

FOR FURTHER INFORMATION CONTACT:
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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

■ **Paragraph 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 new 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 the Temporary Income Tax regulations describes factors that are used to determine, based on the facts and circumstances of a particular case, whether a loan otherwise subject to