

**DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 25**

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

AGENCY: Internal Revenue Service
(IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the definition of a qualified interest under section 2702 of the Internal Revenue Code. The final 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. These final regulations affect individuals who make a transfer in trust to a family member and retain an interest in the trust. These final regulations clarify that a trust that uses a note, other debt instrument, option, or similar financial arrangement to satisfy the annual payment obligation does not meet the requirements of section 2702(b).

DATES: *Effective Date:* These regulations are effective September 5, 2000.

FOR FURTHER INFORMATION CONTACT: James F. Hogan, (202)622-3090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On June 22, 1999, the IRS published in the **Federal Register** (64 F.R. 33235) a notice of proposed rulemaking (REG-108287-98, 1999-28 I.R.B. 27) relating to the definition of a *qualified interest* under section 2702. The IRS received comments on the notice of proposed rulemaking; however, no request for a public hearing was received so no public hearing was held. This document adopts final regulations with respect to the notice of proposed rulemaking. A summary of the principal comments received is provided below.

In addition, the final regulations clarify the regulatory rule regarding the payment period of the annuity or unitrust amount and the proration of payments for periods of less than 12 months.

*Comments on Notice of Proposed
Rulemaking*

Under the proposed regulations, the use of a note, other debt instrument, option, or similar financial arrangement does not constitute a payment of the annuity or unitrust amount to the grantor as required by section 2702. Further, the proposed regulations provide that 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.

Commentators suggested that the regulations should permit the use of short-term notes or notes that bear interest at the section 7520 rate. This suggestion was not adopted. A note issued by the trust, regardless of the term or the interest rate, effectively defers the required payment. Thus, the issuance of a note is not the current payment of the annuity or unitrust amount not less frequently than annually as required by the statute. Under these provisions, in order to satisfy the annuity or unitrust payment obligation under section 2702(b), the annuity or unitrust amount must be paid with either cash or other assets held by the trust.

Commentators also questioned whether the prohibition on the use of notes to make the annuity or unitrust payment applies if the trustee borrows the required funds from an unrelated party. The Treasury Department and the IRS acknowledge that a trustee may borrow from an unrelated party to make the payment. However, the step transaction doctrine will be applied where a series of transactions is used to achieve a result that is inconsistent with the regulations. For example, suppose that the trustee borrows cash from a bank to make the required annuity payment and then borrows cash from the grantor to repay the bank. Similarly, suppose the grantor requests that a bank make a loan to the trust, but as a prerequisite for making the loan, the bank requires the grantor to deposit with the bank an amount equal to the loan. There is no substantive difference between these series of transactions and the situation in which a trustee issues a note for the annuity amount directly to the grantor. The final regulations have added the words “directly or indirectly” to clarify this point.

In response to a comment, the final regulations clarify that a trust instrument provision expressly prohibiting the use of notes to satisfy the annual payments is not required for trusts established before September 20, 1999. However, as provided in the regulations, a retained interest in a trust established before September 20, 1999, will not be treated as a qualified interest if notes are used after September 20, 1999, to satisfy the payment obligation, or any notes is-

sued to satisfy the annual payment obligation on or prior to September 20, 1999, are not paid in full by December 31, 1999.

Proration of First Year's Payment

In response to comments, the regulations clarify the rules covering the period on which the annual payment must be based and the proration of the annuity or unitrust amount in the case of short periods. The final regulations make it clear that the annuity or unitrust amount need not be payable based on the taxable year of the trust. Rather, the annuity or unitrust amount may be payable annually or more frequently, (for example, monthly, quarterly, or semi-annually) based on the anniversary date of the creation of the trust. Thus, a trust providing for an annuity interest created on May 1st need not require that the trustee make payments based on the taxable year of the trust. Instead, the entire annual payment may be made by April 30th of each succeeding year of the trust term. If payment is based on the anniversary date of the trust, proration of the annuity or unitrust amount will be required only if the last period during which such amount is payable to the grantor is a short period. On the other hand, if payment is based on the taxable year of the trust, proration is required for each short taxable year of the trust during the grantor's term.

Special Analyses

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

Drafting Information

The principal author of these regulations is James F. Hogan, Office of the

Chief Counsel, IRS. Other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 25 is 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 revising the second and fourth sentences, and removing the last sentence.

2. Paragraph (b)(3) is revised.

3. Paragraph (b)(4) is redesignated as paragraph (b)(5).

4. A new paragraph (b)(4) is added.

5. Paragraph (c)(1)(i) is amended by revising the third and fifth sentences and removing the last sentence.

6. Paragraph (c)(3) is revised.

7. Paragraphs (c)(4) and (d)(5) are added.

The revisions and additions read as follows:

§25.2702-3 *Qualified interests.*

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(b) * * *

(1) * * * (i) * * * The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually. * * * Issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount.

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(3) *Payment of annuity amount.* The annuity amount may be payable based on either the anniversary date of the creation of the trust or the taxable year of the trust. In either situation, the annuity amount may be paid annually or more frequently, such as semi-annually, quarterly, or monthly. If the payment is made based on the anniversary date, proration of the annuity amount is required only if the last period during which the annuity is

payable to the grantor is a period of less than 12 months. If the payment is made based on the taxable year, proration of the annuity amount is required for each short taxable year of the trust during the grantor's term. The prorated amount is the annual annuity amount multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

(4) *Payment of the annuity amount in certain circumstances.* An annuity amount payable based on the anniversary date of the creation of the trust must be paid by the anniversary date. An annuity amount payable based on the taxable year of the trust may be paid after the close of the taxable year, provided the payment is made no later than the date by which the trustee is required to file the Federal income tax return of the trust for the taxable year (without regard to extensions). If the trustee reports for the taxable year pursuant to §1.671-4(b) of this chapter, the annuity payment must be made no later than the date by which the trustee would have been required to file the Federal income tax return of the trust for the taxable year (without regard to extensions) had the trustee reported pursuant to §1.671-4(a) of this chapter.

* * * * *

(c) * * *

(1) * * * (i) * * * The unitrust amount must be payable to (or for the benefit of) the holder of the unitrust interest at least annually. * * * Issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the unitrust amount does not constitute payment of the unitrust amount.

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(3) *Payment of unitrust amount.* The unitrust amount may be payable based on either the anniversary date of the creation of the trust or the taxable year of the trust. In either situation, the unitrust amount may be paid annually or more frequently, such as semi-annually, quarterly, or monthly. If the payment is made based on the anniversary date, proration of the unitrust amount is required only if the last period during which the annuity is payable to the grantor is a period of less than 12 months. If the payment is made

based on the taxable year, proration of the unitrust amount is required for each short taxable year of the trust during the grantor's term. The prorated amount is the annual unitrust amount multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

(4) *Payment of the unitrust amount in certain circumstances.* A unitrust amount payable based on the anniversary date of the creation of the trust must be paid by the anniversary date. A unitrust amount payable based on the taxable year of the trust may be paid after the close of the taxable year, provided the payment is made no later than the date by which the trustee is required to file the Federal income tax return of the trust for the taxable year (without regard to extensions). If the trustee reports for the taxable year pursuant to §1.671-4(b) of this chapter, the unitrust payment must be made no later than the date by which the trustee would have been required to file the Federal income tax return of the trust for the taxable year (without regard to extensions) had

the trustee reported pursuant to §1.671-4(a) of this chapter.

(d) * * *

(5) *Use of debt obligations to satisfy the annuity or unitrust payment obligation—(i) In general.* In the case of a trust created on or after September 20, 1999, 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 issued after September 20, 1999, to satisfy the annuity or unitrust payment obligation; and

(B) Any notes or any other debt instruments that were 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 Internal Revenue Code, or the fair market value of the option.

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

Approved August 10, 2000.

Jonathan Talisman,
*Acting Assistant Secretary
of the Treasury.*

(Filed by the Office of the Federal Register on September 1, 2000, 8:45 a.m., and published in the issue of the Federal Register for September 5, 2000, 65 F.R. 53587)