable interest is payable to the decedent's spouse for life and then to another individual for life), the qualification of the interest as qualified terminable interest property is determined solely under section 2056(b)(7) and not under section 2056(b)(8). Accordingly, if the decedent died on or before October 24, 1992, or the trust otherwise comes within the purview of the transitional rules contained in § 20.2056(b)-7(e)(5), the spousal annuity or unitrust interest may qualify under § 20.2056(b)-7(e) as a qualifying income interest for life.

§ 20.2056(b)-9 Denial of double deduction.

The value of an interest in property may not be deducted for Federal estate tax purposes more than once with respect to the same decedent. For example, where a decedent transfers a life estate in a farm to the spouse with a remainder to charity, the entire property is, pursuant to the executor's election under section 2056(b)(7), treated as passing to the spouse. The entire value of the property qualifies for the marital deduction. No part of the value of the property qualifies for a

charitable deduction under section 2055 in the decedent's estate.

§ 20.2056(b)-10 Effective dates.

Except as specifically provided in §§ 20.2056(b)-5(c)(3) (ii) and (iii), 20.2056(b)-7(e)(5), and 20.2056(b)-8(b), the provisions of §§ 20.2056(b)-5(c), 20.2056(b)-7, 20.2056(b)-8, and 20.2056(b)-9 are effective with respect to estates of decedents dying after March 1, 1994. With respect to estates of decedents dying on or before such date, the executor of the decedent's estate may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of §§ 20.2056(b)-5(c), 20.2056(b)-7, 20.2056(b)-8, and 20.2056(b)-9 (as well as project LR-211-76, 1984-1 C.B., page 598, see § 601.601(d)(2)(ii)(b) of this chapter), are considered a reasonable interpretation of the statutory provisions.

§§ 20.2056(c)-1 and 20.2056(c)-2 [Removed]

Par. 16. Sections 20.2056(c)-1 and 20.2056(c)-2 are removed.

Par. 17. Section 20.2056(e)-1 is redesignated § 20.2056(c)-1 and amended as follows:

- The section heading is revised as set forth below.
- Headings are added for paragraphs (a) and (b) as set forth below.
- The last sentence in paragraph (b) is removed.

§ 20.2056(c)-1 Marital deduction; definition of passed from the decedent.

(a) *In general.* * * *

(b) *Expectant interest in property under community property laws.* * * *

Par. 18. Section 20.2056(e)-2 is redesignated § 20.2056(c)-2, and amended as follows:

- The section heading is revised.
- The first sentence of paragraph (a) is amended by removing the reference "§ 20.2056(e)-1" and adding "§ 20.2056(c)-1" in its place.
- Paragraphs (a)(2) through (a)(5) are redesignated as paragraphs (a)(3) through (a)(6), respectively, and a new paragraph (a)(2) is added.
- The first sentence in the concluding text of paragraph (a) following newly designated paragraph (a)(6) is revised.
- Paragraphs (b)(1)(iv) and (b)(2)(iii) are amended by removing the reference "§ 20.2056(b)-5" and adding "§ 20.2056(b)-5 or 20.2056(b)-7" in its place.
- Paragraph (b)(3)(v) is amended by removing the reference "section 2056(b)(5)" and adding "§ 20.2056(b)-5 or 20.2056(b)-7" in its place.

g. The revisions and additions read as follows:

§ 20.2056(c)-2 Marital deduction; definition of passed from the decedent to his surviving spouse.

(a) * * *

(2) In the case of certain interests with income for life to the surviving spouse that the executor elects to treat as qualified terminable interest property (see § 20.2056(b)-7);

* * *

A property interest is treated as passing to the surviving spouse only if it passes to the spouse as beneficial owner, except to the extent otherwise provided in §§ 20.2056(b)-5 through 20.2056(b)-7. * * *

* * *

§ 20.2056(e)-3 [Redesignated as § 20.2056(c)-3 and Amended]

Par. 19. Section 20.2056(e)-3 is redesignated § 20.2056(c)-3, and amended by removing the references to "§ 20.2056(e)-1" and "§ 20.2056(e)-2" and adding "§ 20.2056(c)-1" and "§ 20.2056(c)-2" in their respective places in the first sentence.

Par. 20. Sections 20.2207A-1 and 20.2207A-2 are added to read as follows:

§ 20.2207A-1 Right of recovery of estate taxes in the case of certain marital deduction property.

(a) *In general.*—(1) *Right of recovery from person receiving the property.* If the gross estate includes the value of property that is includible by reason of section 2044 (relating to certain property in which the decedent had a qualifying income interest for life under sections 2056(b)(7) or 2523(f)), the estate of the surviving spouse is entitled to recover from the *person receiving the property* (as defined in paragraph (d) of this section) the amount of Federal estate tax attributable to that property. The right of recovery arises when the Federal estate tax with respect to the property includible in the gross estate by reason of section 2044 is paid by the estate. There is no right of recovery from any person for the property received by that person for which a deduction was allowed from the gross estate if no tax is attributable to that property.

(2) *Failure to exercise right of recovery.* Failure of an estate to exercise a right of recovery under this section upon a transfer subject to section 2044 is treated as a transfer for Federal gift tax purposes of the unrecovered amounts from the persons who would benefit from the recovery to the persons from whom the recovery could have been obtained. See § 25.2511-1 of this

chapter. The transfer is considered made when the right of recovery is no longer enforceable under applicable local law. A delay in the exercise of the right of recovery may be treated as an interest-free loan with appropriate gift tax consequences under section 7872 depending on the facts of the particular case.

(3) *Waiver of right of recovery.* The provisions of § 20.2207A-1(a)(2) do not apply to the extent that the surviving spouse's will provides that a recovery shall not be made or to the extent that the beneficiaries cannot otherwise compel recovery. Thus, e.g., if the surviving spouse gives the executor of the estate discretion to waive the right of recovery and the executor waives the right, no gift occurs under § 25.2511-1 of this chapter if the persons who would benefit from the recovery cannot compel the executor to exercise the right of recovery.

(b) *Amount of estate tax attributable to property includible under section 2044.* The amount of Federal estate tax attributable to property includible in the gross estate under section 2044 is the amount by which the total Federal estate tax (including penalties and interest attributable to the tax) under chapter 11 of the Internal Revenue Code that has been paid, exceeds the total Federal estate tax (including penalties and interest attributable to the tax) under chapter 11 of the Internal Revenue Code that would have been paid if the value of the property includible in the gross estate by reason of section 2044 had not been so included.

(c) *Amount of estate tax attributable to a particular property.* An estate's right of recovery with respect to a particular property is an amount equal to the amount determined in paragraph (b) of this section multiplied by a fraction. The numerator of the fraction is the value for Federal estate tax purposes of the particular property included in the gross estate by reason of section 2044, less any deduction allowed with respect to the property. The denominator of the fraction is the total value of all properties included in the gross estate by reason of section 2044, less any deductions allowed with respect to those properties.

(d) *Person receiving the property.* If the property is in a trust at the time of the decedent's death, the person receiving the property is the trustee and any person who has received a distribution of the property prior to the expiration of the right of recovery if the property does not remain in trust. This paragraph (d) does not affect the right, if any, under local law, of any person

with an interest in property to reimbursement or contribution from another person with an interest in the property.

(e) *Example.* The following example illustrates the application of paragraphs (a) through (d) of this section.

Example. D died in 1994. D's will created a trust funded with certain income producing assets included in D's gross estate at \$1,000,000. The trust provides that all the income is payable to D's wife, S, for life, remainder to be divided equally among their four children. In computing D's taxable estate, D's executor deducted, pursuant to section 2056(b)(7), \$1,000,000. Assume that S received no other property from D and that S died in 1996. Assume further that S made no section 2519 disposition of the property, that the property was included in S's gross estate at a value of \$1,080,000, and that S's will contained no provision regarding section 2207A(a). The tax attributable to the property is equal to the amount by which the total Federal estate tax (including penalties and interest) paid by S's estate exceeds the Federal estate tax (including penalties and interest) that would have been paid if S's gross estate had been reduced by \$1,080,000. That amount of tax may be recovered by S's estate from the trust. If, at the time S's estate seeks reimbursement, the trust has been distributed to the four children, S's estate is also entitled to recover the tax from the children.

§ 20.2207A-2 Effective date.

The provisions of § 20.2207A-1 are effective with respect to estates of decedents dying after March 1, 1994. With respect to estates of decedent dying on or before such date, the executor of the decedent's estate may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of § 20.2207A-1 (as well as project LR-211-76, 1984-1 C.B., page 598, see § 601.601(d)(2)(ii)(b) of this chapter), are considered a reasonable interpretation of the statutory provisions.

PART 22—TEMPORARY ESTATE AND GIFT TAX REGULATIONS UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981

Par. 21. The authority citation for part 22 is revised to read as follows:

Authority: 26 U.S.C. 7805.

§ 22.2056-1 [Removed]

Par. 22. Section 22.2056-1 is removed.

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 23. The authority citation for part 25 is revised to read as follows:

Authority: 26 U.S.C. 7805.

(Section 25.2512-5 also issued under 26 U.S.C. 170(f)(4) and 26 U.S.C. 642(c)(5))
(Section 25.2512-9 also issued under 26 U.S.C. 170(f)(4) and 26 U.S.C. 642(c)(5))
(Section 25.2513-1 also issued under 26 U.S.C. 170(f)(4) and 26 U.S.C. 642(c)(5))
(Section 25.2522(c)-3 also issued under 26 U.S.C. 170(f)(4) and 26 U.S.C. 642(c)(5))
(Section 25.2522(d)-1 also issued under 26 U.S.C. 170(f)(4) and 26 U.S.C. 642(c)(5))
(Section 25.2523(a)-1 also issued under 26 U.S.C. 170(f)(4) and 26 U.S.C. 642(c)(5))
(Section 25.2523(b)-1 also issued under 26 U.S.C. 170(f)(4) and 26 U.S.C. 642(c)(5))
(Section 25.6091-1 also issued under 26 U.S.C. 6091)

Par. 24. The authority citations immediately following §§ 25.2512-5, 25.2512-9, 25.2522(c)-3 and 25.2523(a)-1 are removed.

Par. 25. Sections 25.2207A-1 and 25.2207A-2 are added immediately following the undesignated center heading "Determination of Tax Liability" to read as follows:

§ 25.2207A-1 Right of recovery of gift taxes in the case of certain marital deduction property.

(a) *In general.* If an individual is treated as transferring an interest in property by reason of section 2519, the individual or the individual's estate is entitled to recover from the person receiving the property (as defined in paragraph (e) of this section) the amount of gift tax attributable to that property. The value of property to which this paragraph (a) applies is the value of all interests in the property other than the qualifying income interest. There is no right of recovery from any person for the property received by that person for which a deduction was allowed from the total amount of gifts, if no Federal gift tax is attributable to the property. The right of recovery arises at the time the Federal gift tax is actually paid by the transferor subject to section 2519.

(b) *Failure of a person to exercise the right of recovery.* [Reserved].

(c) *Amount of gift tax attributable to all properties.* The amount of Federal gift tax attributable to all properties includible in the total amount of gifts under section 2519 made during the calendar year is the amount by which the total Federal gift tax for the calendar year (including penalties and interest attributable to the tax) under chapter 12 of the Internal Revenue Code which has been paid, exceeds the total Federal gift tax for the calendar year (including penalties and interest attributable to the tax) under chapter 12 of the Internal Revenue Code which would have been paid if the value of the properties includible in the total amount of gifts by

reason of section 2519 had not been included.

(d) *Amount of gift tax attributable to a particular property.* A person's right of recovery with respect to a particular property is an amount equal to the amount determined in paragraph (c) of this section multiplied by a fraction. The numerator of the fraction is the value of the particular property included in the total amount of gifts made during the calendar year by reason of section 2519, less any deduction allowed with respect to the property. The denominator of the fraction is the total value of all properties included in the total amount of gifts made during the calendar year by reason of section 2519, less any deductions allowed with respect to those properties.

(e) *Person receiving the property.* If the property is in a trust at the time of the transfer, the person receiving the property is the trustee, and any person who has received a distribution of the property prior to the expiration of the right of recovery if the property does not remain in trust. This paragraph (e) does not affect the right, if any, under local law, of any person with an interest in property to reimbursement or contribution from another person with an interest in the property.

(f) *Example.* The following example illustrates the application of paragraphs (a) through (e) of this section.

Example. D created an inter vivos trust during 1994 with certain income producing assets valued at \$1,000,000. The trust provides that all income is payable to D's wife, S, for S's life, with the remainder at S's death to be divided equally among their four children. In computing taxable gifts during calendar year 1994, D deducted, pursuant to section 2523(f), \$1,000,000 from the total amount of gifts made. In addition, assume that S received no other transfers from D and that S made a gift during 1996 of the entire life interest to one of the children, at which time the value of trust assets was \$1,080,000 and the value of S's life interest was \$400,000. Although the entire value of the trust assets (\$1,080,000) is, pursuant to sections 2511 and 2519, included in the total amount of S's gifts for calendar year 1996, S is only entitled to reimbursement for the Federal gift tax attributable to the value of the remainder interest, that is, the Federal gift tax attributable to \$680,000 (\$1,080,000 less \$400,000). The Federal gift tax attributable to \$680,000 is equal to the amount by which the total Federal gift tax (including penalties and interest) paid for the calendar year exceeds the federal gift tax (including penalties and interest) that would have been paid if the total amount of gifts during 1996 had been reduced by \$680,000. That amount of tax may be recovered by S from the trust.

§ 25.2207A-2 Effective date.

The provisions of § 25.2207A-1 are effective with respect to dispositions

made after March 1, 1994. With respect to gifts made on or before such date, the donor may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of § 25.2207A-1 (as well as project LR-211-76, 1984-1 C.B., page 598, see § 601.601(d)(2)(ii)(b) of this chapter), are considered a reasonable interpretation of the statutory provisions.

Par. 26. Section 25.2515-1 is amended by:

- a. Redesignating paragraph (a) as (a)(3).
- b. Adding paragraphs (a)(1) and (2) to read as follows:

§ 25.2515-1 Tenancies by the entirety; in general.

(a) *Scope—(1) In general.* This section and §§ 25.2515-2 through 25.2515-4 do not apply to the creation of a tenancy by the entirety after December 31, 1981, and do not reflect changes made to the Internal Revenue Code by sections 702(k)(1)(A) of the Revenue Act of 1978, or section 2002(c)(2) of the Tax Reform Act of 1976.

(2) *Special rule in the case of tenancies created after July 13, 1988, if the donee spouse is not a United States citizen.* Under section 2523(i)(3), applicable (subject to the special treaty rule contained in Public Law 101-239, section 7815(d)(14)) in the case of tenancies by the entirety and joint tenancies created between spouses after July 13, 1988, if the donee spouse is not a citizen of the United States, the principles contained in section 2515 and §§ 25.2515-1 through 25.2515-4 apply in determining the gift tax consequences with respect to the creation and termination of the tenancy, except that the election provided in section 2515(a) (prior to repeal by the Economic Recovery Tax Act of 1981) and § 25.2515-2 (relating to the donor's election to treat the creation of the tenancy as a transfer for gift tax purposes) does not apply.

Par. 27. Sections 25.2519-1 and 25.2519-2 are added immediately after the undesignated center heading "Deductions" and before § 25.2521-1 to read as follows:

§ 25.2519-1 Dispositions of certain life estates.

(a) *In general.* If a donee spouse makes a disposition of all or part of a qualifying income interest for life in any property for which a deduction was allowed under section 2056(b)(7) or section 2523(f) for the transfer creating the qualifying income interest, the donee spouse is treated for purposes of

chapters 11 and 12 of subtitle B of the Internal Revenue Code as transferring all interests in property other than the qualifying income interest. For example, if the donee spouse makes a disposition of part of a qualifying income interest for life in trust corpus, the spouse is treated under section 2519 as making a transfer subject to chapters 11 and 12 of the entire trust other than the qualifying income interest for life. Therefore, the donee spouse is treated as making a gift under section 2519 of the entire trust less the qualifying income interest, and is treated for purposes of section 2036 as having transferred the entire trust corpus, including that portion of the trust corpus from which the retained income interest is payable. A transfer of all or a portion of the income interest of the spouse is a transfer by the spouse under section 2511. See also section 2702 for special rules applicable in valuing the gift made by the spouse under section 2519.

(b) *Presumption.* Unless the donee spouse establishes to the contrary, section 2519 applies to the entire trust at the time of the disposition. If a deduction is taken on either the estate or gift tax return with respect to the transfer which created the qualifying income interest, it is presumed that the deduction was allowed for purposes of section 2519. To avoid the application of section 2519 upon a transfer of all or part of the donee spouse's income interest, the donee spouse must establish that a deduction was not taken for the transfer of property which created the qualifying income interest. For example, to establish that a deduction was not taken, the donee spouse may produce a copy of the estate or gift tax return filed with respect to the transfer creating the qualifying income interest for life establishing that no deduction was taken under section 2056(b)(7) or section 2523(f). In addition, the donee spouse may establish that no return was filed on the original transfer by the donor spouse because the value of the first spouse's gross estate was below the threshold requirement for filing under section 6018. Similarly, the donee spouse could establish that the transfer creating the qualifying income interest for life was made before the effective date of section 2056(b)(7) or section 2523(f), whichever is applicable.

(c) *Amount treated as a transfer—(1) In general.* The amount treated as a transfer under this section upon a disposition of all or part of a qualifying income interest for life in qualified terminable interest property is equal to the fair market value of the entire property subject to the qualifying

income interest, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under section 2503(b) with respect to the transfer creating the interest), less the value of the qualifying income interest in the property on the date of the disposition. The gift tax consequences of the disposition of the qualifying income interest are determined separately under § 25.2511-2.

(2) *Disposition of interest in property with respect to which a partial election was made.* If, in connection with the transfer of property that created the spouse's qualifying income interest for life, a deduction was allowed under section 2056(b)(7) or section 2523(f) for less than the entire interest in the property (i.e., for a fractional or percentage share of the entire interest in the transferred property) the amount treated as a transfer by the donee spouse under this section is equal to the fair market value of the entire property subject to the qualifying income interest on the date of the disposition, less the value of the qualifying income interest for life, multiplied by the fractional or percentage share of the interest for which the deduction was taken.

(3) *Reduction for distributions charged to nonelective portion of trust.* The amount determined under paragraph (c)(2) of this section (if applicable) is appropriately reduced if—

(i) The donee spouse's interest is in a trust and distributions of principal have been made to the donee spouse;

(ii) The trust provides that distributions of principal are made first from the qualified terminable interest share of the trust; and

(iii) The donee spouse establishes the reduction in that share based on the fair market value of the trust assets at the time of each distribution.

(4) *Effect of gift tax recovered under section 2207A on the amount of the transfer.* [Reserved]

(5) *Interest in previously severed trust.* If the donee spouse's interest is in a trust consisting of only qualified terminable interest property, and the trust was previously severed (in compliance with § 20.2056(b)-7(b)(2)(ii) of this chapter or § 25.2523(f)-1(b)(3)(ii) from a trust that, after the severance, held only property that was not qualified terminable interest property, only the value of the property in the severed portion of the trust at the time of the disposition is treated as transferred under this section.

(d) *Identification of property transferred.* If only part of the property in which a donee spouse has a

qualifying income interest for life is qualified terminable interest property, the donee spouse is, in the case of a disposition of all or part of the income interest within the meaning of section 2519, deemed to have transferred a pro rata portion of the entire qualified terminable interest property for purposes of this section.

(e) *Exercise of power of appointment.* The exercise by any person of a power to appoint qualified terminable interest property to the donee spouse is not treated as a disposition under section 2519, even though the donee spouse subsequently disposes of the appointed property.

(f) *Conversion of qualified terminable interest property.* The conversion of qualified terminable interest property into other property in which the donee spouse has a qualifying income interest for life is not, for purposes of this section, treated as a disposition of the qualifying income interest. Thus, the sale and reinvestment of assets of a trust holding qualified terminable interest property is not a disposition of the qualifying income interest, provided that the donee spouse continues to have a qualifying income interest for life in the trust after the sale and reinvestment. Similarly, the sale of real property in which the spouse possesses a legal life estate and thus meets the requirements of qualified terminable interest property, followed by the transfer of the proceeds into a trust which also meets the requirements of qualified terminable interest property, or by the reinvestment of the proceeds in income producing property in which the donee spouse has a qualifying income interest for life, is not considered a disposition of the qualifying income interest. On the other hand, the sale of qualified terminable interest property, followed by the payment to the donee spouse of a portion of the proceeds equal to the value of the donee spouse's income interest, is considered a disposition of the qualifying income interest.

(g) *Examples.* The following examples illustrate the application of paragraphs (a) through (f) of this section. Except as provided otherwise in the examples below, assume that the decedent, D, was survived by spouse, S, that in each example the section 2503(b) exclusion has already been fully utilized for each year with respect to the donee in question, and that section 2503(e) is not applicable to the amount deemed transferred.

Example 1. Transfer of the spouse's life estate in residence. Under D's will, a personal residence valued for estate tax purposes at \$250,000 passes to S for life, and after S's death to D's children. D's executor

made a valid election to treat the property as qualified terminable interest property. During 1995, when the fair market value of the property is \$300,000 and the value of S's life interest in the property is \$100,000, S makes a gift of S's entire interest in the property to D's children. Pursuant to section 2519, S makes a gift in the amount of \$200,000 (i.e., the fair market value of the qualified terminable interest property of \$300,000 less the fair market value of S's qualifying income interest in the property of \$100,000). In addition, under section 2511, S makes a gift of \$100,000 (i.e., the fair market value of S's income interest in the property). See § 25.2511-2.

Example 2. Sale of spouse's life estate. The facts are the same as in Example 1 except that during 1995, S sells S's interest in the property to D's children for \$100,000. Pursuant to section 2519, S makes a gift of \$200,000 (\$300,000 less \$100,000 value of the qualifying income interest in the property). S does not make a gift of the income interest under section 2511, because the consideration received for S's income interest is equal to the value of the income interest.

Example 3. Transfer of income interest in trust subject to partial election. D's will established a trust valued for estate tax purposes at \$500,000, all of the income of which is payable annually to S for life. After S's death, the principal of the trust is to be distributed to D's children. Assume that only 50 percent of the trust was treated as qualified terminable interest property. During 1995, S makes a gift of all of S's interest in the trust to D's children at which time the fair market value of the trust is \$400,000 and the fair market value of S's life income interest in the trust is \$100,000. Pursuant to section 2519, S makes a gift of \$150,000 (the fair market value of the qualified terminable interest property, 50 percent of \$400,000, less the \$50,000 income interest in the qualified terminable interest property). S also makes a gift pursuant to section 2511 of \$100,000 (i.e., the fair market value of S's life income interest).

Example 4. Transfer of a portion of income interest in trust subject to a partial election. The facts are the same as in Example 3 except that S makes a gift of only 40 percent of S's interest in the trust. Pursuant to section 2519, S makes a gift of \$150,000 (i.e., the fair market value of the qualified terminable interest property, 50 percent of \$400,000, less the \$50,000 value of S's qualified income interest in the qualified terminable interest property). S also makes a gift pursuant to section 2511 of \$40,000 (i.e., the fair market value of 40 percent of S's life income interest). See also section 2702 for additional rules that may affect the value of the total amount of S's gift under section 2519 to take into account the fact that S's 30 percent retained income interest attributable to the qualifying income interest is valued at zero under that section, thereby increasing the value of S's section 2519 gift to \$180,000. In addition, under § 25.2511-1(d), S's disposition of 40 percent of the income interest is deemed to be a transfer of a pro rata portion of the qualified terminable interest property. Thus, assuming no further

lifetime dispositions by S, 30 percent (60 percent of 50 percent) of the trust property is included in S's gross estate under section 2036 and an adjustment is made to S's adjusted taxable gifts under section 2001(b)(1)(B). If S later disposes of all or a portion of the retained income interest, see § 25.2702-6.

Example 5. Transfer of a portion of spouse's interest in a trust from which corpus was previously distributed to the spouse. D's will established a trust valued for estate tax purposes at \$500,000, all of the income of which is payable annually to S for life. The trustee is granted the discretion to distribute trust principal to S. All appointments of principal must be made from the portion of the trust subject to the section 2056(b)(7) election. After S's death, the principal of the trust is to be distributed to D's children. The executor makes the section 2056(b)(7) election with respect to 50 percent of the trust. In 1994, pursuant to the terms of D's will, the trustee distributed \$50,000 of principal to S and charged the entire distribution to the qualified terminable interest portion of the trust.

Immediately prior to the distribution, the value of the entire trust was \$550,000 and the value of the qualified terminable interest portion was \$275,000 (50 percent of \$550,000). Provided S can establish the above facts, the qualified terminable interest portion of the trust immediately after the distribution is \$225,000 or 45 percent of the value of the trust (\$225,000/\$500,000). In 1996, when the value of the trust is \$400,000 and the value of S's income interest is \$100,000, S makes a transfer of 40 percent of S's income interest. S's gift under section 2519 is \$135,000; i.e., the fair market value of the qualified terminable interest property, 45 percent of \$400,000 (\$180,000), less the value of the income interest in the qualified terminable interest property, \$45,000 (45 percent of \$100,000). S also makes a gift under section 2511 of \$40,000; i.e., the fair market value of 40 percent of S's income interest. S's disposition of 40 percent of the income interest is deemed to be a transfer under section 2519 of the entire 45 percent portion of the remainder subject to the section 2056(b)(7) election. Since S retained 60 percent of the income interest, 27 percent (60 percent of 45 percent) of the trust property is includible in S's gross estate under section 2036. See also section 2702 and Example 4 as to the principles applicable in valuing S's gift under section 2702 and adjusted taxable gifts upon S's subsequent death.

Example 6. Transfer of Spousal Annuity Payable From Trust. D died prior to October 24, 1992. D's will established a trust valued for estate tax purposes at \$500,000. The trust instrument required the trustee to pay an annuity to S of \$20,000 a year for life. All the trust income other than the amounts paid to S as an annuity are to be accumulated in the trust and may not be distributed during S's lifetime to any person other than S. After S's death, the principal of the trust is to be distributed to D's children. Because D died prior to the effective date of section 1941 of the Energy Policy Act of 1992, S's annuity interest qualifies as a qualifying income

interest for life. Under § 20.2056(b)-7(e) of this chapter, based on an applicable 10 percent interest rate, 40 percent of the property, or \$200,000, is the value of the deductible interest. During 1996, S makes a gift of the annuity interest to D's children at which time the fair market value of the trust is \$800,000 and the fair market value of S's annuity interest in the trust is \$100,000. Pursuant to section 2519, S is treated as making a gift of \$220,000 (the fair market value of the qualified terminable interest property, 40 percent of \$800,000 (\$320,000), less the \$100,000 annuity interest in the qualified terminable interest property). S is also treated pursuant to section 2511 as making a gift of \$100,000 (the fair market value of S's annuity interest).

§ 25.2519-2 Effective date.

Except as specifically provided in § 25.2519-1(g), Example 6, the provisions of § 25.2519-1 are effective with respect to gifts made after March 1, 1994. With respect to gifts made on or before such date, the donee spouse of a section 2056(b)(7) or section 2523(f) transfer may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of § 25.2519-1 (as well as project LR-211-76, 1984-1 C.B., page 598, see § 601.601(d)(2)(ii)(b) of this chapter), are considered a reasonable interpretation of the statutory provisions.

Par. 28. Section 25.2522(c)-4 is added to read as follows:

§ 25.2522(c)-4 Disallowance of double deduction in the case of qualified terminable interest property.

No deduction is allowed under section 2522 for the transfer of an interest in property if a deduction is taken from the total amount of gifts with respect to that property by reason of section 2523(f). See § 25.2523(h)-1.

Par. 29. Section 25.2523(a)-1 is amended as follows:

- Paragraph (a) is revised.
- Paragraph (b)(3)(ii) is revised.
- Paragraphs (c) and (d) are redesignated as paragraphs (d) and (e), respectively.
- New paragraph (c) is added.
- Newly designated paragraph (d) is amended by:
 - Revising the paragraph heading.
 - Revising the introductory text.
 - The designations "(1)", "(2)", "(3)", "(4)", "(5)", "(6)", "(7)" appearing before each example are revised to read "1.", "2.", "3.", "4.", "5.", "6.", "7."
 - Example 8 is added.
- Newly designated paragraph (e) is amended by revising the first sentence.
- The revisions and additions read as follows:

§ 25.2523(a)-1 Gift to spouse; in general.

(a) *In general.* In determining the amount of taxable gifts for the calendar quarter (with respect to gifts made after December 31, 1970, and before January 1, 1982), or calendar year (with respect to gifts made before January 1, 1971, or after December 31, 1981), a donor may deduct the value of any property interest transferred by gift to a donee who at the time of the gift is the donor's spouse, except as limited by paragraphs (b) and (c) of this section. See § 25.2502-1(c)(1) for the definition of calendar quarter. This deduction is referred to as the *marital deduction*. In the case of gifts made prior to July 14, 1988, no marital deduction is allowed with respect to a gift if, at the time of the gift, the donor is a nonresident not a citizen of the United States. Further, in the case of gifts made on or after July 14, 1988, no marital deduction is allowed (regardless of the donor's citizenship or residence) for transfers to a spouse who is not a citizen of the United States at the time of the transfer. However, for certain special rules applicable in the case of estate and gift tax treaties, see section 7815(d)(14) of Public Law 101-239. The donor must submit any evidence necessary to establish the donor's right to the marital deduction.

(b) * * *

(3) * * *

(ii) Any property interest transferred by a donor to the donor's spouse is a *nondeductible interest* to the extent it is not required to be included in a gift tax return for a calendar quarter (for gifts made after December 31, 1970, and before January 1, 1982) or calendar year (for gifts made before January 1, 1971, or after December 31, 1981).

(c) *Computation*—(1) *In general.* The amount of the marital deduction depends upon when the interspousal gifts are made, whether the gifts are terminable interests, whether the limitations of § 25.2523(f)-1A (relating to gifts of community property before January 1, 1982) are applicable, and whether § 25.2523(f)-1 (relating to the election with respect to life estates) is applicable, and (with respect to gifts made on or after July 14, 1988) whether the donee spouse is a citizen of the United States (see section 2523(i)).

(2) *Gifts prior to January 1, 1977.* Generally, with respect to gifts made during a calendar quarter prior to January 1, 1977, the marital deduction allowable under section 2523 is 50 percent of the aggregate value of the deductible interests. See section 2524 for an additional limitation on the amount of the allowable deduction.

(3) *Gifts after December 31, 1976, and before January 1, 1982.* Generally, with respect to gifts made during a calendar quarter beginning after December 31, 1976, and ending prior to January 1, 1982, the marital deduction allowable under section 2523 is computed as a percentage of the deductible interests in those gifts. If the aggregate amount of deductions for such gifts is \$100,000 or less, a deduction is allowed for 100 percent of the deductible interests. No deduction is allowed for otherwise deductible interests in an aggregate amount that exceeds \$100,000 and is equal to or less than \$200,000. For deductible interests in excess of \$200,000, the deduction is limited to 50 percent of such deductible interests. If a donor remarries, the computations in this paragraph (c)(3) are made on the basis of aggregate gifts to all persons who at the time of the gifts are the donor's spouse. See section 2524 for an additional limitation on the amount of the allowable deduction.

(4) *Gifts after December 31, 1981.* Generally, with respect to gifts made during a calendar year beginning after December 31, 1981 (other than gifts made on or after July 14, 1988, to a spouse who is not a United States citizen on the date of the transfer), the marital deduction allowable under section 2523 is 100 percent of the aggregate value of the deductible interests. See section 2524 for an additional limitation on the amount of the allowable deduction, and section 2523(i) regarding disallowance of the marital deduction for gifts to a spouse who is not a United States citizen.

(d) *Examples.* The following examples (in which it is assumed that the donors have previously utilized any specific exemptions provided by section 2521 for gifts prior to January 1, 1977) illustrate the application of paragraph (c) of this section and the interrelationship of sections 2523 and 2503.

Example 8. A donor made a transfer by gift to the donor's spouse, a United States citizen, of \$200,000 cash on January 1, 1995. The donor made no other transfers during 1995. For calendar year 1995, the amount excluded under section 2503(b) is \$10,000; the marital deduction is \$190,000; and the amount of taxable gifts is zero (\$200,000—\$10,000 (annual exclusion)—\$190,000 (marital deduction)).

(e) *Valuation.* If the income from property is made payable to the donor or another individual for life or for a term of years, with remainder to the donor's spouse or to the estate of the donor's spouse, the marital deduction is computed (pursuant to § 25.2523(a)–

1(c)) with respect to the present value of the remainder, determined under section 7520. * * *

Par. 30. Section 25.2523(b)–1 is amended as follows:

a. Paragraph (a)(1) is revised.
b. In paragraph (b)(3), the first sentence is amended by removing the reference “§ 25.2523(e)–1” and adding “§ 25.2523(e)–1 or 25.2523(f)–1” in its place.

c. In paragraph (b)(3), the designations “(1)” and “(2)” appearing before each example are revised to read “1.” and “2.”

d. In paragraph (b)(3), the phrase immediately preceding *Example 1* is revised.

e. In paragraph (b)(6), the designations “(1)”, “(2)”, “(3)”, “(4)”, “(5)”, “(6)” appearing before each example are revised to read “1.”, “2.”, “3.”, “4.”, “5.”, “6.”

f. In paragraph (b)(6), the phrase immediately preceding *Example 1* is revised.

g. In paragraph (c)(2), the phrase immediately preceding the example is removed and a sentence is added in its place.

h. The additions and revisions read as follows:

§ 25.2523(b)–1 Life estate or other terminable interest.

(a) *In general.* (1) The provisions of section 2523(b) generally disallow a marital deduction with respect to certain property interests (referred to generally as *terminable interests* and defined in paragraph (a)(3) of this section) transferred to the donee spouse under the circumstances described in paragraph (a)(2) of this section, unless the transfer comes within the purview of one of the exceptions set forth in § 25.2523(d)–1 (relating to certain joint interests); § 25.2523(e)–1 (relating to certain life estates with powers of appointment); § 25.2523(f)–1 (relating to certain qualified terminable interest property); or § 25.2523(g)–1 (relating to certain qualified charitable remainder trusts).

(b) * * *
(3) * * * The following examples, in which it is assumed that the donor did not make an election under sections 2523(f)(2)(C) and (f)(4), illustrate the application of the provisions of this paragraph (b)(3):

(6) * * * In each example, it is assumed that the donor made no election under sections 2523(f)(2)(C) and (f)(4) and that the property interest that the donor transferred to a person other than the donee spouse is not

transferred for adequate and full consideration in money or money's worth: * * *

(c) * * *
(2) * * * The application of this paragraph may be further illustrated by the following example, in which it is assumed that the donor made no election under sections 2523(f)(2)(C) and (f)(4).

Par. 31. § 25.2523(c)–1 is amended by removing the first sentence of paragraph (c) and adding three new sentences in its place to read as follows:

§ 25.2523(c)–1 Interest in unidentified assets.

(c) If both of the circumstances set forth in paragraph (b) of this section exist, only a portion of the property interest passing to the spouse is a deductible interest. The portion qualifying as a deductible interest is an amount equal to the excess, if any, of the value of the property interest passing to the spouse over the aggregate value of the asset (or assets) that if transferred to the spouse would not qualify for the marital deduction. See paragraph (c) of § 25.2523(a)–1 to determine the percentage of the deductible interest allowable as a marital deduction. * * *

Par. 32. The third sentence of § 25.2523(d)–1 is revised to read as follows:

§ 25.2523(d)–1 Joint interests.

* * * Thus, if the donor purchased real property in the name of the donor and the donor's spouse as tenants by the entirety or as joint tenants with rights of survivorship, a marital deduction is allowable with respect to the value of the interest of the donee spouse in the property (subject to the limitations set forth in § 25.2523(a)–1). * * *

Par. 33. Section 25.2523(e)–1, paragraph (c) is revised to read as follows:

§ 25.2523(e)–1 Marital deduction; life estate with power of appointment in donee spouse.

(c) *Meaning of specific portion—(1) In general.* Except as provided in paragraphs (c)(2) and (c)(3) of this section, a partial interest in property is not treated as a *specific portion* of the entire interest. In addition, any specific portion of an entire interest in property is nondeductible to the extent the specific portion is subject to invasion for the benefit of any person other than the donee spouse, except in the case of

a deduction allowable under section 2523(e), relating to the exercise of a general power of appointment by the donee spouse.

(2) *Fraction or percentage share.* Under section 2523(e), a partial interest in property is treated as a specific portion of the entire interest if the rights of the donee spouse in income, and the required rights as to the power described in § 25.2523(e)-1(a), constitute a fractional or percentage share of the entire property interest, so that the donee spouse's interest reflects its proportionate share of the increase or decrease in the value of the entire property interest to which the income rights and the power relate. Thus, if the spouse's right to income and the spouse's power extend to a specified fraction or percentage of the property, or its equivalent, the interest is in a specific portion of the property. In accordance with paragraph (b) of this section, if the spouse has the right to receive the income from a specific portion of the trust property (after applying paragraph (c)(3) of this section) but has a power of appointment over a different specific portion of the property (after applying paragraph (c)(3) of this section), the marital deduction is limited to the lesser specific portion.

(3) *Special rule in the case of gifts made on or before October 24, 1992.* In the case of gifts within the purview of the effective date rule contained in paragraph (c)(3)(iii) of this section:

(i) A specific sum payable annually, or at more frequent intervals, out of the property and its income that is not limited by the income of the property is treated as the right to receive the income from a specific portion of the property. The specific portion, for purposes of paragraph (c)(3)(i) of this section, is the portion of the property that, assuming the interest rate generally applicable for the valuation of annuities at the time of the donor's gift, would produce income equal to such payments. However, a pecuniary amount payable annually to a donee spouse is not treated as a right to the income from a specific portion of trust property for purposes of this paragraph (c)(3)(i) if any person other than the donee spouse may receive, during the donee spouse's lifetime, any distribution of the property. To determine the applicable interest rate for valuing annuities, see sections 2512 and 7520 and the regulations under those sections.

(ii) The right to appoint a pecuniary amount out of a larger fund (or trust corpus) is considered the right to appoint a specific portion of such fund or trust in an amount equal to such pecuniary amount.

(iii) The rules contained in paragraphs (c)(3) (i) and (ii) of this section apply with respect to gifts made on or before October 24, 1992.

(4) *Local law.* A partial interest in property is treated as a specific portion of the entire interest if it is shown that the donee spouse has rights under local law that are identical to those the donee spouse would have acquired had the partial interest been expressed in terms satisfying the requirements of paragraph (c)(2) of this section (or paragraph (c)(3) of this section if applicable).

(5) *Examples.* The following examples illustrate the application of paragraphs (b) and (c) of this section, where D, the donor, transfers property to D's spouse, S:

Example 1. Spouse entitled to the lesser of an annuity or a fraction of trust income. Prior to October 24, 1992, D transferred in trust 500 identical shares of X Company stock, valued for gift tax purposes at \$500,000. The trust provided that during the lifetime of D's spouse, S, the trustee is to pay annually to S the lesser of one-half of the trust income or \$20,000. Any trust income not paid to S is to be accumulated in the trust and may not be distributed during S's lifetime. S has a testamentary general power of appointment over the entire trust principal. The applicable interest rate for valuing annuities as of the date of D's gift under section 7520 is 10 percent. For purposes of paragraphs (a) through (c) of this section, S is treated as receiving all of the income from the lesser of one-half of the stock (\$250,000), or \$200,000, the specific portion of the stock which, as determined in accordance with § 25.2523(e)-1(c)(3)(i) of this chapter, would produce annual income of \$20,000 ($20,000/10$). Accordingly, the marital deduction is limited to \$200,000 ($200,000/500,000$ or $2/5$ of the value of the trust.)

Example 2. Spouse possesses power and income interest over different specific portions of trust. The facts are the same as in Example 1 except that S's testamentary general power of appointment is exercisable over only $1/4$ of the trust principal. Consequently, under section 2523(e), the marital deduction is allowable only for the value of $1/4$ of the trust (\$125,000); i.e., the lesser of the value of the portion with respect to which S is deemed to be entitled to all of the income ($2/5$ of the trust or \$200,000), or the value of the portion with respect to which S possesses the requisite power of appointment ($1/4$ of the trust or \$125,000).

Example 3. Power of appointment over shares of stock constitutes a power over a specific portion. D transferred 250 identical shares of Y company stock to a trust under the terms of which trust income is to be paid annually to S, during S's lifetime. S was given a testamentary general power of appointment over 100 shares of stock. The trust provides that if the trustee sells the Y company stock, S's general power of appointment is exercisable with respect to the sale proceeds or the property in which the proceeds are reinvested. Because the amount of property represented by a single

share of stock would be altered if the corporation split its stock, issued stock dividends, made a distribution of capital, etc., a power to appoint 100 shares at the time of S's death is not necessarily a power to appoint the entire interest that the 100 shares represented on the date of D's gift. If it is shown that, under local law, S has a general power to appoint not only the 100 shares designated by D but also 100/250 of any distributions by the corporation that are included in trust principal, the requirements of paragraph (c)(2) of this section are satisfied and S is treated as having a general power to appoint 100/250 of the entire interest in the 250 shares. In that case, the marital deduction is limited to 40 percent of the trust principal. If local law does not give S that power, the 100 shares would not constitute a specific portion under § 25.2523(e)-1(c) (including § 25.2523(e)-1(c)(3)(iii)). The nature of the asset is such that a change in the capitalization of the corporation could cause an alteration in the original value represented by the shares at the time of the transfer and is thus not a specific portion of the trust.

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Par. 34. An undesignated center heading is added immediately following § 25.2524-1 to read as follows:

"Deductions Prior to 1982"

Par. 35. Section 25.2523(f)-1 is redesignated as § 25.2523(f)-1A under the new undesignated center heading "Deductions Prior to 1982" and amended as follows:

- (a) The section heading of newly designated § 25.2523(f)-1A is revised.
- (b) The first sentence of paragraph (a) is revised.
- (c) The revisions read as follows:

§ 25.2523(f)-1 A Special rule applicable to community property transferred prior to January 1, 1982.

(a) *In general.* With respect to gifts made prior to January 1, 1982, the marital deduction is allowable with respect to any transfer by a donor to the donor's spouse only to the extent that the transfer is shown to represent a gift of property that was not, at the time of the gift, held as *community property*, as defined in paragraph (b) of this section.

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Par. 36. New §§ 25.2523(f)-1, 25.2523(g)-1, 25.2523(h)-1 and 25.2523(h)-2 are added to read as follows:

§ 25.2523(f)-1 Election with respect to life estate transferred to donee spouse.

(a) *In general.* (1) With respect to gifts made after December 31, 1981, subject to section 2523(i), a marital deduction is allowed under section 2523(a) for transfers of *qualified terminable interest property*. Qualified terminable interest property is terminable interest property described in section 2523(b)(1) that

satisfies the requirements of section 2523(f)(2) and this section. Terminable interests that are described in section 2523(b)(2) cannot qualify as qualified terminable interest property. Thus, if the donor retains a power described in section 2523(b)(2) to appoint an interest in qualified terminable interest property, no deduction is allowable under section 2523(a) for the property.

(2) All of the property for which a deduction is allowed under this paragraph (a) is treated as passing to the donee spouse (for purposes of § 25.2523(a)-1), and no part of the property is treated as retained by the donor or as passing to any person other than the donee spouse (for purposes of § 25.2523(b)-1(b)).

(b) *Qualified terminable interest property*—(1) *Definition*. Section 2523(f)(2) provides the definition of qualified terminable interest property.

(2) *Meaning of property*. For purposes of section 2523(f)(2), the term *property* generally means an *entire interest in property* (within the meaning of § 25.2523(e)-1(d)) or a *specific portion of the entire interest* (within the meaning of § 25.2523(e)-1(c)).

(3) *Property for which the election may be made*—(i) *In general*. The election may relate to all or any part of property that meets the requirements of section 2523(f)(2) (A) and (B), provided that any partial election must be made with respect to a fractional or percentage share of the property so that the elective portion reflects its proportionate share of the increase or decrease in the entire property for purposes of applying sections 2044 or 2519. Thus, if the interest of the donee spouse in a trust (or other property in which the spouse has a qualifying income interest) meets the requirements of this section, the election may be made under section 2523(f)(2)(C) with respect to a part of the trust (or other property) only if the election relates to a defined fraction or percentage of the entire trust (or other property) or specific portion thereof within the meaning of § 25.2523(e)-1(c). The fraction or percentage may be defined by formula.

(ii) *Division of trusts*. If the interest of the donee spouse in a trust meets the requirements of this section, the trust may be divided into separate trusts to reflect a partial election that has been made, if authorized under the terms of the governing instrument or otherwise permissible under local law. A trust may be divided only if the fiduciary is required, either by applicable local law or by the express or implied provisions of the governing instrument, to divide the trust according to the fair market

value of the assets of the trust at the time of the division. The division of the trusts must be done on a fractional or percentage basis to reflect the partial election. However, the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust.

(4) *Manner and time of making election*. (i) An election under section 2523(f)(2)(C) (other than a deemed election with respect to a joint and survivor annuity as described in section 2523(f)(6)), is made on a gift tax return for the calendar year in which the interest is transferred. The return must be filed within the time prescribed by section 6075(b) (determined without regard to section 6019(a)(2)), including any extensions authorized under section 6075(b)(2) (relating to an automatic extension of time for filing a gift tax return where the donor is granted an extension of time to file the income tax return).

(ii) If the election is made on a return for the calendar year that includes the date of death of the donor, the return (as prescribed by section 6075(b)(3)) must be filed no later than the time (including extensions) for filing the estate tax return. The election, once made, is irrevocable.

(c) *Qualifying income interest for life*—(1) *In general*. For purposes of this section, the term *qualifying income interest for life* is defined as provided in section 2056(b)(7)(B)(ii) and § 20.2056(b)-7(d)(1).

(i) *Entitled for life to all the income*. The principles outlined in § 25.2523(e)-1(f) (relating to whether the spouse is entitled for life to all of the income from the entire interest or a specific portion of the entire interest) apply in determining whether the donee spouse is entitled for life to all the income from the property, regardless of whether the interest passing to the donee spouse is in trust. An income interest granted for a term of years, or a life estate subject to termination upon the occurrence of a specified event (e.g., divorce) is not a qualifying income interest for life.

(ii) *Income between last distribution date and date of spouse's death*. An income interest does not fail to constitute a qualifying income interest for life solely because income for the period between the last distribution date and the date of the donee spouse's death is not required to be distributed to the estate of the donee spouse. See § 20.2044-1 of this chapter relating to the inclusion of such undistributed income in the gross estate of the donee spouse.

(iii) *Pooled income funds*. An income interest in a pooled income fund

described in section 642(c)(5) constitutes a qualifying income interest for life for purposes of this section.

(iv) *Distribution of principal for the benefit of the donee spouse*. An income interest does not fail to constitute a qualifying income interest for life solely because the trustee has a power to distribute principal to or for the benefit of the donee spouse. The fact that property distributed to a donee spouse may be transferred by the spouse to another person does not result in a failure to satisfy the requirement of section 2056(b)(7)(B)(ii)(II). However, if the governing instrument requires the donee spouse to transfer the distributed property to another person without full and adequate consideration in money or money's worth, the requirement of section 2056(b)(7)(B)(ii)(II) is not satisfied.

(2) *Immediate right to income*. In order to constitute a qualifying income interest for life, the donee spouse must be granted the immediate right to receive the income from the property. Thus, an income interest does not constitute a qualifying income interest for life if the donee spouse receives the right to trust income commencing at some time in the future, e.g., on the termination of a preceding life income interest of the donor spouse.

(3) *Annuities payable from trusts in the case of gifts made on or before October 24, 1992*. (i) In the case of gifts made on or before October 24, 1992, a donee spouse's lifetime annuity interest payable from a trust or other group of assets passing from the donor is treated as a qualifying income interest for life for purposes of section 2523(f)(2)(B). The deductible interest, for purposes of § 25.2523(a)-1(b), is the specific portion of the property that, assuming the applicable interest rate for valuing annuities at the time the annuity interest is transferred, would produce income equal to the minimum amount payable annually to the donee spouse. If, based on the applicable interest rate, the entire property from which the annuity may be satisfied is insufficient to produce income equal to the minimum annual payment, the value of the deductible interest is the entire value of the property. The value of the deductible interest may not exceed the value of the property from which the annuity is payable. If the annual payment may increase, the increased amount is not taken into account in valuing the deductible interest.

(ii) An annuity interest is not treated as a qualifying income interest for life for purposes of section 2523(f)(2)(B) if any person other than the donee spouse may receive during the donee spouse's

lifetime, any distribution of the property or its income from which the annuity is payable.

(iii) To determine the applicable interest rate for valuing annuities, see sections 2512 and 7520 and the regulations under those sections.

(4) Joint and survivor annuities.

[Reserved]

(d) *Treatment of interest retained by the donor spouse*—(1) *In general.* Under section 2523(f)(5)(A), if a donor spouse retains an interest in qualified terminable interest property, any subsequent transfer by the donor spouse of the retained interest in the property is not treated as a transfer for gift tax purposes. Further, the retention of the interest until the donor spouse's death does not cause the property subject to the retained interest to be includable in the gross estate of the donor spouse.

(2) *Exception.* Under section 2523(f)(5)(B), the rule contained in paragraph (d)(1) of this section does not apply to any property after the donee spouse is treated as having transferred the property under section 2519, or after the property is includable in the gross estate of the donee spouse under section 2044.

(e) *Application of local law.* The provisions of local law are taken into account in determining whether or not the conditions of section 2523(f)(2) (A) and (B), and the conditions of paragraph (c) of this section, are satisfied. For example, silence of a trust instrument on the frequency of payment is not regarded as a failure to satisfy the requirement that the income must be payable to the donee spouse annually or more frequently unless applicable local law permits payments less frequently to the donee spouse.

(f) *Examples.* The following examples illustrate the application of this section, where D, the donor, transfers property to D's spouse, S. Unless stated otherwise, it is assumed that S is not the trustee of any trust established for S's benefit:

Example 1. Life estate in residence. D transfers by gift a personal residence valued at \$250,000 on the date of the gift to S and D's children, giving S the exclusive and unrestricted right to use the property (including the right to continue to occupy the property as a personal residence or rent the property and receive the income for her lifetime). After S's death, the property is to pass to D's children. Under applicable local law, S's consent is required for any sale of the property. If D elects to treat all of the transferred property as qualified terminable interest property, the deductible interest is \$250,000, the value of the property for gift tax purposes.

Example 2. Power to make property productive. D transfers assets having a fair

market value of \$500,000 to a trust pursuant to which S is given the right exercisable annually to require distribution of all the trust income to S. No trust property may be distributed during S's lifetime to any person other than S. The assets used to fund the trust include both income producing assets and nonproductive assets. Applicable local law permits S to require that the trustee either make the trust property productive or sell the property and reinvest the proceeds in productive property within a reasonable time after the transfer. If D elects to treat the entire trust as qualified terminable interest property, the deductible interest is \$500,000. If D elects to treat only 20 percent of the trust as qualified terminable interest property, the deductible interest is \$100,000; i.e., 20 percent of \$500,000.

Example 3. Power of distribution over fraction of trust income. The facts are the same as in Example 2 except that S is given the power exercisable annually to require distribution to S of only 50 percent of the trust income for life. The remaining trust income may be accumulated or distributed among D's children and S in the trustee's discretion. The maximum amount that D may elect to treat as qualified terminable interest property is \$250,000; i.e., the value of the trust for gift tax purposes (\$500,000) multiplied by the percentage of the trust in which S has a qualifying income interest for life (50 percent). If D elects to treat only 20 percent of the portion of the trust in which S has a qualifying income interest as qualified terminable interest property, the deductible interest is \$50,000; i.e., 20 percent of \$250,000.

Example 4. Power to distribute trust corpus to other beneficiaries. D transfers \$500,000 to a trust providing that all the trust income is to be paid to D's spouse, S, during S's lifetime. The trustee is given the power to use annually \$5,000 from the trust for the maintenance and support of S's minor child, C. Any such distribution does not necessarily relieve S of S's obligation to support and maintain C. S does not have a qualifying income interest for life in any portion of the trust because the gift fails to satisfy the condition in sections 2523(f)(3) and 2056(b)(7)(B)(ii)(II) that no person have a power, other than a power the exercise of which takes effect only at or after S's death, to appoint any part of the property to any person other than S. The trust would also be nondeductible under section 2523(f) if S, rather than the trustee, were given the power to appoint a portion of the principal to C. However, in the latter case, if S made a qualified disclaimer (within the meaning of section 2518) of the power to appoint to C, the trust could qualify for the marital deduction pursuant to section 2523(f), assuming that the power was personal to S and S's disclaimer terminates the power. Similarly, if C made a qualified disclaimer of the right to receive distributions from the trust, the trust would qualify under section 2523(f) assuming that C's disclaimer effectively negates the trustee's power under local law.

Example 5. Spouse's interest terminable on divorce. The facts are the same as in Example 3 except that if S and D divorce, S's interest

in the trust will pass to C. S's income interest is not a qualifying income interest for life because it is terminable upon S's divorce. Therefore, no portion of the trust is deductible under section 2523(f).

Example 6. Spouse's interest in trust in the form of an annuity. Prior to October 24, 1992, D established a trust funded with income producing property valued for gift tax purposes at \$800,000. The trustee is required by the trust instrument to pay \$40,000 a year to S for life. Any income in excess of the annuity amount is to be accumulated in the trust and may not be distributed during S's lifetime. S's lifetime annuity interest is treated as a qualifying income interest for life. If D elects to treat the entire portion of the trust in which S has a qualifying income interest as qualified terminable interest property, the value of the deductible interest is \$400,000, because that amount would yield an income to S of \$40,000 a year (assuming a 10 percent interest rate applies in valuing annuities at the time of the transfer).

Example 7. Value of spouse's annuity exceeds value of trust corpus. The facts are the same as in Example 6, except that the trustee is required to pay S \$100,000 a year for S's life. If D elects to treat the entire portion of the trust in which S has a qualifying income interest for life as qualified terminable interest property, the value of the deductible interest is \$800,000, which is the lesser of the entire value of the property (\$800,000) or the amount of property that (assuming a 10 percent interest rate) would yield an income to S of \$100,000 a year (\$1,000,000).

Example 8. Transfer to pooled income fund. D transfers \$200,000 on June 1, 1994, to a pooled income fund (described in section 642(c)(5)) designating S as the only life income beneficiary. If D elects to treat the entire \$200,000 as qualified terminable interest property, the deductible interest is \$200,000.

Example 9. Retention by donor spouse of income interest in property. On October 1, 1994, D transfers property to an irrevocable trust under the terms of which trust income is to be paid to D for life, then to S for life and, on S's death, the trust corpus is to be paid to D's children. Because S does not possess an immediate right to receive trust income, S's interest does not qualify as a qualifying income interest for life under section 2523(f)(2). Further, under section 2702(a)(2) and § 25.2702-2(b), D is treated for gift tax purposes as making a gift with a value equal to the entire value of the property. If D dies in 1996 survived by S, the trust corpus will be includable in D's gross estate under section 2036. However, in computing D's estate tax liability, D's adjusted taxable gifts under section 2001(b)(1)(B) are adjusted to reflect the inclusion of the gifted property in D's gross estate. In addition, if S survives D, the trust property is eligible for treatment as qualified terminable interest property under section 2056(b)(7) in D's estate.

Example 10. Retention by donor spouse of income interest in property. On October 1, 1994, D transfers property to an irrevocable trust under the terms of which trust income is to be paid to S for life, then to D for life

and, on D's death, the trust corpus is to be paid to D's children. D elects under section 2523(f) to treat the property as qualified terminable interest property. D dies in 1996, survived by S. S subsequently dies in 1998. Under § 2523(f)-1(d)(1), because D elected to treat the transfer as qualified terminable interest property, no part of the trust corpus is includible in D's gross estate because of D's retained interest in the trust corpus. On S's subsequent death in 1998, the trust corpus is includible in S's gross estate under section 2044.

Example 11. Retention by donor spouse of income interest in property. The facts are the same as in Example 10, except that S dies in 1996 survived by D, who subsequently dies in 1998. Because D made an election under section 2523(f) with respect to the trust, on S's death the trust corpus is includible in S's gross estate under section 2044. Accordingly, under section 2044(c), S is treated as the transferor of the property for estate and gift tax purposes. Upon D's subsequent death in 1998, because the property was subject to inclusion in S's gross estate under section 2044, the exclusion rule in § 25.2523(f)-1(d)(1) does not apply under § 25.2523(f)-1(d)(2). However, because S is treated as the transferor of the property, the property is not subject to inclusion in D's gross estate under section 2036 or section 2038. If the executor of S's estate made a section 2056(b)(7) election with respect to the trust, the trust is includible in D's gross estate under section 2044 upon D's later death.

§ 25.2523(g)-1 Special rule for charitable remainder trusts.

(a) *In general.* (1) With respect to gifts made after December 31, 1981, subject to section 2523(i), if the donor's spouse is the only noncharitable beneficiary (other than the donor) of a charitable remainder annuity trust or charitable remainder unitrust described in section 664 (qualified charitable remainder trust), section 2523(b) does not apply to the interest in the trust transferred to the donee spouse. Thus, the value of the annuity or unitrust interest passing to the spouse qualifies for a marital deduction under section 2523(g) and the value of the remainder interest qualifies for a charitable deduction under section 2522.

(2) A marital deduction for the value of the donee spouse's annuity or unitrust interest in a qualified charitable remainder trust to which section 2523(g) applies is allowable only under section 2523(g). Therefore, if an interest in property qualifies for a marital deduction under section 2523(g), no election may be made with respect to the property under section 2523(f).

(3) The donee spouse's interest need not be an interest for life to qualify for a marital deduction under section 2523(g). However, for purposes of section 664, an annuity or unitrust interest payable to the spouse for a term of years cannot be payable for a term

that exceeds 20 years or the trust does not qualify under section 2523(g).

(4) A deduction is allowed under section 2523(g) even if the transfer to the donee spouse is conditioned on the donee spouse's payment of state death taxes, if any, attributable to the qualified charitable remainder trust.

(5) For purposes of this section, the term *noncharitable beneficiary* means any beneficiary of the qualified charitable remainder trust other than an organization described in section 170(c).

(b) *Charitable remainder trusts where the donee spouse and the donor are not the only noncharitable beneficiaries.* In the case of a charitable remainder trust where the donor and the donor's spouse are not the only noncharitable beneficiaries (for example, where the noncharitable interest is payable to the donor's spouse for life and then to another individual (other than the donor) for life), the qualification of the interest as qualified terminable interest property is determined solely under section 2523(f) and not under section 2523(g). Accordingly, if the transfer to the trust is made prior to October 24, 1992, the spousal annuity or unitrust interest may qualify under § 25.2523(f)-1(c)(3) as a qualifying income interest for life.

§ 25.2523(h)-1 Denial of double deduction.

The value of an interest in property may not be deducted for Federal gift tax purposes more than once with respect to the same donor. For example, assume that D, a donor, transferred a life estate in a farm to D's spouse, S, with a remainder to charity and that D elects to treat the property as qualified terminable interest property. The entire value of the property is deductible under section 2523(f). No part of the value of the property qualifies for a charitable deduction under section 2522 for gift tax purposes.

§ 25.2523(h)-2 Effective dates.

Except as specifically provided, in §§ 25.2523(e)-1(c)(3), 25.2523(f)-1(c)(3), and 25.2523(g)-1(b), the provisions of §§ 25.2523(e)-1(c), 25.2523(f)-1, 25.2523(g)-1, and 25.2523(h)-1 are effective with respect to gifts made after March 1, 1994. With respect to gifts made on or before such date, donors may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of §§ 25.2523(e)-1(c), 25.2523(f)-1, 25.2523(g)-1, and 25.2523(h)-1, (as well as project LR-211-76, 1984-1 C.B., page 598, see § 601.601(d)(2)(ii)(b) of this chapter), are considered a reasonable interpretation of the statutory provisions.

Par. 37. Section 25.6019-1 is amended as follows:

- a. Paragraphs (a) and (b) are revised.
- b. Paragraphs (c) and (d) are redesignated paragraphs (g) and (h).
- c. New paragraphs (c) through (f) are added.
- d. The revisions and additions read as follows:

§ 25.6019-1 Persons required to file returns.

(a) *Gifts made after December 31, 1981.* Subject to section 2523(i)(2), an individual citizen or resident of the United States who in any calendar year beginning after December 31, 1981, makes any transfer by gift other than a transfer that, under section 2503 (b) or (e) (relating, respectively, to certain gifts of \$10,000 per donee and the exclusion for payment of certain educational and medical expenses), is not included in the total amount of gifts for that year, or a transfer of an interest with respect to which a marital deduction is allowed for the value of the entire interest under section 2523 (other than a marital deduction allowed by reason of section 2523(f), regarding qualified terminable interest property for which a return must be filed in order to make the election under that section), must file a gift tax return on Form 709 for that calendar year.

(b) *Gifts made after December 31, 1976, and before January 1, 1982.* An individual citizen or resident of the United States who makes a transfer by gift within any calendar year beginning after December 31, 1976, and before January 1, 1982, must file a gift tax return on Form 709 for any calendar quarter in which the sum of the taxable gifts made during that calendar quarter, plus all other taxable gifts made during the year (for which a return has not yet been required to be filed), exceeds \$25,000. If the aggregate transfers made in a calendar year after 1976 and before 1982 that must be reported do not exceed \$25,000, only one return must be filed for the calendar year and it must be filed by the due date for a fourth quarter gift tax return (April 15).

(c) *Gifts made after December 31, 1970, and before January 1, 1977.* An individual citizen or resident of the United States who makes a transfer by gift within any calendar year beginning after December 31, 1970, and before January 1, 1977, must file a gift tax return on Form 709 for the calendar quarter in which any portion of the value of the gift, or any portion of the sum of the values of the gifts to such donee during that calendar year, is not excluded from the total amount of taxable gifts for that year, and must also

make a return for any subsequent quarter within the same taxable year in which any additional gift is made to the same donee.

(d) *Gifts by nonresident alien donors.* The rules contained in paragraphs (a) through (c) of this section also apply to a nonresident not a citizen of the United States provided that, under section 2501(a)(1) and § 25.2511-3, the transfer is subject to the gift tax.

(e) *Miscellaneous provisions.* Only individuals are required to file returns and not trusts, estates, partnerships, or corporations. Duplicate copies of the return are not required to be filed. See §§ 25.6075-1 and 25.6091-1 for the time and place for filing the gift tax return. For delinquency penalties for failure to file or pay the tax, see section 6651 and § 301.6651-1 of this chapter (Procedure and Administration Regulations). For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

(f) *Return required even if no tax due.* The return is required even though, because of the deduction authorized by section 2522 (charitable deduction) or the unified credit under section 2005, no tax may be payable on the transfer.

Par. 38. Section 25.6019-2 is revised to read as follows:

§ 25.6019-2 Returns required in case of consent under section 2513.

Except as otherwise provided in this section, the provisions of § 25.6019-1 (other than paragraph (d) of § 25.6019-1) apply with respect to the filing of a gift tax return or returns in the case of a husband and wife who consent (see § 25.2513-1) to the application of section 2513. If both spouses are (without regard to the provisions of section 2513) required under the provisions of § 25.6019-1 to file returns, returns must be filed by both spouses. If only one of the consenting spouses is (without regard to the provisions of section 2513) required under § 25.6019-1 to file a return, a return must be filed by that spouse. In the latter case if, after giving effect to the provisions of section 2513, the other spouse is considered to have made a gift not excluded from the total amount of such other spouse's gifts for the taxable year by reason of section 2503 (b) or (e) (relating, respectively, to certain gifts of \$10,000 per donee and the exclusion for certain educational or medical expenses), a return must also be filed by such other spouse. Thus, if during a calendar year beginning after December 31, 1981, the first spouse made a gift of \$18,000 to a child (the gift not being either a future interest in

property or an amount excluded under section 2503(e)) and the other spouse made no gifts, only the first spouse is required to file a return for that calendar year. However, if the other spouse had made a gift in excess of \$2,000 to the same child during the same calendar year or if the gift made by the first spouse had amounted to \$21,000, each spouse would be required to file a return if the consent is signified as provided in section 2513.

Par. 39. Section 25.6019-3 is amended as follows:

a. The first sentence in paragraph (a) is revised.

b. The second sentence in paragraph (b) is revised.

c. The revisions read as follows:

§ 25.6019-3 Contents of return.

(a) *In general.* The return must set forth each gift made during the calendar year (or calendar quarter with respect to gifts made after December 31, 1970, and before January 1, 1982) that under sections 2511 through 2515 is to be included in computing taxable gifts; the deductions claimed and allowable under sections 2521 through 2524; and the taxable gifts made for each of the preceding reporting periods. * * *

(b) * * * In any case where a husband and wife enter into a written agreement of the type contemplated by section 2516 and the final decree of divorce is not granted on or before the due date for the filing of a gift tax return for the calendar year (or calendar quarter with respect to periods beginning after December 31, 1970, and ending before January 1, 1982) in which the agreement became effective (see § 25.6075-1), then, except to the extent § 25.6019-1 provides otherwise, the transfer must be disclosed by the transferor upon a gift tax return filed for the calendar year (or calendar quarter) in which the agreement becomes effective, and a copy of the agreement must be attached to the return. * * *

Par. 40. Section § 25.6019-4 is amended by revising the first sentence to read as follows:

§ 25.6019-4 Description of property listed in return.

The properties comprising the gifts made during the calendar year (or calendar quarter with respect to gifts made after December 31, 1970, and before January 1, 1982) must be listed on the return and described in a manner that they may be readily identified.

* * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 41. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 42. Section 602.101(c) is amended by adding two entries in numerical order in the table to read as follows:

§ 602.101 OMB Control numbers.

(c) * * *

CFR part or section where identified and described	Current OMB control No.
20.2056(b)-7.....	1545-0015
25.2523(f)-1.....	1545-0015

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved: January 7, 1994.

Leslie Samuels,
Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 94-3945 Filed 2-28-94; 8:45 am]

BILLING CODE 4830-01-U

26 CFR Part 31

[TD 8525]

RIN 1545-AR07

Supplemental Annuity Tax—Railroad Retirement

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning the supplemental annuity tax under the Railroad Retirement Tax Act (RRTA). The regulations contain rules for calculating the work-hours subject to the tax. The regulations also contain a safe harbor that railroad employers may use to determine the taxable work-hours in lieu of calculating work-hours separately for each employee. The regulations provide railroad employers with guidance necessary to comply with the law and offer a simple safe-harbor calculation that can significantly reduce the burden on employers. The regulations affect all railroad employers and employee representatives.

EFFECTIVE DATES: These regulations are effective for calendar years beginning after December 31, 1992, except that

§ 31.3221-3(d) is effective for calendar years beginning after December 31, 1993.

FOR FURTHER INFORMATION CONTACT:
Karin Loverud at 202-622-6060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On May 13, 1993, the IRS published in the *Federal Register* (58 FR 28371) proposed amendments to the Employment Tax Regulations (26 CFR part 31) under section 3221(c) of the Internal Revenue Code (Code), which imposes a supplemental tax on railroad employers for each work-hour for which compensation is paid by the employer for services rendered to the employer during a calendar quarter.

Two written comments were received from the public on the proposed regulations, and a public hearing was held on August 30, 1993. After consideration of the written comments received and the statements made at the public hearing, the proposed regulations are adopted by this Treasury decision.

Explanation of Provisions

Retirement benefits for railroad employees are provided under a system that currently combines elements similar to those under both the social security system and the private pension system.

In addition to Tier I benefits (similar to social security benefits) and Tier II benefits (similar to private pension benefits), a supplemental retirement annuity was established in 1966 by Public Law 89-699 (1966 Act). The benefit provisions are administered by the Railroad Retirement Board (Board).

The 1966 Act established a program to be administered by the Board for the payment of supplemental annuities for career railroad employees. The program, which was required to be self-financing, was to be financed separately from the regular railroad retirement program by imposing on railroad employers an excise tax under section 3221(c) of the Code. The rate was originally set at 2 cents for each work-hour of employment. In 1970, Public Law 91-215 replaced the 2-cents rate with a rate determined quarterly by the Board at a level sufficient to finance the annuities. The rate is currently 30 cents.

The supplemental tax is imposed on every employer for each work-hour for which compensation is paid by the employer for services rendered to the employer during a calendar quarter. Section 3211(b) of the Code imposes a similar tax on employee representatives.

No tax is imposed on employees to fund the supplemental annuities.

The only guidance previously published with respect to the supplemental tax is in the instructions for Form CT-1, Employer's Annual Railroad Retirement and Unemployment Repayment Tax Return. The instructions today are nearly identical to the instructions 25 years ago. Nevertheless, in recent years, significant variations in the interpretation of the statutory language have arisen.

Definition of Work-Hours

The final regulations, like the proposed regulations, do not change the longstanding interpretation of work-hours that was included in the instructions for Form CT-1 when the supplemental annuity tax was enacted. A commentator suggested that the 1970 legislation clarified that the term is limited to those hours both worked and paid for, and recommended that the regulations be revised accordingly. This recommendation has not been adopted for the reasons set forth below.

The definition of work-hours as it appeared in the instructions for Form CT-1 was not changed following the 1970 legislation, because the IRS believed that the revised statutory language was not intended to change the meaning of work-hours, or to clarify its meaning. When the taxing provision was enacted in 1966, the tax was equal to 2 cents for each work-hour. The 1970 legislation changed the rate from 2 cents to a rate to be determined quarterly by the Board, beginning April 1, 1970. Because the rate would no longer be constant, Congress changed the statutory language to make it clear that the taxing period is a calendar quarter and that, for purposes of the tax, the timing of the services, not the timing of the payment for the services, governed.

With respect to services rendered, the Treasury and the IRS believe that Congress intended to tax those hours for which the employee was paid both to perform and not to perform services. If an employee is guaranteed x hours of work a week and is paid for x hours, this is the number of hours to be taxed, even if there are less than x hours of work to be performed. The Treasury and the Service believe that this is so whether the employee is expected to report to the work site and do no work, whether the employee is not expected to report when no work is available, or whether the employee is not expected to report when no work is available but is expected to be available to be called to work.

The 1970 legislation did not alter the statutory language regarding employees

who receive daily, weekly, or monthly rates of compensation. The language is clear that the tax applies to the number of hours comprehended in the rate, plus overtime hours. Thus, if a monthly rate of compensation comprehends that the employee is entitled to time off from work for holiday time, vacation time, and sick time, all of those hours are taxed, not merely the hours during which the employee actually performed services.

Safe Harbor

The final regulations retain a safe harbor method of calculating work-hours provided in the proposed regulations. Under the safe harbor, the employer counts the number of employees who received any compensation during the month and multiplies that figure by a "safe harbor number" to determine the number of work-hours subject to the tax. Each individual who is paid compensation is counted, even if the individual is a part-time, temporary, or seasonal employee. For purposes of the safe harbor count, it is irrelevant whether an employee actually performed any services for the employer during the month.

The Treasury and the IRS believe that the safe harbor is an attractive method of significantly reducing administrative complexity, because the safe harbor will simplify calculation of the supplemental annuity tax. The Service has worked with the railroad industry in establishing a safe harbor number that will fairly and equitably implement the supplemental annuity tax provisions while providing a method of computing the liability that reduces the need to make a work-hour determination on an individual-by-individual basis. The Treasury and the IRS anticipate that, for most employers, use of the safe harbor number will result in fewer taxable hours, and the Board will adjust the tax rate accordingly.

The regulations provide the Commissioner with the authority to publish the safe harbor number in guidance of general applicability. Pursuant to this grant of authority, a revenue procedure will be published to announce the safe harbor number. Commentators on the proposed regulations, representing both the Class I railroads and the Class III railroads, suggested a safe harbor number of 164. These comments have been taken into account in developing the revenue procedure.

Retroactivity

One commentator suggested that the safe harbor provision be made retroactive to the election of the

taxpayer. Because the number the safe harbor produces is generally more favorable than work-hours calculated under the regulations, retroactive application of the safe harbor would, in many situations, produce taxable work-hours at levels below those anticipated when prior-period tax rates were set. Also, retroactive application would be inequitable because some taxpayers have many open tax years and others do not. For these reasons, the Treasury and the IRS have rejected any period of retroactivity and, therefore, this approach is not included in the final regulations. Thus, the safe harbor provision is effective for calendar years beginning after December 31, 1993, as proposed.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Karin Loverud of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 31

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 31 is amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Paragraph 1. The authority citation for part 31 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 31.3211-3 is added to read as follows:

§ 31.3211-3 Employee representative supplemental tax.

See paragraphs (a), (b), and (c) of § 31.3221-3 for rules applicable to the supplemental tax for each work-hour for which compensation is paid to an employee representative for services rendered as an employee representative.

Par. 3. Section 31.3221-3 is added under the heading "Tax on Employers" to read as follows:

§ 31.3221-3 Supplemental tax.

(a) *Introduction*—(1) *In general.* Section 3221(c) imposes an excise tax on every employer, as defined in section 3231(a) and § 31.3231(a)-1, with respect to individuals employed by the employer. The tax is imposed for each work-hour for which the employer pays compensation, as defined in section 3231(e) and § 31.3231(e)-1, for services rendered to the employer during a calendar quarter. This § 31.3221-3 provides rules for determining the number of taxable work-hours.

(2) *Overview.* Paragraph (b) of this section defines work-hours. Paragraph (c) of this section demonstrates the calculation of work-hours. Paragraph (d) of this section offers a safe harbor calculation of work-hours for use by any employer in lieu of calculating the number of work-hours for each employee.

(b) *Definition of work-hours*—(1) *In general.* For purposes of section 3221(c) and this section, work-hours are hours for which the employee is compensated, whether or not the employee performs services.

(i) *Payments included in work-hours.* Work-hours include regular time worked; overtime; time paid for vacations and holidays; time allowed for meals; away-from-home terminal time; called and not used, runaround, and deadheading time; time for attending court, participating in investigations, and attending claim and safety meetings; and guaranteed time not worked. Work-hours also include conversion hours, that is, compensation converted into work-hours. Conversion hours may be derived from payment by the mile or by the piece. Work-hours also include time for which the employee is paid for periods of absence not due to sickness or accident disability, such as for routine medical and dental examinations or for time lost.

(ii) *Payments excluded from work-hours.* Certain kinds of payments are not subject to conversion into work-hours. These include those payments that are

specifically excluded from compensation within the meaning of section 3231(e), such as certain sick pay payments (section 3231(e)(1)(i)); tips (section 3231(e)(1)(ii)); and amounts paid specifically (either as an advance, as reimbursement, or allowance) for traveling expenses (section 3231(e)(1)(iii)). Traveling expenses paid under a nonaccountable plan are excluded from work-hours even though they are includible in compensation. See § 31.3231(e)-1(a)(5). Also excluded from work-hours are amounts representing bonuses, amounts received pursuant to the exercise of an employee stock option, and all separation payments or severance allowances.

(2) *Hourly compensation.* Because the tax under section 3221(c) is calculated on the basis of work-hours, the number of hours for which an employee receives compensation is the figure used to determine work-hours. In the case of an hourly-rated employee, each hour for which the employee receives compensation is one work-hour.

(3) *Daily, weekly, monthly compensation.* (i) If an employee is paid by the day, week, month, or other period of time, the tax is imposed on the number of hours comprehended in the rate and, if any, the number of overtime hours for which additional compensation is paid. Thus, in the case of an office worker who receives an annual salary based on an 8-hour, 5-day-a-week work schedule that includes paid holidays, vacations, and sick time, the number of work-hours for one month is 174 (2088 hours/year ÷ 12 months).

(ii) The rule in paragraph (b)(3)(i) of this section is illustrated by the following examples.

Example 1. A, an office worker, receives an annual salary that is paid monthly. The salary is based on an 8-hour, Monday through Friday work schedule. A is not paid for overtime hours. A is not expected to work on holidays, during A's annual vacation, or during periods that A is ill. The number of work-hours for one month is 174 (2088 hours/year ÷ 12 months). This figure remains constant, even though some months have more workdays than others.

Example 2. B is paid a stated amount for each day B works, regardless of the number of hours worked. However, if B works more than 8 hours during any day, B is paid overtime for each additional hour worked that day. B is not paid for holidays, vacations, or sick time. During May, B worked 6 hours on 4 days, 7 hours on 6 days, 8 hours on 6 days, and 9 hours on 5 days. Because B is paid a daily rate for up to 8 hours, 8 hours are comprehended in the daily rate. Therefore, the number of work-hours for May is 173 (21 days × 8 hours/day + 5 overtime hours), even though B actually worked 159 hours.

(4) Conversion hours—(i)

Compensation not based on time (hour, day, month, etc.), such as compensation paid by the mile or by the piece, must be converted into the number of hours represented by the compensation paid. Thus, if an employee is paid by the mile, 1 work-hour equals the number of miles constituting a workday, divided by 8 hours. However, in the case of a collective bargaining agreement that specifies a number of hours as constituting a workday, the number of hours specified under the agreement may be used instead of 8.

(ii) The rule in paragraph (b)(4)(i) of this section is illustrated by the following example.

Example. C's normal workday consists of 2 150-mile round trips that together take 6 hours. C is paid by the mile. The collective bargaining agreement does not specify the number of hours in a workday. Thus, the number of work-hours for each day C works is 8, or 1 work-hour for each 37.5 miles (300 miles/day ÷ 8 hours/day). If the applicable collective bargaining agreement specifies that 6 hours constitute a workday, the number of work-hours for each day C works would be 6.

(c) Calculation of work-hours—(1) An employer may calculate the work-hours separately for each employee, as described in the examples in this paragraph. If the employer chooses to calculate work-hours separately for each employee, the employer must calculate the number of regular hours, overtime hours, and conversion hours for each employee for each month. In lieu of separate calculations, the employer may calculate the work-hours for all the employer's employees using the safe harbor formula described in paragraph (d) of this section.

(2) The rules in paragraph (c) of this section are illustrated by the following examples.

Example 1. D worked 8 hours a day, Monday through Friday, during the months of February and March 1992. D did not work on President's Day, but was paid for the holiday. D's work-hours for February were 160 (19 days × 8 hours a day + 8 holiday hours). D's work-hours for March were 176 (22 days × 8 hours a day).

Example 2. E worked 7-hour shifts every Tuesday through Saturday during the months of February and March 1992. E also worked 7 overtime hours during February and 21 overtime hours during March. Also, E was paid for 7 hours on President's Day, even though E did not work on that day. The number of work-hours for February was 161 (21 days × 7 hours a day + 7 overtime hours + 7 holiday hours). The number of work-hours for March was 168 (21 days × 7 hours a day + 21 overtime hours). Because E receives an hourly wage and was paid for the President's Day holiday, the number of hours (7) for which E was paid are added to the

hours E actually worked. If E had worked on President's Day and had received extra pay for working on a holiday and holiday pay for 7 hours, the employer would include 14 hours in E's work-hours for that day, the 7 hours E actually worked and the 7 holiday hours for which E was paid.

Example 3. Employment beginning during month. F began employment on March 16, a Monday, and worked 8 hours a day, Monday through Friday. The employer calculates that F's hours for the month were 96, because F worked 12 8-hour days during the month. If March 16 were on a Friday, the employer would calculate 11 days, or 88 hours.

Example 4. Employment ending during month. G's last day of employment was Friday, March 13. G worked 8 hours a day, Monday through Friday, except for March 3, when G was ill. G was paid for 8 hours for March 3. The employer calculates that G's work-hours for March were 80, because G worked 9 8-hour days and was paid for an additional 8 hours.

(d) Safe harbor—(1) In general. In lieu of calculating work-hours separately for each employee, an employer may use the safe harbor for all employees. If the employer elects to use the safe harbor for a calendar year, the employer must use the safe harbor for all employees for the entire calendar year. If an employer uses the safe harbor for a calendar year, the employer need not elect the safe harbor for the following calendar year. An employer that elects the safe harbor for a calendar year may not subsequently elect to separately calculate employee work-hours for that calendar year.

(2) Method of calculation. The safe harbor treats each employee of the employer as receiving monthly compensation for a number of hours equal to the safe harbor number. To determine the number of work-hours for a month, the employer multiplies the safe harbor number by the number that equals the total number of employees to whom the employer paid compensation during the month.

(i) Safe harbor number defined. The safe harbor number is the number established in guidance of general applicability promulgated by the Commissioner.

(ii) Employee defined. Solely for purposes of this paragraph, an employee is any individual who is paid compensation, within the meaning of § 31.3221(e)-1, regardless of the amount, during the month. Thus, for example, a part-time, temporary, or seasonal employee is counted as an employee. A terminated employee is counted in the month of termination (provided the terminated employee received compensation in the month of termination), but not in any subsequent month in which the employee does not perform service for the employer as an

employee, even if the terminated employee is paid compensation in a subsequent month. Thus, for example, an employee who terminates employment during the month, receives compensation during the month of termination, and receives a final paycheck the following month is counted as an employee of the employer for the month of termination but not for the following month.

(3) Method of election. An employer makes the safe harbor election for a calendar year on the employment tax return filed for the previous calendar year.

(4) Additional rules. The Commissioner may, in revenue procedures, revenue rulings, notices, or other guidance of general applicability, revise the safe harbor number or provide additional safe harbors that satisfy section 3221(c).

(e) Effective dates. This § 31.3221-3 is effective for calendar years beginning after December 31, 1992, except that paragraph (d) is effective for calendar years beginning after December 31, 1993. Taxpayers may apply the rules in paragraphs (a), (b), and (c) of this section before January 1, 1993.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved: February 23, 1994.

Leslie Samuels,
Assistant Secretary of the Treasury.
[FR Doc. 94-4675 Filed 2-25-94; 8:54 am]
BILLING CODE 4830-01-U

DEPARTMENT OF DEFENSE

Defense Logistics Agency

32 CFR Part 323

[Defense Logistics Agency Reg. 5400.21]

Privacy Program

AGENCY: Defense Logistics Agency,
DOD.

ACTION: Final rule.

SUMMARY: On January 19, 1994, (59 FR 2786) the Defense Logistics Agency published a proposed rule to exempt an existing system of records, S255.01 DLA-GC, entitled Fraud and Irregularities, from certain provisions of the Privacy Act of 1974. The exemptions are intended to increase the value of the system of records for law enforcement purposes, to comply with prohibitions against the disclosure of certain kinds of information, and to protect the privacy of individuals identified in the system of records. The notice was previously published on November 16, 1993, at 58 FR 60428.