REPORT #757

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED REGULATIONS

RELATING TO TEE

GENERATION-SKIPPING TRANSFER TAX

Prepared by the Committee on Estates and Trusts

April 19, 1993

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TAX SECTION
New York State Bar Association

April 21, 1993

Michael P. Dolan
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue NW
Room 3000
Washington, D.C. 20224

Dear Commissioner Dolan:

Enclosed is a report of the New York State Bar Association Tax Section Committee on Estates and Trusts dealing with proposed regulations under the Generation-Skipping Transfer Tax.

The report was co-authored by the Committee's Chairs, Kim E. Baptiste and Steven M. Loeb. If you have any questions, please feel free to contact either co-author directly.

Yours truly,

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REPORT ON PROPOSED REGULATIONS RELATING TO TEE GENERATION-SKIPPING TRANSFER TAX

Prepared by the Committee on Estates and Trusts
New York State Bar Association
Tax Section

April 19, 1993

NEW YORK STATE BAR ASSOCIATION TAX SECTION

Report on Proposed Regulations Relating to the Generation – Skipping Transfer Tax

This report[1] discusses Proposed Treasury Regulations §§ 26.2601-1, 26.2612-1, 26.2632-1, 26.2642-2, 26.2642-3, 26.2642-4, 26.2642-5, 26.2652-1, 26.2652-2, 26.2654-1, and 26.2663-2 (the "Proposed Regulations"), interpreting the generation-skipping transfer tax.

I. Introduction and Background

The Proposed Regulations are proposed additions to the Generation-Skipping Transfer Tax Regulations under IRC §§ 2601 through 2663 of the Internal Revenue Code.[2] These code sections are contained in Chapter 13 of the Code.

The Tax Reform Act of 1986[3] retroactively repealed the generation-skipping transfer tax enacted in 1976 and replaced it with Chapter 13 of the Code. Chapter 13 of the Code imposes a flat tax equal to the highest federal estate tax rate (currently

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1 This report was written by Kim E. Baptiste and Steven M. Loeb, Co-Chairs of the Committee on Estates and Trusts of the Tax Section of the New York State Bar Association. Assistance in preparation of the report was provided by Peter V. Arcese, Catherine Borneo, Carol F. Burger, Susan Greenwald, Cheryl E. Hader, Nathan Hale, Alan Halperin, William P. LaPiana, Joseph Mahon, Dana C. Mark, Jonathan J. Rikoon, Hume R. Steyer, Ronald J. Weiss and David Wilfert.

2 Section references and references to the "Code" are to the Internal Revenue Code of 1986, as amended; references to "Reg. §___" are to Treasury regulations promulgated thereunder and references to "Prop. Reg. §___" are to proposed Treasury regulations promulgated thereunder.

3 P.L. 99-514 as amended.

50% but expected to be increased retroactively to 55% under the President's revenue proposals) on every generation-skipping transfer ("GST").

Chapter 13 generally applies to GSTs made after October 22, 1986.[4] Certain lifetime transfers made after September 25, 1985 and before October 22, 1986 are treated as made on October 22, 1986 and are subject to the GST tax. However, transfers from a trust irrevocable on September 25, 1985 are exempted from the GST tax.[5]

The GST tax is imposed on transfers to a beneficiary at least two generations below that of the transferor (a "skip person").[6] The GST tax is in addition to any applicable Federal estate tax imposed tinder Chapter 11 of the Code or Federal gift tax imposed under Chapter 12 of the Code. A GST tax will result upon the occurrence of any one of three events: a "direct skip", a "taxable termination" or a "taxable distribution".

A "direct skip" occurs upon the transfer of an interest in property to or for the benefit of a skip person or to a trust for one or more skip persons. To be a direct skip the transfer must also be subject to Federal estate tax or Federal gift tax.[7]

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4 October 22, 1986 was the date of enactment of the Tax Reform Act of 1986 ("1986 Act"); 1986 Act § 1433(a).

5 1986 Act § 1433(b).

6 Prop. Reg. § 26.2612-1(d). References to non-skip persons are to all persons other than skip persons.

7 IRC § 2612(c).

A “taxable termination” occurs upon the expiration of an interest in a trust if, after that termination, all interests in the property are held by skip persons.[8]

A “taxable distribution” is any distribution from a trust to a skip person which is not a taxable termination or a direct skip.[9]

The GST tax does not apply to inter vivos outright transfers exempt from gift tax pursuant to either the $10,000 annual gift tax exclusion or the special gift tax exclusion for certain tuition and medical expense payments made directly to the educational institution or to the medical supplier.[10]

In addition, every transferor (or his executor) may exempt up to $1,000,000 in GSTs from the tax by allocation of his “GST exemption”.[11] Once a transfer of property in trust is designated as exempt because the transferor's GST exemption was allocated to the property, all subsequent GSTs from such property are exempt, no matter how many times the property skips generations or how much the property has appreciated. However, if a portion of a trust has not been designated as exempt, an “inclusion ratio”[12] is used to calculate the rate of tax imposed on a GST from such trust. The rate of tax is equal to the product of the maximum Federal estate tax rate and the inclusion ratio.[13]

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8 IRC § 2612(a).

9 IRC § 2612(b).

10 IRC § 2642(c)(3).

11 IRC § 2631(a).

12 IRC § 2642(a)(1).

13 IRC § 2641.

The inclusion ratio with respect to a transfer is one minus the "applicable fraction".[14] The numerator of the applicable fraction is generally the amount of GST exemption allocated to the trust and the denominator is the value of the trust on the date the GST exemption allocation became effective (less death taxes recovered from the trust and any charitable deduction allowed).

The Proposed Regulations were issued on December 24, 1992 and are generally effective with respect to GSTs made on or after that date.[15]

* * *

II. Summary of Comments and Recommendations

The Proposed Regulations provide a welcome explanation of the highly complex rules of Chapter 13. The detailed discussion and many examples provided will certainly prove invaluable to practitioners working in this area. The Committee also appreciates the Preamble's discussion of the broad policy goals underlying the Proposed Regulations and is encouraged by the requests for comments on some of the more problematical issues.

The Committee believes, however, that in the following areas the Proposed Regulations reach results that are inappropriate.

1. Estate Tax Inclusion Period ("ETIP") Provisions

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14 IRC § 2642(a)(2).

15 Prop. Reg. § 26.2601-1.

The Committee believes that the ETIP provisions should not be extended to interests held by the transferor's spouse acquired from the transferor in a non-taxable transfer. In addition to unduly hampering a transferor's ability to make a timely allocation of his GST exemption, it has a particularly onerous and presumably unintended effect on life insurance trusts.

2. Nominal Interest Rule

The Committee feels that the Proposed Regulations should conform to the statute in providing that a nominal interest will only be disregarded if its “primary” purpose i6 to postpone or avoid a GST tax.

3. Redetermination of Applicable Fraction

The Committee does not believe that a trust's applicable fraction should be redetermined when no additional property is added to it or no additional GST exemption is allocated to it. The Committee recommends that this provision be amended to provide that both the numerator and denominator of a trust's redetermined applicable fraction should be based on post event values.

4. Finality of Inclusion Ratio

The Committee does not feel there is any reason to delay the finality of a trust's inclusion ratio until the expiration of the period for assessment of Federal estate tax with respect to the transferor's estate. In addition to being unnecessary, retaining this provision could leave the status of a particular trust and the transferor's other GSTs uncertain for many years.

5. Separate Trusts

The Committee believes the Proposed Regulations should be amended to provide that any trust treated as a separate trust under local law should also be treated as such for Chapter 13 purposes.

6. Transfers by Nonresident Aliens

The Committee believes the Proposed Regulations create an inconsistency between the GST tax and the Federal estate and gift tax with respect to transfers of non-U.S. situs property from nonresident aliens to certain United States beneficiaries.

Our specific comments with respect to the Proposed Regulations follow.

* * *

III. Discussion

A. Prop. Reg. § 26.2601-1(e)(1): Effective Dates

1. Summary

The Proposed Regulations generally apply to GSTs made on or after December 24, 1992.

2. Comment

Although the Proposed Regulations generally apply to GSTs made after December 24, 1992, they may affect transfers to trusts made prior to that date which will be subject to Chapter 13. It is possible, for example, with respect to the calculation of the inclusion ratio for a trust to have made a different calculation with respect to GSTs occurring before December 24, 1992 than it would now make pursuant to the Proposed Regulations with respect to GSTs occurring after the effective date. In this case, the Committee recommends that the Proposed Regulations be amended so that any reasonable allocation method of GST exemption adopted with respect to pre-December 24, 1992 GSTs should be respected with respect to GSTs occurring both before and after the effective date.

B. Prop. Reg. § 26.26l2-l(a); Definition of Direct Skip

1. Summary

A direct skip is a transfer to a skip person that is subject to Federal estate or gift tax. If property is transferred to a trust, the transfer is a direct skip only if the trust is exclusively for the benefit of skip persons.

2. Comment

The Proposed Regulation is unclear as to the characterization of a transfer that could either be a direct skip or a taxable termination. To resolve this ambiguity, the Proposed Regulation should state that any such transfer that is subject to Federal estate or gift tax should be considered a direct skip, other than a qualified terminable interest property ("QTIP") trust[16] for which a reverse QTIP election has been made. In the case of a reverse QTIP trust, the creator of the trust is considered the transferor but the property is subject to estate tax in his spouse's estate. Since the transfer is not subject to estate tax in the transferor's estate, the termination of the spouse's income interest should be considered a taxable termination rather than a direct skip.

The Proposed Regulation provides that "[i]f property is transferred to a trust, the transfer is a direct skip only if the trust is a skip person".[17] This raises a question as to the treatment of a transfer to a trust that is a non-skip person subject to a power of withdrawal held by a skip person. Is such a transfer to the trust or to the individual power holder? The

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16 A QTIP trust is a trust that qualifies for the Federal estate or gift tax marital deduction if the transferor's executor, or in the case of an inter vivos QTIP trust, the transferor himself, so elects. The trust must provide for a lifetime income interest for the spouse. IRC §§ 2056(b)(7) and 2523(f). The transferor's executor or the transferor may, for purposes of Chapter 13, elect to treat the property as if the QTIP election had not been made (this is known as the "reverse QTIP election"). IRC § 2652(a)(1)(3). The effect of the reverse QTIP election is that the original transferor remains the transferor for Chapter 13 purposes (and not the spouse as would otherwise be the case) so that the original transferor can effectively allocate his GST exemption to the QTIP trust.

17 Prop. Reg. § 26.2612-l(a).

Preamble[18] states "that a transfer to a trust subject to a beneficiary's right to withdraw is treated as a transfer to the trust rather than a transfer to the beneficiary."[19] Inasmuch as the Preamble will not appear in the final regulations, this statement should be included in the regulations.

Finally, the Proposed Regulation should clarify that if the transferor's will or state law provides that the transferor is deemed to survive a particular beneficiary in the event of a simultaneous death, that presumption will be respected for Chapter 13 purposes.

C. Prop. Reg. § 26.2612-1(b): Definition of Taxable Termination

1. Summary

A taxable termination occurs upon the termination of an interest in a trust unless (i) a transfer subject to Federal estate or gift tax occurs with respect to the property held in the trust at the time of the termination, so that a new transferor is determined with respect to the property; (ii) immediately after the termination, a person who is not a skip person has an interest in the trust; or (iii) at no time after the termination may a distribution (including a distribution at the termination of the trust) be made from the trust to a skip person.

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[18] Reference to the Preamble refers to the Explanation of Provisions published in the Federal Register along with the Proposed Rules on Generation-Skipping Transfer Tax on December 24, 1992. 57 FR 61356.

[19] 57 FR 61359.

2. <u>Comment</u>

The Proposed Regulation does not clearly distinguish a taxable termination from a taxable distribution. For example, if a trustee exercises his discretionary authority to terminate a trust by distributing the entire trust principal to a skip person, is that a taxable termination or a taxable distribution? Example 8 of Prop. Reg. § 26.2612-l(f) would appear to treat this as a taxable termination. However, would this still be the result if the trustee withheld a small portion of the trust principal in order to pay the trust's wind-up expenses? Presumably yes, but the Proposed Regulation should specifically state this.

The second requirement for a taxable termination is that at no time after the termination of the interest “may a distribution (including distributions on termination) be made to a skip person”.[20] This requirement is unclear as it relates to remote contingent remaindermen. Many trusts provide that if the presumptive remainderman of a trust is not living at the time the trust terminates, the trust principal will pass to his living issue. If the presumptive remainderman is a non-skip person but does not have a current interest in the trust upon the termination of the original income interest (e.g., because income will be accumulated for him over a period of years), will a taxable termination occur upon the expiration of the income term because it is theoretically possible for a skip person (i.e., the presumptive remainderman's children) to receive the property? Clearly, this is not intended to be the result and the Proposed Regulation should adopt a rule ignoring such remote contingent interests in this context.

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[20] IRC § 2612(a)(1).

D. Prop. Reg. § 26.2612-l(c): Definition of Taxable Distribution

1. Summary

A taxable distribution is a distribution of income or principal from a trust to a skip person unless the distribution is a taxable termination or a direct skip.

2. Comment

The Proposed Regulation does not explicitly state that a transfer that would otherwise be a taxable distribution should not be considered a taxable distribution if it is subject to Federal estate or gift tax. Since the Proposed Regulations do contain such a statement with respect to taxable terminations,[21] they should here as well.

E. Prop. Reg. § 26.2612-l(d): Definition of Skip Person as Applied to a Trust

1. Summary

A trust is a skip person if no person holds an interest in the trust and no distributions (including distributions at termination) may be made to a person other than a skip person.

2. Comment

The same issue relating to remote contingent remaindermen exists here as in the definition of a taxable termination. Again, the possibility of payment to a contingent remainderman should be ignored if the possibility of that person taking is remote.

F. Prop. Reg. § 26.2612-l(e): Definition of Interest in Trust

1. Summary

An individual will have an interest in a trust for Chapter 13 purposes if he (i) has a present right to receive trust principal or income or (ii) is a permissible current recipient of trust principal or income and is not a charitable organization.

2. Comment

The Proposed Regulation is unclear as to the effect a survivorship requirement contained in a trust document will have on whether an individual has an interest in a trust. For example, assume a trust has a non-skip presumptive remainderman whose receipt of the trust principal is conditioned on his surviving the income beneficiary by some period of time. If he dies within that time frame, the property will pass to his children. The Proposed Regulation should state that, if the remainderman in this situation dies within the prescribed time period, he should not be treated as ever having had an interest in the trust.

A similar rule should apply to renounced interests, in that situation, the trust income beneficiary is a skip person who renounces his interest in favor of his parent, a non-skip person. The Proposed Regulations should provide that, as a result of his disclaimer, the skip person should not be treated as ever having

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[21] Prop. Reg. § 26.2612-l(b)(i).

had an interest in the trust. Furthermore, to the extent the transferor allocated any GST exemption to the trust, it should be restored as a consequence of the disclaimer.

G. Prop. Reg. § 26.2612-l(e)(2)(ii): Nominal Interests

1. Summary

Under Prop. Reg. § 26.2612-l(e)(2)(ii), if a significant purpose for the creation of an interest in a trust is to postpone or avoid the GST tax, the interest is disregarded for purposes of Chapter 13. The creation of an interest in a trust may have more than one significant purpose.

2. Comment

The Proposed Regulation differs from IRC § 2652(c)(2) in one material respect. Under the statute, an interest will only be disregarded if its “primary” purpose -- as opposed to the “significant” purpose test of the Proposed Regulation -- is to postpone or delay the GST tax. Given these different standards, a great deal of uncertainty is likely to arise in the application of this rule. Accordingly, the Proposed Regulation should be amended to conform to IRC § 2652(c)(2). Furthermore, in view of the subjective nature of the purpose underlying the creation of a particular interest, some examples illustrating this section would be helpful.

H. Prop. Reg. § 26.2632-l(a), (b): Allocation of GST Exemption

i. summary

The Proposed Regulation states that the allocation of GST exemption is made to the entire trust rather than to specific assets.[22] The Preamble states that the allocation cannot be made to a fractional share of a trust.[23]

If a direct skip occurs during a transferor's lifetime, the transferor's available GST exemption is automatically allocated unless the transferor elects out of such treatment on a timely-filed U.S. Gift (and Generation-Skipping Transfer) Tax Return (Form 709).

Under the transitional rules of the Proposed Regulations, an election to prevent an automatic allocation of the GST exemption to an *inter vivos* direct skip filed on or before January 29, 1993, will become irrevocable on July 22, 1993.

The Proposed Regulation provides that a timely allocation of GST exemption with respect to an *inter vivos* transfer (that is not a direct skip) is effective as of the date of the transfer. A late allocation is effective on the date the late allocation is filed unless the transferor elects to have the property (other than life insurance) valued on the first day of the month in which the late allocation is filed.[24]

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22 Prop. Reg. § 26.2632-1(a).

23 57 FR 61358.

24 Prop. Reg. § 26.2632-l(b)(2)(ii).

2. Comment

Prop. Reg. § 26.2632-l(b)(2)(i) and Prop. Reg. § 26.2632-l(b)(2)(ii) are inconsistent inasmuch as (i) states that an allocation of GST exemption is irrevocable and (ii) provides rules for modifying an earlier allocation so long as the last allocation is made on a timely filed Federal gift tax return. The Proposed Regulation should be modified to state that the allocation is irrevocable after the due date of the Federal gift tax return.

The Proposed Regulation implies that the transferor can elect to treat the allocation either as timely or late on a timely filed Federal gift tax return.[25] Given the importance of this distinction, if it is intended that the transferor has the election to treat an allocation as timely or late, the Proposed Regulation should specifically provide for this election. The Committee recommends that such an election be permitted; otherwise, transferors will purposely file late returns which will add to the administrative burden.

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25 Prop. Reg. § 26.2632-l(b)(2)(ii).

I. Prop. Reg. § 26.2632-l(c): Special Rules During an Estate Tax Inclusion Period

1. Summary

Prop. Reg. § 26.2632-1(c) implements the provisions of IRC § 2642(f) concerning the Estate Tax Inclusion Period (“ETIP”). The effect of the ETIP is to coordinate the GST tax with the Federal estate tax retained interest and powers sections.[26] For purposes of determining an inclusion ratio, the transferor's allocation of GST exemption to property subject to an ETIP will not be effective until the termination of the ETIP. The Proposed Regulation states that the ETIP rules do not apply to a QTIP trust for which a reverse QTIP election has been made.[27]

The Proposed Regulation defines the ETIP as the period during which, should death occur, the value of the transferred property would be includible in the gross estate of (i) the transferor, (ii) the transferor's spouse and (iii) the transferor had the transferor retained an interest held by the transferor's spouse (but only to the extent that the spouse acquired the interest from the transferor in an inter vivos transfer that was not included in the transferor's taxable gifts or for which a Federal gift tax marital deduction was allowed).[28]

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[26] See IRC §§ 2036-2038 and 2041.

[27] Prop. Reg. § 26.2632-l(c)(1).

[28] Prop. Reg. § 26.2632-l(c)(2).

2. Comment

As a policy matter, the ETIP concept is defensible and necessary to the GST tax. Without the ETIP, it would be possible to leverage the GST exemption by, for example, transferring $1,000,000 into a trust, retaining a life income interest such that the trust will be included in the transferor's gross estate under IRC § 2036(a)(1), and allocating the GST exemption to the trust at the time of transfer, thus sheltering it and all appreciation from the GST tax while still retaining the benefits of the property. Nevertheless, the Committee believes that the Proposed Regulation, as worded, is overly broad and would cover nonabusive situations such as the traditional life insurance trust. As noted below, the Committee recommends that Prop. Reg. § 26.2632-l(c)(2)(ii) (concerning ETIP caused by the transferor being deemed to have retained an interest held by his spouse) be deleted and that the remaining provisions be clarified in several respects.

a. Prop. Reg. § 26.2632-1(c)(2): Definition of the Term "Interest"

The Proposed Regulations do not define the term "interest" for purposes of determining what qualifies as an interest held by the transferor's spouse for purposes of the ETIP rules, or for any other purpose. The Proposed Regulations do define the term "interest in trust" under the general definitional section as including only a present beneficial interest,[29] and one could conclude that a similar definition applies to the term "interest" as used in this Proposed

[29] Prop. Reg. § 26.2612-l(e). See discussion at p. 8, supra.

Regulation. The Preamble, however, states that for ETIP purposes, an individual is treated as holding any “interest in or power over (emphasis added) property held by the individual's spouse.[30] If the term “interest” is intended to include both a beneficial interest in and a power over property, the Proposed Regulations should be clarified accordingly. However, in view of the many problems discussed below created by treating a power as equivalent to a beneficial interest, it is the Committee's recommendation that this aspect of the ETIP concept be deleted, or be limited to beneficial interests and to powers held by a spouse that could be exercised in favor of the spouse.

b. Prop. Reg. § 26.2632-l(c)(2)(ii): Interest [Power] Held by the Transferor's Spouse Acquired from the Transferor in a Transfer not Included in the Transferor's Taxable Gifts

Assuming that powers over property held by the transferor's spouse are intended to cause the ETIP to remain open, a further ambiguity arises from the requirement that the interest be acquired from the transferor in a transfer that is not included in the transferor's taxable gifts. Presumably, a power created in the spouse in connection with a beneficial transfer of property by the transferor to a third party is itself an interest “acquired from the transferor.” However, the transfer of a power over property without any beneficial interest in the power holder is never includible in a transferor's taxable gifts.[31] It is not clear whether the inclusion in the “transferor's taxable gifts” of the underlying beneficial interest is intended to cause the transfer or creation of the

[30] 57 FR 61358.

[31] See Reg. § 25.2511-l(g)(1).

power also to be considered as having been included in the "transferor's taxable gifts".

For example, if a transferor transfers property to a trust for the benefit of his grandchildren, naming his spouse as trustee with the power to sprinkle income and principal among the grandchildren, presumably the spouse would be considered to have acquired the sprinkling power from the transferor. Assuming the transfer to the grandchildren is includible in the transferor's taxable gifts (e.g., there are no withdrawal rights), it is not clear whether the acquisition of the sprinkling power by the spouse should be considered as having been acquired in a transfer that was included in the transferor's taxable gifts. Since the transfer of a naked power would never be a taxable gift to the power holder, any transfer of a power to a spouse in connection with a GST would cause the transferor's ETIP to remain open, so long as the power is one that, if retained by the transferor, would cause the property to be included in the transferor's gross estate. It is not clear whether this result was intended.

It is equally unclear as to whether Prop. Reg. § 26.2632—1(c)(2)(iii) is intended to apply to the transfer of a naked power. This would only be the case if the spouse's power or interest was deemed to be created by the spouse and thus includible in the spouse's estate. Thus, in the example of the trust for grandchildren discussed above, Prop. Reg. § 26.2632-1(c)(2)(iii) would create an ETIP only if the spouse were considered to be the creator of the trust. As written, however, Prop. Reg. § 26.2632-l(c)(2)(iii) does not have this result. The transferred property would not be includible in the spouse's estate because the spouse is not the transferor for purposes of the federal estate tax. In fact, it is difficult to imagine to what situations the Proposed Regulation would apply. Any interest held by the spouse created by the transferor would not be included in the spouse's estate unless the spouse were given a interest outright or in a marital deduction trust for which the reverse QTIP election were not made. In that case, the spouse would be the transferor of the interest for purposes of the GST tax since the interest would be subject to estate tax in the spouse's estate and the transferor would not want to allocate his GST exemption to the trust.

A similar problem exists with Prop. Reg. § 26.2632-l(c)(3)(iv). This Proposed Regulation states that the ETIP terminates in the case of an ETIP arising by reason of an interest held by the transferor's spouse on the first to occur of (i) the death of the spouse or (ii) the time at which no portion of the property would be includible in the spouse's gross estate.

In Example 5,[32] the ETIP would immediately end on the transfer of the remaining income interest to the spouse because the interest would not be included in the spouse's estate were the spouse to die before the expiration of-the interest. The income interest vanishes at death and the underlying trust property would not be included in the spouse's estate because the spouse is not the transferor for purposes of IRC § 2036(a)(1). The same result applies to the sprinkling power in the example of the trust for grandchildren discussed above. If the intent is indeed to create an ETIP where the spouse has only a naked power or an interest which was never held by the transferor, both regulations should be amended to clearly state that inclusion in the gross estate of the spouse is determined as if the spouse

[32] Prop. Reg. § 26.2632-l(c)(5), Example 5.

were the transferor. In any event, Prop. Reg. § 26.2632-1(c)(3)(iv) should be amended so that it gives the intended result in Example 5.

c. Application to Life Insurance Trusts

The application of the proposed ETIP rules to life insurance trusts is particularly onerous because of the potential application of IRC § 2042 concerning incidents of ownership in a life insurance policy. For example, assume a transferor transfers cash to a trust for the benefit of his children and grandchildren, naming his spouse as trustee with the power to sprinkle income and principal among the beneficiaries, and that the trust acquires a life insurance policy on the transferor's life. The spouse's power to sprinkle among the beneficiaries would be a power that, if retained by the transferor, would cause inclusion in the transferor's gross estate both under IRC § 2038 as a revocable transfer and under IRC § 2042 as an incident of ownership of a life insurance policy.[33] Even if the sole beneficiary was the transferor's grandchild, and the spouse had no discretion as to distributions, other trustee powers held by the spouse, such as the power to borrow against the cash value of the policy to pay premiums, would also be incidents of ownership.[34]

This interpretation of the Proposed Regulation would prevent spouses from serving as trustees of many life insurance trusts and it is hard to see what purpose that accomplishes. Moreover, even if the spouse were not the trustee but was a beneficiary of the trust, which is usually the case,

33 Reg. § 20.2036-l(b)(3); Reg. § 20.2042-l(c)(4).

34 See. Reg. § 20.2042-l(c)(2).

the interest of the spouse could be considered a reversionary interest and therefore an incident of ownership if its value exceeded 5% of the value of the policy[35]. Thus, almost all life insurance trusts where the spouse is either a trustee or a beneficiary would be subject to an ETIP. This result seems unwarranted.

d. Prop. Reg. § 26.2632-l(c)(2)(ii): Definition of the Phrase “Not Included in the Transferor's Taxable Gifts”

Example 5 of Prop. Reg. § 26.2632-l(c)(5) makes it clear that the phrase “not included in the transferor's taxable gifts” in Prop. Reg. § 26.2632-l(c)(2)(ii) is intended to cover gifts that are not included in taxable gifts because they qualify for the gift tax annual exclusion under IRC § 2503(b). This is not clear, however, from the text itself. It is also not clear whether other transfers might be considered “not included in the transferor's taxable gifts.”

The Proposed Regulations define the term “nontaxable gifts” for purposes of Chapter 13 generally as transfers excluded from taxable gifts by reason of IRC §§ 2503(b) or 2503(e), with an exception for transfers in trust for the benefit of an individual unless (a) during the individual's lifetime, trust principal or income may only be distributed to or for the benefit of that individual, and (b) the trust assets would be included in the individual's gross estate if the individual died before the trust terminated.[36] If the term transfers “not included in taxable gifts” is equivalent to the

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[35] See Reg. § 20.2042-l(c)(3).

[36] Prop. Reg. § 26.2642-l(c)(3).

term “nontaxable gifts”, the treatment of transfers in trust subject to withdrawal powers needs to be clarified, since it appears that transfers in trust subject to withdrawal powers would not be “nontaxable gifts” if the trust had more than one beneficiary. Accordingly, such transfers would be “included in taxable gifts” and therefore not subject to the ETIP.

Adding to the confusion is the definition of a “transfer subject to gift tax” under Prop. Reg. §26.2652-l(a)(2) as a transfer that is a completed gift within the meaning of Reg. § 25.2511-2, regardless of whether gift tax is actually imposed. Under this definition, a gift subject to the annual exclusion is a transfer subject to gift tax. Although the definition of a transfer subject to gift tax is expressly made applicable only to Prop. Reg. § 26.2652-1, the similarity of the various phrases makes it difficult to determine what definition should apply for purposes of the ETIP rules. Given the different policy considerations underlying the terms “nontaxable gifts” and “gifts not included in the transferor's taxable gifts”, it would appear that these concepts should not be regarded as the same. Nevertheless, this should be clarified.

It is also not clear whether transfers not subject to gift tax for reasons other than the annual exclusion would be considered gifts not included in the transferor's taxable gifts. For example, under IRC § 2702, if an individual transferred an interest to a trust for his grandchild, retaining an income interest in the trust for a period of ten years, gift tax would be imposed on the transfer to the grandchild as though the retained interest had a value of zero.[37] If that retained interest were later transferred to the spouse, the individual

[37] This assumes the transfer did not qualify as a personal residence trust under Reg. § 25.2702-5.

would be entitled to a reduction in aggregate taxable gifts on the subsequent transfer.[38] The facts in Example 4 of Prop. Reg. § 26.2632-1(c)(5) assume that T transferred property to a trust, retaining the right to trust income for the earlier of nine years or T's death. The example overlooks the Chapter 14 implications of such a transfer.

For example, assume that in Example 4 T transferred property worth $100,000, and that the value of the retained interest under IRC § 7520 was $50,000. The transfer would be valued for gift tax purposes at $100,000, as though there were no retained interest. If the transferor subsequently transferred the retained interest to his spouse, as in Example 5 of Prop. Reg. § 26.2632-l(c)(5), at a time when the value of the interest was still $50,000, no taxable gift would result because the transferor would be entitled to a reduction in aggregate taxable gifts under Reg. § 25.270l-6(a)(1). (If no other gifts to the spouse were made during the year, $40,000 would be excludable under Reg. § 25.2702-6 and $10,000 would be excludable under the annual gift tax exclusion. If other gifts to the spouse during the year fully utilized the annual exclusion, the entire $50,000 would be excludable under Reg. § 25.2702-6.[39]) Pursuant to Example 4 of the Prop. Reg. § 25.2632-l(c)(5), it is clear that if a transferor retains an income interest, the ETIP provisions apply. Given the policy considerations underlying the ETIP rules, it would appear that the same result should obtain if such an income interest is transferred to a spouse. Example 5 illustrates this point but only in a situation where the income interest is excluded entirely by the annual gift tax exclusion.

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[38] Reg. § 25.2702-6.

[39] See Reg. § 25.2702-6(b)(2).

The examples contained in the final regulations should be expanded to cover situations where transfers would not be subject to gift tax for reasons other than the annual gift tax exclusion such as in the foregoing examples.

e. Change of Transferor on Transfers in Trust Qualifying for the Marital Deduction

Prop. Reg. § 26.2632-l(c)(2)(ii) includes a transfer that would be includible in the gross estate of the transferor had the transferor retained an interest held by the transferor's spouse, if the spouse acquired the interest in an inter vivos transfer for which a marital deduction was allowed under IRC § 2523. The ETIP rules are expressly made inapplicable, however, to qualified terminable interest property with respect to which a reverse QTIP election is made.[40] It appears that any transfer to the transferor's spouse for which a marital deduction is allowable would result in a change of transferor with respect to any future GSTs, unless a reverse QTIP election is made. Thus, there would be no reason for the transferor to allocate GST exemption to a marital deduction transfer without making a reverse QTIP election. The portion of the parenthetical in (ii) reading “or for which a deduction was allowed under section 2523 of the Code” is therefore unnecessary and should be deleted.

J. Prop. Reg. § 26.2642-2(a): Valuation of Lifetime Transfers

1. Summary

The Proposed Regulations provide, as a general rule,

[40] See Prop. Reg. § 26.2632-l(c)(1).

that for lifetime transfers the denominator of the applicable fraction is the fair market value of the property on the date the GST exemption allocation becomes effective.[41] However, there is an exception to this general rule. If a late allocation of GST exemption to a trust is made, the transferor may elect to value the transferred property as of the first day of the month in which the late allocation is made.[42] If the transferor makes this election, the allocation is not effective until filed with the IRS. The election must state (i) that an election is being made; (ii) the valuation date; and (iii) the fair market value of the property on the valuation date.[43] The Proposed Regulations, however, provide that this election is "not effective with respect to life insurance".[44]

2. Comment

The Committee generally endorses the approach adopted by the Proposed Regulations of the right to elect to treat a late allocation as having been made on the first day of the month of the late allocation. Inasmuch as Prop. Reg. § 26.2632-1(b)(2)(ii) provides that an allocation to a trust made on a late filed Federal gift tax return (Form 709) is effective on the date the Form 709 is filed, without this election it would be difficult, if not impossible, to file the allocation on the same date as the valuation. In fact, as stated in the Preamble, this difficulty was the reason for the provision.

41 Prop. Reg. § 26.2642-2(a)(1).

42 Prop. Reg. § 26.2642-2(a)(2).

43 Ibid.

44 Ibid.

The principal objection the Committee has raised concerns the exclusion from this election of life insurance under certain circumstances. If the insured is still alive as of the date of the late allocation, there is no potential for abuse. In addition, since it would be difficult to file the allocation on the same date the insurance is valued, the reason for the election applies equally to life insurance as to other assets. Furthermore, if assets transferred to a trust consist of not only life insurance policies but other assets, then the transferor would have two valuation dates and, therefore, would be required to make two allocations. Example 3 of Prop. Reg. § 26.2642-2(c) is an example of double valuation dates. This seems to be unduly complex.

Therefore, the Committee recommends that the election under Prop. Reg. § 26.2642-2(a)(b) be unavailable with respect to life insurance only when the insured has died prior to the date of the late allocation.

K. Prop. Reg. § 26.2642-2(b): Valuation of Transfers at Death

1. Summary

The Proposed Regulations provide that the value of property included in the decedent's gross estate, for determining the denominator of the applicable fraction, is the value reported for estate tax purposes.[45] There are, however, special rules for both pecuniary bequests followed by residual transfers. The pecuniary amount will be the denominator of the applicable fraction (i) if the pecuniary amount is satisfied in cash or,

[45] Prop. Reg. § 26.2642-2(b)(1).

(ii) if satisfied in kind, if the pecuniary amount is paid with property valued on the date of distribution or, if valued on a date other than the date of distribution, on a basis that fairly takes into account net appreciation and depreciation in all assets from which the distribution could have been made.[46] The value for the denominator[47] for all other pecuniary bequests payable in kind will be the date of distribution value of the property.

If the pecuniary bequest carries “appropriate interest”, the denominator of the applicable fraction with respect to residual transfers is the estate tax value of all assets available to satisfy the pecuniary bequests reduced by the pecuniary amount. If the pecuniary bequest does not carry appropriate interest, then the estate tax value of the assets is reduced by the present value of the pecuniary bequest.[48]

The Proposed Regulations define appropriate interest as interest that must be payable from either (i) the date of the transferor's death or (ii) from the date specified under state law requiring that interest be paid. The rate at which such interest must be paid must be at least equal to either the rate provided by state law or, if there is no applicable state law, 80% of the rate applicable under IRC § 7520 at the decedent's death. The interest rate is not to exceed the greater of the statutory rate, if any, and 120% of the rate applicable under IRC § 7520.[49] However, a pecuniary bequest will be deemed to carry appropriate interest if the bequest is paid or irrevocably set

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[46] Prop. Reg. § 26.2642-2(b)(2)(i); see also Rev. Proc. 64-19, 1964-1 C.B. 682.

[47] Prop. Reg. § 26.2642-2(b)(2)(ii).

[48] Prop. Reg. § 26.2642-2(b)(3)(i).

[49] Prop. Reg. § 26.2642-2(b)(4)(i).

aside within 15 months of the transferor's death or the governing document requires the fiduciary to allocate to the pecuniary bequest, on a pro rata basis, the income earned until satisfaction of the bequest.[50]

2. Comment

In determining appropriate interest, the Proposed Regulations provide a range within which the interest rate must fall. If state law does not require interest be paid on a pecuniary bequest or does not state a rate, then the Proposed Regulations provide a range of 80% of the applicable rate under IRC § 7520 to 120% of the applicable rate under IRC § 7520. IRC § 7520(a)(2) provides for an interest rate equal to 120% of the applicable federal mid-term rate. If there is no statutory rate under applicable state law, it appears that the range of appropriate interest is to be no less than 80% of 120% of the applicable federal mid-term rate and no greater than 120% of 120% of the applicable federal mid-term rate. It might have been simpler to use a range between 80% of the federal mid-term rate to 120% of the federal mid-term rate.

Under the Proposed Regulations, if a pecuniary payment does not carry appropriate interest, the pecuniary payment is considered to carry appropriate interest to the extent that the payment is made or property is irrevocably set aside to satisfy the pecuniary payment within 15 months of the transferor's death.[51] Guidance should be provided as to what constitutes irrevocably setting aside a payment since often the exact amount of the pecuniary amount will not be known until after the 15

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[50] Prop. Reg. § 26.2642-2(b)(4)(ii).

[51] Prop. Reg. § 26.2642-2(b)(4)(ii)(A).

month period. For example, would setting aside particular assets either physically or on the estate's books from which payment will be made with a share of income and appreciation and depreciation be deemed a set aside for this purpose?

In addition, the Committee believes there was an oversight in the provisions relating to when a pecuniary bequest is deemed to carry appropriate interest. Prop. Reg. § 26.2642(b)(4)(ii)(B) provides that a pecuniary bequest is deemed to carry appropriate interest if the governing document requires the fiduciary to allocate income to the pecuniary bequest. There is no reference in this provision, however, to whether state law may require such allocation. New York Estates Powers and Trusts Law § 11-2.1(d)(2) provides that unless the governing instrument states otherwise, income earned is to be allocated in accordance with the statutory provisions. The class of beneficiaries to whom income is to be allocated includes beneficiaries of pecuniary dispositions in trust (it specifically excludes pecuniary bequests not in trust). However, other states may have statutory requirements concerning allocations of income. Therefore, some reference to applicable state law should be made.

Lastly, the Committee would like to see examples of the rules applicable to pecuniary payments followed by residual transfers included in the final regulations.

L. Prop. Reg. § 26.2642-3: Special Rule for Charitable Lead Annuity Trusts

1. Summary

Under Prop. Reg. § 26.2642-3, in determining the applicable fraction for a charitable lead annuity trust, the numerator is equal to the “adjusted GST exemption” and the denominator is the value of the trust at the end of the charitable term. The “adjusted GST exemption” is defined as “the amount of GST exemption allocated to the trust increased by an amount equal to the interest that would accrue if an amount equal to the allocated GST exemption were invested at the rate used to determine the amount of the estate or gift tax charitable deduction, compounded annually, for the actual period of the charitable lead annuity. If a late allocation is made to a charitable lead annuity trust, the adjusted GST exemption is the amount of GST exemption allocated to the trust increased by the interest that would accrue if invested at such rate for the period beginning on the date of the late allocation and extending for the balance of the actual period of the charitable lead annuity.”[52]

2. Comment

Prop. Reg. § 26.2642-3(b) differs from IRC § 2642(c) in one significant respect. Under the statute, if a late allocation of GST exemption is made, the interest adjustment relates back to the date the trust was created, whereas under the Proposed Regulation, the interest adjustment will only run from the date

[52] Prop. Reg. § 26.2642-3(b).

of allocation. This means that if the trust is to have the same inclusion ratio with a late allocation as with a timely allocation, a greater amount of exemption will have to be allocated to the trust.

Apart from its questionable statutory authority, the proposed change unfairly penalizes taxpayers for acting in a manner that is clearly contemplated by the statute. Because it is virtually impossible to predict what the value of the trust will be at the end of the charitable term, it is generally preferable to delay the allocation of GST exemption until the end of the term. This allows the taxpayer to use precisely the amount of exemption necessary to obtain the desired tax result.

Under the Proposed Regulation, achieving this type of precision would only come at a sizeable tax cost. The taxpayer would therefore be faced with a difficult choice: (i) making a timely but imprecise allocation and thus risking either wasting a portion of his exemption unnecessarily or incurring an otherwise avoidable tax; or (ii) making a precise allocation at the end of the charitable term but using more of his exemption than the statute seems to require. Clearly, creating such a choice could not have been Congress' intention in enacting the statute and it is therefore recommended that the proposed change be eliminated.

Even if the Proposed Regulation is retained as a general rule, there are two special situations to which it should not apply. First, taxpayers who created charitable lead annuity trusts prior to the effective date of the final regulations should be given at least 90 days after that date in which to make an allocation and receive the interest adjustment based on the full charitable term. Second, charitable lead annuity trusts that are subject to the ETIP requirements should receive a full interest adjustment so long as the transferor allocates his exemption on a timely filed Federal gift tax return following the first to occur of the death of the grantor and the expiration of the charitable term. Since an exemption allocation at the time the trust is created would not be effective, an allocation at the end of the ETIP cannot be considered a “late allocation.” Accordingly, the statutory rule should apply.

Finally, because of the complexity of this rule, an example which shows how to compute the inclusion ratio for a charitable lead annuity trust would be helpful.

M. Prop. Reg. § 26.2642-4: Redetermination of Applicable Fraction

1. Summary

Prop. Reg. § 26.2642-4 requires a trust's applicable fraction to be redetermined whenever additional GST exemption is allocated to the trust or when certain changes occur with respect to the principal of the trust. “[T]he numerator of the redetermined applicable fraction is the sum of the amount of GST exemption currently being allocated to the trust (if any) plus the value of the nontax portion of the trust.”[53] The denominator of the new fraction is the value of the trust principal immediately after the event occurs. The nontax portion of a trust is determined by multiplying the value of the trust principal, determined immediately prior to the event, by the then applicable fraction.

[53] Prop. Reg. § 26.2642-4(a).

Prop. Reg. § 26.2642-4 lists certain events which expressly require a redetermination of the applicable fraction, including transfers of additional property to an existing trust, consolidation of two or more separate trusts, property being included in the transferor's gross estate and additional exemption being allocated to it and the imposition of a recapture tax under IRC § 2032A. The Proposed Regulations do not state whether this is an exclusive list.

2. Comment

Under Prop. Reg. § 26.2642-4, the numerator of the redetermined applicable fraction is based on pre-event values and the denominator is based on post-event values. As a result of this timing mismatch, it is quite possible for a trust inclusion ratio to increase even when no additional property has been added to the trust or when no additional exemption has been allocated to it.

Consider, for example, two trusts with minority interests in the same closely held enterprise. If the trusts are combined to create a single trust with a controlling interest, the value of the new trust will undoubtedly exceed the aggregate value of the two former trusts. Under Prop. Reg. § 26.2642-4(a)(2), a consolidation of two separate trusts requires a redetermination of the applicable fraction. In making this redetermination, the denominator, using post-event values, will reflect the increased value of the combined trust's principal whereas the numerator, using pre-event values, will not. The result is to decrease the ratio even though no new property has been added to the trust.

The same result would occur if a minority interest in a company were added to a trust with a similar interest and, as a result of the transfer, the trust obtained a controlling interest. Even if the transferor allocated additional exemption to the trust in an amount equal to the newly transferred interest, under the Proposed Regulation, the inclusion ratio would increase. This result was clearly not intended by the statute.

Prop. Reg. § 26.2642-4(a)(3), applicable to trust property included in the transferor's gross estate, will have a similar effect if the property increases in value simply as a result of the transferor's death. For example, consider an irrevocable _inter vivos_ trust to which the decedent transferred a life insurance policy with a gift tax value of $10,000 and allocated $5,000 of GST exemption. Two years after the transfer, the decedent dies causing the entire value of the trust (including the life insurance proceeds) to be included in his gross estate. Immediately prior to the decedent's death, the value of the policy was $20,000. The face amount of the insurance proceeds payable to the trust was $100,000.

The applicable fraction for this trust should remain at .500 if no new GST exemption is allocated to it, and the statute does not expressly cause a different result. If the decedent's executor allocates $10,000 of his remaining GST exemption to the trust, the new applicable fraction should be .600 (.500 x $100,000 market value = $50,000 nontax portion, plus $10,000 new exemption = $60,000, over a $100,000 denominator). Under the Proposed Regulation, however, the applicable fraction becomes .200 under this last scenario ($20,000 numerator and $100,000 denominator). Thus, even though additional exemption has been allocated to the trust, the applicable fraction has been reduced from .500 to .200.

The Committee does not believe it was Congress' intention to change a trust's inclusion ratio when no additional property is added to the trust or no additional exemption is allocated to it. Accordingly, the Proposed Regulation should be amended to provide that the amount of the nontax portion contained in the numerator should be determined immediately after, rather than before, the event, whether it be a consolidation, addition or the transferor's death. Alternatively, the existing applicable fraction could be increased by a second fraction having a numerator equal to the additional exemption allocated and a denominator equal to the value of the trust immediately after the event.

The Proposed Regulation should also be amended to clarify whether the changes listed in Prop. Reg. §§ 26.2642-4(a)(1)-(4) (i.e., adding property to a trust, consolidation of two trusts, including property in a transferor's gross estate and allocating additional exemption to it, imposing a tax under IRC § 2032A) are the only changes requiring a redetermination of the applicable fraction. For example, it is not clear from the Proposed Regulation whether a redetermination is required for property included in the transferor's gross estate when no additional exemption is allocated to it. This should be clarified.

Finally, Prop. Reg. § 26.2642-4(a)(3) should be amended to provide that if additional GST exemption is allocated to property included in the transferor's gross estate, in redetermining the trust's applicable fraction, the denominator should be reduced by any estate taxes attributable to the property, without regard to the source of such payment. This change could be made in Prop. Reg. § 26.2642-4(b), Example 1 by simply providing that the estate taxes payable on the inclusion of the $500,000 in the transferor's gross estate will reduce the denominator of the trust's applicable fraction.

N. Prop. Reg. § 26.2642-5: Finality of Inclusion Ratio

1. Summary

Under Prop. Reg. § 26.2642-5(b), with respect to taxable distributions and taxable terminations, the trust's inclusion ratio does not become final until the later of (i) the expiration of the period for assessment of the first GST tax computed using that inclusion ratio, or (ii) the expiration of the period for assessment of federal estate tax with respect to the transferor's estate.

2. Comment

Prop. Reg. § 26.2642-5(b)(1) is susceptible of two inconsistent interpretations. First, the period of assessment described in (b)(1) may begin to run only when a GST tax has actually been paid. Alternatively, the period may commence only after the filing of an appropriate tax return that reports a GST transaction that either results in a tax due or, by reason of an asserted zero inclusion ratio, results in no tax at all.

If the first interpretation is the intended meaning, that is, the period of limitations starts with the payment of a

GST tax, there is no need for the Proposed Regulation to contain the alternative period set forth in Prop. Reg. § 26.2642-5(b)(2), because in each case there would in fact be a justifiable issue presented during the period of limitations described in (b)(1). It would, therefore, be unnecessary to hold the determination of the inclusion ratio open until the death of the transferor as (b)(2) would do.[54]

On the other hand, if (b)(1) has the second meaning set forth above, that is, the period of assessment with respect to a GST event commences upon the filing of an appropriate return even if there is no tax by reason of a claimed zero inclusion ratio, the Proposed Regulation should be revised to state this explicitly. Even if this is the intended meaning, it appears that there would be a justiciable issue presented by such a return, even without any tax shown as due, because a GST tax would be assessed if the inclusion ratio is finally determined to be other than zero. Thus, under either interpretation (b)(2) is unnecessary, and imposes a needless and substantial burden on taxpayers.

Additionally, the Proposed Regulation should be clarified by expressly stating that it relates only to a GST tax as to which the statute of limitations has not yet expired. Thus, by way of example, if upon the termination of a trust the inclusion ratio is determined to be larger than was asserted in a return reporting an earlier taxable distribution as to which the period of assessment has expired, a redetermination of the

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[54] Another possible solution would be that, if a gift tax is paid, the inclusion ratio would become final after the expiration of the period of assessment for the gift tax. In addition, even if no gift tax or GST tax is payable, but the gift tax return reporting the transfer is audited, the inclusion ratio should become final on termination of the gift/GST tax proceeding.

trust's inclusion ratio should only apply to the taxable termination and not the earlier taxable distribution. (If this is not the result, the Proposed Regulation clearly exceeds the statutory period of assessment with respect to the taxable distribution and is therefore invalid.)[55]

An appropriate analogy for this point is the effect of a redetermination of the value of a taxable gift after the expiration of the gift tax period of limitations. In such a case, only the rate of tax imposed on subsequent gifts made during the life of the same donor and the availability of the unified credit with respect to later gifts, and similarly the rate of estate tax and the availability of unified credit against the estate tax, is affected by the change in valuation. In no event, however, can the gift tax with respect to the original gift be affected by the revaluation. The analogous result should apply here.

From the viewpoint of tax planning, the Proposed Regulation, even if corrected in the manner described above, leads to substantial uncertainty. For example, under the Proposed Regulation, any allocation of GST exemption to a trust by the use of a formula such as “the amount of exemption required to reduce the applicable fraction to zero” may not yield a firm figure until long after the creation of the trust, and possibly until long after the GST tax is first due with respect to transactions involving the trust. As a result, the transferor will not know how much GST exemption remains available for lifetime gifts or at his death. Moreover, legacies determined by certain formulas (such as “I give an amount equal to my remaining GST exemption at my death . . . “) will remain incapable of valuation, possibly

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[55] I.R.C. § 6501(a).

for years or decades after the death of the transferor. To solve this problem, either the second to last word of the first paragraph of Prop. Reg. § 26.2642-5(b) should be changed from "later" to "earlier," or paragraph (b)(2) should be deleted (with ancillary changes in the remaining language).

A comprehensive example would be helpful for this Proposed Regulation. A possible example is set forth below, on the assumption that no substantive change is made in this Proposed Regulation and that the first interpretation described above is correct for paragraph b(1):

Example. T creates an irrevocable trust for the benefit of T's child and grandchild in 1993 by transferring 100 shares of XYZ Corporation to the trust on the date of creation. On the Form 709 reporting the transfer, T reports the value of the stock at $100,000 and allocates $100,000 of GST exemption to the trust. The return is not audited. In 1994, T's grandchild receives $10,000 from the trust, and the transaction is reported on an appropriate return filed on April 15, 1995, with no GST tax reported due because the inclusion ratio is reported at zero. On July 1, 1995, T contributes an additional 100 shares of stock of XYZ Corporation. On the Form 709 reporting the transfer (filed April 15, 1996), T reports the value of the 1995 transfer at $100,000, and allocates no GST exemption to it. On July 1, 1999, the trust distributes $10,000 to T's grandchild, and on a GST return filed April 15, 2000 reports a taxable distribution of $5,000 based on a recomputed inclusion ratio of .500 (reporting the value of the assets of the trust at the time of the 1995 addition, exclusive of the addition itself, at $100,000). T dies on July 1, 2001. On September 5, 2010, T's child dies and the entire trust corpus is distributed to T's grandchild.

(i) The inclusion ratio with respect to the 1994 distribution to T's grandchild may be determined at any time prior to April 15, 1998, the expiration of the period of assessment with regard to the return that reported the transfer.

(ii) The inclusion ratio with respect to the 1999 distribution to T's grandchild may be redetermined at any time prior to April 15, 2002, the expiration of the period of assessment with regard to the return that reported the transfer. Any redetermination of the inclusion ratio with respect to the 1999 transfer, however, will not affect the tax consequences of the 1994 transfer.

(iii) The inclusion ratio upon termination of the trust in 2010 may not be redetermined, because the termination of the trust takes place after the later to occur of the expiration of the period of assessment with respect to T's estate tax and the period of assessment with respect to the 1999 transfer, which resulted in the first GST tax that was computed using the inclusion ratio of .500. Thus, even if the valuation of the XYZ Corporation stock as of 1993 or 1995 is determined (after termination of the trust) to have been greater at that time than $100,000, or the value of the assets of the trust (exclusive of the addition) at the time of the 1995 addition is determined (after termination of the trust) to have been less than $100,000, the inclusion ratio remains .500. The value of the corpus of the trust upon termination, however, including any XYZ stock it then owns, is not affected by this rule.

O. Prop. Reg. § 26.2652-l(a): Transferor Defined

1. Summary

Prop. Reg. § 26.2652-1(a) defines the transferor of property for purposes of Chapter 13 to be the individual with respect to whom such transferred property was most recently subject to Federal estate or gift tax. The Proposed Regulations clarify that a transfer is “subject to gift tax” if it is a completed gift without regard to whether a gift tax is actually imposed.[56] Similarly, a transfer is “subject to estate tax” if the property would be includible in the individual's gross estate as determined under IRC § 2031 even if no Federal estate tax would be imposed. One exception to the foregoing rules exists for property which is subject to the so-called “reverse QTIP election”[57] where the transferor spouse remains the transferor even though the property is includible in his spouse's estate.

2. Comment

a. Prop. Reg. § 26.2652-l(a)(4): Perpetuities Period

Prop. Reg. § 26.2652-1(a)(4) provides that a power of appointment that is not a general power[58] is treated as a transfer subject to Federal estate or gift tax by the creator of the power if it is exercised so that the vesting of the property

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56 Prop. Reg. § 26.2652-l(a).

57 IRC § 2652(a); see Fn. 16, supra.

58 IRC § 2041(b).

is postponed beyond the normal perpetuities period (generally 21 years plus lives in being), determined with respect to when the power was originally created. A similar alternative rule applies to the exercise of such a power that postpones vesting for a term of more than 90 years in gross from the creation of the trust. Under Examples 8 and 9 of prop. Reg. § 26.2652-l(a)(5), the creator of the power will not be treated as the transferor for Chapter 13 purposes so long as the power is exercised in such a manner as to have the property vest within the earlier of the normal perpetuities period or 90 years from the creation of the trust.

It would appear that the effect of this Proposed Regulation is to subject a transfer to GST tax in cases where the trust is grandfathered under the transitional rules or an allocation of GST exemption would otherwise avoid such a tax. Accordingly, to the extent that this rule is regarded as necessary at all, it should be included as a transitional rule.

The rule also essentially creates a new perpetuities period for virtually all jurisdictions. This result does not seem appropriate as compliance with the local law rule against perpetuities should be adequate for purposes of the statute. In addition, an example should be provided illustrating the consequences of a violation of this rule.

b. Prop. Reg. § 26.2652-l(a)(5), Example 5: Effect of Lapse on Withdrawal Right on Identity, of Transferor

Under Prop. Reg. § 26.2552-l(a)(5), Example 5, a transfer to a so-called “Crummey trust”[59] is regarded as a transfer to the trust as opposed to the individual who holds the withdrawal right. If, as a result of the lapse of the power of withdrawal right, the power holder makes a taxable gift, the power holder will be treated as the transferor for Chapter 13 purposes with respect to the amount of the gift. A taxable gift will result when the amount subject to the withdrawal right exceeds the greater of $5000 and 5% of the property subject to the power.[60]

As Example 5 illustrates, the original creator is regarded as the transferor with respect to the original trust principal and, upon the lapse of the power, the power holder becomes the transferor with respect to the portion subject to gift tax. A problem arises with respect to the allocation of the original transferor's GST exemption. It would appear that if a timely allocation of GST exemption is made with respect to the original transfer, the portion of that allocation which is attributable to the property which has a new transferor will be wasted. This is clearly not the intended result and the example should be clarified to address this issue.

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59 See Crummey v. Comm'r., 397 F.2d 82 (9th Cir. 1968), rev'g. in part, 25 TCM 772 (1966). A Crummey trust is a trust which provides withdrawal rights to beneficiaries with respect to additions to the trust. The purpose of the withdrawal right is to convert a gift to the trust from a gift of a future interest in property to a present interest in property so that the gift will qualify for the gift tax annual exclusion. IRC § 2503(b). Typically, the withdrawal rights lapse after a period of time (usually 60 - 90 days) after the gift is made.

60 IRC § 2041(b).

c. Prop. Reg. § 26.2652-l(a)(5), Example 7: Effect of Reverse QTIP Election on Constructive Additions

Example 7 provides that no constructive addition will be deemed made to a reverse QTIP trust if the estate tax due with respect to that trust is paid out of the surviving spouse's estate. Given the importance of this rule, the Committee feels it should be incorporated in the final regulations as opposed to being illustrated by an example. Furthermore, the rule should be expanded to provide that estate tax attributable to the trust may be paid from any source, including a second QTIP trust for the benefit of the surviving spouse, without being considered a constructive addition. This rule should also apply where the governing instrument of the reverse QTIP trust imposes the obligation to pay the estate tax on another entity such as a QTIP trust for which the reverse QTIP election would not be made.

P. Prop. Reg. § 26.2652-l(b): Trust Defined

1. Summary

Prop. Reg. § 26.2652-1(b) defines a trust as "any arrangement (other than an estate) that has substantially the same effect as a trust." Such arrangements include life estates and remainders, estates for years, and insurance and annuity contracts. In addition, the Proposed Regulation states that "a transfer as to which the identity of the transferee is contingent upon the occurrence of an event is a transfer in trust; however, a testamentary transfer as to which the identity of the transferor is contingent upon an event that must occur within six months of the transferor's death is not considered a transfer in trust solely by reason of the existence of the contingency."[61]

2. Comment

Under the Proposed Regulation, an estate will be considered a trust if the decedent's will conditions a bequest on survival beyond a six month period. This is inconsistent with IRC § 2652(b)(1) which provides that an estate is not a trust equivalent. Furthermore, it is not clear whether the six month rule applicable to testamentary transfers applies to revocable trusts. The regulations should be clarified to address this issue since many individuals use revocable trusts as their primary testamentary instrument.

Q. Prop. Reg. § 26.2652-l(c): Trustee Defined

1. Summary

Prop. Reg. § 26.2652-1(c) defines the trustee of a trust as "the person designated as trustee under local law or, if no such person is so designated, the person in actual or constructive possession of property held in trust."

2. Comment

This rule should be expanded to address who would be considered the trustee for Chapter 13 purposes of non-traditional trust arrangements such as life estate and remainder interests, insurance and annuity contracts and estates for years.

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61 Prop. Reg. § 26.2652-l(b).

R. Prop. Reg. § 26.2652-2: Special Election for Qualified Terminable Interest Property

1. Summary

Prop. Reg. § 26.2652-2 contains rules applicable to the special QTIP election. If a QTIP election is made under IRC § 2523(f) or IRC § 2056(b)(7), the transferor (or the transferor's executor) may, for purposes of Chapter 13, elect to treat the property as if the QTIP election had not been made - the reverse QTIP election.[62]

The purpose of the provision allowing the reverse QTIP election is to permit a person who wishes to claim a marital deduction with respect to property transferred to a trust to also apply his GST exemption to that transfer. In the absence of a special provision permitting the reverse QTIP election, the spouse of the person creating the trust, as opposed to the creator himself, will be treated as the transferor with respect to the property transferred to the trust.

Prop. Reg. § 26.2652-2(a) states that a reverse QTIP election is not effective unless it is made with respect to all of the property in the trust to which the QTIP election applies.

Prop. Reg. § 26.2652-2(c) contains a transitional rule which applies to QTIP trusts with respect to which a reverse QTIP election was made prior to December 24, 1992 (the date on which the Proposed Regulations were published in the Federal Register) and an allocation of GST exemption was made. Under the

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[62] See Fn. 16, supra.

transitional rule, the transferor (or his executor) may elect to treat the trust as two separate trusts, one of which has a zero inclusion ratio by reason of the GST exemption allocated to the trust. This rule applies even though there is no authorization for a severance of the trust into separate trusts under either state law or the trust's governing instrument.

2. Comment

a. Prop. Reg. § 26.2652-2(c): Transitional Rule

The Proposed Regulations provides that the election under the transitional rule is to be made by attaching a statement to a copy of the return on which the reverse QTIP election was made. This statement (and the return to which it is attached) must be filed before April 15, 1993. Inasmuch as April 15, 1993 has already passed, the Committee recommends that this effective date be extended until 90 days after final regulations have been adopted.

Under the transitional rule contained in Prop. Reg. § 26.2652-2(c), parts of a single QTIP trust can be treated as separate trusts for Chapter 13 purposes if a reverse QTIP election was made with respect to the trust prior to December 24, 1992 and GST exemption was allocated to the trust. The transitional rule suggests that parts of a single trust can be treated as separate trusts if the reverse election is made because the parts have different transferors.

IRC § 2654(b), which is discussed below, provides that separate parts of a single trust which have been transferred to the trust by different transferors are also treated as separate trusts for Chapter 13 purposes.

The Committee sees no rationale for limiting the reasoning upon which the transitional rule is based to a transitional rule. In other words, any person who transfers property to a trust (or his executor) should be able to make a reverse QTIP election with respect to part of a QTIP trust and allocate some or all of his GST exemption to that part, since that part will in any event be treated as a separate trust for Chapter 13 purposes under IRC § 2654(b).

b. Prop. Reg. § 26.2652-2(d), Example 3: Recovery of Estate Tax from QTIP

Example 3, which is contained in Prop. Reg. § 26.2652-2(d), deals with a trust with respect to which a QTIP election has been made and a reverse QTIP election has not been made. When the surviving spouse dies, the trust property will be included in the estate of the surviving spouse for estate tax purposes and the surviving spouse will be treated as the transferor for Chapter 13 purposes.

Example 3 states the denominator of the applicable fraction which is used to determine the inclusion ratio of the trust involved is reduced by any Federal estate and state death tax "attributable to the trust property that is actually recovered from the trust." Since the example contains a single QTIP trust, it can be read to create a rule that was unintended.

Taken literally, estate taxes which are actually paid from a QTIP trust upon the death of the surviving spouse, but which are attributable to another QTIP trust or any other property in the gross estate would not reduce the denominator of the applicable fraction. It is a common practice for a taxpayer to create two QTIP trusts for the surviving spouse and for a reverse QTIP election to be made with respect to one of those trusts. It is often provided that the estate taxes payable with respect to the exempt trust (the trust as to which the reverse QTIP election is made) upon the death of the surviving spouse will be payable from the other trust. The Committee believes that the words “attributable to the trust property” should be removed and that the above sentence should simply refer to any Federal estate and state death tax “that is actually recovered from the trust.”

S. Prop. Reg. § 26.2654-1: Certain Trusts Treated as Separate Trusts

1. Summary

Prop. Reg. § 26.2654-1 addresses when parts of a trust may be treated as separate trusts for Chapter 13 purposes.

IRC § 2654(b) states that for purposes of Chapter 13 a single trust will be treated as separate trusts in two cases: (i) when portions of a trust are attributable to different transferors, and (ii) when a trust has substantially separate and independent shares for different beneficiaries. IRC § 2654(b) provides that except for the foregoing two cases nothing in Chapter 13 is to be construed as authorizing a single trust to be treated as separate trusts.

The rule set forth in IRC § 2654(b) is needed because under the two cases described above each separate part of the trust will have its own inclusion ratio.

Prop. Reg. § 26.2654-1 contains three subsections. Prop. Reg. § 26.2654-l(a) explains that where separate trust treatment is allowed under IRC § 2654(b) the trust will continue to be treated as one trust for income tax purposes. In other words, separate income tax returns may not be filed for the separate trusts and the income taxes of the trust will continue to be computed as though the trust was one trust.

Prop. Reg. § 26.2654-1(a) also states that additions to and distributions from the separate trusts are allocated pro rata to the separate trusts unless otherwise expressly provided in the governing instrument. Also, when an individual allocates his GST exemption to the single trust, it will be allocated pro rata among the separate trusts unless the individual explicitly provides otherwise.

Prop. Reg. § 26.2654-1(b) describes in detail the application of the two cases referred to in IRC § 2654(b) which were referred to above. Included in this description is an exception for certain pecuniary amounts. In essence, if a person holds a present right to receive a mandatory payment of a pecuniary amount at the death of the transferor from a trust which is included in the transferor's gross estate, the separate and independent share rule will apply if certain requirements are met. First, “appropriate interest” must be paid on the pecuniary amount if the pecuniary amount is not paid within 15 months after the date of death. Second, if the pecuniary amount can be paid in kind on the basis of values other than date of distribution values the trustee must be required to allocate assets that fairly represent the appreciation or depreciation of the entire fund.

Finally, Prop. Reg. § 26.2654-1(c) describes the circumstances under which the severance of a trust into separate trusts will be recognized for Chapter 13 purposes. Paragraph (1) of this provision states that trusts which are treated as separate trusts under the multiple transferors or substantially separate and independent share rules of IRC § 2654(b) can be divided into separate trusts at any time. Paragraph (2) provides a trust which is included in the transferor's gross estate can be severed into separate trusts for Chapter 13 purposes if (i) the severance is authorized by the governing instrument or by local law, (ii) the severance occurs prior to the due date of the Federal estate tax return (with extensions actually granted) and (iii) the new trusts are funded with fractional shares. Where the severance is required to be made on the basis of a pecuniary amount, severance will be recognized if the pecuniary amount is satisfied in a manner which would meet the requirements of Prop. Reg. § 26.2654-l(b)(2)(ii), which apply to a pecuniary amount payable to an individual.

Prop. Reg. § 26.2654-l(c)(3) provides a special rule when a court order severing the trusts has not been issued but a court proceeding requesting such an order has been commenced.

2. Comment

The question of when parts of a single trust will be recognized as separate trusts for Chapter 13 purposes is an important one for estate planning purposes. It is a common practice for an individual to create two trusts with the intention of having his GST exemption allocated to one (which will have an inclusion ratio of zero). Under such an arrangement, the trusts can be administered in such a way as to make maximum use of the GST exemption.

For example, distributions to non-skip persons, which would not be subject to the GST tax, would be made from the trust which is not protected by the GST exemption, thus preserving the exempt trust. Conversely, distributions to skip persons, which would be subject to the GST tax, would be made from the exempt trust, thus sheltering the distributions from GST tax.

a. Prop. Reg. § 26.2654-l(c): Separate Trusts under Local Law

Taken to its logical extreme, the Proposed Regulation appears to be too strict in its interpretation in that it does not necessarily accord separate trust treatment to trusts that are considered separate trusts under local law. This interpretation ignores the legislative history of IRC § 2654(b) which specifically states that this section is not intended to be a multiple trust rule and is not supposed to affect the treatment of trusts that are considered separate trusts under local law.[63] Accordingly, the Committee believes that the last sentence of Prop. Reg. § 26.2654-l(c)(1) should be amended to provide as follows: “Except as provided in this paragraph (c), the severance of a single trust into separate trusts is not recognized for purposes of Chapter 13 until such severance has actually occurred as a matter of local law.” Furthermore, the last sentence of Prop. Reg. § 26.2654-l(c)(2)(ii) should be amended to provide as follows: “If the governing instrument of a trust or local law

[63] Report of the Committee on Ways and Means, House of Representatives, on the Miscellaneous Revenue Act of 1988, HR Rep. Ho. 100-795, 100th Cong., 2d Sess. p 354 (1988) and Report of the Senate Finance Committee on the Technical Corrections Bill of 1988, S. Rep. No. 100-445, 100th Cong. 2d Sess. p 440 (1988).

authorizes the severance of the trust, a severance pursuant to that authorization is treated as meeting the requirement of paragraph (c)(2)(i)(B) of this section if the executor indicates on the Federal estate tax return that separate trusts will be created (or funded) and clearly sets forth the manner in which the trust is to be severed and the separate trusts funded." Finally, a definition of the word "severance" would be helpful.

b. Prop. Reg. § 26.2654-l(b): Exception for Certain Pecuniary Amounts

Prop. Reg. § 26.2654-l(b)(2)(ii)(A)(1) provides that in order for a pecuniary amount to be treated as a separate and independent share, (i) "appropriate interest" as defined in Prop. Reg. § 26.2642-2(b)(4) oust be paid on such amount or (ii) the trustee must permanently set aside property in satisfaction of the pecuniary amount within 15 months of the transferor's date of death.[64] This requirement should only apply where the GST exemption is being allocated to the balance of the trust property after payment of the pecuniary amount, and not where the exemption is being allocated to the pecuniary amount itself.

Both the Preamble and Example 4 of Prop. Reg. § 26.2654-l(b)(2)(iii) appear to indicate that the appropriate interest and funding requirements of Prop. Reg. § 26.2654-1(b)(2)(ii) will both be satisfied if the pecuniary bequest is paid within 15 months of the transferor's death. The Proposed Regulation, however, does not make this clear and, in fact, appears to impose a separate funding requirement where the pecuniary amount is payable in kind on the basis of value other than the date of distribution value of the asset. This should be

[64] See discussion on pages 18-20, supra.

clarified to provide that the result indicated in Example 4 is the operative rule.

c. Prop. Reg. § 26.2654-l(c)(2): Trust Property Included in the Gross Estate

Prop. Reg. § 26.2654-l(c)(2) deals with situations in which parts of a trust that are not separate trusts under local law may be treated as separate trusts for purposes of Chapter 13. This provision starts with the sentence “The severance of a trust that is included in the transferor's gross estate (or created under the transferor's will) into two or more trusts is recognized for purposes of Chapter 13 ...” This provision should also permit the division of an irrevocable inter vivos trust into separate trusts, if the division occurs before the GST exemption is allocated.

A literal reading of Prop. Reg. § 26.2654-l(b)(2) would seem to require that different beneficiaries are required for separate trust treatment. Since this is clearly not the intended result, Prop. Reg. § 26.2654-l(c) should be clarified to provide that as long as the other requirements of the Proposed Regulation are met, separate trust treatment will be available for trusts with identical beneficiaries.

Prop. Reg. § 26.2654-l(b)(2) provides that a single trust will be treated as a separate trust for purposes of Chapter 13 if it consists solely of “separate and independent shares for different beneficiaries.” The phrase “separate and independent shares” has the sane meaning as provided in Reg. § 1.663(c)-3. The Proposed Regulation does not, however, state whether the income tax separate share rule as interpreted by Reg. § 1.663(c)—3 is to be used for the purpose of determining whether such share exists for “different beneficiaries”. It is the Committee's view that inasmuch as the income tax separate share rule is an annual determination, it would not seem appropriate for it to apply to the GST tax.

d. Multiple Trust Rule

IRC § 643(f) provides that separate trusts which have substantially the same grantors and primary beneficiaries shall be treated as one trust if a principal purpose of such trusts is the avoidance of the income tax. Since IRC § 643(f) by its terms applies only to the income tax, it is not applicable for Chapter 13 purposes. The Proposed Regulations should state that trusts which are separate trusts under the governing instrument or local law but have the same grantors and beneficiaries will not be treated as one trust for Chapter 13 purposes regardless of whether or not they are treated as one trust for income tax purposes.

T. Prop. Reg. § 26.2663-2: Application of Chapter 13 to Transfers by Nonresidents Not Citizens of the United States

1. Summary

IRC § 2663 provides that “[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this chapter, including ... (2) regulations (consistent with the principles of Chapters 11 and 12) providing for the application of this chapter in the case of transferors who are nonresidents not citizens of the United States ...” (emphasis added).

The Proposed Regulations set forth two general rules with respect to GSTs of nonresident aliens ("NRAs"). The first rule deals with GSTs by NRAs of property situated in the United States[65] and the second with non-U.S. situs property.[66] As discussed below, the Committee feels the Proposed Regulations generally, with some reservations, carry out the goals stated in IRC § 2663(2) with respect to property situated in the United States but that the rules governing GSTs of non-U.S. situs property are overbroad.

a. Property Situated in the United States

The Proposed Regulations state that Chapter 13 applies to GSTs of NRA decedents to the extent that the transferred property is situated in the United States for purposes of Chapter 11.[67] Similarly, Chapter 13 applies to GSTs attributable to inter vivos transfers by a NRA of property situated in the United States for purposes of Chapter 12 that are subject to Federal gift tax under IRC § 2501(a).[68] The Proposed Regulations state that the property is treated as situated in the United States to the extent that the property is treated as situated in the United States "at the time of the initial

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65 Prop. Reg. § 26.2663-2(b).

66 Prop. Reg. § 26.2663-2(c).

67 Generally, real property and tangible personal property located in the U.S., stock in U.S. corporations, debt obligations of U.S. persons (other than certain bank deposits and certain debt obligations the interest from which is exempted from income tax under IRC § 871(b)(1)) is considered situated in the U.S. for purposes of Chapter 11. Reg. § 20.2104-1.

68 Generally, real property and tangible personal property located in the U.S. are considered situated in the U.S. for purposes of Chapter 12. Shares of stock of a U.S. corporation or other intangible personal property is considered non-U.S. situs property. See Reg. § 25.2511-3.

transfer to the skip person or to a trust that is a non-skip person ...”.[69]

b. Non-U.S. Situs Property

The Proposed Regulations provide that Chapter 13 applies to GSTs if (i) at the time of the initial transfer to the skip person (or to a trust that is a non-skip person), a lineal descendant of the transferor who is a lineal ancestor of the skip person was a resident or citizen of the United States and (ii) at the time of the GST a beneficial interest in property passes to a skip person who is a resident or citizen of the U.S.

c. Effective Date

The Proposed Regulation states that the provisions of Chapter 13 do not apply to any transfer by a NRA with respect to non-U.S. situs property made before December 24, 1992.[70]

2. Comment

a. Prop. Reg. § 26.2663-2(b): U.S. Situs Property

Paragraph (b) of Prop. Reg. § 26.2663-2, dealing with transfers of U.S. situs property by NRAs, is inconsistent in some applications with the principles of Chapters 11 and 12. Under Prop. Reg. § 26.2663-2(b)(3), taxable distributions and taxable terminations with respect to property held in trust

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[69] Prop. Reg. § 26.2663-2(b)(4).

[70] Prop. Reg. § 26.2601-l(e)(2).

generally are subject to Chapter 13 to the extent the initial transfer by the NRA transferor involved U.S. situs property. Thus, the Proposed Regulations call for application of the GST tax to taxable distributions and terminations where the sole connection with the U.S. may be the situs of the property initially transferred by the NRA, and nothing more. Taken to its logical end, the Proposed Regulations result in a GST tax on distributions of foreign property, by a foreign trustee, to a foreign beneficiary of a foreign trust, created by a foreign grantor, merely because the property initially transferred (which transfer may have occurred many years prior to the distribution) was U.S. situs property. Under such circumstances, the ties to the U.S. are too remote to justify the application of Chapter 13.

To the extent the situs of the property provides a basis for imposing the GST tax, the test should be applied both at the time of the initial transfer and at the time of the taxable distribution or termination. This is consistent with the principles of Chapters 11, 12 and 13. A transfer from an NRA to an NRA child generally is subject to Federal gift or estate tax only with respect to U.S. situs property.[71] Thereafter, a transfer from the NRA child to an NRA grandchild generally is subject to U.S. gift or estate tax only if the subsequent transfer also involves U.S. situs property. If, during the period between the two transfers, the NRA child sells the U.S. situs property, acquires foreign situs property and transfers the foreign situs property to the NRA grandchild, no U.S. transfer tax generally would be imposed on the second transfer.

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[71] But see IRC § 2104(b), which provides that a trust originally funded with U.S. situs property by a NRA and which would be includible in the gross estate of a U.S. decedent under IRC §§ 2035-2038 is U.S. situs property for purposes of the Federal estate tax on NRAs even if the property held in the trust as of the date of death is non-U.S. situs property.

Similarly, Chapter 13 should not apply to taxable terminations and distributions, unless, at the very least, they involve U.S. situs property or, alternatively, there is more of a connection between the U.S. and the grantor of the trust.

b. Prop. Reg. § 26.2663-2(c): Non-U.S. Situs Property

IRC § 2103 provides that the gross estate subject to Federal estate tax of an NRA includes only property situated in the U.S. at the time of his or her death.[72] Similarly, IRC § 2511(a) provides that, with respect to NRAs, Federal gift tax is imposed only on transfers of real and tangible personal property situated in the U.S. Moreover, IRC § 2501(a) provides that transfers by an NRA of intangible personal property situated in the U.S. are subject to Federal gift tax only if the donor is an expatriate for whom tax avoidance was one of the principal reasons for giving up his or her U.S. citizenship, and if the transfer occurs within 10 years thereafter. Thus, transfers by NRAs of property not situated in the U.S. are never subject to U.S. estate or gift tax (other than with respect to the IRC § 2107 estate tax on tax expatriates), and gifts of intangible personal property, even if situated in the U.S., are subject to Federal gift tax only in cases of tax expatriation.

Despite the clear limitation in IRC § 2663(2) and the equally clear ambit of Chapters 11 and 12, Prop. Reg. § 26.2663-2(c) purports to impose the GST tax on transfers of property not situated in the U.S. by an NRA to a:

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[72] Unless the NRA decedent renounced his U.S. citizenship for tax purposes within the 10-year period preceding his or her death, in which case under IRC § 2107 the decedent's interest in certain foreign corporations also would be subject to U.S. estate tax.

skip person who is a resident or citizen of the United States at the time of the direct skip, taxable termination or taxable distribution (as the case may be) if, at the time of the initial transfer to the skip person or to a trust that is not a skip person, a lineal descendant of the transferor who is a lineal ancestor of the skip person was a resident or citizen of the United States.[73]

Thus, the treatment of such transfers for GST tax purposes depends upon the residence or citizenship of the recipient and of his ancestor at what are very likely two different points in time. This test is inconsistent with the provisions of Chapters 11 and 12, which in cases of non-U.s. situs property look exclusively to the residence or citizenship of the donor.[74] Moreover, the introduction of a member of an intervening generation as a “deemed transferor” has no basis in the current law and is reminiscent of the concept which figured in the GST tax law enacted in 1976 but repealed by the 1986 Act.[75] Finally, taken to its extreme, the Proposed Regulation's imposition of a tax based upon the unrelated residence in the U.S. of two family members at discrete moments, perhaps decades apart, can produce results (as illustrated below) that are neither fair nor practical.

Oddly, Prop. Reg. § 26.2663-2(c) is inconsistent with Chapter 13 as well as with Chapters 11 and 12. Chapter 13 imposes the GST tax on every transfer by a U.S. resident or citizen if the recipient is deemed to be more than one generation removed from the donor. The scope of Prop. Reg. § 26.2663-2(c), however, is limited to transfers to lineal descendants. This distinction

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73 Prop. Reg. § 26.2663-2(c)(1).

74 But see Fn. 71, supra.

75 The “deemed transferor” was generally the intermediate generation member who had an interest in a trust (e.g., a child) upon whose death a transfer of property, but for the GST tax, escaped estate and gift tax.

has no support in the law, and may represent a subtle effort to counter criticism that the reach of Prop. Reg. § 26.2663-2(c) is overbroad.

In any event, Prop. Reg. § 26.2663-2(c) would be virtually impossible to enforce in an equitable fashion. While there doubtless would be a measure of voluntary compliance, and the Internal Revenue Service would happen upon some other taxable transfers, a significant proportion of taxable transfers would probably never be reported or taxed (either out of ignorance or expediency). In many cases there would not even be a reporting requirement. The GST tax, as it relates to NRA transfers of non-U.S. situs property, would become a trap for the unwary and unlucky.

The scope of Prop. Reg. § 26.2663-2(c) may be illustrated by the following example. Assume a British subject and resident creates an English trust for his issue while his childless son, also British, is resident in the U.S. The son subsequently returns to England and has a child of his own. Thirty years later, that grandchild moves to the U.S., whereupon he receives a discretionary principal distribution from the trust created by his grandfather, which is directly deposited by the British trustee into the grandson's account in London. First, it is questionable whether any of the individuals involved would realize that the distribution to the grandson would be subject to a U.S. GST tax. Second, if any of them did know of the tax, he might choose to ignore it, thinking that the son's temporary residence in the U.S. over 30 years before is little justification for the imposition of a U.S. tax on a distribution to the grandson. Finally, the Internal Revenue Service would have no way of knowing that the transaction had occurred. None of the grandfather, son, grandson and trustee would ever have been required to file a U.S. gift or estate tax return.

In the past, when transfer tax provisions have been widely perceived as overreaching, unworkable or unfair, they have been repealed, as was the case with IRC § 2036(c)[76] and the 1976 GST tax. At least those provisions had the imprimatur of Congress. In contrast, Prop. Reg. § 25.2663-2(c) runs beyond, and even contrary to, the express intention of the Congress. That fact, combined with its fairness and enforceability problems, warrants its deletion from the final regulations.

c. Prop. Reg. § 26.2663-2(c)(2): Definition of Beneficial Interest in Property

Under Prop. Reg. § 26.2663-2(c)(1), Chapter 13 applies to GSTs attributable to transfers of an NRA to the extent that, among other things, a beneficial interest in property passes to a skip person who is a U.S. resident or citizen at the time of the GST. Prop. Reg. § 26.2663-2(c)(2) provides that a “beneficial interest in property passes to an individual to the extent the individual may at any time, directly or indirectly, hold the right to receive or be a permissible recipient of, the property or the income therefrom.”

The definition of “beneficial interest in property” is overly broad. The Proposed Regulations would result in the application of Chapter 13 where the property continues in trust

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[76] IRC § 2036(c) was the provision concerning “estate freeze transactions” which was repealed and replaced by Chapter 14 of the Code - Special Valuation Rules, in the Omnibus Budget Reconciliation Act of 1990.

and one beneficiary, with a remote interest, "indirectly [is] ... a permissible recipient of the property or the income there from." For example, the Proposed Regulations would impose a GST tax with respect to the entire trust where an NRA grantor creates a foreign sprinkling trust with foreign situs property for grandchildren and more remote descendants, if only one potential beneficiary, of perhaps many, is a U.S. citizen or resident, provided that the ancestor of that beneficiary who is a descendent of the transferor was a U.S. citizen or resident at the time of the initial transfer. Accordingly, under the Proposed Regulations, the U.S. would impose a GST tax on the transfer of foreign situs property by an NRA to a foreign trust, merely because a possibility exists that a U.S. skip person might receive trust property. This provision is inconsistent with the doctrine applicable under Chapter 11 that a trust interest must be indefeasibly vested in the non-transferor decedent if it is to be subject to U.S. estate tax.[77]

The definition also is overbroad in that it could be interpreted to trigger a direct skip or require allocation of GST exemption in the case where property continues in trust for the current benefit of a person who is himself an NRA, but who has a testamentary power to appoint the trust remainder at his death in favor of a U.S. citizen or resident. This result is presumably unintended and is, in any case, inappropriate.

If the Proposed Regulation is not deleted, the Committee recommends that the definition of "beneficial interest" be narrowed to prevent these results.

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[77] See Hamilton v. Comm'r, 35 T.C.M. 1609 (1976); Lee v. U.S., 63-1 U.S.T.C. 112,128 (1962).

d. <u>Prop. Reg. § 26.2663-2(d): Anti-Abuse Rule</u>

Under the “anti-abuse rule” described in Prop. Reg. § 26.2663-2(d), the rules governing the application of Chapter 13 to transfers by NRAs apply without regard to any transaction or other activity if its effect is to transfer U.S. situs property from the transferor to the transferee. The “anti abuse rule” is illustrated in the last sentence of Examples l and 2 in Prop. Reg. § 26.2663-2(e)(1). According to Example 1, if a NRA transfers property located in the U.S. to a wholly owned foreign corporation and “shortly thereafter” transfers the stock in the corporation to a grandchild, the two transactions will be collapsed and treated as though the NRA transferred the U.S. real property directly to the grandchild. Under Example 2, if an NRA transfers cash to a foreign trust for the benefit of the NRA's descendants, none of whom are residents or citizens of the U.S., Chapter 13 applies if the trustee “shortly thereafter” purchases U.S. situs property from the NRA transferor. In both cases, according to the Proposed Regulations, Chapter 13 would apply because the effect of the transaction is to transfer U.S. property from the NRA to a skip person or a trust for the NRA's descendants.

The “anti abuse rule”, as articulated in Prop. Reg. § 26.2663-2(d) and the examples, is flawed. First, the regulations should establish a rebuttable presumption; and not the automatic collapsing of two or more transactions occurring within a short period of time. If the taxpayer can establish that the use of two or more separate transactions did not have as a principal purpose the avoidance of the GST tax, or that the corporation in Example l is not a “sham”[78] or a “nominee”[79], then the transactions should not be collapsed. Shifting the burden to the taxpayer under such circumstances should adequately protect the interests of the Internal Revenue Service. Second, the phrase “shortly thereafter” as used in the examples is too vague to provide any guidance as to whether a “step transaction” has occurred which should be ignored for GST tax purposes, it should be noted that the Federal gift tax on transfers of U.S. situs property can be avoided by transfer of the U.S. situs property to a corporation followed by a gift of the shares of the corporation. If Congress does not feel that this is abusive for purposes of Chapter 12, the Committee can see no reason to introduce a Chapter 13 anti-abuse rule with respect to this concept.

e. Prop. Reg. § 26.2663-2(f): Automatic Allocation of GST Exemption

Under Prop. Reg. § 26.2663-2(f), an NRA transferor's GST exemption is automatically allocated in a given year first to direct skips, and then to trusts as to which distributions and terminations may be subject to GST tax in the order prescribed in IRC § 2632(c). The exemption would be allocated automatically from year to year until exhausted. An NRA, or the executor of his estate, could elect to prevent the automatic application of his GST exemption to a particular transfer by filing a “timely” U.S. gift or estate tax return (which might not otherwise be due at all on the transfer).

[78] See Moline Properties, Inc. v. Comm'r, 319 U.S. 436, 439 (1933).

[79] See Fillman v. U.S., 355 F.2d 632 (Ct. Cl. 1966).

The automatic application of the exemption to trusts that are not themselves skip persons is justified in the Preamble as “mitigat[ing] the unexpected application of chapter 13.”[80] What this apparently means is that deliberate or inadvertent non-compliance with the proposed Regulations by trustees and beneficiaries, which is likely to be rampant in the case of such trusts, will be partially “self-correcting.” Prop. Reg. § 26.2663-2(f) does not address the underlying reasons for such non-compliance, which are discussed above. It would, however, result in the application of GST exemption to trusts which may never actually be subject to GST tax, because the skip person beneficiaries may not be U.S. citizens or residents when otherwise taxable distributions or terminations occur in their favor. This inequity could not be corrected by “timely” filed gift or estate tax returns, so the opting-out alternative available under the Proposed Regulation is clearly inadequate.

A more effective (and complex) mechanism could probably be devised for applying an NRA's GST exemption to transfers that will actually attract the tax. The best solution to the problem which Prop. Reg. § 26.2663-2(f) purports to address, however, would be to eliminate the “unexpected application” of Chapter 13 by deleting Prop. Reg. § 26.2663-2(c), and by narrowing the scope of Prop. Reg. § 26.2663-2(b) to include only taxable distributions and terminations involving property having a U.S. situs at the time the distribution or termination actually occurs.

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[80] 57 FR 61359.

f. Prop. Reg. § 26.2601-1(e)(2); Effective Date

The provisions of Chapter 13 with respect to transfers by NRAs apply as of the original effective date of Chapter 13.[81] The Proposed Regulation, however, states that Chapter 13 does not apply to transfers by a NRA with respect to non-U.S. situs property made before December 24, 1992.

It is unclear whether the term transfer refers to a GST or to the initial transfer of property to a trust. The Committee recommends that the term be defined or clarified. Given the purpose of the effective date rule as set forth in the Preamble to avoid an unexpected application of Chapter 13 to transfers by NRAs, the Committee recommends that the term “transfer” be changed to “initial transfer”. This change would eliminate the possibility of irrevocable transfers to trusts made prior to December 24, 1992 being considered a taxable termination or taxable distribution. Moreover, in light of the great possibility that NRAs did not receive notice of the new rule on December 24, 1992, (if it is not deleted), the Committee recommends that a later effective date such as one year after the date of final regulations are issued be adopted.

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[81] Generally, the GST tax applies to transfers after the date of enactment of the 1986 Act, October 22, 1986 and to certain inter vivos transfers after September 25, 1985.