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Please Address Reply to:

Executive Director
DEBORAH O. McKINNON

July 25, 2022

Submitted electronically
IRS 2022-0008-001

CC:PA:LPD:PR (REG_118913-21)
Room 5203
Internal Revenue Service,
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Regulations under Code 2010 Concerning Limitation on the Special Rule Regarding a Difference in the Basic Exclusion Amount

To U.S. Department of the Treasury and the Internal Revenue Service:

The American College of Trust and Estate Counsel ("ACTEC") is pleased to submit its comments to address the proposed regulations issues under section 2001(g) of the Internal Revenue Code on April 27, 2022. The Notice of Proposed Rulemaking 87 Fed. Reg. 24918 (4/27/22) requested comments on proposed regulations issued under Code section 2010 that would modify final Regulations published by the Treasury Department and IRS on November 26, 2019 (T.D. 9884) ("Final Regulations"). Specifically, the Final Regulations created a taxpayer favorable "Special Rule" to be applied in situations described in section 2001(g)(2), where the basic exclusion amount described in sections 2010(c)(3) ("the BEA") in effect at the time of the decedent's death is lower than the BEA applicable to gifts made during the decedent's lifetime. The proposed regulations on which we are commenting create exceptions to the Special Rule, cases in which "Reinstated Clawback" would apply such that the decedent would lose the benefit of the BEA in effect at the time of a gift. ACTEC's comments address several technical issues with the proposed regulations.

ACTEC is a nonprofit association of lawyers and law professors. Its more than 2,400 members are called "Fellows" and practice throughout the United States, Canada and other foreign countries with extensive experience in the preparation of wills and trusts, estate planning, and administration of trusts and estates of decedents, minors and incompetents. Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar association activities. Fellows of ACTEC have extensive experience in providing advice to taxpayers on matters of transfer tax planning. ACTEC offers technical comments about the law and its effective administration but does not take positions on matters of policy or political objectives.

ACTEC's comments and recommendations regarding the Proposed Regulations are set forth in the attached memorandum. If you or your staff would like to discuss the contents of this memorandum with the ACTEC Fellows who created it, please contact, William I. Sanderson, Chair of the Washington Affairs Committee, (202-857-1743,

wsanderson@mcguirewoods.com) Chair Stacey Delich-Gould, who led the relevant task force of the Estate and Gift Tax Committee, (212-830-0140, scyd@capitalgroup.com) or Deborah McKinnon, ACTEC Executive Director (202-684-8460, domckinnon@actec.org).

Respectfully submitted,

Robert W. Goldman

ACTEC President 2022-2023

Comments of the American College of Trust and Estate Counsel on Proposed Regulations under Code Section 2010 Concerning Limitation on the Special Rule Regarding a Difference in the Basic Exclusion Amount

These comments ("Comments") of the American College of Trust and Estate Counsel ("ACTEC") address the proposed regulations issued under section 2001(g) of the Internal Revenue Code on April 27, 2022. The Notice of Proposed Rulemaking 87 Fed. Reg. 24918 (4/27/22) requested comments on proposed regulations ("Proposed Regulations") issued under Code[1] section 2010 that would modify final Regulations published by the Treasury Department and IRS on November 26, 2019 (T.D. 9884) ("Final Regulations"). Specifically, the Final Regulations created a taxpayer favorable "Special Rule" to be applied in situations described in section 2001(g)(2), where the basic exclusion amount described in section 2010(c)(3) (the "BEA") in effect at the time of a decedent's death is lower than the BEA applicable to gifts made during the decedent's lifetime. The purpose of the Final Regulations was to prevent the loss at death of BEA used during life. Because lifetime gifts that are not included in a decedent's gross estate remain part of the estate tax base as adjusted taxable gifts, without the Special Rule, a BEA that was higher at the time of a gift than at the time of a decedent's death would not be available at death to shield previously protected gifts from the estate tax. The potential loss of BEA at death is frequently referred to as a "Clawback" and the Special Rule that avoids the Clawback, the "Anti-Clawback Rule." The Proposed Regulations would limit the application of the Special Rule in certain situations. These comments refer to the situations in which the Special Rule does not apply as the "Proposed Exceptions" and the clawback that applies in such situations as "Reinstated Clawback."

BACKGROUND

Section 2010(c)(3)

Section 11061 of the Tax Cuts and Jobs Act of 2017 ("Act") amended section 2010(c)(3) to provide that, for decedents dying and gifts made during the period from January 1, 2018, through December 31, 2025, the BEA is increased from $5 million to $10 million, as adjusted for inflation ("increased BEA"). Under the Act, the increased BEA will revert to $5 million, as adjusted for inflation, on January 1, 2026.

Section 2001(g)(2)

The Act also added new section 2001(g)(2), which grants the Secretary of the Treasury the authority to enact regulations necessary or appropriate to carry

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[1] Unless otherwise stated, references in these Comments to "section(s)" or to "Code" are to the Internal Revenue Code of 1986, as amended. References in these Comments to "§" are to relevant sections of the Treasury regulations promulgated under the Code.

out section 2001 with respect to any difference between the BEA applicable at a decedent's death and the BEA applicable in the year in which the decedent made any gifts during the decedent's life.

The Final Regulations

The Final Regulations adopted the Special Rule that applies in cases where the credit against the estate tax that is attributable to the BEA is less at the date of death than the sum of the credits attributable to the BEA allowable in computing gift tax payable within the meaning of section 2001(b)(2) with regard to the decedent's lifetime gifts. In these cases, the portion of the credit against the net tentative estate tax that is attributable to the BEA is based on the sum of the credits attributable to the BEA allowable in computing gift tax payable regarding the decedent's lifetime gifts.

The Preamble to the Final Regulations states, "The purpose of the special rule is to ensure that bona fide inter vivos transfers are not subject to inconsistent treatment for estate tax purposes." That Preamble went on to reason that if a transfer is includible in the gross estate, the possibility for such inconsistency does not arise; therefore, an anti-abuse provision could be adopted that excepts transfers includible in the gross estate from the application of the Special Rule.

The Preamble then states as follows:

> A commenter recommended consideration of an anti-abuse ***provision to prevent the application of the special rule to transfers made during the increased BEA period that are not true inter vivos transfers, but rather are treated as testamentary transfers for transfer tax purposes.*** Examples include transfers subject to a retained life estate or other retained powers or interests, and certain transfers within the purview of chapter 14 of subtitle B of the Code. The purpose of the special rule is to ensure that bona fide inter vivos transfers are not subject to inconsistent treatment for estate tax purposes. Arguably, the possibility of inconsistent treatment does not arise with regard to transfers that are treated as part of the gross estate for estate tax purposes, rather than as adjusted taxable gifts. An anti-abuse provision could except from the application of the special rule transfers where value is included in the donor's gross estate at death. Although the Treasury Department and the IRS agree that such a provision is within the scope of the regulatory authority granted in section 2001(g)(2), such an anti-abuse provision would benefit from prior notice and comment. Accordingly, this issue will be reserved to allow further consideration of this comment. (***Emphasis*** added)

The Final Regulations reserved § 20.2010-1(c)(3) for an anti-abuse rule. The Proposed Regulations supply that rule.[2]

We express no opinion as to whether it is appropriate, as a policy matter, to treat "lifetime gifts treated as testamentary transfers" as subject to Reinstated Clawback, but submit these Comments in order to recommend clarification as to the scope of the Proposed Exceptions and better alignment between the Proposed Exceptions and the apparent policy they are attempting to achieve.

DISCUSSION

1. Transfers to Which the Special Rule Does Not Apply

Section 20.2010-1(c)(3)(i) states that the Special Rule does not apply to "transfers includible in the gross estate, or treated as includible in the gross estate for purposes of section 2001(b) . . . ." It then lists in clauses (A) through (D) four different types of transfers that are said to be either includible or treated as includible.

As a technical matter, the Special Rule does not apply to transfers. Instead it applies to the amounts attributable to the basic exclusion amount allowed as a credit in computing the gift tax payable on the decedent's post 1976 gifts. We suggest that the exception focus clearly on the amounts that the Special Rule applies to by changing the introductory language of section 20.2010-1(c)(3)(i) to read as follows:

> Except as provided in paragraph (c)(3)(ii) of this section, the special rule of section (c) of this section does not apply to amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable on those of the decedent's post-1976 gifts that are listed below:

Clause (A) deals with transfers actually includible in the gross estate. It lists transfers that are includible under sections 2035 through 2038 and section 2042. Clause (A) makes no mention of sections 2033, 2039, or 2041. Presumably, transfers includible under these three sections are intended to fit within the Proposed Exceptions. It is unclear why they are omitted from the list.

We suggest Clause A be changed to read as follows:

"(A) The decedent's post-1976 gifts that are includible in the decedent's gross estate."

[2] The proposed regulations can be found at the following link: https://www.federalregister.gov/documents/2022/04/27/2022-08865/estate-and-gift-taxes-limitation-on-the-special-rule-regarding-a-difference-in-the-basic-exclusion.

Clause (B) addresses transfers made by enforceable promise to the extent unsatisfied at death. This is the only example given of a transfer "treated as includible in the gross estate for purposes of section 2001(b)." When a lifetime transfer is included in a decedent's gross estate, the flush language of section 2001(b) excludes it from the decedent's adjusted taxable gifts. Neither the Code nor the regulations contains any provision that treats a lifetime gift as includible in the gross estate of the decedent if it is not actually includible under another provision of the Code. Revenue Ruling 84-25, however, does treat the amount of an enforceable gratuitous promise made by a decedent that is unsatisfied at death as "deemed to be includible in [the Decedent's] gross estate for purposes of section 2001 of the Code."[3] The purpose of the deemed inclusion is to eliminate the amount of the gift from the decedent's adjustable taxable gifts in order to avoid a double transfer tax on the same amount. If the IRS thinks there are other types of transfers "deemed includible," it would be helpful if examples were provided.

If there are no additional examples, we suggest Clause (B) be changed to read as follows:

"(B) The decedent's post 1976 gifts that consist of enforceable promises to the extent made for less than adequate and full consideration in money or money's worth and to the extent they remain unsatisfied at death."

Clause (C) deals with transfers described in §§ 25.2701-5(a)(4) and 25.2702-6(a)(2).[4] Neither of those sections actually describes a transfer that is deemed includible in the gross estate for purposes of section 2001(b). Section 25.2701-5(a)(4) describes a retained interest in an entity if that retained interest was valued using the special valuation rules of section 2701 in connection with the decedent's transfer or deemed transfer of another interest in that entity that was valued using the special valuation rules of section 2701. Section 25.2702-6(a)(2) describes a retained interest, includable in a decedent's gross estate, in transferred property if that retained interest was valued at zero in connection with the decedent's lifetime transfer of another interest in that property.

If the decedent owns at death interests described in Clause C, the interests are actually included rather than merely deemed included in the decedent's gross estate. They are included under section 2033. When these types of interests are includible in a decedent's gross estate, a mechanism is needed to avoid imposing

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[3] 1984-1 CB 191.

[4] The Proposed Regulations actually refer to § 25.2702-6(a)(1). We assume this was intended to be a reference to § 25.2702-6(a)(2) because (a)(1) deals with inter vivos transfers of retained interests that were subject to section 2702's zero valuation rule while (a)(2) deals with zero valued interests that are included in the transferor's gross estate.

an estate tax on values that have already been treated as taxable gifts. The mechanism chosen in the section 2701 regulations is to reduce the amount on which the decedent's tentative estate tax is computed by an amount equal to the lesser of (i) the amount by which section 2701 caused an increase in the decedent's taxable gifts and (ii) the amount by which the estate tax value of the interest exceeds the section 2701 value of that interest at the time of the original transfer. The mechanism chosen in the section 2702 regulations is the reduction of the decedent's adjusted taxable gifts by an amount equal to the lesser of (i) the amount by which section 2702 caused an increase in the decedent's taxable gifts and (ii) the increase in the decedent's gross estate caused by the inclusion of that interest in the decedent's gross estate.

In order to clarify the manner in which the Proposed Exceptions apply to interests described in §§ 25.2701-5(a)(4) and 25.2702-6(a)(2), we suggest Clause (C) be changed to read as follows:

> (C) The decedent's gifts subject to the special valuation rules of section 2701 or 2702 to the extent of any reduction in the amount on which the decedent's tentative tax is computed under section 2001(b) pursuant to § 25.2701-5(a)(3) of this chapter or to the extent of any reduction of the decedent's adjusted taxable gifts pursuant to § 25.2702-6(a)(2) of this chapter.

Clause D describes transfers that would have been described in any of clauses (A) through (C) but for the elimination, for any reason, of an interest, power, or property effectuated within 18 months of the decedent's death. To shift the focus from the decedent's "transfers," we suggest Clause D be changed to read as follows:

> (D) The decedent's gifts that would have been described in paragraph (c)(3)(i)(A), (B), or (C) but for the transfer, relinquishment, or elimination of an interest, power, or property or, in the case of clause (B), the payment of an obligation, effectuated within 18 months of the date of the decedent's death by the decedent alone, by the decedent in conjunction with any other person, or by any other person.

2. **General Policy Concerns**

Both the Preamble to the Final Regulations and the Preamble to the Proposed Regulations contain several references to the types of transactions that the Proposed Regulations intend to exclude from the Special Rule. The Preamble to the Final Regulations stated that further consideration would be given to the issue of whether gifts that are not "true inter vivos transfers" should be excepted from the Special Rule. Similarly, the Preamble to the Proposed Regulations distinguishes between "completed gifts that are treated as adjusted taxable gifts,"

and “completed gifts that are treated as testamentary transfers,” and it also refers to a “bona fide” inter vivos gift versus a gift of property that is includible in the Grantor’s gross estate.

We appreciate that the underlying intent of the Proposed Regulations is to prevent situations in which a donor can lock in the increased exemption without having surrendered the benefits of ownership with respect to the gifted asset. It may, however, not be appropriate to treat gifts that are in a form expressly authorized under the provisions of section 2702 as subject to Reinstated Clawback. For example, even if a donor executes a gift transaction that is intended to result in a complete termination of the donor’s interest in the transferred property within a period of time expected to occur before the donor’s death and that is expressly protected from the zero valuation rules of section 2702, such as a Qualified Personal Residence Trust (“QPRT”) or a grantor retained annuity trust (”GRAT”), the Proposed Regulations would treat the gift as subject to Reinstated Clawback if the donor died before the retained interest had terminated. From a policy perspective, these safe-harbor transactions may not be the types of transfers to which an “anti-abuse” regulation should be applied. Therefore, we recommend that the IRS reconsider whether transfers that are compliant with the safe-harbor provisions of Chapter 14 of the Code should be subject to Reinstated Clawback.

For example, suppose in June 2022 a 65-year-old donor who has previously used $7,000,000 of BEA transfers to a five-year QPRT a personal residence worth $6,638,678. The taxpayer’s gift will be reduced by the value of two retained rights under section 2702 the right to live in the residence for five years, and the five-year reversionary right to receive the return of the residence if the donor dies within the five-year term, with the resulting gift being $5,060,000. If the donor died within the five-year term of the retained interests, the personal residence would be included in the taxpayer’s estate and the gift of $5,060,000 would be excluded from the donor’s adjusted taxable gifts by section 2001(b). The gift to a QPRT is not the equivalent of a testamentary transfer. When making the gift, the taxpayer relied on the reduction in the value of the gift by the two retained rights as specifically provided for by section 2702. Treating the donor’s gift as subject to Reinstated Clawback may be inappropriate. Instead, we suggest that consideration be given to allowing the donor the benefit of the increased BEA available at the time of the original gift. We recognize, however, that it may be appropriate to treat a transfer to a QPRT in which rights to a personal residence are retained for a term exceeding the donor’s life expectancy as equivalent to a testamentary transfer. For example, if the 65-year-old donor in this example created a QPRT with a 35-year term, the 2022 gift would be approximately $35,000. If the taxpayer died within the 35-year term, we agree that Reinstated Clawback treatment would be appropriate.

We also note that retained interests causing estate tax inclusion (“strings”) do not always provide financial value to the donor. For example, a donor who

retains control over the timing of enjoyment of transferred property has retained a string sufficient to cause the inclusion of the transferred property in the donor's gross estate under section 2038. Yet, this string creates no possibility that the donor will regain the benefit of the transferred property. To take the position that every retention of a string by a taxpayer who has gratuitously transferred property should result in a conclusion that the donor has not made a bona fide gift, may make the Proposed Exceptions too broad. In many of these cases, the donor has suffered a financial detriment, by forgoing the use of the BEA and increased BEA (which will not be restored for many years), thereby foreclosing other planning opportunities. The potential loss of exemption is a very real detriment to the taxpayer.

3. **Clarification Regarding Treatment of Notes Outstanding at Death and Examples 1, 2, and 3**

The Proposed Regulations specifically address transfers made by enforceable promise to the extent they remain unsatisfied as of the date of death. We recommend modification of the examples to make it clear that they apply only to decedent's enforceable promises and only to the extent the promises were not made for adequate and full consideration in money or money's worth.

Section 20.2010-1(c)(3)(i)(B) of the Proposed Regulations is consistent with the reasoning set forth in the Preamble *only if* the transfer of an enforceable promise was a completed gift under section 2511. If the promise was a completed gift, it would be treated under Revenue Ruling 84-25 as includible in the donor's gross estate (rather than as an adjusted taxable gift). The reasoning set forth in Revenue Ruling 84-25 relies on several key assumptions:

1. The promise to pay is enforceable under state law;
2. The promise to pay is made by the donor (*i.e.*, the donor is the obligor);
3. The transfer of the enforceable promise to pay was gratuitously made and, therefore, was a completed gift;
4. The assets available to satisfy the promise to pay are part of the donor's estate; and
5. The promise to pay remains unsatisfied (or partially unsatisfied) at the time of the donor's death.

The facts set forth in Example 1 and 2 satisfy all of these assumptions other than the enforceability requirement. The example would be clearer if the first sentence were changed to insert the word "enforceable" before the words "Promissory note." The gratuitous transfer of an unenforceable promise to pay would not have been a completed gift, and, therefore, would not have used any of individual A's BEA. Furthermore, the Examples' conclusions that the "note" is treated as includible in the gross estate for purposes of section 2001(b) is not technically correct. The note is an obligation, not an asset to be included in the

estate. We suggest that the word "note" be changed to "gift." This change would be consistent with the conclusion reached in Revenue Ruling 84-25.

The wording of § 20.2010-1(c)(3)(i)(B) of the Proposed Regulations is not limited to "gratuitous" transfers or transfers "other than for money or money's worth" and we believe it should be. A plain reading of § 20.2010-1(c)(3)(i)(B) suggests that it would apply to any transfer made by enforceable promise to the extent it remains unsatisfied as of the date of death. Consider, however, a decedent who had purchased assets in exchange for a promissory note having the same fair market value as the purchased assets. The value represented by the note was transferred to the seller by an enforceable promise to pay, but the decedent received adequate and full consideration in money or money's worth in exchange for the promise. The modified language we suggest in section 1 of these Comments would provide the requested clarification

4. Additional Guidance Needed Concerning Application of the Proposed Exceptions to the Special Rule to Section 2701 Interests

We request clarification concerning the exception to the Special Rule for transfers described in § 25.2701-5(a)(4) ("Section 2701 Interests")[5] and that examples be added to the Proposed Regulations that specifically address Section 2701 Interests.

Proposed Regulation § 20.2010-1(c)(3)(i) provides, in pertinent part, that "[e]xcept as provided in paragraph (c)(3)(ii) of this section , the [S]pecial [R]ule of paragraph (c) of this section does not apply to transfers includible in the gross estate, or treated as includible in the gross estate for purposes of section 2001(b), including without limitation the following transfers: . . . *(C) Transfers described in § 25.2701-5(a)(4) or § 25.2702-6(a)(1) of this chapter . . . ."* (*emphasis* added)

As Proposed Regulation § 20.2010-1(c)(3)(i) currently reads, it is not clear whether the provisions would apply only with respect to transfers in which the "zero valuation" rule under § 25.2701-1(a)(2) and § 25.2701-2(a) *is applicable* in determining the value ascribed to an applicable retained interest, OR, if the

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[5] Treas. Reg. § 25.2701-5(a)(4) provides:

> (4) Section 2701 interest – A section 2701 interest is an applicable retained interest that was valued using the special valuation rules of section 2701 at the time of initial transfer. However, an interest is a section 2701 interest only to the extent the transfer of that interest effectively reduces the aggregate ownership of such class of interest by the initial transferor and applicable family members of the initial transferor below that held by such persons at the time of the initial transfer (or the remaining portion thereof).

provisions would also apply in any situation in which the value ascribed to an applicable retained interest is merely *determined* using the special valuation rules of section 2701. For instance, if the applicable retained interest is not subject to the "zero valuation" rule under § 25.2701-1(a)(2)(ii) because the right is a qualified payment right, the interest is still "determined" under the special valuation rules of section 2701. Additionally, clarification is requested with respect to the above proposed language wherein reference is made to "transfers *described in* 25.2701-5(a)(4)" (*emphasis* added), since § 25.2701-5(a)(4) does not actually *describe* specific "transfers," but rather, provides a *definition* of a "section 2701 interest" as being "an applicable retained interest that was valued using the special valuation rules of section 2701 at the time of the initial transfer . . . ." The modified language we suggest in section 1 of these Comments would provide the requested clarification.

In addition, while transfers described in Treasury Regulation § 25.2702-6(a)(1) – and specifically, GRATs – are addressed at length in Examples 4, 5 and 6 of the Proposed Regulations, none of the examples address preferred partnership structures or Section 2701 Interests. We believe it would be very helpful if the examples in the Proposed Regulations were expanded to address Section 2701 Interests as well. We suggest the following examples for your consideration:

> **Example [•]:** Individual A makes a capital contribution of $10 million to partnership X in exchange for 100% of the preferred equity interests in X. Concurrently, B, who is A's child, makes a capital contribution of $2 million to partnership X in exchange for 100% of the common equity interest. A's preferred interest entitles the holder to an annual 6% non-cumulative return limited to the amount of X's income for the year, and, as such, does not meet the definition of a "qualified payment" under section 2701(a)(3)(A), or §§ 25.2701-2(a)(2) and 25.2701-2(b)(6) of this chapter. A does not elect qualified payment treatment on A's Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return pursuant to section 2701(c)(3)(C)(ii) and § 25.2701-2(c)(2) of this chapter. A's capital contribution is a "transfer" pursuant to section 2701(e)(5) and § 25.2701-1(b)(2)(i) of this chapter with A's retained right to distributions constituting a "distribution right" pursuant to section 2701(b)(1)(A) and § 25.2701-2(b)(1)(ii) and (3) of this chapter. This treatment results in A's retained distribution right being subject to the "zero valuation" rule under § 25.2701-1(a)(2) and § 25.2701-2(a) of this chapter assuming that there are no liquidation, participation, or other rights that would be given value under section 2701. The application of the zero valuation rule causes A's capital contribution to result in a deemed taxable gift utilizing some or all of the transferor's BEA (assume $10 million, for simplicity, assuming that there are no liquidation participation rights, or other

rights that would be given value under section 2701). Assume further that, if section 2701 had not applied to A's contribution, the contribution would not have been treated as a taxable gift taking into account the factors described in Rev. Rul. 83-120. Upon A's death, A's preferred equity interest is included in A's estate under section 2031 at a value of $10 million. Pursuant to § 25.2701-5(a)(3) of this chapter, A's estate may reduce the amount on which A's tentative tax is computed under section 2001(b) by $10 million. A's capital contribution to X is subject to Reinstated Clawback. Therefore, the credit to be applied for purposes of computing A's estate tax is based on the $6.8 million BEA as of A's date of death, subject to the limitation of section 2010(d).

Example [•]: The facts are the same as Example [•] above, except that A has already used $7 million of A's BEA and A's preferred return is cumulative and meets the definition of a "qualified payment" under section 2701(a)(3)(A) and §§ 25.2701-2(a)(2) and 25.2701-2(b)(6) of this chapter, and A's preferred return is cumulative and entitles the holder to a 3% return. A's capital contribution to partnership X is a "transfer" pursuant to section 2701(e)(5) and § 25.2701-1(b)(2)(i) of this chapter with A's retained preferred interest including a "distribution right" pursuant to section 2701(b)(1)(A) and § 25.2701-2(b)(1)(ii) and (3) of this chapter. Because the distribution right included in A's preferred interest meets the definition of a qualified payment right, A's retained preferred partnership interest is not subject to the "zero valuation" rule under. § 25.2701-1(a)(2) and § 25.2701-2(a) of this chapter. Nevertheless, it remains subject to the special valuation rules described in § 25.2701-3 of this chapter. Because a 3% rate of return is not a fair market rate of return taking into account the factors described in Rev. Rul. 83-120, the application of these rules results in a deemed taxable gift by A under section 2701 of an amount that is determined to be $4 million, applying the factors described in Rev. Rul. 83-120. Upon A's death, A's preferred equity interest is included in A's estate under section 2031 at a value of $10 million. Pursuant to § 25.2701-5(a)(3) of this chapter, A's estate may reduce the amount on which A's tentative tax is computed under section 2001(b) by $4 million. The credit to be applied for purposes of computing A's estate tax is based on the $6.8 million BEA as of A's date of death, subject to the limitation of section 2010(d).

5. <u>The Eighteen Month Rule</u>

Section 20.2010-1(c)(3)(i)(D) of the Proposed Regulations (referred to below as the "18-month rule") provides that the Special Rule does not apply to:

> Transfers that would have been described in paragraph (c)(3)(i)(A), (B), or (C) of this section but for the transfer, relinquishment, or elimination of an interest, power, or property, effectuated within 18 months of the date of the decedent's death by the decedent alone, by the decedent in conjunction with any other person, or by any other person.

The Preamble to the Proposed Regulations explains:

> The exception to the special rule also would apply to transfers that would be described in the preceding sentence but for the transfer, elimination, or relinquishment within 18 months of the donor's date of death of the interest or power that would have caused inclusion in the gross estate, effectively allowing the donor to retain the enjoyment of the property for life. In addition to transfers, eliminations, or relinquishments by the donor, examples include the elimination, by a third party having the power to eliminate or extinguish the interest or power, of the interests or powers that otherwise would have resulted in inclusion of transferred property in the donor's gross estate; the payment of a gift made by enforceable promise as described in Rev. Rul. 84–25, *supra*; and the transfer of a section 2701 interest within the meaning of § 25.2701–5(a)(4) or a section 2702 interest within the meaning of § 25.2702–6(a)(1). For purposes of the preceding sentence, such transfers, eliminations, and relinquishments include those effectuated by the donor, the donor in conjunction with any other person, or by any other person, but do not include those effectuated by the expiration of the period described in the original instrument of transfer, whether by a death or the lapse of time.

The 18-month rule appears inconsistent with the policy decisions that Congress made when enacting section 2035 and changing it over the years. For example, while section 2035 originally utilized a contemplation of death rule, after much litigation as to the intent of decedents, Congress substituted a 3-year bright line test for the contemplation of death rule. The 18-month rule seems to override Congress' choice of the 3-year period.

Further, section 2035 captures only transfers and relinquishments made ***by the decedent***. In contrast, the proposed 18-month rule would include actions taken by persons other than the decedent, *i.e.*, actions that are outside the scope of section 2035. Similarly, section 2035 has a specific exception for a transfer that qualifies as a "bona fide sale for an adequate and full consideration," while the 18-month rule does not appear to contain such an exception.

For example, building on the fact pattern in Example 7, if a trustee who is not a related or subordinate party with respect to C, as defined in section 672(c), terminates the GRIT within 18 months before C's death, the 18-month rule would apply to the GRIT, yet section 2035 would not include that property in C's estate and Revenue Ruling 95-58 would not impute the trustee's powers to C for purposes of section 2036. Explanation of the effect of the 18-month rule in this circumstance would be helpful.

6. <u>The Five Percent Safe Harbor</u>

Section 20.2010-1(c)(3)(ii)(A) of the Proposed Regulations provides, in part, that the Special Rule applies only to "[t]ransfers includible in the gross estate in which the value of the taxable portion of the transfer, determined as of the date of transfer, was 5 percent or less of the total value of the transfer" ("5 Percent Safe Harbor"). In the Preamble to the Proposed Regulations, an explanation of the purpose of the 5 Percent Safe Harbor provides that a "bright-line exception" is intended to replace "a facts and circumstances determination of whether a particular transfer was intended to take advantage of the increased BEA without depriving the donor of the use and enjoyment of the property."

The Preamble to the Proposed Regulations states that the purpose of the 5 Percent Safe Harbor is to ensure the Special Rule would only apply to transfers includable in the gross estate when the taxable amount of the gift is not material (presumably because if the gift is immaterial, the transfer was not designed to take advantage of the increased exemption without depriving the donor of the use and enjoyment of the property.) The Preamble then states that the 5-percent amount relates to the 5-percent provisions that appear in section 2037(a)(2), section 2042(2) and section 673(a).

We believe the 5 Percent Safe Harbor is both over and under inclusive. Notably, there are other transfers that fall under section 2702, which are not "testamentary in nature" and therefore should not be subject to Reinstated Clawback.

For example, a 10-year GRAT funded with $1 million in July 2022, when the section 7520 rate is 3.6% and the annuity payout chosen is $50,000 results in a taxable gift of $586,260. This gift exceeds the 5% Safe Harbor amount. However, if the 10-year period is far less than the donor's life expectancy, this transaction, which complies with section 2702, does not seem to be a transfer where the donor's intention was to take advantage of the increased BEA without giving up use and enjoyment of the property.

Although the 5 percent test is easy to apply, we suggest it should not be the only circumstance in which taxable gifts made under section 2702 qualify for the Special Rule. Furthermore, under the 5 Percent Safe Harbor, a GRAT with a larger gift as a proportion of the amount transferred would be subject to

Reinstated Clawback, while one with a gift valued at 5 percent or less of the transfer (even if a large dollar amount) would not be, creating an inconsistency that does not appear in section 2702. While we appreciate the effort to provide a bright line test, we do not believe that transfers under section 2702 that do not satisfy the bright line test should automatically be considered testamentary in nature and therefore subject to Reinstated Clawback.

7. Clarification of Example 4 of the Proposed Regulations

The last two sentences of Example 4 of the Proposed Regulations ("Example 4") are confusing in light of the language of Example 4 that precedes them. We accordingly recommend that Treasury either delete the last two sentences of Example 4 or put them in a separate example.

Set forth below is full text of Example 4, with ***emphasis*** on the last two sentences:

> (D) Example 4. Individual B transferred $9 million to a grantor retained annuity trust (GRAT), retaining a qualified annuity interest within the meaning of §25.2702-3(b) of this chapter valued at $8,550,000. The taxable portion of the transfer valued as of the date of the transfer was $450,000. B died during the term of the GRAT. The entire GRAT corpus is includible in the gross estate pursuant to §20.2036-1(c)(2). Because the value of the taxable portion of the transfer was 5 percent or less of the total value of the transfer determined as of the date of the gift, the 5 percent de minimis rule in paragraph (c)(3)(ii)(A) of this section is met and the exception to the special rule found in paragraph (c)(3) of this section does not apply to the gift. ***However, because the total of the amounts allowable as a credit in computing the gift tax payable on B's post-1976 gift of $450,000 is less than the credit based on the $6.8 million basic exclusion amount allowable on B's date of death, the special rule of paragraph (c) of this section does not apply to the gift. The credit to be applied for purposes of computing B's estate tax is based on the $6.8 million basic exclusion amount as of B's date of death, subject to the limitation of section 2010(d).***

The use of the word "[h]owever" at the beginning of the penultimate sentence of Example 4 is confusing because it suggests that the last two sentences of the example reach a different conclusion than the earlier sentences. As written, the last two sentences seem to provide an alternative (and superfluous) reason for reaching the same result. We recommend illustrating the point that the Proposed Exceptions to the Special Rule do not apply when the taxpayer's gifts do not exceed the BEA in effect at the date of death in a separate example that does not fall within the 5 Percent Safe Harbor.

8. Recommendation For Additional Example of the Application of the Proposed Exceptions to the Special Rule

The Proposed Regulations do not make any distinction between gifts made prior to enactment of the increased BEA and those made prior to enactment of the Act. Yet the preamble to the Proposed Regulations states that the impetus for the Proposed Exceptions was to address whether the Special Rule "should apply to taxable gifts made during an increased BEA period." We recommend an additional variation on Example 7 that allows more favorable treatment for gifts made prior to enactment of the Act. Specifically, suppose taxpayer created the GRIT described in Example 7 in 2013, before the increased BEA was even contemplated, and funded it with $5 million. In 2020, the taxpayer made an outright gift to the taxpayer's children to use the remaining BEA and increased BEA. Proposed Regulation § 20.2010-1(c)(3) would appear to deny the use of the increased BEA with respect to the GRIT, even though the taxpayer created the GRIT well before the concerns described in the Preamble to the Proposed Regulations could ever have been considered. We do not believe the Proposed Exceptions to the Special Rule were intended to apply to such a fact pattern.