

Notice of Proposed Rulemaking and Notice of Public Hearing

Definition of a Qualified Interest in a Grantor Retained Annuity Trust and a Grantor Retained Unitrust

REG-108287-98

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the definition of a qualified interest. The proposed regulations apply to a grantor retained annuity trust (GRAT) and a grantor retained unitrust (GRUT) in determining whether a retained interest is a “qualified interest.” The proposed regulations will affect individuals who have made a transfer in trust to a family member and have retained an interest in the trust. The proposed regulations clarify that a trust that uses a note, other debt instrument, option or similar financial arrangement to satisfy the annual payment obligation will not meet the requirements of section 2702(b) of the Internal Revenue Code. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by September 20, 1999. Outlines of topics to be discussed at the public hearing scheduled for October 20, 1999, at 10:00 a.m., must be received by September 29, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-108287-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-108287-98), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the “Tax Regs” option on the IRS Home Page, or by sub-

mitting comments directly to the IRS internet site at <http://www.irs.gov/prod/taxregs/regslst.html>. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, James F. Hogan, (202) 622-3090; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Sections 2701 through 2704 were added to the Internal Revenue Code in the Omnibus Budget and Reconciliation Act of 1990 (1990 Act), 1991-2 C.B. 481, 524. Section 2702 applies to a transfer in trust that benefits a family member where the transferor retains an interest in the property subject to the transfer. If section 2702 applies to a transfer, the transferor’s retained interest will be valued at zero for gift tax purposes (and the transferor will be treated as making a gift of the entire value of the property), unless the interest is a “qualified interest.” The term “qualified interest” is defined in section 2702(b) and includes a right to receive, annually, fixed payments (a qualified annuity interest) and a right to receive, annually, a fixed percentage of the trust corpus determined annually (a qualified unitrust interest).

Congress was particularly concerned about properly valuing gifts in trust with retained interests. The legislative history that accompanied the 1990 Act states:

[T]he committee is concerned about the undervaluation of gifts valued pursuant to Treasury tables. Based on average rates of return and life expectancy, those tables are seldom accurate in a particular case, and therefore, may be the subject of adverse selection. Because the taxpayer decides what property to give, when to give it, and often controls the return on the property, use of Treasury tables undervalues the transferred interests in the aggregate, more often than not.

Therefore, the committee determines that the valuation problems inherent in trusts and term interests in property are best addressed by valuing retained interests at zero unless they take an easily valued form—as an annuity or unitrust interest. By doing so, the bill draws upon present law rules valuing split interests in property for purposes of the charitable deduction.

136 Cong. Rec. S15681 (daily ed. Oct. 18, 1990) (Informal Senate Report on S. 3209).

The provisions of section 2702 and the regulations thereunder are intended to ensure that, when a donor transfers property and retains an interest in the property, the value of the retained interest is readily ascertainable. Thus, the value of the gift, that is, the value of the transferred property less the value of the retained interest, can be accurately determined. Section 25.2702-3(b)(1) of the Gift Tax Regulations implements this principle by requiring that for a qualified annuity interest: (1) the annuity must be a fixed amount; (2) the annuity must be payable at least annually; and (3) the yearly amount must be paid by a specified date each year, that is, the annuity payment may be paid after the close of the taxable year, but no later than the due date of the trust’s income tax return. The annuity payment must be payable to (or for the benefit of) the holder of the annuity interest for each taxable year of the trust term. A right of withdrawal, whether or not cumulative, is not a qualified annuity interest. Section 25.2702-3(c) provides comparable rules applicable in the case of a qualified unitrust interest.

To avoid making a cash or an in-kind payment, some GRATs have issued notes to the transferor in satisfaction of the obligation to make the annual payment. In certain cases, the trust instrument specifically authorizes the trustee to satisfy the annual payment obligation with notes. The notes provide for actual payment at a date some time in the future.

Thus far, the transactions that have come to the Service’s attention have involved the use of notes. However, the Service is also concerned about other financial arrangements that have the effect of delaying payment from the trust to the

grantor and thus may alter the value of the transferor's retained interest. These techniques include the grant of an option to purchase trust property in the future.

Issuing a note is not payment of a fixed amount not less frequently than annually, nor is it payment of a fixed percentage of the trust assets determined annually, as required by the statute and regulations. A note is merely a promise to pay in the future. Delaying payment by the use of a note to satisfy the annual payment obligation alters the true value of the transferor's retained interest, contrary to Congressional intent in requiring provisions ensuring an accurate valuation of the interest. This position is consistent with case law and rulings concluding that the use of a note to satisfy an obligation does not constitute payment of the obligation for tax purposes. *Don E. Williams Company v. Commissioner*, 429 U.S. 569 (1977); *Helvering v. Price*, 309 U.S. 409 (1940); *Eckert v. Burnet*; 283 U.S. 140 (1931); *Maddrix v. Commissioner*, 780 F.2d 946 (11th Cir. 1986); *Battelstein v. Internal Revenue Service*, 631 F.2d 1182 (5th Cir. 1980); Rev. Rul. 76-135, 1976-1 C.B. 114.

Furthermore, under §§25.2702-(3)(b)-(1)(i) and 25.2702-(3)(c)(1)(i), a right of withdrawal is not a qualified annuity or unitrust interest. A right of withdrawal allows the payee to determine, in the payee's discretion, when the payment will be made, and thus, neither the timing nor the amount of each payment is fixed and determinable under the trust instrument. For similar reasons, the use of notes, other debt instruments, options or other similar financial arrangements that place the amount and timing of each payment at the discretion of the payee should not satisfy the annual payment obligation.

Accordingly, these proposed regulations amend the regulations under section 2702 to provide that issuance of a note, other debt instrument, option or similar financial arrangement does not constitute payment for purposes of section 2702. A retained interest that can be satisfied with such instruments is not a qualified annuity interest or a qualified unitrust interest. In examining all of these transactions, the Service will apply the step transaction doctrine where more than one step is used to achieve similar results. In addition, a retained interest is not a qualified interest

under section 2702, unless the trust instrument expressly prohibits the use of notes, other debt instruments, options or similar financial arrangements that effectively delay receipt by the grantor of the annual payment necessary to satisfy the annuity or unitrust interest amount. Under these provisions, in order to satisfy the annuity or unitrust payment obligation under section 2702(b), the annuity or unitrust payment must be made with either cash or other assets held by the trust.

The proposed regulations provide a transition rule for trusts created before September 20, 1999. If a trust created before September 20, 1999, does not prohibit a trustee from issuing a note, other debt instrument, option or other similar financial arrangement in satisfaction of the annuity or unitrust payment obligation, the interest will be treated as a qualified interest under section 2702(b) if notes, etc. are not used after September 20, 1999, to satisfy the obligation and any note or notes or other debt instruments issued on or prior to September 20, 1999, to satisfy the annual payment obligation are paid in full by December 31, 1999, and any option or similar financial arrangement is terminated by December 31, 1999, such that the grantor actually receives cash or other trust assets in satisfaction of the payment obligation. For purposes of this section, an option will be considered terminated if the grantor is paid the greater of the required annuity or unitrust payment plus interest computed under section 7520 of the Code, or the fair market value of the option.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the regulations will be submitted to the Small

Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 20, 1999, at 10:00 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit comments by September 20, 1999, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by September 29, 1999. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is James F. Hogan, Office of the Chief Counsel, IRS. Other personnel from the IRS and Treasury Department participated in their development.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 25 is proposed to be amended as follows:

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

Par. 1. The authority citation for part 25 continues to read in part as follows:

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

Par. 2. Section 25.2702-3 is amended as follows:

1. Paragraph (b)(1)(i) is amended by adding a new sentence after the third sentence.

2. Paragraph (c)(1)(i) is amended by adding a new sentence after the fourth sentence.

3. A new paragraph (d)(5) is added.

The additions read as follows:

§25.2702-3 *Qualified interests.*

* * * * *

(b) * * *

(1) * * * (i) * * * Issuance of a note, other debt instrument, option or other similar financial arrangement in satisfaction of the annuity amount does not constitute payment of the annuity amount. * * *

* * * * *

(c) * * *

(1) * * * (i) * * * Issuance of a note, other debt instrument, option or other similar financial arrangement in satisfaction of the unitrust amount does not constitute payment of the unitrust amount. * * *

* * * * *

(d) * * *

(5) *Use of debt obligations to satisfy the annuity or unitrust payment obligation*—(i) *In general.* The trust instrument must prohibit the trustee from issuing a note, other debt instrument, option or other similar financial arrangement in satisfaction of the annuity or unitrust payment obligation.

(ii) *Special rule in the case of a trust created prior to September 20, 1999.* In

the case of a trust created prior to September 20, 1999, the interest will be treated as a qualified interest under section 2702(b) if—

(A) Notes, other debt instruments, options or similar financial arrangements are not used after September 20, 1999, to satisfy the annuity or unitrust payment obligation; and

(B) Any note or notes or any other debt instruments issued to satisfy the annual payment obligation on or prior to September 20, 1999, are paid in full by December 31, 1999, and, any option or similar financial arrangement issued to satisfy the annual payment obligation is terminated by December 31, 1999, such that the grantor receives cash or other trust assets in satisfaction of the payment obligation. For purposes of the preceding sentence, an option will be considered terminated only if the grantor receives cash or other trust assets equal in value to the greater of the required annuity or unitrust payment plus interest computed under section 7520 of the Code, or the fair market value of the option.

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Robert E. Wenzel,
*Deputy Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on June 21, 1999, 8:45 a.m., and published in the issue of the Federal Register for June 22, 1999, 64 F.R. 33235)