The Disregarded Interest Rule under Internal Revenue Code 2652(c)(2): The Catch-22 of Estate Planning for Large Estates

By Neal Nusholtz

A "catch 22" happens when the act of claiming something contradicts the truth of what is being claimed. The term comes from Joseph Heller's satirical novel about World War II, *Catch-22*. In his novel, an army psychologist explains to the main character, John Yossarian, that if a pilot claims insanity as a reason to discontinue flying dangerous missions, the pilot is not insane because it is the rational request of a sane person. The psychologist calls the inconsistency a catch-22.

The Disregarded Interest Rule

Internal Revenue Code ("IRC") 2652(c)(2) contains a similar circular logic that applies when an estate planner deliberately includes a beneficial interest in a trust to prevent the 40% generation-skipping transfer ("GST") tax (40% at current rates). Deliberately including a beneficial interest to avoid the GST tax causes the beneficial interest to be disregarded. The code section states:

> (2) Certain interests disregarded.
>
> For purposes of paragraph (1), an interest which is used primarily to postpone or avoid any tax imposed by this chapter shall be disregarded.

The statute allows the Internal Revenue Service ("IRS") to apply the GST tax after it has disregarded a trust interest that effectively avoids the GST, that is, if the interest was used "primarily to avoid the tax." 26 CFR 26.2612(e)(2)(ii) defines primary purpose as "a significant purpose."[1]

The act of deliberately including an interest in a trust to avoid or postpone the generation-skipping tax provides a factual basis for that included interest to be disregarded. Thus, the statute creates a predicament for drafters of estate plans for large estates. It's like trying to jump over your own shadow.

The Breadth of IRC 2652(c)(2)

Along with other definitions in IRC 2652, the disregarded interest rule is part of definition of "an interest in property held in trust."[2] Prior to the Technical and Miscellaneous Revenue Act of 1988, the word "nominal" appeared in the first four words of IRC 2652(c)(2) and implied that only nominal interests would be disregarded.[3]

Congress removed the requirement that a disregarded interest be "nominal" in the Technical and Miscellaneous Revenue act of 1988 saying, "[t]he bill clarifies the rule of present law that disregards interests primarily used to postpone or avoid the generation-skipping transfer tax by removing any suggestion that the interest to be disregarded must be nominal and by providing that the rule applies if the primary purpose of the interest is to avoid any generation-skipping transfer tax."[4]

Taxable Terminations

On its face, IRC 2652(c)(2) looks like it could be used to knock out any beneficial interest that stands in the path of the government collecting a GST tax. No rulings or treatises address limits on the breadth of its application. The disregarded interest rule is a form over substance attack on adding interests to a trust in an effort to postpone or avoid GST taxable terminations. Taxable terminations are defined under IRC 2612(a)(1) as a termination of an interest in a trust (by death, lapse of time, release of power, or otherwise) unless:

> (A) Immediately afterward a non-skip person has an interest in the trust (a skip person is a person two or more generations below the transferor). [See IRC 2613]; or
>
> (B) At no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.

Adding non-skip persons to a trust will prevent

a taxable termination under paragraph A. Under the disregarded interest rule, that non-skip interest will be disregarded if a significant purpose for the creation of the interest is to postpone or avoid the tax.[5]

The Postponement Rule

The disregarded interest rule relates to the (obsolete) postponement rule. The postponement rule existed in prior Treas. Reg. 26.2613-2(b)(1) & (2).[6] The postponement rule applied when the deaths of two or more beneficiaries could cause multiple GST taxes in a single trust. To avoid multiple GST taxes to the same trust property, the postponement rule specified that a taxable termination occurs after the last death:

> (b) Time certain terminations deemed to occur — (1) Where two or more beneficiaries are assigned to same generation. If two or more younger generation beneficiaries of a trust with present interests or present powers are assigned to the same generation, the transfer constituting the termination with respect to each beneficiary shall be treated as occurring at the time when the last termination occurs, unless the separate share rules under §26. 2613-5 apply.
>
> (2) Successive interests. If a younger generation beneficiary's present interest or present power terminates and if a beneficiary assigned to the same generation as, or a higher generation than, such younger generation beneficiary has a present interest or present power immediately after the termination and such present interest or present power arose as a result of the termination, the transfer constituting the termination with respect to each beneficiary shall be treated as occurring at the time when the last termination occurs with respect to the younger generation beneficiary assigned to the same or higher generation.

Treas. Reg. 26.2613-1 continued on to say that the postponement rule will not apply if a remaining interest is "nominal." An interest would not be classified as nominal if the interest is classified as "substantial":

> (3) Nominal interest — (i) In general. If the rule under paragraph (b)(1) or (b)(2) of this section is utilized primarily for the postponement of the taxable termination, the taxable termination will occur at the time determined under paragraph (a) of this section, without regard to paragraph (b)(1) or (b)(2). Whether the rule under paragraph (b)(1) or (b)(2) is utilized primarily for the postponement of the taxable termination depends, under all the facts and circumstances, on the classification of the remaining beneficiary's interest or power as nominal. A taxable termination will not be postponed if the remaining beneficiary's present interest or present power is classified as nominal. Conversely, if the remaining beneficiary's present interest or present power is classified as substantial, the taxable termination will be postponed until the time that it terminates or is classified as nominal. If an interest or power is classified as nominal, the value of that interest or power will not reduce the value of the terminated interest or power and the termination of the nominal interest or power is not a taxable event.

Without the postponement rule, if a trust with only two beneficiaries had left income to a grandchild and then left income to a great grandchild, after the death of both of them, there would have been two 40 percent GST taxes on the entire trust. An application of the postponement rule would result in only one tax at the second death.

An example of a disregarded interest rule is provided in the Committee Report of the Technical and Miscellaneous Revenue Act of 1988:

> For example, if a transferor placed property in trust which is to pay income to a great grandchild for a relatively short period, then income to a grandchild for life, with remainder going back to a great grandchild, in order to avoid a second imposition of the generation-skipping transfer tax, the income interest of the great grandchild would be disregarded so that there would be a generation-skipping transfer tax at the death of the grandchild. That interest would be disregarded even though distributions to the great grandchild are taxable distributions.[7]

In 1981, the IRS issued proposed Treas. Reg. 26.2611-1 through 26. 2611-4.[8] The regulations addressed taxable terminations. The proposed regulations contained the postponement rule and a requirement that remaining interests in a trust be "substantial" to have the postponement rule apply. The preamble to the proposed regulations provided:

> The proposed regulation under §26.2613-2 defines the term "taxable termination" and sets forth the rules that result in the postponement of a taxable termination. In addition, the proposed regulation provides, in part, that the postponement rules will not apply unless the remaining beneficiary's interest or power is substantial.

The Multiple Skips Rule

The need for a postponement rule to avoid taxation of multiple taxable terminations was eliminated by a "multiple skips" rule in IRC 2653, enacted in the Tax Reform Act of 1986.[9] According to that rule, after a GST, the transferor for determining skip generations would be deemed to be the "generation immediately above the highest generation of any person holding an interest in the trust immediately after the transfer." To illustrate, if a trust has a grandchild and a great grandchild as beneficiaries, after a taxable generation skipping transfer, the original transferor will be treated as being one generation above the grandchild (see example 1, Treas. Reg. 26.2653-1(b)(1)). Treas. Reg. 26.2653-1(a) states:

> (a) General rule.—If property is held in trust immediately after a GST, solely for purposes of determining whether future events involve a skip person, the transferor is thereafter deemed to occupy the generation immediately above the highest generation of any person holding an interest in the trust immediately after the transfer. If no person holds an interest in the trust immediately after the GST, the transferor is treated as occupying the generation above the highest generation of any person in existence at the time of the GST who then occupies the highest generation level of any person who may subsequently hold an interest in the trust. See § 26.2612-1(e) for rules determining when a person has an interest in property held in trust.

The disregarded interest rule was intended to apply to postponement rule situations where one or more insubstantial non-skip interests had been added to a trust to avoid a tax from generation-skipping transfers. Because of the multiple skips rule, the disregarded interest rule no longer serves a purpose. Nevertheless, its language extends to all interests, nominal, substantial, insignificant or otherwise, as long as the purpose is to avoid or postpone the GST tax. That can make GST drafting unpredictable.

The Disregarded Interest Rule Meets the Delaware Tax Trap

Consider the estate plan of a married couple having $40 million in assets with three children and five grandchildren. Upon their joint deaths, their estate plan leaves the maximum to grandchildren without a GST tax ($24.12 million in 2022). The balance is left in trust with income to their daughter Jane. On Jane's death, the remainder is distributed to the remaining children or their surviving issue per stirpes. If one of Jane's siblings predecease her with surviving children, the distribution to those grandchildren will be subject to the 40 percent GST tax.[10]

One way to avoid the GST tax on Jane's death is if the distribution to grandchildren is part of her estate. Under Treas. Reg. 26.2652-1(a), if the trust is part of Jane's estate, Jane would be the transferor for GST purposes. If so, her nieces or nephews would not be a taxable skip generation. That regulation states:

> (a) Transferor defined—(1) In general. Except as otherwise provided in paragraph (a)(3) of this section, 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.

Under the regulation, if the property going to grandchildren is included in Jane's estate, there would be no GST tax because her nieces and

nephews are not two generations below Jane. But Jane's family would probably protest including her parent's trust in her estate because including $16 million would put her over the exemption and cause her deceased estate to pay estate taxes on everything in her estate.

What we would like to do is to allow Jane to selectively decide whether to include a distribution to a particular niece and nephew in her estate—if it turns out that doing so doesn't cost her estate anything in the way of taxes on her estate. That's where the Delaware Tax Trap[11] comes in handy.

Under IRC 2041(a)(3), if Jane has the option of leaving her nieces or nephews a power of withdrawal[12] instead of a distribution from the trust, and she leaves them a power of withdrawal, that will cause the amount going to the niece or nephew to be included in her estate, thereby avoiding the GST tax. Jane would only do that if her estate was small enough, compared to the estate tax exemption, so as not to incur an estate tax on the amount going to a particular niece or nephew. The problem is, by leaving a niece or nephew a power of withdrawal, Jane has created an interest that is "used primarily to avoid" the GST tax; and the question is, would it be disregarded under IRC 2562(c)(2)?

Three arguments can be made that the creation of a power of withdrawal by Jane should not be a disregarded interest under IRC 2652(c)(2). The first is that the disregarded interest rule should have no application outside of the (obsolete) postponement rule. A broad application of the rule will wreak havoc in the area of estate planning for large estates. The list of possibly affected interests is limited only by your imagination and would include independent trustees, trust protectors, and trust directors.

Secondly, a power of withdrawal of at least 5 percent of the value of the trust property was classified as "substantial" in proposed Treas. Reg. 26.2613-2(b)(3)(ii)[13] and, consequently, a power of withdrawal is not a disregarded interest regarding the postponement rule:

> If a beneficiary possesses the right to withdraw or receive income or corpus (or both), the present value of which at the time of the termination is at least 5 percent of the value of the trust, then the beneficiary's interest is substantial. Proposed Treas. Reg. 26.2613-2(b)(3)(ii).

Thirdly and lastly, in December 1995, the IRS issued proposed Treas. Reg. 26.2652-1(a)(4),[14] which said taxpayers who trigger the Delaware Tax Trap are transferors for GST purposes. That proposed regulation did not include a requirement that the trap be triggered without an intention of avoiding or postponing a GST tax. The proposed regulation was removed in 1997 "to eliminate any uncertainty" and because that section of the proposed regulation could cause a GST tax "when it may not otherwise have applied."[15]

Conclusion

Bottom line, it doesn't hurt to give a life estate beneficiary the ability to leave powers of withdrawal to a selected group of remainder beneficiaries (a group that cannot include the life estate beneficiary, his or her estate, or his or her creditors or the creditors of his or her estate), and it might help.

Notes

1. Treas. Reg. 26.2612(e)(2)(ii). Certain interests disregarded. — An interest which is used primarily to postpone or avoid the GST tax is disregarded for purposes of chapter 13. An interest is considered as used primarily to postpone or avoid the GST tax if a significant purpose for the creation of the interest is to postpone or avoid the tax.

2. IRC 2652(c)(1) In General— A person has an interest in property held in trust if (at the time the determination is made) such person—

(A)—has a right (other than a future right) to receive income or corpus from the trust,

(B)—is a permissible current recipient of income or corpus from the trust and is not described in section 2055(a), or

is described in section 2055(a) and the trust is—

(i)—a charitable remainder annuity trust,

(ii)—a charitable remainder unitrust within the mean-

(iii)—a pooled income fund within the meaning of section 642(c)(5)

ing of section 664, or

(iii)—a pooled income fund within the meaning of section 642(c)(5)

(2) Certain Interests Disregarded — For purposes of paragraph (1), an interest which is used primarily to postpone or avoid any tax imposed by this chapter shall be disregarded.

3. The old law (IRC 2652(c)(2)) said:

Certain nominal interests disregarded—For purposes of paragraph (1), an interest which is used primarily to postpone or avoid the tax imposed by this chapter shall be disregarded.

4. Committee Reports—H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 351 (1998).

5. *See* n 1.

6. 1981-1 CB 718-19.

7. *See* n. 4.

8, Notice of Proposed Rulemaking LR 205-76, 1981-1 CB 713, Jan 1, 1981.

9. IRC 2653(a) (1) If there is a generation-skipping transfer of any property, and (2) immediately after such transfer such property is held in trust, for purposes of applying this chapter (other than section 2651) to subsequent transfers from the portion of such trust attributable to such property, the trust will be treated as if the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the transfer.

10. The predeceased parent rule under IRC 2651(e) only applies to parents who are deceased at the time of the transfer – not parents who become deceased between the time of the transfer and the date of distribution.

11. *See* IRC 2041(a)(3).

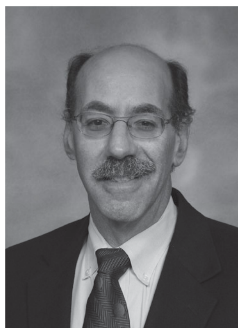
12. MCL 700.7103(f).

13. *See* n. 6.

14. *See* n. 9, Prop. Treas. Reg. 26.2652-1(a)(4):

(4) Exercise of certain nongeneral powers of appointment. The exercise of a power of appointment that is not a general power of appointment (as defined in section 2041(b)) is treated as a transfer subject to Federal estate or gift tax by the holder of the power if the power is exercised in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any specified life in being at the date of creation of the trust plus a period of 21 years plus, if necessary, a reasonable period of gestation (perpetuities period). For purposes of this paragraph (a)(4), the exercise of a power of appointment that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date of creation of the trust) is not an exercise that may extend beyond the perpetuities period.

15. *See* Treasury Decision 8720. May 20, 1997.



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