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DEPARTMENT OF TREASURY

Internal Revenue Service

26 CFR Parts 20 and 25

TD 9077

RIN 1545-AY91

Net Gift Treatment under Section 2519

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating both to the amount treated as a transfer under section 2519 of the Internal Revenue Code when there is a right to recover gift tax under section 2207A(b) and to the related gift and estate tax consequences if the right to recover the gift tax is not exercised. The final regulations will affect donee spouses who make lifetime dispositions of all or part of a qualifying income interest in qualified terminable interest property.

EFFECTIVE DATE: These regulations are effective July 18, 2003.

FOR FURTHER INFORMATION CONTACT: DeAnn K. Malone, (202) 622-7830 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

## **Background**

On July 22, 2002, the IRS and the Treasury Department published in the **Federal Register** (67 FR 47755) a notice of proposed rulemaking (REG-123345-01) relating to the amount treated as a transfer under section 2519 of the Internal Revenue Code when there is a right to recover gift tax under section 2207A(b) and the related gift tax consequences if the right to recover the gift tax is not exercised. Written comments responding to the notice were received. No public hearing was requested or held. This document adopts final regulations with respect to the notice of proposed rulemaking. The principal comments received and revisions in response to those comments are discussed below.

## **Explanation of Provisions**

Under the proposed regulations, any delay in the exercise of the right of recovery was treated as an interest-free loan with the resulting Federal tax consequences. One commentator suggested that the regulations be revised to provide a thirty-day safe harbor to ease the administrative burden to taxpayers and to avoid complex loan calculations. Accordingly, the commentator suggested that section 7872 would not apply if the transferor received reimbursement of the amount of gift tax within thirty days after paying the tax.

Whether a transaction involves a below-market loan subject to section 7872 depends on all the facts and circumstances of the particular case. Section 1.7872-5T(b)(14) of the Temporary Income Tax Regulations exempts from the application of section 7872 loans the interest arrangements of which the taxpayer is able to show have no significant effect on any Federal tax liability of the lender or the borrower, as described in §1.7872-5T(c)(3). Section 1.7872-5T(c)(3) provides that whether a loan is without significant effect is determined according to all of the facts and circumstances. Among the factors to be considered are:

- (1) whether items of income and deduction generated by the loan offset each other;
- (2) the amount of such items;
- (3) the cost to the taxpayer of complying with the provisions of section 7872 if the section were applied;
- and (4) any non-tax reasons for deciding to structure the transaction as a below-market loan rather than a loan with interest at a rate equal to or greater than the applicable Federal rate and a payment by the lender to the borrower.

The Treasury Department and the IRS believe that, in most cases, a reasonable delay in the exercise of the right of recovery will result in a loan without significant tax effect under the facts and circumstances test in §1.7872-5T(c)(3). Accordingly, these

final regulations do not create an additional safe harbor for a payment received within thirty days of payment of the tax.

The final regulations have been revised to more completely describe the interrelation of section 2207A and section 7872. Specifically, the final regulations provide that a delay in the exercise of the right of recovery (that is, the request for and receipt of the amount of the tax) will be treated as a below-market loan if the loan does not provide for the payment of sufficient interest. Depending on the facts and circumstances as described in §1.7872-5T(c)(3), a loan arising from the delay may be a loan exempt from the application of section 7872 because it is a loan the interest arrangements of which do not have a significant effect on any Federal tax liability of the lender or the borrower. The estate tax regulations under section 2207A are revised to be consistent with the gift tax regulations.

In response to a comment, the final regulations clarify that the enforceability of the right of recovery is determined under applicable law.

Commentators requested simplification of the method of determining when a right to recovery is no longer enforceable.

One commentator suggested adopting a three-year period for determining whether or not the right of recovery is

enforceable, and thus whether the gift is complete for gift tax purposes if the right of recovery is not exercised. The final regulations instead provide that the transferor may waive the right of recovery thus causing the gift from the transferor to the donee to be complete upon the later of the date of the waiver or the date of the payment of the Federal gift tax. The Treasury Department and the IRS believe that the waiver allows for the certainty requested by the commentators, and is more efficient for a taxpayer who will not exercise the right of recovery because the gift of the unrecovered tax can be completed simultaneously with the lifetime disposition of the qualifying income interest.

### **Special Analyses**

It has been determined that these final regulations are not a significant regulatory action as defined in Executive Order 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 proposed regulations preceding this final rule were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

**Drafting Information**

The principal author of these regulations is DeAnn K. Malone, Office of the Chief Counsel, IRS. Other personnel from the IRS and Treasury Department participated in their development.

**List of Subjects**

26 CFR Part 20

Estate taxes, Reporting and recordkeeping requirements.

26 CFR Part 25

Gift taxes, Reporting and recordkeeping requirements.

**Adoption of Amendments to the Regulations**

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

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

Par. 1. The authority citation for part 20 continues to read in part as follows:

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

Par. 2. Section 20.2207A-1 is amended by removing the

last two sentences of paragraph (a)(2) and adding three sentences in their place to read as follows:

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

(a) \* \* \*

(2) \* \* \* The transfer is considered made when the right of recovery is no longer enforceable under applicable law. A delay in the exercise of the right of recovery without payment of sufficient interest is a below-market loan. Section 1.7872-5T of this chapter describes factors that are used to determine, based on the facts and circumstances of a particular case, whether a loan otherwise subject to imputation under section 7872 (relating to the treatment of below-market loans) is exempted from its provisions.

\* \* \* \* \*

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

Par. 3. The authority citation for part 25 continues to read in part as follows:

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

Par. 4. Section 25.2207A-1 is amended by adding the text of paragraph (b) to read as follows:

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

\* \* \* \* \*

(b) Failure of a person to exercise the right of recovery. (1) The failure of a person to exercise a right of recovery provided by section 2207A(b) upon a lifetime transfer subject to section 2519 is treated as a transfer for Federal gift tax purposes of the unrecovered amounts to the person(s) from whom the recovery could have been obtained. See §25.2511-1. The transfer is considered to be made when the right to recovery is no longer enforceable under applicable law and is treated as a gift even if recovery is impossible. A delay in the exercise of the right of recovery without payment of sufficient interest is a below-market loan. Section 1.7872-5T of this chapter describes factors that are used to determine, based on the facts and circumstances of a particular case, whether a loan otherwise subject to imputation under section 7872 (relating to the treatment of below-market loans) is exempted from its provisions.

(2) The transferor subject to section 2519 may execute a written waiver of the right of recovery arising under section 2207A before that right of recovery becomes unenforceable. If a waiver is executed, the transfer of the unrecovered amounts by the transferor is considered to be made on the later of --

(i) The date of the valid and irrevocable waiver

rendering the right of recovery no longer enforceable; or

(ii) The date of the payment of the tax by the transferor.

\* \* \* \* \*

Par. 5. Section 25.2519-1 is amended as follows:

1. Paragraph (c)(1) is amended by adding a sentence to the end of the paragraph.

2. The paragraph heading for paragraph (c)(4) is revised and the text of paragraph (c)(4) is added.

3. Paragraph (g) introductory text is revised.

The additions and revisions read as follows:

§25.2519-1 Disposition of certain life estates.

\* \* \* \* \*

(c) \* \* \*(1) \* \* \* See paragraph (c)(4) of this section for the effect of gift tax that the donee spouse is entitled to recover under section 2207A.

\* \* \* \* \*

(4) Effect of gift tax entitled to be recovered under section 2207A on the amount of the transfer. The amount treated as a transfer under paragraph (c)(1) of this section is further reduced by the amount the donee spouse is entitled to recover under section 2207A(b) (relating to the right to recover gift tax attributable to the remainder interest). If

the donee spouse is entitled to recover gift tax under section 2207A(b), the amount of gift tax recoverable and the value of the remainder interest treated as transferred under section 2519 are determined by using the same interrelated computation applicable for other transfers in which the transferee assumes the gift tax liability. The gift tax consequences of failing to exercise the right of recovery are determined separately under §25.2207A-1(b).

\* \* \* \* \*

(g) Examples. The following examples illustrate the application of paragraphs (a) through (f) of this section. Except as provided otherwise in the examples, assume that the decedent, D, was survived by spouse, S, that in each example the section 2503(b) exclusion has already been fully utilized for each year with respect to the donee in question, that section 2503(e) is not applicable to the amount deemed transferred, and that the gift taxes on the amount treated as transferred under paragraph (c) are offset by S's unified credit. The examples are as follows:

\* \* \* \* \*

-11-

Robert E. Wenzel,

Deputy Commissioner for Services and Enforcement.

Approved: July 9, 2003

Pamela F. Olson,

Assistant Secretary of the Treasury (Tax Policy).