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# Proposed Regulation Section 26.2663-2 and the Application of the Generation-Skipping Transfer Tax to Transfer by Nonresident Aliens

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*In this article the authors review and analyze Proposed Regulation Section 26.2663-2. Because non-United States situs properties would be subjected to U.S. taxation, the authors argue that this tax would be unconstitutional. They also argue that Congress has not delegated to the Internal Revenue Service the authority to impose such a tax. Furthermore, the administrative burden that would be generated by this Proposed Regulation makes it impractical.*

## I.

### INTRODUCTION

On December 24, 1992, the Internal Revenue Service ("IRS") issued proposed regulations (the "Proposed Regulations") relating to the application of the generation-skipping transfer tax "GSTT") imposed under Chapter 13 of the Internal Revenue Code of 1986, as amended (the "Code").<sup>1</sup> Proposed Regulation Section 26.2663-2 addresses the applicability of Chapter 13 of the Code to transfers by nonresidents who are not citizens of the United States ("NRAs").<sup>2</sup> Since publication, the Proposed Regulations, and particularly Section 26-2663-2, have met with considerable opposition.

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1. PS-73-88, 57 Fed. Reg. No. 248, 61356 (1992) (proposed Dec. 24, 1992).

2. Under Proposed Regulation Section 26.2663-2(a), "residence" under Chapter 13 is defined under the rules of Chapter 11 or Chapter 12, as the case may be. Under Chapters 11 and 12, "residence" is generally synonymous with "domicile." Treas. Reg. §§ 20.0-1(b), 25.2501-1(b) (1988).

This article attempts to provide a basic but comprehensive review and analysis of Section 26-2663-2, together with suggested revisions and, where possible, planning strategies.

## II.

### BACKGROUND

Under the United States federal wealth transfer tax system, a federal estate tax and a federal gift tax are imposed upon certain transfers of wealth by a decedent at death and during a donor's lifetime.<sup>3</sup> Typically, the U.S. federal wealth transfer tax system applies to transfers of wealth from one generation to the next. To that extent, the system can be thought of as "generational."

However, there are certain benefits to "skipping a generation." Consider the following example: T, a U.S. domiciliary for estate tax purposes, has an estate with a net fair market value of \$10,000,000. If T dies in 1994 and leaves his entire estate outright to C, his daughter, she would receive the net amount of \$5,052,000 after the imposition of \$4,948,000 in federal estate taxes.<sup>4</sup> If C is able to live solely on the income from this inheritance so that at her death she passed the entire \$5,052,000 to her child, GC (T's grandchild), at C's death, the estate tax would be \$2,226,600, leaving GC with an estate of \$2,285,400 after taxes. Thus, after passing T's original estate down two generations to GC, the estate of \$10,000,000 would have shrunk to \$2,226,600. T could have accomplished the same result, i.e., made the net estate available to C during her lifetime, by transferring the \$5,052,000 to a trust under the terms of which C could be given the right to the income for life with distribution of the principal outright to GC after C's death. The result would have been a total estate tax saving of \$2,226,600.

Congress, in order to eliminate this perceived abuse, enacted Chapter 13 of the Code, which imposes a tax on certain generation-skipping transfers ("GSTs").<sup>5</sup> In general, a GST is a transfer to, or for the benefit of, a "skip person."<sup>6</sup> The Joint Committee on Taxation described the purpose of the generation-skipping transfer tax (the "GSTT") under Chapter 13 as follows:

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3. The Federal estate tax is addressed in Chapter 11 of the Code while the federal gift tax is addressed in Chapter 12 of the Code.

4. Federal estate and gift taxes apply at marginal rates of up to fifty-five percent (sixty percent in excess of \$10,000,000 up to \$21,000,000) to the extent that wealth transfers made during the donor's lifetime and at death exceed the "unified credit" exemption equivalent, which is currently \$600,000. I.R.C. § 2001 (1993).

5. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006(a), 90 Stat. 1520 (certified at 26 U.S.C. §§ 2600-2622 (1988)). Chapter 13 was completely revised in 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1431(a), 1433(b)-(d), 100 Stat. 2085.

6. A "skip person" is (i) a natural person assigned to a generation that is two or more generations below the generation assignment of the transferor, or (ii) a trust (A) if all interests in such trust are held by a skip person, or (B) if there is no person holding an interest in such trust and at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person. I.R.C. § 2613(a) (1988).

A "non-skip person" is a person who is not a skip person. I.R.C. § 2613(b) (1988).

The Committee believes, as it stated when the generation-skipping transfer tax originally was enacted in 1976, that the purpose of the three transfer taxes (gift, estate, and generation-skipping) is not only to raise revenue, but also to do so in a manner that has as nearly as possible a uniform effect. This policy is best served when transfer tax consequences do not vary widely depending on whether property is transferred outright to immediately succeeding generations or is transferred in ways that skip generations.<sup>7</sup>

Congress identified three types of GSTs:<sup>8</sup> (i) "taxable distribution";<sup>9</sup> (ii) a "taxable termination";<sup>10</sup> and (iii) a "direct skip."<sup>11</sup> The GSTT is paid by the distributee in a taxable distribution, by the trustee following a taxable termination, and by the transferor in a direct skip not from a trust.<sup>12</sup>

Section 2663(2) of the Code authorizes the IRS to prescribe such regulations as necessary and appropriate to carry out the purposes of Chapter 13 of the Code, including:

... regulations (consistent with the principles of Chapters 11 and 12) providing for the application of [Chapter 13] in the case of transferors who are nonresidents not citizens of the United States ...<sup>13</sup>

Thus, Section 26.2663-2 of the Proposed Regulations specifically addresses the applicability of Chapter 13 to NRAs.

### III.

#### ANALYSIS OF PROPOSED REGULATION SECTION 26.2663-2(C)-NON- U.S. SITUS PROPERTY

An analysis of the Proposed Regulations must begin by focusing on the subject matter of the transfer, i.e., the property itself, and the need to distinguish

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7. H.R. REP. NO. 426, 99th cong., 1st Sess. 824 (1985).

8. I.R.C. § 2611 (1988).

9. A "taxable distribution" is any distribution from a trust to a skip person (other than a taxable termination or a direct skip). I.R.C. § 2612(b) (1988).

10. A "taxable termination" is the termination (by death, lapse of time, release of power or otherwise) of an "interest in property held in trust" if (at the time the determination is made) such person (i) has a present right to receive income or principal from the trust, (ii) is a permissible current recipient of income or principal and is not a charity described in Code Section 2055(a), or (iii) is a charity described in Code Section 2055(a), but only if the trust is a charitable remainder trust. I.R.C. § 2652(c)(1) (1988).

11. A "direct skip" is a transfer that subjects a skip person to federal estate or gift tax. I.R.C. § 2612(c) (1988).

Note that a direct skip ordinarily results in an estate or gift tax and a GSTT on the same transfer. On the other hand, a taxable distribution or a taxable termination typically results in an estate or gift tax upon the initial transfer to the trust and a GSTT later when the taxable distribution or taxable termination occurs.

12. I.R.C. § 2603 (1988). The GSTT is equal to the maximum estate tax rates. See I.R.C. § 2641 (1988). Code § 2631(a) allows each transferor an exemption of \$1,000,000 for GSTs. I.R.C. § 2631(a)(1988). A transferor may allocate the exemption to transfers during life or at death. I.R.C. § 2632 (1988). Chapter 13 also excludes any inter vivos direct skip transfers that qualify for the gift tax annual exclusion under Code § 2503(b) or the gift tax education or medical expense exclusion under Code Section 2503(e). I.R.C. §§ 2611(b)(1), 2642(c) (1988). Further, Code § 2612(c)(2) exempts direct skip transfers to a grandchild whose parent was a lineal descendant of the transferor and who is deceased at the time of the transfer.

13. I.R.C. § 2663(2) (1988).

between property situated in the U.S. and property that is not U.S. situs property.<sup>14</sup> The most controversial provision of the Proposed Regulations is Section 26.2663-2(c), which addresses the applicability of Chapter 13 of the Code to transfers of non-situs property by NRAs. Section 26.2663-2(c)(1) provides as follows:

Chapter 13 of the Internal Revenue Code applies to GSTs attributable to transfers by an NRA to the extent a beneficial interest in property passes to a skip person who is a resident or citizen of the United States at the time of the direct skip, taxable termination, or taxable distribution (as the case may be) if, at the time of the initial transfer to the skip person or to a trust that is not a skip person, a lineal descendant of the transferor who is a lineal ancestor of the skip person was a resident or citizen of the United States.

In short, according to this Section of the Proposed Regulations, a transfer of property by an NRA is subject to the GSTT, *regardless of the transferred property*, if (i) the recipient is a U.S. resident or citizen at the time of receipt, and (ii) a member of an intervening generation (who is a lineal relative of both the transferor and the recipient) is a U.S. resident or citizen at the time of receipt (in a direct skip) or at the time of the initial transfer (in a taxable distribution or taxable termination). This empowers the IRS to impose the GSTT on transfers by NRAs of non-U.S. situs property.<sup>15</sup> Section 26.2663-2(c) and the taxation scheme it represents are objectionable for numerous reasons set forth in detail below.

In order to understand the full impact of Section 26.2663-2(c), consider the following alternative hypothetical situations. All involve the transfer of non-U.S. situs property by an NRA transferor ("T"), where T's child is C, T's grandchild is GC, and T's great-grandchild is GCC. In each case the property is non-U.S. situs property at the time of the direct skip or at the time of the initial transfer to a trust that is not a skip person:

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14. See Prop. Treas. Reg. § 26.2663-2(b)(4), 57 Fed. Reg. 61371 (1992), which provides that "... transferred property is situated in the United States to the extent that the property is treated as situated in the United States at the time of the initial transfer to the skip person or to a trust that is not a skip person, as the case may be."

15. Prior to the issuance of the Proposed Regulations, the IRS maintained the position that GSTT did not apply to transfers by NRAs of non-U.S. situs property. See instructions to IRS Form 706NA (revised July 1990), p. 3.

|  | Direct Skip  | Taxable Termination  | Taxable Distribution   |
|--|--|--|--|
| Situation 1: at the time of the initial transfer by T, C is an NRA and GC is an NRA.   | No GSTT upon transfer by T to GC.  | No GSTT upon death of C leaving GC as the sole beneficiary of the trust.   | No GSTT when trust terminates upon death of C resulting in a direct transfer to GC, even if C and/or GC are residents or citizens of the U.S. immediately prior to T's death. <sup>16</sup>              |
| Situation 2: at the time of the initial transfer by T, C is a resident or citizen of the U.S. and GC is an NRA.                        | No GSTT upon transfer by T to GC. <sup>17</sup>                              | A GSTT will be imposed upon death of C leaving GC the sole beneficiary of the trust.   | A GSTT will be imposed when trust terminates upon death of C resulting in a direct transfer to GC.   |
| Situation 3: at the time of the initial transfer by T, C and GC are both residents or citizens of the U.S..                            | A GSTT will be imposed as a result of the transfer by T to GC. <sup>18</sup> | A GSTT will be imposed upon death of C leaving GCC the sole beneficiary of the trust.  | A GSTT will be imposed when trust terminates upon death of C resulting in a direct transfer to GC.   |
| Situation 4: at the time of the initial transfer by T, C is an NRA, GC is a resident or citizen of the U.S. and GCC has not been born. | A GSTT will be imposed as a result of the transfer by T to GC.               | No GSTT will be imposed upon the transfer to the trust for the benefit of GC even though at GC's death the trust will continue for the benefit of GCC (born after the date of the initial transfer). | No GSTT upon the transfer to the trust for the benefit of GC even though at GC's death the trust will be distributed to GCC. <sup>19</sup>   |
| Situation 5: at time of the initial transfer by T, C is an NRA, GC and GCC are both either residents or citizens of the U.S..          | A GSTT will be imposed as a result of the transfer by T to GC.               | No GSTT will be imposed at the time of the transfer by T to the trust for the benefit of GC. A GSTT will be imposed when at GC's death the trust continues for the benefit of GCC.                   | No GSTT will be imposed at the time of the transfer by T to the trust for the benefit of GC. A GSTT will be imposed when the trust is distributed to GCC at the time the trust terminates. <sup>20</sup> |

### A. Constitutionality

The attempt by Section 26.2663-2(c)(1) to impose a GSTT on NRAs for transfers of property located outside the United States is arguably unconstitu-

16. See Prop. Treas. Reg. § 26.2663-2(e)(2), 57 Fed. Reg. 61372 (1992), Example 4.

17. See Prop. Treas. Reg. § 26.2663-2(e)(2), 57 Fed. Reg. 61372, Example 3.

18. *Id.*

19. See Prop. Treas. Reg. § 26.2663-2(e)(2), 57 Fed. Reg. 61372 (1992), Example 5.

20. *Id.*

tional as it extends beyond the sovereign jurisdiction of the U.S. government to tax such transactions.<sup>21</sup>

The U.S. Supreme Court has held that the mere residence of a beneficiary in a state is insufficient to allow that state to constitutionally tax trust income where the beneficiary has (i) no present right to the control or possession of the trust assets that are located in another state, (ii) no present right to receive income from such assets, and (iii) no present right to cause the assets to be brought into the state seeking to impose the tax.<sup>22</sup> The Court ruled that a state seeking "to tax things wholly beyond her jurisdiction or control conflicts with the Fourteenth Amendment."<sup>23</sup> Because Section 26.2663-2(c)(1) taxes property outside of the U.S.'s sovereign jurisdiction, it may violate this standard.

### B. Statutory Authority

Even if Section 26.2663-2(c)(1) is not unconstitutional, it exceeds the statutory grant of authority under Chapter 13 of the Code in two fundamental aspects. First, Section 26-2663-2(c)(1) attempts to prescribe GSTT consequences in cases that lack a "transferor" (as expressly required in Code Section 2663(2)). Second, it is not "consistent with the principles of Chapters 11 and 12" (as also expressly required by Code Section 2663(2)).<sup>24</sup>

#### 1. Definition of "Transferor"

The GSTT, like the estate tax and the gift tax, is fundamentally transferor-based. In fact, each of the GSTs subject to the GSTT is ultimately defined with reference to a "transferor."<sup>25</sup> In addition, Section 2663(2) of the Code permits the promulgation of regulations providing for the application of Chapter 13 only for "transferors" who are NRAs. A "transferor" is (i) in the case of any property subject to the tax imposed by Chapter 11, the decedent, and (ii) in the case of any property subject to the tax imposed by Chapter 12, the donor.<sup>26</sup> Thus, arguably, no "transferor" exists unless the transferred property is subject to estate or gift tax.

Under Chapter 11 of the Code, the estate tax is imposed on the "taxable estate" of every NRA decedent.<sup>27</sup> The "taxable estate" of an NRA encompasses

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21. See *Safe Deposit Trust Co. v. Virginia*, 280 U.S. 83 (1929); *Graves v. Elliott*, 307 U.S. 383 (1939); *Graves v. Schmidlapp*, 315 U.S. 657 (1942); *Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947).

22. *Safe Deposit Trust Co. v. Virginia*, 280 U.S. 83 (1929).

23. *Id.* at 92-93.

24. I.R.C. § 2663(2) (1988).

25. See I.R.C. §§ 2612, 2613 (1988). Also, the Preamble to the Proposed Regulations notes that determining whether an event is a GST involves, among other factors, determining the identity of the "transferor." See 57 Fed. Reg. 61357 (1992).

26. I.R.C. § 2652(a)(1) (1988). § 26.2652(a)(1) of the Proposed Regulations further provides that "the individual with respect to whom property was most recently subject to Federal estate or gift tax is the transferor of that property for purposes of Chapter 13." Prop. Treas. Reg. 26.2652(a)(1), *supra* note 16, at 61368.

27. I.R.C. § 2101(a) (1988).

his "gross estate which at the time of his death is situated in the United States."<sup>28</sup> Therefore, property not situated in the United States is not "property subject to" the tax imposed by Chapter 11. Similarly, the gift tax under Chapter 12 of the Code does not apply to transfers by an NRA of non-U.S. situs property or, generally speaking, of intangible property.<sup>29</sup> Therefore, no "transferor" exists under the Code with respect to non-U.S. situs property for estate tax purposes and, generally speaking, intangible property for gift tax purposes.

However, the preamble to the Proposed Regulations (the "Preamble") states that a transfer is "subject to gift tax" if it is a completed gift within the meaning of Section 25.2511-2 of the Treasury Regulations, regardless of whether a gift tax is actually imposed on the transfer. Similarly, a transfer is "subject to estate tax" if the property would be includable in the decedent's gross estate as determined under Code Section 2031.<sup>30</sup> Despite the clear limitation on the authority of the IRS to prescribe regulations under Code Section 2663(2), Section 26.2663-2(c)(1) purports to redefine "transferor" and to impose the GSTT on transfers on non-U.S. situs property by an NRA.

Such an approach disregards the plain meaning of the statute and extends well beyond the regulatory authority granted in Code Section 2663(2). By treating all transfers by an NRA as "subject" to U.S. tax (if such transfers constitute a completed gift or the transferred property is includable in the decedent's gross estate under Section 2031), Section 26.2663-2(c)(1) effectively eliminates the word and definition of "transferor" from the Code.

## 2. *Consistency with Chapters 11 and 12*

Code Section 2663(2) also requires that all regulations promulgated thereunder be "consistent with the principles of Chapters 11 and 12." Section 26.2663-2(c)(1) is inconsistent with Section 2663(2) in at least two respects.

First, the situs and intangible property limitations placed on the imposition of estate and gift taxes on NRAs are not merely incidental features of Chapters 11 and 12. Such limitations reflect necessary restrictions to avoid the constitutional and practical obstacles presented by the extraterritorial application and enforcement of U.S. transfer taxes. A regulation that purports to impose the GSTT on transfers by NRAs of non-U.S. situs property faces identical obstacles and must reflect similar restrictions to be consistent with the principles of Chapter 11 and 12.

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28. See I.R.C. § 2106(a) (1988); see also, I.R.C. § 2103 (1988). Code §§ 2104 and 2105 set forth specific situs rules for certain types of property. For example, shares of stock in a U.S. corporation are deemed to be U.S. situs property. I.R.C. § 2104(a) (1988).

29. I.R.C. §§ 2501(a)(2), 2511(a) (1988). Transfers by an NRA of intangible property situated in the United States are subject to federal gift tax if the donor is an expatriate for whom tax avoidance was one of the principal reasons for relinquishing her U.S. citizenship, and the transfer occurs within ten years thereafter. I.R.C. §§ 2501(a)(3), 2513(a)(3)(B) (1988).

30. It should be noted that Code § 2103, not § 2031, contains the rules for inclusion in the gross estate in the case of an NRA decedent, although reference to § 2031 is contained therein. See I.R.C. §§ 2031, 2103 (1988).

In addition, imposition of the GSTT under Section 26.2663-2(c)(1) depends upon the residence or citizenship of the recipient of the transferred property and of a member of an intervening generation who is a lineal relative of both the transferor and the recipient. This also is clearly inconsistent with the principles of Chapters 11 and 12, which in cases of non-U.S. situs property look solely to the residence or citizenship of the transferor.

### C. Internal Consistency

Not only is Section 26.2663-2(c)(1) inconsistent with the principles of Chapters 11 and 12, it is also inconsistent with Chapter 13 itself in a number of respects. As one example, Chapter 13 imposes the GSTT on every transfer by a U.S. resident or citizen if the recipient is deemed to be more than one generation removed from the donor. On the other hand, the scope of Section 26.2663-2(c)(1) is limited to transfers to lineal descendants.<sup>31</sup> The Proposed Regulations provide no explanation for this distinction.

More importantly, in a domestic context, the GSTT only applies if a transfer is subject to estate or gift tax. This inconsistency can be seen most clearly in the definition of "direct skip," which requires that such a transfer, to be considered a direct skip, be subject to estate or gift tax.<sup>32</sup> Section 26.2663-2(c)(1), without justification or explanation, disregards this limitation in the international context.

Further, nowhere in Chapter 13 (or for that matter in Chapter 11 or 12) is the residence or citizenship of the recipients or members of the intervening generation considered relevant. Under Chapter 13 (and for that matter under Chapters 11 and 12), transfers by U.S. residents or citizens are taxable. For example, if a grandfather, a U.S. citizen, bequeaths his estate to his grandchildren, the GSTT is imposed even if neither the grandchildren nor the grandchildren's parents are U.S. residents or citizens. Thus, with respect to transfers by U.S. residents or citizens, the GSTT is applied even though no U.S. estate or gift taxes are being "skipped" at the intervening generation.<sup>33</sup> The residence and citizenship of the recipient and members of the intervening generation should similarly be irrelevant in applying the GSTT to transfers by NRAs.

Section 26.2663-2(c)(1) is not even consistent with Section 26.2663-2(b) of the same Proposed Regulations. To illustrate, if an NRA transfers stock in a U.S. corporation to a grandchild, the GSTT liability is governed by Section 26.2663-2(b)(2), which states that the GSTT will not apply unless the property has a U.S. situs and, if made inter vivos, the transfer is subject to tax under Code

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31. Because of this limitation, from a planning perspective, an effective method of avoiding the application of § 26.2663-2(c) is to make the transfer to the spouse of a skip person (assuming, of course, the marriage is stable and happy) because such spouse is unlikely to have a lineal ancestor who is also a lineal descendant of the transferor. Similarly, transfers to collateral relatives (e.g., nieces and nephews and their descendants) will not be subject to GSTT under § 26.2663-2(c).

32. See I.R.C. § 2612(c) (1988).

33. This result is fundamentally consistent with the U.S. estate and gift tax principles that tax transfers by U.S. residents and citizens regardless of the status of the recipient.

Section 2501(a). Under Code Section 2501(a)(2), transfers of intangible property by an NRA are not subject to tax under Section 2501(a). Therefore, the GSTT will not apply to the NRA's transfer of U.S. stock. On the other hand, the same transfer by an NRA of stock in a foreign corporation, which has less of a nexus for U.S. transfer taxation purposes, is subject to the GSTT under Section 26.2663(c)(1) if the transferee and a lineal ancestor of the transferee who is a lineal descendant of the transferor are U.S. residents or citizens at the time of the transfer.<sup>34</sup>

#### D. Prior Congressional Action

Section 26.2663(c)(1) is an apparent attempt to replicate the U.S. tax results that would occur if the property was first transferred by the NRA to a U.S. descendant in an intermediate generation and then to the skip person (i.e., an outright, successive transfer) on the assumption that an estate or gift tax is being skipped. In adhering to this concept of a two-step transfer, Section 26.2663(c)(1) disregards the well-known history of the GSTT in the Code and resurrects the discredited and repealed principle of the "deemed transferor."

The "deemed transferor" principle originated with the Tax Reform Act of 1976 (the "1976 Act"),<sup>35</sup> which enacted the original Chapter 13. In short, under the 1976 Act, the non-skip ancestor of a skip person was labeled a "deemed transferor" and the GSTT due was based upon the tax status and bracket of such a deemed transferor. With respect to a transfer by an NRA, if the deemed transferor was a U.S. resident or citizen, the GSTT applied; it did not apply if the deemed transferor was an NRA. Under the Tax Reform Act of 1986 (the "1986 Act"), Congress repealed the 1976 Act in its entirety because it was "unduly complicated,"<sup>36</sup> opting for increased simplicity at the cost of, in many instances, the imposition of the GSTT in a consistent manner with outright, successive transfers.

Congress, having rejected the "deemed transferor" concept in 1986, could not have intended that it serve as a guiding principle under the new law—by whatever label. In fact, various provisions of the 1986 Act clearly suggest that the GSTT is not meant to apply the "deemed transferor" concept. For example, a transfer that skips more than one generation nevertheless is subject to only one GSTT.<sup>37</sup> Under the "deemed transferor" concept, the GSTT would be imposed for each "deemed transfer." Further, the GSTT does not apply at all to a direct skip if the parent of the skip person is a lineal descendant of the transferor and is

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34. Note that a strict interpretation of § 26.2663-2(c)(1), which disregards the situs of the transferred property, would require the imposition of the GSTT on the transfer of U.S. stock as well, despite the express language of § 26.2663-2(b)(2), if the transferee and a lineal ancestor of the transferee who is a lineal descendant of the transferor are U.S. residents or citizens at the time of the transfer.

35. Pub. L. No. 94-455, *supra* note 5.

36. H.R. REP. NO. 426, 99th Cong., 1st Sess. 824 (1985).

37. Prop. Treas. Reg. § 26.2663-2(b)(2), *supra* note 16, at 61371.

deceased at the time of the transfer.<sup>38</sup> This exclusion treats the skip person and all succeeding generations as “moved up” to a higher generation, and thus the skip person is considered a non-skip person for GSTT purposes. The “deemed transferor” concept would make the death of the deemed transferor irrelevant to the imposition of the GSTT. Both examples illustrate that Congress truly intended to eliminate the “deemed transferor” concept from Chapter 13 in 1986.

Despite the clear mandate of Congress, Section 26.2663(c)(1) not only attempts to revive the “deemed transferor” concept, but purports to implement a broader version. For example, even under the 1976 Act, a transfer by an NRA involving non-U.S. situs property was not subject to the GSTT if the deemed transferor was no longer a U.S. resident or citizen at the time of the GST.<sup>39</sup> In contrast, under Section 26.2663(c)(1), the status of the intermediate generation is considered only at the time of the initial transfer.

The principle of the “deemed transferor” was clearly abandoned in 1986 as a general basis for imposing the GSTT. Nothing suggests that Congress considered it to be an appropriate basis for imposing the GSTT on NRAs. Further, from a practical standpoint, if the imposition of the GSTT consistently with outright, successive transfers could not be accomplished in a domestic context, the imposition is far more difficult to accomplish in an international setting. The attempt to reinstate the concept in the Proposed Regulations is not only confusing and unexplained, it is unjustified and a violation of Congressional intent.

#### E. Definition of “Beneficial Interest”

Under Section 26.2663-2(c)(1), Chapter 13 applies to an NRA to the extent that a “beneficial interest in property” passes to a skip person who is a U.S. resident or citizen at the time of the GST. Proposed Regulation Section 26.2663-2(c)(2) provides that a “beneficial interest in property passes to an individual to the extent the individual may at any time, directly or indirectly, hold the right to receive, or be a permissible recipient of, the property or the income therefrom.”<sup>40</sup>

The definition of “beneficial interest in property” is overly broad, extending far beyond the reach of the definition of “interest” for purposes of the GSTT generally.<sup>41</sup> For example, if an NRA creates a foreign trust with foreign situs property for his grandchildren or more remote descendants, and if one potential beneficiary, of perhaps many, is a U.S. resident or citizen, the GSTT would be imposed (provided that a lineal ancestor of that beneficiary is a lineal descendant of the transferor and is a U.S. resident or citizen at the time of the initial transfer to a trust). This broad definition allows the IRS to impose a

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38. I.R.C. § 2612(c)(2) (1988).

39. See *supra* note 7.

40. Prop. Treas. Reg. § 26.2663-2(c)(2), *supra* note 16, at 61372.

41. See I.R.C. § 2652(c)(1) (1988). See also I.R.C. § 2612(a)(1) (1988), *supra* note 12, for the definition of an “interest in property held in trust” as applied for purposes of the GSTT generally under Chapter 13.

GSTT merely because of the *possibility* that a U.S. skip person *might* receive property and, as discussed in further detail below, contributes to the administrative burdens, enforcement problems, and arbitrary taxation associated with Section 26.2663-2(c)(1).

#### F. *Administrative Burdens*

Chapters 11 and 12 currently require a determination of U.S. residence (*i.e.*, domicile) or citizenship for the transferor, who in turn has the primary obligation to report any transfer and pay any estate or gift tax based on his status at the time of such a transfer. Even in such limited circumstances, the determination of status is often a complex question, as the U.S. concept of "residence" is entirely fact-based. The GSTT under Chapter 13 is much more difficult to apply and enforce and requires record-keeping and factual analysis over a much longer period of time.<sup>42</sup> Yet Section 26.2663-2(c)(1) would require the determination of U.S. residence or citizenship not only for the transferor but for at least two other generations. Moreover, these two generations often will have several members, many with competing connections to different jurisdictions, and each jurisdiction may have its own treaties and internal rules.

To illustrate this administrative nightmare, in the case of a trust, Section 26.2663-2(c) would require the identification and determination of the residency or citizenship status for (i) the transferor at the time of the initial transfer, (ii) each potential or actual distributee of such a trust over the intervening years, and (iii) each member of the intervening generation at the time of the initial transfer. Further, the initial transfer may have occurred several decades before the applicable GST. Such passage of time may often result in obscured facts, misplaced records and substantive changes in the U.S. law of residence, as well as in the laws of competing jurisdictions.

Although theoretically it would not be impossible to make the necessary identifications and determinations, this presumes the proper maintenance of the relevant records, which in turn presumes recognition of the relevant issues. Many, if not most, trusts established by NRAs are intended to hold and manage reserve assets or special investments. Thus, most of these trusts usually do not make frequent distributions. Consequently, the trustees of such trusts do not regularly maintain the information files needed to track the status of the various beneficiaries. Even if such files were maintained, beneficiaries frequently change residence, especially in this age of the peripatetic taxpayer. Further, if a given trust includes a large class of beneficiaries, the trustee may never be informed of births and deaths on a regular basis, or have access to other information regarding all of the members of the intervening generation (especially if the transferor is estranged from such persons). Even with such information, the

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42. 26 U.S.C. §§ 2601, 2651 (1988).

significance of such events would regularly escape notice for these trustees (and beneficiaries) who do not consult sophisticated U.S. tax advisors.<sup>43</sup>

### G. Enforcement

For the same reasons Section 26.2663-2(c) places enormous administrative burdens on the taxpayer, Section 26-2663-3(c) would be virtually impossible for the IRS to equitably enforce. While a measure of voluntary compliance would be expected, and the IRS would happen upon some other GSTs, a significant proportion of such GSTs would escape detection and enforcement.

For example, no federal estate or gift tax return is required to be filed by an NRA transferring non-U.S. situs property because such property would not be subject to U.S. estate or gift tax. Thus, even if such a transfer is subject to the GSTT under Section 26.2663-2(c), in most cases the NRA would be unaware of the requirement to file a return with respect to the GSTT; and similarly, the IRS would be unaware of the NRA's filing obligation. Also, a trustee of a trust subject to the GSTT under Section 26.2663-2(c) will often be unaware of the filing requirement. Sometimes the trustee will not pay the GSTT by design because, although a U.S. trustee is subject to personal liability if the GSTT is not paid by the trust, a non-U.S. trustee is not subject to U.S. jurisdiction.

Further, the proposed definition of "beneficial interest in property" would potentially extend the reach of Section 26.2663-2(c) to every trust anywhere in the world for which a U.S. resident or citizen "may at any time, directly or indirectly, . . . be a permissible recipient"<sup>44</sup> (provided that a member of the intervening generation is a lineal relative of both the recipient and the transferor and is a U.S. resident or citizen at the time of the initial transfer). Moreover, any U.S. resident or citizen caught in such a broad class of potential recipients could well have a U.S. ancestor in the intermediate generation. In light of the vast expanse of possible transfers that would qualify for the imposition of the GSTT, the level of effort required for the U.S. government to enforce Section 26.2663-2(c) would be unrealistically high.

### H. Arbitrary and Unfair Taxation

Under Section 26.2663(c), many common international family trust arrangements would be subject to the full GSTT even though no U.S. situs property is involved and little or no benefit will be enjoyed by U.S. persons. So long as one U.S. resident or citizen is a potential trust beneficiary or a permissible

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43. Another complication inherent in Chapter 13 involves the fact that a "skip person" is defined to include a trust. Section 26.2663-2(c)(1) is unclear as to the determination of the residence or citizenship of such a trust, as well as the identification of, and the same determination for, the "lineal ancestor" thereof.

44. Note that a permissible appointee under a power of appointment would also be considered a "permissible recipient" under § 26.2663-2(c)(2). Prop. Treas. Reg. § 26.2663-2(c)(2), *supra* note 16, at 61372.

appointee under a power of appointment, the entire trust may be subject to the full GSTT.<sup>45</sup>

To illustrate the most basic example, assume that an NRA grandfather, T, a citizen of Country A, transfers real property in Country A in trust for T's child, C, for life and on C's death, to C's descendants, who are unborn at the time of the initial transfer. At the time of the initial transfer, C, a citizen of Country A, is temporarily residing in the United States, but returns to Country A shortly thereafter and never again visits the United States. The trust holds real estate in Country A at all times, C dies a resident of Country A and is survived by one child, GC, who is a citizen of Country A but is temporarily resident in the United States at the time of C's death.

Under Section 26.2663-2(c), the GSTT would be imposed despite the almost non-existent nexus with the United States, and even though no U.S. estate tax would have been imposed on C's death had the real estate been transferred outright to C.<sup>46</sup> Further, no GSTT would have been imposed had C been a U.S. resident any time other than at the time of the initial transfer, or had GC been a U.S. resident any time other than at the time of C's death.

Taken one step further, assume T bequeaths his estate to a trust providing income to C for life, remainder in trust for C's descendants. At T's death, C is a U.S. resident. C later dies as a resident in Country A. At her death, only one of C's twenty descendants (a grandchild, GC) is a U.S. resident, but he moves to Country A two weeks later. Under Section 26.2663-2(c), the GSTT would be imposed at C's death on the entire trust, even though GC received no trust distribution while a U.S. resident. On the other hand, assume C never left the United States and at her death, all of her descendants were in Country A. If GC moved to the United States two weeks later, the GSTT is apparently not imposed unless and until distributions are made to him while he is a U.S. resident.

The Proposed Regulations provide no justification for the divergent results illustrated above.

Further, such arbitrary consequences are compounded by the broad definition of "beneficial interest in property" under which an entire trust appears to be subject to the GSTT because of the mere possibility, however remote, that a distribution might be made to a U.S. resident or citizen. For example, assume that an NRA grandfather, T, a citizen of Country A, establishes an irrevocable

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45. It should be noted that under § 26.2663(c)(2) a beneficial interest in property passes "to the extent" an individual may hold the right to receive or be a permissible recipient of such property. Although the phrase, "to the extent," may evidence that the GSTT would not apply to the entire trust, the expansive language that follows suggests that the phrase is not meant to serve as a material limitation. In addition, because a U.S. resident or citizen could receive all of the trust property, the IRS will likely attempt to tax the entire trust. Thus, from a planning perspective, practitioners should be careful to avoid including U.S. citizens or residents as beneficiaries if they are not intended to receive any distributions. Alternatively, the use of a savings clause, which expressly prohibits a U.S. citizen or resident from acquiring any beneficial interest in the trust, might be considered.

46. Note that the GSTT can be avoided in this case by distributing the trust outright to C at any time before C's death.

discretionary trust for the primary benefit of T's NRA child, C, also a citizen of Country A. The class of discretionary beneficiaries also includes T's other descendants, including a U.S. daughter, D, and her U.S. children. The trustee has the discretion to allocate among this class but is generally guided by a non-binding Letter of Wishes that requests the trustee to provide for C and her family, and only if none of these persons are living, then for D and her family. C and D later die and the trust is then held under its terms for the discretionary benefit of T's grandchildren, some of whom are U.S. residents or citizens. Under Section 26.2663-2(c), because an interest in property is deemed to have passed to the U.S. grandchildren, the death of the surviving child would be considered a taxable termination as to the whole of the trust and the GSTT would be imposed. This would be true even though T did not intend any portion of the trust to be distributed to the U.S. grandchildren unless and until C's descendants had all died.<sup>47</sup>

As another example, assume that a grandfather, T, a citizen of Country A, establishes an irrevocable trust for the primary benefit of his son, C, and C's family, all citizens of Country A. The trustee is given a power to appoint the trust property into a new trust for the discretionary benefit of a class of beneficiaries, including T's U.S. daughter, D, and T's grandchildren. Under Section 26.2663-2(c), the trust would be subject to the GSTT under the taxable termination rules when C dies (or perhaps at the later death of D). Even though the trust is intended to be held for C's family, all citizens of Country A, an interest in the entire trust is apparently deemed to have passed to them at the time because T's U.S. grandchildren could receive distributions pursuant to the trustee's exercise of its power of appointment.<sup>48</sup>

As the above examples illustrate, the inconsistency of Section 26.2663-2(c) with the principles of Chapters 11 and 12 and with Chapter 13 itself, together with the overly broad language defining "beneficial interest in property," appear to arbitrarily impose the full GSTT on a broad range of transfers that provide little or no real benefit for U.S. residents or citizens.

### I. International Comity

Section 26.2663-2(c) also creates the possibility of double taxation in violation of fundamental principles of international taxation. As an illustration, the United Kingdom employs an equivalent system to the GSTT through provisions imposing certain tax on discretionary trusts (*i.e.*, trusts in which no one has a life interest). The U.K. system imposes a periodic charge on such trusts every ten

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47. Note that the result appears to be the same even if the trust expressly incorporated the same terms as in the Letter of Wishes. § 26.2663-2(c)(2) provides that a beneficial interest in property passes to the extent an individual may "at any time" hold a right to receive or be a permissible recipient of such property. Prop. Treas. Reg. § 26.2663-2(c)(2), *supra* note 16, at 61372. This suggests that even a contingent future interest is sufficient to trigger the GSTT.

48. The result is presumably the same if, instead of the trustee having this power of appointment, one or more of T's grandchildren, who are citizens of Country A, had a limited power to appoint the trust among T's descendants (other than the power holder).

years and a charge on actual distributions made from such trusts in the interim, all an effort to confront the same problem addressed by the GSTT in the United States.

The U.K. discretionary trust tax is imposed only with respect to property situated in the United Kingdom or to all property held in trusts created by U.K. settlors, adhering to the normal jurisdictional principles of international taxation. Under Section 26.2663-2(c), however, if a U.K. settlor establishes a U.K. trust with U.K. situs property, but the income is payable to a U.S. child for life with the remainder distributable to a U.S. grandchild, both the U.K. tax system and Section 26.2663-2(c)(1) are likely to apply, resulting in double taxation.

Double taxation problems are often addressed by treaty, and the Preamble expressly provides that the Proposed Regulations are not intended to override any treaty limitation on the United States' authority to impose the GSTT. However, in the case of the United Kingdom, the double taxation issue with respect to the GSTT is not currently addressed by treaty. Further, although the Preamble states that "several bilateral tax treaties negotiated by the United States prior to 1986 cover the generation-skipping transfer tax," few treaties in force to date adequately address the GSTT.<sup>49</sup>

Even such treaties currently in force that do address the GSTT do not address a GSTT of the territorial scope now being presented in Section 26.2663-2(c). Thus, the existing treaties would need to be radically modified if the Proposed Regulations are adopted in their present form as the GSTT would then apply to many NRA transfers that are entitled to treaty protection. In addition, such treaties must protect against the double taxation caused by the broad reach of Section 26.2663-2(c), as discussed above.<sup>50</sup>

### *J. Policy Considerations*

Section 26.2663-2(c) is counter-productive from a policy perspective. For example, the arbitrary and expansive reach of Section 26.2663(c), together with the lack of U.S. jurisdiction over foreign trustees, will discourage foreign grant-

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49. Some of the estate and gift tax treaties with the United States refer expressly or by implication to the GSTT. However, the language does little more than purport to cover the GSTT. For example, in the treaties with Germany and France, "taxes" is defined to include the "generation-skipping tax," but the operative sections of such treaties concerning primary taxing jurisdiction and credits do not adequately address a tax that is levied on property that is not always part of the estate of, or a gift made by, a single identifiable person. Convention for the Avoidance of Double Taxation, Nov. 24, 1978, U.S.-Fr., 32 U.S.T. 1935, 1938; Convention for the Avoidance of Double Taxation, Dec. 3, 1980, U.S.-F.R.G., T.I.A.S. No. 11082, at 5. The treaty with the United Kingdom is more specific, but that treaty relies on the "deemed transferor" concept, which is not used under the current GSTT. Convention for the Avoidance of Double Taxation, Oct. 19, 1978, 30 U.S.T. 7223, 7228.

50. The treaty issues are further complicated by the fact that non-U.S. jurisdictions often apply an entirely different basis for taxation (e.g., a deemed capital gains tax or an inheritance tax) than the U.S. system. Further, such other systems do not lend themselves to resolving double taxation issues, especially when the GSTT in the United States is imposed based on different "triggering" events (e.g., in a taxable termination that occurs without a distribution and without a change in the ownership of appreciated property) and at different times.

ors from choosing U.S. banks or their foreign subsidiaries as trustees, and trust and investment management business will gravitate toward foreign institutions with no U.S. contacts. Similarly, an individual with some flexibility as to residence may consider establishing his residence in a jurisdiction that has a treaty that provides for GSTT protection. In addition, a well-informed transferor will reduce gifts to U.S. residents and citizens, thereby reducing the U.S. tax base.

Implementation of Section 26.2663-2(c) will continue to send the wrong message to foreign investors, namely, that the United States is prepared to discriminate against them tax-wise and to impose annoyances upon them in ways that it is not prepared to impose on its own citizens. This message will further discourage foreign persons from investing in the United States at a time when such investment is badly needed. Section 26.2663-2(c) will also incur international bad will as it is contrary to international law at a time when the United States already suffers from poor international tax relations.

Finally, a transfer of property by an NRA where the recipient is a U.S. resident or citizen, even if not subject to U.S. estate or gift tax, will ultimately be subject to the regular regime of U.S. transfer taxes and income taxes. Therefore, not only is imposition of the GSTT on such a transfer unconstitutional, unworkable, unenforceable and unfair, it is also unnecessary.

#### IV.

##### ANALYSIS OF OTHER SECTIONS OF THE PROPOSED REGULATIONS

###### A. Proposed Regulation Section 26.2663-2(b)—U.S. Situs Property

Section 26.2663-2(b) of the Proposed Regulations imposes the GSTT on transfers of U.S. situs<sup>51</sup> property by NRAs. Like Section 26.2663-2(c), Section 26.2663-2(b) is inconsistent with the principles of Chapters 11 and 12 of the Code.

Under Section 26.2663-2(b)(3) of the Proposed Regulations, taxable distributions and taxable terminations with respect to property held in trust are generally subject to Chapter 13 to the extent the initial transfer by the NRA transferor involved U.S. situs property. Taken to its logical end, Section 26.2663-2(b)(3) results in a GSTT on distributions of foreign property, by a foreign trustee, to a foreign beneficiary of a foreign trust merely because the property initially transferred was U.S. situs property. This is true even though such transfer may have occurred many years prior to the distribution.

To illustrate this inconsistency of Section 26.2663-2(b) with the principles of Chapters 11 and 12, assume an NRA grandfather, T, whose will leaves a portfolio of U.S. stocks to his NRA son, C. Under Chapter 11 of the Code, this

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51. Under § 26.2663-2(b)(1) and (2) of the Proposed Regulations, situs is determined under Chapter 11 with respect to transfers at death and under Chapter 12 with respect to inter vivos transfers. Under § 26.2663-2(b)(4) of the Proposed Regulations, situs is determined at the time of the initial transfer to a skip person or to a trust that is not a skip person. Prop. Treas. Reg. §§ 26.2663(b)(1)-(2), *supra* note 16, at 61371.

transaction is subject to estate tax. C manages the portfolio and, in the process, sells some of the U.S. stocks and buys some foreign securities. C then transfers such foreign securities to T's grandchild, GC. This transaction is free from U.S. estate or gift tax because the transferred property is non-U.S. situs property. On the other hand, under Section 26.2663-2(b), if T's will leaves U.S. stocks to a trust for the benefit of C for life with a remainder to GC, the initial transfer to the trust would be subject to the GSTT at the time of any distribution to GC.

Further, from a practical standpoint, even in a domestic context, imposition of the GSTT on a taxable distribution or termination many years after the initial transfer poses obstacles. Applying Section 26.2663-2(b) in an international context raises the same administrative problems for the trustee and the same enforcement problems for the IRS as under Section 26.2663-2(c).<sup>52</sup> In particular, significant issues will result from the lack of awareness by foreign transferors and trustees of the taxability of such transfers, and the lack of jurisdiction by the United States over foreign trustees.

#### *B. Proposed Regulation Section 26.2663-2(d)—Anti-abuse Rule*

Section 26.2662(d) of the Proposed Regulations broadens the definition of "U.S. situs property" with respect to transfers by NRAs, and provides as follows:

The rules of this section are applicable without regard to any transaction or other activity if the effect of such transaction or activity is to transfer United States situs property from the transferor to the transferee.

The intended purpose of Section 26.2663-2(d) is to prevent taxpayers from avoiding the GSTT by transforming U.S. situs property into property deemed to be located in a foreign country.<sup>53</sup> However, the rule is neither limited to transactions that have tax avoidance as a purpose, nor to transactions or activities occurring within a specified time frame around the initial transfer, as is required in similar anti-abuse rules under Chapters 11 and 12.<sup>54</sup>

Examples 1 and 2 of Section 26.2663-2(e) of the Proposed Regulations further illustrate this inconsistency. In Example 1, a transfer of U.S. situs real property by an NRA to a "wholly owned"<sup>55</sup> corporation, domestic or foreign, followed "*shortly thereafter*" by a transfer of the stock in the corporation to a

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52. Prop. Treas. Reg. § 26.2663-2(c), *supra* note 16, at 61371.

53. Prop. Treas. Reg. § 26.2663-2(d), *supra* note 16, at 61372.

54. I.R.C. §§ 2107, 2501(a)(3)(1988); *see also* *Davies v. Comm'r*, 40 T.C. 525 (1963); *De Goldschmidt-Rothschild v Comm'r*, 168 F.2d 975 (2d Cir. 1948). In *Davies*, for example, an NRA transferred cash to a relative offshore with the understanding that the relative would in turn use the cash to "purchase" U.S. real estate from the NRA. The Tax Court applied a step-transaction analysis and concluded that the NRA effectively made a gift of the U.S. real estate. *Davies v. Commissioner*, 40 T.C. 525 (1963).

55. It is unclear whether § 26.2663-2(d) would apply if the corporation was not "wholly owned." Taken to its extreme, a gift of stock in a publicly traded foreign corporation, one percent of whose assets consist of U.S. real estate, could conceivably be subject to the GSTT. As another example, a transfer of stock in a foreign corporation whose assets are composed entirely of interests in U.S. real property initially purchased from third parties by the corporation (and thus never directly owned by the NRA) could also be subject to the GSTT under § 26.2663-2(d).

skip person, is subject to the GSTT. For gift tax purposes, it is well established that a transferor can circumvent the situs rules by the transfer described in Example 1. If the IRS desired to close this loophole as an "abuse," it should do so for all transfer taxes, not just the GSTT. In addition, such a change in the law should be accomplished through the legislature, not through regulatory action. Moreover, even if Section 26.2663-2(d) is a legitimate exercise of regulatory power, the term "shortly thereafter" requires clarification. Interpretation of such a term will likely attract time-consuming and expensive audits or litigation for both the IRS and taxpayers.

Under Example 2, the GSTT is imposed on a transfer of cash to a trust followed "shortly thereafter" by the purchase by the trustee of U.S. situs property "from the transferor."<sup>56</sup> If a binding obligation existed to make the purchase at the time the trust was funded, the imposition of the GSTT under Section 26.2663-2(d) seems justified. On the other hand, even if no such obligation existed and full and adequate consideration was paid by the trustee for the purchase of the U.S. situs property, in an arm's length transaction, the GSTT would be imposed under Section 26.2663-2(d), even though gift tax would not apply under Code Section 2501(a)(1) (as no gift was made). Moreover, as in Example 1 above, "shortly thereafter" must be more clearly defined.

From a practical standpoint, Section 26.2663-2(d) raises the same administrative problems for the trustee and the same enforcement problems for the IRS as seen under Sections 26.2663-2(b) and (c). If U.S. real estate is transferred to a foreign corporation, and such shares are then transferred to a skip person who is an NRA, the IRS would neither have the awareness in many cases nor the jurisdiction to enforce the GSTT.

Moreover, although the more objective standard of Section 26.2663-2(d) would at first appear to promote better and more consistent enforcement, closer analysis reveals that it will actually lead to arbitrary, and therefore unfair, enforcement. For example, assume an NRA purchases mutual funds (by personal check), which he then transfers to his investment holding company. The NRA then transfers his holding company to a revocable trust with a non-U.S. trustee, turning over the investment management of the company to a professional investment advisor. The trust provides for the NRA's descendants in perpetuity after the NRA's death. Several years later, the professional advisor decides to sell all of the non-U.S. equities and reinvest the proceeds in U.S. mutual funds. The NRA dies unexpectedly two days later, just after the transaction closes. Section 26.2663-2(d) would apparently apply, despite no tax avoidance purpose or prearranged plan by the NRA to transfer U.S. situs property two days later to his descendants.

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56. It is unclear whether § 26.2663-2(d) would apply if the U.S. situs property was not purchased "from the transferor."

*C. Proposed Regulation Section 26.2663-2(f)—Automatic Allocation  
of Exemption*

Section 26.2663-2(f) of the Proposed Regulations automatically allocates an NRA transferor's GST exemption in a given calendar year first to direct skips, and then to trusts as to which distributions and terminations may be subject to GSTT in the order prescribed in Code Section 2632(c). This appears to be an attempt to 'self-correct' the likely rampant non-compliance, deliberate or inadvertent, with the Proposed Regulations by trustees and beneficiaries with respect to applicable trusts.

While Section 26.2663-2(f) is intended to mitigate the unexpected application of chapter 13 to transfers by NRAs,<sup>57</sup> it instead may result, in conjunction with Proposed Regulation Section 26.2663-2(c), in unfair tax consequences. Because the GST exemption is automatically allocated not only to direct skips but also to transfers in trust as to which *someday* a taxable distribution or termination *might* be realized (no matter how remote the likelihood of such event), the exemption may be wasted, irrevocably, before the transferor ever knows that the trust might become subject to the GSTT.

For example, assume an NRA grandfather, T, a citizen of Country A, creates a \$1,000,000 irrevocable trust in Country A, funded exclusively with non-U.S. situs property, for the benefit of his son, C, also a citizen of Country A, for life, with a contingent remainder to T's grandson, GC, also a citizen of Country A, and a gift over of the contingent remainder to T's daughter, D, if surviving, and if not, to any after-born children of D. D is then resident in the United States. Under Section 26.2663-2(f), T's GST exemption is automatically allocated to, and fully exhausted by, this trust. Subsequently, GC lives to receive his remainder and in the interim the other non-U.S. situs property of T passes at his death in trust for the benefit of D for her life, with the remainder passing for D's children, who are U.S. citizens. D then returns to Country A, not realizing that a U.S. GSTT is due on the trust at her death under Section 26.2663-2(c), and that the GST exemption of T has been wasted on the first trust.

In an apparent response to such concerns, Section 26.2663-2(f) also permits an NRA, or the executor of his estate, to elect to prevent the automatic allocation of the exemption with respect to a particular transaction by filing a timely U.S. estate or gift tax return. However, if a U.S. estate or gift tax is not imposed on the establishment by an NRA of a certain trust, such an NRA would have no reason to file an estate or gift tax return, and thus would be unable to opt out of the automatic allocation. In particular, because such an NRA will often be unaware of the applicability of the GSTT to such a trust, allowing the filing of a return that is not otherwise due is not an adequate solution.

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57. See *supra* note 27, at 61357.

*D. Proposed Regulation Section 26.2601-1(e)(2)—Effective Date*

Under Section 26-2601-1(e)(2), the Proposed Regulations would not apply to any transfer by an NRA made before December 24, 1992.<sup>58</sup> Although this transition period is necessary as the Proposed Regulations, in particular, Section 26.2663-2(c) and Section 26.2663-2(d), would unexpectedly impose the GSTT on a broad range of transfers that previously have never been considered subject to any U.S. transfer tax, Section 26.2601-1(e)(2) does not adequately define the term "transfer." For example, in a direct skip, a gift or bequest of non-U.S. situs property made before December 24, 1992 by an NRA would not be subject to the GSTT. Similarly, the GSTT would clearly not be imposed with respect to a taxable distribution or termination made before December 24, 1992. On the other hand, in an initial transfer to trust that occurs before December 24, 1992, with a taxable distribution or termination that occurs after December 24, 1992, the imposition of the GSTT will depend on whether the term "transfer" refers to the initial transfer or to the GST. If "transfer" means the initial transfer, trusts created before December 24, 1992 would not be subject to the GSTT, even in the event of a taxable distribution or termination after December 24, 1992. If "transfer" means a GST, a transfer to trust made before December 24, 1992, even though irrevocable, would result in imposition of the GSTT under Section 26.2663-2(c). Logic and history dictate that "transfer" means the initial transfer with respect to trusts created by NRAs. However, clarification is required.

V.

PROPOSED REVISIONS TO THE PROPOSED REGULATIONS

In the absence of legislation specifically designed to extend the reach of the GSTT to transfers by NRAs of non-U.S. situs property, and because of the myriad of problems and obstacles posed by such a rule, we suggest the following revisions:

1. Section 26.2663-2(c), as well as Examples 3, 4 and 5 under Section 26.2663-2(e) should be omitted.<sup>59</sup> If Section 26.2663-2(c) is omitted, the automatic allocation under Section 26.2663-2(f) will be unnecessary and should also be omitted.

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58. Under the Proposed Regulation § 26.2601-1(e)(1), the Proposed Regulations would generally be effective with respect to the GSTs made on or after December 24, 1992. Prop. Treas. Reg. § 26.2601-1(e)(1), 57 Fed. Reg. 61356 (1992).

59. For the sake of clarity, § 26.2652-1(a)(2) of the Proposed Regulations could be revised to read in full as follows:

*Transfers subject to Federal estate or gift tax.* For purposes of this section, a transfer is subject to Federal gift tax if the transfer is a completed gift within the meaning of § 25.2511-2 regardless of whether gift tax is actually imposed. A transfer by a non-resident not a citizen of the United States is subject to Federal gift tax under this section only if the transfer is a transfer to which Federal gift tax applies under § 25.2511-1(b). A transfer is subject to Federal estate tax if the value of the property is includable in the decedent's gross estate as determined under section 2031 in the case of a decedent who is a citizen or resident of the United States, or under section 2103 in the case of a nonresident decedent not a citizen of the United States.

If, however, Section 26.2663-2(c) is retained, the final regulations must adequately address the concerns set forth in this article.<sup>60</sup> First, to address issues of constitutionality and the scope of the statutory authority of the IRS under Code Section 2663(2), Section 26.2663-2(c) must be made consistent with the principles of Chapters 11 and 12 of the Code, and with other provisions of the Proposed Regulations. For example, the final regulations should limit the application of Section 26.2663-2(c) to GSTs that are subject to estate or gift taxes. Further, in the case of property transferred by an NRA to a skip person through a trust, the final regulations should include a requirement that the beneficiary and the member of the intervening generation be U.S. residents or citizens both at the time of the initial transfer to the trust and at the time of the GST. Such modifications would also address concerns regarding the administrative burdens, the enforcement problems and the potential arbitrary and unfair taxation.

2. In addition, the definition of "beneficial interest" should be narrowed and clarified. For example, in situations where the potential future benefit is impossible or impracticable to determine for purposes of imposing the GSTT, the GSTT should not apply. Alternatively, the trust should be treated as not subject to the GSTT until and only to the extent a distribution is actually made to a U.S. resident or citizen or an interest is vested for that person's benefit. The IRS may also consider limiting the tax base to the actuarial value of the recipient's contingent remainder interest. Such revisions would further address issues of administration, enforcement and arbitrary and unfair taxation.<sup>61</sup>

3. In response to concerns regarding international comity, the United States must include a provision providing relief from possible double taxation.

4. Election out of the automatic allocation rules of Section 26.2663-2(f) should be permitted at any time before a GST occurs to the extent the transferor was never required to file an estate or gift tax return.

5. Whether or not Sections 26.2663-2(c) and (f) are retained, Section 26.2663-2(d) should be more clearly defined and made consistent with equivalent provisions in Chapters 11 and 12. For example, the application of the so-called "anti-abuse" rule should be limited to situations where tax avoidance is a principal purpose of the transaction. Any presumption of a tax avoidance purpose should be rebuttable by the taxpayer. A bright-line test (e.g., one year) could be employed to determine when a transaction will not be treated as having a tax avoidance purpose. Alternatively, the application of Section 26.2663-2(d) should be limited to situations where the NRA directly owns the U.S. situs property transferred. The examples under Section 26.2663-2(e) should be expanded considerably to address such issues as the definitions of "effect," "transaction or

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60. See *supra* text accompanying notes 15-42.

61. If § 26.2663-2(c) retains the definition of "beneficial interest" in its present form, the administrative burden of determining the residency status of each potential or actual distributee of a trust established by an NRA, as well as each member of the intervening generation at the time of the initial transfer to such trust, can be somewhat alleviated by permitting the trustee of such a trust to rely on a certification of affidavit from the relevant individuals as to the residency status of such individuals.

activity,” and “shortly thereafter.” In particular, more meaningful guidance should be considered to assist in the interpretation of the term “shortly thereafter.”

6. Section 26.2663-2(b) should be modified to provide that, in order for a taxable distribution or termination to be subject to the GSTT, the property must be located in the United States both at the time of the initial transfer, as required by Section 26.2663-2(b)(3), and at the time of the GST.

7. With respect to the provisions regarding the effective date of the Proposed Regulations in Section 26.2601-1(e)(2), the term “transfer” should clearly be defined as the “initial transfer” in cases involving a trust.<sup>62</sup> There is no justifiable reason to exempt direct skips or taxable terminations or distributions that have already occurred and yet still apply the tax to taxable events that occur thereafter but pursuant to pre-existing irrevocable transfers under which the NRA no longer retains the right to prevent or avoid the taxable events. Further, because of the heavy administrative burden that would result if the Proposed Regulations are adopted, it is unrealistic to suggest that they should be applied to pre-existing irrevocable dispositions of property.<sup>63</sup>

8. The final regulations under Code Section 2663(2) should also provide transitional relief with respect to all testamentary documents that are practically, if not legally, irrevocable.<sup>64</sup> For example, a will or trust instrument that by its terms (or by operation of law) is revocable but that was created by an NRA who has been incapacitated since the promulgation of the Proposed Regulations should be exempt from GSTT. Such documents are for all intents and purposes “irrevocable.” The continuing mental disability of such incapacitated individuals will effectively preclude any amendment of such documents through which such individuals might otherwise respond to the unanticipated application of Chapter 13 to transfer of non-U.S. situs property by NRAs.

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62. One suggested modification of § 26.2601-1(e)(2) reads in full as follows:

(2) *Certain transfers by nonresidents not citizens of the United States.* The provisions of chapter 13 do not apply to any GST (as defined in section 26.2611-1) described in paragraph (c) of section 26.2663-2 made before December 24, 1992 by an NRA (as defined in section 26.2663-2(a), or to a GST described in paragraph (c) of section 26.2663-2 made under a trust of which an NRA was the transferor to the extent such trust was irrevocable on December 23, 1992, but only to the extent that such transfer is not made from corpus added to such trust after December 23, 1992 (or out of income attributable to such corpus).

63. Under the effective date rules accompanying the 1986 legislation, future GSTs from pre-existing irrevocable trusts were exempted from the GSTT, reflecting a well-reasoned and long-standing policy not to apply novel transfer tax regimes to pre-existing irrevocable trusts. § 26.2601-1(b)(1) of the Temporary Regulations specifies which trusts are deemed to be “irrevocable” for this purpose. Promulgation of parallel regulations under Code § 2663(2) would permit consistent application of the current GSTT effective-date rules and regulations to all pre-existing irrevocable trusts by utilizing the same basic standards for determining irrevocability as of the relevant effective date. Temp. Treas. Reg. § 26.2601-1(b)(1)(1988).

64. Under the 1986 legislation, Temporary Regulation Section 26.2601-1(b)(3) implemented an exemption with respect to wills in existence on the effective date of the 1986 law “if the decedent was incompetent on that date and at all times thereafter until death.” Temp. Treas. Reg. § 26.2601-1(b)(3), Fed. Reg. 8441 (1988). See also House Committee Report on P.L. 99-514.

Finally, it would also be appropriate to grant a transitional period for revocable documents to allow sufficient time for appropriate amendments, as was done when the GSTT was first imposed domestically in 1976. This transition period would also allow time for the U.S. government and tax advisors to properly address the anticipated issues under the Proposed Regulations, as set forth above.<sup>65</sup>

## VI. CONCLUSION

Section 26.2663-2 of the Proposed Regulations represents, in our opinion, a step in the wrong direction. The purported scope of Section 26.2663-2 extends beyond that of any existing scheme of taxation, both in the United States and throughout the world. Moreover, Section 26.2663-2 is also largely impractical from the perspective of taxpayers and the IRS and is, in many instances, unclear and in need of further guidelines. The most serious transgression involves the application of the GSTT to non-U.S. situs property. Besides raising serious constitutional issues, this attempt to arbitrarily expand the arm of the U.S. wealth-transfer tax system well beyond the shores of the United States lacks statutory authority and represents a regression to the 1976 generation-skipping transfer-tax system that Congress had repealed in 1986. In short, instead of providing the guidance needed to allow taxpayers to comply with the provisions of Chapter 13 of the Code, and instead of providing a road map for implementation, Section 26.2663-2 adds confusion, administrative burden and a record-keeping nightmare to an already complex area of the Code.

Without proper guidance in this area, planning for the international property owner will be rendered difficult if not impossible. As evidenced above, such confusion is hardly conducive to the success of a system of taxation that relies almost entirely upon the voluntary compliance of the taxpayer. Considering the serious theoretical and practical defects in Section 26.2663-2, we urge that Section 26.2663-2 be examined before issuance of final regulations. Furthermore, such revisions of the Proposed Regulations in the manner suggested would simplify proceedings, make voluntary compliance easier (and more attractive) and would eliminate the appearance that the United States is overstepping its legal authority with respect to non-U.S. situs property. Failure to revise the Codes, however, would result in serious setbacks in this area.

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65. The temporarily available \$2,000,000 per grandchild exemption (the so-called "Gallo Amendment") promulgated under Temporary Regulation § 26.2601-1(d) of the 1986 law is another example of a regulation that should be paralleled for purposes of regulations implemented under Code § 2663(2).