

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Identification Number:
Taxpayer's Address:

Year in Issue:
Date of Conference:
District Director:

LEGEND:

Donor:

Partnership:

Company:

Trust:

Partnership Agreement:

Donor's daughter:

Donor's son-in-law:

a:

w:

x:

y:

z:

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State:

ISSUE:

Is the limited partnership interest of Partnership of the same class as (or in a class proportional to) the general partnership interest under § 2701(a)(2) of the Internal Revenue Code thus excluding Donor's transfer of an interest in Trust to form Partnership and subsequent transfer of a general partnership interest from the application of the special valuation rules of § 2701?

CONCLUSION:

Donor's transfer of an interest in Trust to form Partnership and subsequent transfer of a general partnership interest is subject to the special valuation rules of § 2701 because Donor has made a transfer of an equity interest in a partnership to a member of Donor's family while retaining an applicable retained interest. To the extent the retained interest (the limited partnership interest) is not of the same class of equity as (or of a class of equity proportional to) the transferred interest (the general partnership interest), the transfer at issue does not represent an "excluded transaction" for purposes of § 2701.

FACTS:

Partnership, a State limited partnership, was formed on a pursuant to the State Revised Limited Partnership Act, Article 6132a-1, State Revised Civil Statutes. Partnership was formed "for the purpose of contributing such cash, services, and property toward an investment strategy as may be deemed appropriate in the sole discretion of the General Partner, in exchange for such limited partnership interests as set forth in Section 1.1.3. [of the Partnership Agreement]." The Partnership Agreement provides for a 35-year term.

Company, a State Corporation, is the general partner of Partnership. At the time of Partnership's formation, Company was owned in equal shares by Donor's daughter and son-in-law. Company contributed w in exchange for a 1 percent general partnership interest in Partnership.

Trust is the limited partner of Partnership and consists of interests held by Donor and her spouse. Trust contributed x in exchange for a 99 percent limited partnership interest in Partnership. Of that contribution, y was community property, and z was Donor's separate property.

The Partnership Agreement delineates the "Partnership Interests" of the partners and provides that Company, the general partner, will hold a 35 percent partnership interest while

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Trust, the limited partner, will hold a 65 percent partnership interest.¹ Other pertinent partnership provisions include the following:

Article I, section 1.1 defines the "Adjusted Capital Contribution" for each partner as the excess, if any, of the aggregate capital contributions of that partner over the aggregate distributions to that partner from capital transactions. Section 1.3 defines "Capital Transactions" as the sale or refinancing of any capital asset of the partnership. Section 1.5 defines "Distributable Cash" as net cash receipts of the partnership (other than receipts from capital transactions and capital contributions) remaining after the payment of the expenses and obligations of the partnership through the end of the period for which distributable cash is being ascertained, less such amounts as the general partner, in its sole discretion, elects to retain as reserves to meet the foreseeable needs and expenses of the partnership

Article VI describes, in relevant part, the allocation of profits and losses as well as distributions. Section 6.1.1.A provides that net losses for any fiscal year shall be allocated to the partners who have positive capital account balances on a pro rata basis in accordance with and up to the amount of such positive balances. Section 6.1.1.B provides that any remaining net losses shall be allocated to the general partner.

Section 6.2.1 provides that net income shall be allocated to the general partner until the cumulative net income allocated pursuant to section 6.2.1 equals the cumulative net losses allocated to the general partner pursuant to section 6.1.1.B, and then to the partners until the cumulative net income allocated pursuant to section 6.2.2 equals the cumulative net losses allocated to the partners pursuant to section 6.1.1.A. Section 6.2.3 provides that any remaining net income shall be allocated to the partners according to their partnership interests.

Section 6.4 provides that, at the discretion of the general partner, the partnership shall make distributions of "Distributable Cash" to the partners in proportion to their partnership interests. See Article I, Section 1.5 ("Distributable Cash").

Section 6.5 provides for the distribution of "Capital Transactions." See Article I, Section 1.3 ("Capital Transactions"). At the discretion of the general partner, proceeds from capital transactions shall be distributed first to the limited partners until their "Adjusted Capital Contributions" are reduced to zero, then to the general partner until its Adjusted Capital Contribution is reduced to zero. See Article I, Section 1.1 ("Adjusted Capital Contribution"). The balance of any proceeds, if any, shall be distributed to the partners in proportion to their partnership interests.

¹ The Partnership Agreement does not specify the type of partnership interest held by Company and Trust. In the absence of any facts to the contrary and based upon the facts as represented to us, we infer that Company held a 35 percent general partnership interest and Trust a 65 percent limited partnership interest.

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Article VIII and Article IX address the management of the partnership by the general partner and the rights and duties of the limited partners, respectively. Section 8.2.1 provides that the general partner shall be compensated by the partnership for services rendered to the partnership. Section 9.4 provides that each partner shall have voting power equal to such partner's partnership interest. Under section 9.4.1, the limited partners have the right to vote on the removal of the general partner for cause; the election of a successor to the general partner; the amendment of the Partnership Agreement; the sale of all or substantially all of the assets of the partnership in a single transaction (except under certain circumstances); the continuation of the business of the partnership after its dissolution due to bankruptcy, insolvency, or removal of the general partner; and, any other matters for which the approval of the limited partner is expressly required. Section 9.4.2 generally provides that matters upon which the limited partners may vote shall require the approval of at least 75 percent in interest of the limited partners.

Article XI addresses changes in partnership membership. Section 11.5 provides that the partnership shall be dissolved upon the removal or adjudication of bankruptcy or insolvency of the general partner, provided, however, that within 30 days after such occurrence the limited partners may elect to continue the partnership and select a new general partner. Section 11.7.1 provides that should the business of the partnership be continued under section 11.5, then any portion of the interest of the former general partner not otherwise disposed of under the Partnership Agreement, shall be converted to an interest as a limited partner.

Article XII addresses the termination of the partnership and events occasioning dissolution. Upon dissolution, partnership assets not otherwise disposed of under the terms of the Partnership Agreement shall be distributed first to partnership creditors and then to partners who made loans to the partnership. Any remaining assets are then distributed to the partners in accordance with their positive capital account balances.

LAW:

Section 2701(a)(1) provides that, solely for purposes of determining whether a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any right--

(A) that is described in § 2701(b)(1)(A) or (B), and

(B) that is with respect to any applicable retained interest that is held by the transferor or an applicable family member immediately after the transfer,

is determined under § 2701(a)(3). Section 2701(a)(1) does not apply to the transfer of any interest for which market quotations are readily available (as of the date of transfer) on an established securities market.

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Section 2701(a)(2) provides that § 2701(a)(1) does not apply to any right with respect to an applicable retained interest if--

(A) market quotations are readily available (as of the date of the transfer) for such interest on an established securities market,

(B) such interest is of the same class as the transferred interest, or

(C) such interest is proportionally the same as the transferred interest, without regard to nonlapsing differences in voting power (or, for a partnership, nonlapsing differences with respect to management and limitations on liability).

Further, § 2701(a)(2)(C) shall not apply to any interest in a partnership if the transferor or an applicable family member has the right to alter the liability of the transferee. Except as provided by the Secretary, any difference described in § 2701(a)(2)(C) which lapses by reason of any Federal or State law is treated as a nonlapsing difference for purposes of § 2701(a)(2)(C).

Section 2701(a)(3)(A) provides that the value of any right described in § 2701(a)(1), other than a distribution right which consists of a right to receive a qualified payment, shall be treated as being zero.

Section 2701(a)(3)(B) provides that if--

(i) any applicable retained interest confers a distribution right which consists of the right to a qualified payment, and

(ii) there are 1 or more liquidation, put, call, or conversion rights with respect to such interest,

the value of all such rights shall be determined as if each liquidation, put, call, or conversion right were exercised in the manner resulting in the lowest value being determined for all such rights.

Section 2701(a)(3)(C) provides that in the case of an applicable retained interest which is described in § 2701(a)(3)(B)(i) but not § 2701(a)(3)(B)(ii), the value of the distribution right shall be determined without regard to § 2701.

Section 2701(a)(4)(A) provides that in the case of a transfer described in § 2701(a)(1) of a junior equity interest in a corporation or partnership, such interest shall in no event be valued at an amount less than the value which would be determined if the total value of all of the junior equity interests in the entity were equal to 10 percent of the sum of--

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(i) the total value of all of the equity interests in such entity, plus

(ii) the total amount of indebtedness of such entity to the transferor (or an applicable family member).

Section 2701(a)(4)(B)(i) provides that the term "junior equity interest" means common stock or, in the case of a partnership, any partnership interest under which the rights as to income and capital (or, to the extent provided in regulations, the rights as to either income or capital) are junior to the rights of all other classes of equity interests.

Section 2701(a)(4)(B)(ii) provides that the term "equity interest" means stock or any interest as a partner, as the case may be.

Section 2701(b)(1) provides that the term "applicable retained interest" means any interest in an entity with respect to which there is--

(A) a distribution right, but only if, immediately before the transfer described in § 2701(a)(1), the transferor and applicable family members hold (after application of § 2701(e)(3)) control of the entity, or

(B) a liquidation, put, call, or conversion right.

Section 2701(b)(2)(B) provides that in the case of a partnership, the term "control" means--

(i) the holding of at least 50 percent of the capital or profits interests in the partnership, or

(ii) in the case of a limited partnership, the holding of any interest as a general partner.

Section 2701(b)(2)(C) provides that for purposes of § 2701(b), the term "applicable family member" includes any lineal descendant of any parent of the transferor or the transferor's spouse.

Section 2701(c)(1)(A) provides that the term "distribution right" means: (i) a right to distributions from a corporation with respect to its stock; and (ii) a right to distributions from a partnership with respect to a partner's interest in the partnership.

Section 2701(c)(1)(B) provides that the term "distribution right" does not include: (i) a right to distributions with respect to any interest which is junior to the rights of the transferred interest; (ii) any liquidation, put, call, or conversion right; or (iii) any right to receive any

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guaranteed payment described in § 707(c) of a fixed amount.

Section 2701(c)(3)(A) provides that the term "qualified payment" means any dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under any partnership interest) to the extent that such dividend (or comparable payment) is determined at a fixed rate.

Section 2701(d) generally provides rules applicable to the transfer tax treatment of cumulative but unpaid distributions.

Section 2701(e)(1) provides that the term "member of the family" means, with respect to any transferor: (A) the transferor's spouse; (B) a lineal descendant of the transferor or the transferor's spouse; and (C) the spouse of any such descendant.

Section 2701(e)(2) provides that the term "applicable family member" means, with respect to any transferor: (A) the transferor's spouse; (B) an ancestor of the transferor or the transferor's spouse; and (C) the spouse of any such ancestor.

Section 2701(e)(6) provides that under regulations prescribed by the Secretary, if there is any subsequent transfer, or inclusion in the gross estate, of any applicable retained interest which was valued under the rules of § 2701(a), appropriate adjustments will be made for purposes of chapter 11, 12, or 13 to reflect the increase in the amount of any prior taxable gift made by the transferor or decedent by reason of such valuation or to reflect the application of § 2701(d).

Section 25.2701-1(a)(1) states that § 2701 provides special valuation rules to determine the amount of the gift when an individual transfers an equity interest in a corporation or partnership to a member of the individual's family. For § 2701 to apply, the transferor or an applicable family member (as defined in § 25.2701-1(d)(2)) must, immediately after the transfer, hold an applicable retained interest (a type of equity interest described in § 25.2701-2(b)(1)).

Section 25.2701-1(a)(2) provides that if § 2701 applies to a transfer, the amount of the transferor's gift, if any, is determined using a subtraction method of valuation (described in § 25.2701-3). Under this method, the amount of the gift is determined by subtracting the value of any family-held applicable retained interests and other non-transferred equity interests from the aggregate value of family-held interests in the corporation or partnership (the "entity"). Generally, in determining the value of any applicable retained interest held by the transferor or an applicable family member--

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(i) any put, call, or conversion right, any right to compel liquidation, or any similar right is valued at zero if the right is an "extraordinary payment right" (as defined in § 25.2701-2(b)(2));

(ii) any distribution right in a controlled entity (e.g., a right to receive dividends) is valued at zero unless the right is a "qualified payment right" (as defined in § 25.2701-2(b)(6)); and

(iii) any other right (including a qualified payment right) is valued as if any right valued at zero did not exist but otherwise without regard to § 2701.

Section 25.2701-1(b)(2)(i) provides, in relevant part, that, except as provided in § 25.2701-1(b)(3), for purposes of § 2701, transfer includes: a contribution to the capital of a new or existing entity; or, a redemption, recapitalization, or other change in the capital structure of an entity (a "capital structure transaction"), if the transferor or an applicable family member receives an applicable retained interest in the capital structure transaction.

Section 25.2701-1(b)(3)(i) provides that for purposes of § 2701, a transfer does not include a capital structure transaction, if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction.

Section 25.2701-1(c)(3) provides, in relevant part, that § 2701 does not apply if the retained interest is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest. A class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability). For purposes of § 25.2701-1, non-lapsing provisions necessary to comply with partnership allocation requirements of the Code (e.g., § 704(b)) are non-lapsing differences with respect to limitations on liability. An interest in a partnership is not an interest in the same class as the transferred interest if the transferor or applicable family members have the right to alter the liability of the transferee.

Section 25.2701-1(d)(1) provides that a "member of the family" is, with respect to any transferor: (i) the transferor's spouse; (ii) any lineal descendant of the transferor or the transferor's spouse; and (iii) the spouse of any such lineal descendant.

Section 25.2701-1(d)(2) provides that an "applicable family member" is, with respect to any transferor: (i) the transferor's spouse; (ii) any ancestor of the transferor or the transferor's spouse; and (iii) the spouse of any such ancestor.

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Section 25.2701-2(a)(1) provides that any extraordinary payment right is valued at zero.

Section 25.2701-2(a)(2) provides that any distribution right in a controlled entity is valued at zero, unless it is a qualified payment right.

Section 25.2701-2(b)(1) provides that an applicable retained interest is any equity interest in a corporation or partnership with respect to which there is either: (i) an extraordinary payment right; or (ii) in the case of a controlled entity, a distribution right.

Section 25.2701-2(b)(2) generally provides that an extraordinary payment right is any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest. A call right includes any warrant, option or other right to acquire one or more equity interests.

Section 25.2701-2(b)(3) provides that a distribution right is the right to receive distributions with respect to an equity interest. A distribution right does not include: (i) any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest; (ii) any extraordinary payment right; or (iii) any right described in § 25.2701-2(b)(4).

Section 25.2701-2(b)(4) provides that mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under § 707(c), and non-lapsing conversion rights are neither extraordinary payment rights nor distribution rights.

Section 25.2701-2(b)(5)(i) provides that, for purposes of § 2701, a controlled entity is a corporation or partnership controlled, immediately before a transfer, by the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse.

Section 25.2701-2(b)(5)(iii) provides, in relevant part, that in the case of any partnership, control means the holding of at least 50 percent of either the capital interest or the profits interest in the partnership. In addition, in the case of a limited partnership, control means the holding of any equity interest as a general partner.

Section 25.2701-5(a)(1) states that § 25.2701-5 provides rules under which an individual (the initial transferor) making a transfer subject to § 2701 (the initial transfer) is entitled to reduce his or her taxable gifts or adjusted taxable gifts (the reduction). The amount of the reduction is determined under § 25.2701-5(b).

Section 25.2701-5(a)(2) provides that if, during the lifetime of the original transferor, the holder of a § 2701 interest (as defined in § 25.2701-5(a)(4)) transfers the interest to or for the benefit of an individual other than the initial transferor or an applicable family member of the

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initial transferor in a transfer subject to Federal estate or gift tax, the initial transferor may reduce the amount on which the initial transferor's tentative tax is computed under § 2502(a). The reduction is first applied on any gift tax return required to be filed for the calendar year in which the § 2701 interest is transferred; any excess reduction is carried forward and applied in each succeeding calendar year until the reduction is exhausted. The amount of the reduction that is used in a calendar year is the amount of the initial transferor's taxable gifts for that year. Any excess reduction remaining at the death of the initial transferor may be applied by the executor of the initial transferor's estate as provided under § 25.2701-5(a)(3). See § 25.2701-5(a)(4) for the definition of a § 2701 interest.

Section 25.2701-5(a)(3) provides that, except as otherwise provided in this paragraph (a)(3), in determining the Federal estate tax with respect to an initial transferor, the executor of the initial transferor's estate may reduce the amount on which the decedent's tentative tax is computed under § 2001(b) (or § 2101(b)) by the amount of the reduction (including any excess reduction carried forward under § 25.2701-5(a)(2)). The amount of the reduction under this paragraph (a)(3) is limited to the amount that results in zero Federal estate tax with respect to the estate of the initial transferor.

Section 25.2701-5(b) provides that, except as otherwise provided in § 25.2701-5(c)(3)(iv) (pertaining to transfers of partial interests) and § 25.2701-5(e) (pertaining to initial split gifts), the amount of the reduction is the lesser of--

(1) The amount by which the initial transferor's taxable gifts were increased as a result of the application of § 2701 to the initial transferor; or

(2) The amount (determined under § 25.2701-5(c)) duplicated in the transfer tax base at the time of the transfer of the § 2701 interest (the duplicated amount).

ANALYSIS:

The issue in this request for technical advice is whether Donor's transfer of an interest in Trust to form Partnership and subsequent transfer of a general partnership interest is subject to the special valuation rules of IRC § 2701. It is the position of Donor's representative that this transaction is not subject to § 2701 because § 2701, on its face, does not apply to the formation of new entities. In addition, it is the position of Donor's representative that this transaction is not subject to § 2701 because the applicable retained interest in this case is of the same class, or is proportionally the same, as the transferred interest.

Partnership was organized as a limited partnership on a. The general partner was Company, owned by Donor's daughter and son-in-law, whose contribution of w represented 1 percent of Partnership's total capital assets. The limited partner was Trust, consisting of interests held by Donor and her spouse, whose contribution of x represented 99 percent of Partnership's

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total capital assets. As we interpret the terms of the Partnership Agreement and based upon the facts as represented to us, Company received a 35 percent general partnership interest and Trust received a 65 percent limited partnership interest at the time of Partnership's formation.

It is clear that § 2701 generally applies to the formation of new entities. See § 25.2701-1(b)(2)(i)(A) and (b)(3). Furthermore, § 2701 applies with respect to an individual's transfer of an equity interest in a partnership to a member of the individual's family as long as the transferor holds an applicable retained interest immediately after the transfer. For purposes of § 2701(a), Donor made a transfer of an equity interest in Partnership to Donor's daughter and son-in-law, who are members of Donor's family within the meaning of § 2701(e)(1)(B).

Under § 25.2701-2(b)(1), an applicable retained interest is any equity interest in a corporation or a partnership with respect to which there is either (i) an extraordinary payment right, or (ii) in the case of a controlled entity, a distribution right. Under § 2701(b)(2)(B) and § 25.2701-2(b)(5)(iii), in the case of a partnership, control means the holding of at least 50 percent of either the capital interest or the profits interest in the partnership. In addition, in the case of a limited partnership, control means the holding of any equity interest as a general partner. Under § 2701(e)(1)(B), an individual is treated as holding any interest held by the individual's brothers, sisters, or lineal descendants.

In the present case, Donor is deemed to control, under § 2701(b)(2)(B) and § 25.2701-2(b)(5)(iii), 100 percent of Partnership because 100 percent of the capital or profits interest of Donor's daughter and son-in-law is attributed to Donor under § 2701(e)(1)(B). Donor is also deemed to control Partnership because the equity interest in the general partnership interest held by Donor's daughter and son-in-law is attributed to Donor. Section 2701(b)(2)(B) and § 25.2701-2(b)(5)(iii). The transfers among the parties, Donor and Donor's daughter and son-in-law, represent contributions to the capital of a new or existing entity for purposes of § 25.2701-1(b)(2)(i)(A) and a transfer of an equity interest. Further, for purposes of § 2701(c)(1)(A), Donor holds a right to distributions from Partnership with respect to Donor's interest in Partnership. See § 2701(b)(1)(A) and § 25.2701-2(b)(1). Accordingly, Donor has made a transfer of an equity interest in a partnership (Partnership) to a member of Donor's family (daughter and son-in-law) while retaining an applicable retained interest in Partnership.

Section 2701(a)(2) provides, however, that § 2701(a)(1) does not apply to rights with respect to an applicable retained interest under certain circumstances. Specifically, § 2701(a)(1) does not apply if the retained interest is of the same class of equity as the transferred interest, or if the retained interest is of a class that is proportional to the class of the transferred interest. Section 2701(a)(2)(B) and (C) and § 25.2701-1(c)(3).

Section 2701(a)(2)(B) and (C) explicitly provides that § 2701(a)(1) does not apply to any right with respect to an applicable retained interest if such interest is of the same class as the transferred interest, or such interest is proportionally the same as the transferred interest, without

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regard to nonlapsing differences in voting power (or, for a partnership, nonlapsing differences with respect to management and limitations on liability). Section 25.2701-1(c)(3) explicitly provides that a class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability).

Underlying the statute and regulations, the legislative history states that a "retained interest is valued under present law if it is of a class which is proportionally the same as the transferred interest but for nonlapsing differences in voting power (or, in the case of a partnership, nonlapsing differences with respect to management and limitations on liability)." H.R. Rep. No. 101-964, at 1133 (1990). Further, the legislative history notes that § 2701 generally does not affect the valuation of a gift of a partnership interest if all interests in the partnership share equally in all items of income, deduction, loss and gain in the same proportion (i.e., straight-up allocations). See 136 Cong. Rec. S15681 (daily ed. October 18, 1990) (1990 Senate Report on Proposed Revision of Estate Freeze Rules). However, the legislative history also notes that the exception to the valuation rules of § 2701 "would not apply to a partnership with both a general and limited partner if one partner had a preference with respect to distributions." H.R. Rep. No. 101-964, at 1133 (1990). Thus, if either the transferred or applicable retained interest in Partnership enjoy a preference as to distributions, the applicable retained interest in Partnership will be valued under the rules of § 2701. See Id.

In the present case, the Partnership Agreement provides that proceeds from capital transactions shall be distributed first to the limited partners until their Adjusted Capital Contributions are reduced to zero, then to the general partner until its Adjusted Capital Contribution is reduced to zero. The balance of any proceeds, if any, shall be distributed to the partners in proportion to their partnership interests. On its face, this provision in the Partnership Agreement is a preference enjoyed by the limited partner (Trust) with respect to distributions of proceeds from capital transactions. Thus, the transfers at issue are not excluded from the special valuation rules of § 2701(a)(1) because Donor's applicable retained interest is not of the same class of equity as the transferred interest, nor is Donor's applicable retained interest of a class that is proportional to the class of the transferred interest. Accordingly, the value of Donor's gift to Donor's daughter and son-in-law is to be determined under the special valuation rules of § 2701 and § 25.2701-3. See § 25.2701-5 for appropriate adjustments to mitigate double taxation for subsequent gifts.

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Except as specifically stated in this technical advice memorandum, we express or imply no opinion on the federal tax consequences of the transaction under the cited provisions of the Code or under any other provisions of the Code. Additionally, we express or imply no opinion on the amount of the gift under the special valuation rules of § 2701, or as to whether the purported transfer in trust under these facts implicates the special valuation rules of § 2702.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.