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Related Parties and the Need to Bridge the Gap Between Income Tax and Transfer Tax Systems

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RELATED PARTIES AND THE NEED TO BRIDGE THE GAP BETWEEN THE INCOME TAX AND TRANSFER TAX SYSTEMS

Jay A. Soled*
Mitchell Gans**

Related parties can readily manipulate transactions in ways that unfairly reduce their tax burdens relative to unrelated taxpayers. In the income tax arena, Congress has instituted numerous legislative measures to safeguard the tax base from related-taxpayer manipulations; yet, the same developed system of related-party safeguards does not extend to protect the transfer tax base. This analysis points out that this disparity has had a corrosive effect on the integrity of the transfer tax system. Indeed, insofar as the treatment of related parties is concerned, Congress should employ the same level of scrutiny and circumspection in the realm of transfer taxes as it does in the income tax. Reform of the transfer tax system is accordingly in order.

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I. INTRODUCTION

The Internal Revenue Code (Code) views related-party transactions with great skepticism. The reason is obvious: related parties can easily manipulate transactions to produce tax-favorable outcomes.¹ Congress has accordingly instituted numerous safeguards, prevalent throughout the Code, to protect against such related-party manipulation.² These safeguards are manifest in statutes that involve property valuation,³ ownership arrangements,⁴ and sales transactions.⁵

1. See, e.g., *Dorzback v. Collison*, 195 F.2d 69, 71 (3d Cir. 1952) (“We have not overlooked the principle that transactions between husband and wife calculated to reallocate family income or reduce family taxes are subject to careful scrutiny.”); *Cuyuna Realty Co. v. United States*, 382 F.2d 298, 300–01 (Ct. Cl. 1967) (“Claim to a debt relationship in a parent-subsidiary transaction merits particular scrutiny because the control element suggests the opportunity to contrive a fictional debt, an opportunity less present in an arms-length transaction between strangers.”); *Diesel Country Truck Stop, Inc. v. Comm’r*, 2000 T.C.M. (RIA) 1759, 1774 (1990) (“[T]ransactions between related parties are subject to close scrutiny.”); *Maxwell v. Comm’r*, 95 T.C. 107, 117 (1990) (“In determining whether the form of a transaction between closely related parties has substance, we should compare their actions with what would have occurred if the transaction had occurred between parties who were dealing at arm’s length.”); *United Builders Supply Inc. v. United States*, 41 A.F.T.R. 2d (RIA) 654, 659 (S.D. Miss. 1978) (“In cases of close relationship between the lessor and the lessee, . . . the Courts have always ruled that close scrutiny of the situation is appropriate in determining whether some part of the amounts designated as rentals and taken as a business expense deduction for income tax purposes were in fact disguised distribution of profits or dividends.”); *Hatt v. Comm’r*, 38 T.C.M. (P-H) 1293, 1304 (1969), *aff’d per curiam*, 457 F.2d 499 (7th Cir. 1972) (“The facts that Hatt was the president and majority stockholder of Johann necessitate careful scrutiny of the [employment] arrangement . . .”).

2. For an exhaustive overview of related-party, attribution, and constructive ownership rules, see Karen B. Brown, *The Attribution Rules*, 554-3d Tax Mgmt. (BNA) (2009). Excellent articles on how taxpayer relatedness bears upon tax outcomes include the following: Glenn E. Coven, *The Affinity Provisions of the Internal Revenue Code: A Case Study in Nonsimplification*, 45 TENN. L. REV. 557 (1978); Thomas J. Reilly, *An Approach to the Simplification and Standardization of the Concepts “The Family,” “Related Parties,” “Control,” and “Attribution of Ownership,”* 15 TAX L. REV. 253 (1960); Fred M. Ringel, Stanley S. Surrey & William C. Warren, *Attribution of Stock Ownership in the Internal Revenue Code*, 72 HARV. L. REV. 209 (1958).

3. See, e.g., I.R.C. § 482 (2006) (requiring that the purchase price of property sold between related parties be set at fair market value).

4. See, e.g., *id.* § 302(c) (for purposes of determining whether a corporation’s purchase of its

In the income tax sphere, these safeguards have done a remarkable job of protecting the income tax base. In the sphere of the gift, estate, and generation-skipping transfer taxes (collectively, transfer taxes), however, the safeguards designed to protect against taxpayer manipulation are far less effective. Evidence for this latter proposition abounds. By strategically capitalizing upon their relatedness, taxpayers can readily utilize valuation techniques,⁶ exploit ownership arrangements,⁷ and engage in sales transactions⁸ in fashions that systematically erode the transfer tax base. To date, legislative measures designed to halt or defeat taxpayers' transfer tax-saving strategies involving related-party transactions have met with mixed success.⁹

Since related-party transactions, such as those between a parent and a child, are part and parcel of the transfer tax regime, the regime's integrity is at risk of being compromised. Congress must accordingly institute reforms. This is not uncharted territory, however; Congress can employ compliance tactics similar to those it has instituted in the income tax arena to curb taxpayer transfer tax manipulations. Such compliance tactics include instituting mandatory attribution rules,¹⁰ recasting gratuitous transfers to conform to their underlying economic substance,¹¹ and having oversight mechanisms in place to monitor and ensure taxpayer compliance.¹² Adoption of such compliance tactics, in the form of legislation, will make transfer tax compliance far less voluntary in nature.¹³

own stock shares constitutes a distribution or a redemption, requiring the attribution of related parties' stock ownership to the taxpayer's direct stock ownership).

5. See, e.g., *id.* § 267(a)(1) (disallowing losses, if any, associated with property sales to a related party).

6. See *infra* Part III.A.

7. See *infra* Part III.B.

8. See *infra* Part III.C.

9. See, e.g., James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415 (1995) (pointing out how taxpayers can strategically discount the value of property interests they transfer); Wendy C. Gerzog, *Valuation Discounting Techniques: Terms Gone Awry*, 61 TAX LAW. 775 (2008) (reaching the same conclusion). Cf. Louis S. Harrison, *Using a Multi-Class Corporation to Achieve Estate and Gift Tax Savings: Does It Work After Chapter 14?*, 44 SYRACUSE L. REV. 1153 (1993) (claiming that congressional passage of Chapter 14 effectively closed down or significantly limited the use of at least one estate planning technique).

10. See *infra* Part IV.A.

11. See *infra* Part IV.B.

12. See *infra* Part IV.C.

13. See generally George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977) (explaining how through various transfer tax strategies taxpayers can minimize their transfer tax burdens); Jeffrey S. Kinsler, *A Comparative Proposal to Reform the United States Gift Tax Annual Exclusion*, 30 VAND. J. TRANSNAT'L L. 949, 952 (1997) ("United States citizens are not required to pay estate and gift taxes! In fact, the only people who should pay such taxes are those wishing to donate money to the U.S. government."); J.D. Trout & Shahid A. Buttar, *Resurrecting "Death Taxes": Inheritance, Redistribution, and the Science of Happiness*, 16 J.L. & POL. 765, 818 (2000) (estimating the effective estate tax rate to be 5%). Cf. Paul L. Caron & James R. Repetti, *The Estate Tax Non-Gap: Why Repeal a "Voluntary" Tax?*, 20 STAN. L. & POL'Y REV. 153, 169 (2009) ("[T]he evidence shows that the estate tax is clearly not voluntary today . . ."); James R. Repetti, *The Case for the Estate and Gift Tax*, 86 TAX NOTES 1493 (2000) (arguing

In Part II of this analysis, we summarize the safeguards that Congress has instituted to curb related-party manipulations pertaining to taxpayers' income tax obligations. In Part III, we explore how related parties circumvent their transfer tax obligations. In Part IV, we propose reforms, modeled after the income tax compliance tactics, to help preserve the integrity of the transfer tax base. In Part V, we offer our conclusions.

II. RELATED-PARTY TRANSACTIONS AND THE INCOME TAX

One of the main challenges of the tax system is to accurately measure income. Many commentators have attempted to define the term *income*,¹⁴ but perhaps the most prominent definition is the one offered by tax scholar Henry Simons, namely, *income* is "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."¹⁵ Once the amount of income earned by a taxpayer is measured, then the appropriate tax rate can be applied.

Measuring the amount of taxable income that a taxpayer earns is sometimes fraught with challenges.¹⁶ One challenge, however, that is particularly nettlesome is the fact that related taxpayers can conspire with one another to disguise income and minimize their tax burdens. For example, if left unchecked, taxpayers might use alter egos such as their spouses, children, and controlled entities (e.g., corporations, partnerships, estates, and trusts) to achieve tax-favorable outcomes,¹⁷ particularly if such tactics

that the transfer tax system is far less "voluntary" than some commentators contend).

14. See generally Richard Goode, *The Economic Definition of Income*, in COMPREHENSIVE INCOME TAXATION 1 (J. Pechman ed., 1977) (offering an economic definition of the term *income*); Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081 (1980) (advocating a social product theory of the term *income*); Stanley A. Koppelman, *Personal Deductions Under an Ideal Income Tax*, 43 TAX L. REV. 679 (1988) (defining the term *income* based upon individual welfare); Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45 (1990) (describing how the term *income* should be defined by principles of equity); JB McCombs, *An Historical Review and Analysis of Early United States Tax Policy Scholarship: Definition of Income and Progressive Rates*, 64 ST. JOHN'S L. REV. 471 (1990) (offering a historical overview of several definitions of the term *income* and the role that such definitions have played in shaping tax legislation).

15. HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

16. See, e.g., William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972) (discussing the difficulties of determining the nature of those personal deductions that the Code should permit to be deductible); see also Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 STAN. L. REV. 831 (1979) (same).

17. See George C. Koutouras et al., *Related Party Transactions*, 564 Tax Mgmt. (BNA), A-1 (2005) ("Taxpayers, through transactions with related parties or controlled entities, could technically realign their property ownership while effectively retaining the benefits and burdens of the same property. For example, a husband could realize a loss upon the sale of property to his wife, but the benefits and burdens of ownership would remain within the family unit.")

involved no downside risk to their alter egos and if the employment of such tactics came entirely at the government's expense.¹⁸

To avoid the subversion of the tax base, Congress has had to institute a series of laws designed to keep related-party transactions in check. While these laws come in a variety of forms, they generally adhere to the following statutory pattern: first, the Code sets forth a definition of what constitutes relatedness for the particular tax issue at hand; and second, the specific tax implications associated with this relatedness are then elaborated. In Subparts A, B, and C that follow, we outline how this statutory pattern operates and its effectiveness in preserving the income tax base.

A. *The Meaning of Relatedness and Its Variations Under the Code*

There are numerous Code sections designed to bring related taxpayers' transactions into conformity with their economic substance.¹⁹ A first step in this conforming process is to examine the relationship between parties engaged in the particular transaction. If the relationship is such that (1) the two parties are apt to act collaboratively, (2) one party can control the other party, or (3) one party and the other party are each other's alter egos, the Code generally denies arm's-length tax treatment to their transactions.

1. *Collaboration*

The Code typically defines taxpayers who are apt to act collaboratively as "[m]embers of a family."²⁰ Depending on the applicable Code section, the phrase *members of a family* is defined differently. In some cases, for example, it includes "his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. . . ."²¹ In other cases, it includes "his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and . . . his children, grandchildren, and parents."²² Each of these definitions sets forth the parameters of those relationships that the Code considers close in kinship; indeed, the taxpayers who fall within the ambit of

18. See 81 CONG. REC. 9019 (1937) (noting that in related-party transactions between individuals and entities, "[t]he evidence submitted to the joint committee disclosed that a considerable loss of revenue was resulting from the artificial taking and establishment of losses where property was shuffled back and forth between various legal entities owned by the same persons or person. These transactions seem to occur at moments remarkably opportune to the real party in interest in reducing his tax liability but at the same time allowing him to keep substantial control of the assets being traded or exchanged.")

19. See Koutouras, *supra* note 17.

20. I.R.C. § 267(b)(1) (2006).

21. *Id.* § 267(c)(4).

22. *Id.* § 318(a)(1)(A)(i)–(ii).

these definitions are deemed to act in concert, generally precluding any opportunity for the related taxpayers to prove to the contrary.²³

2. Control

There are also those situations when one party can dictate another party's actions. When these circumstances exist, the Code presumes that the controlling party will always exploit this relationship to its tax advantage. There is no universal definition of the term *control* in the Code; instead, its definition is contextual. For one purpose, the term *control* may mean "[a]n individual and a corporation *more than 50 percent* in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual. . . ."²⁴ In another instance, the term *control* may mean "[i]f *50 percent or more* in value of the stock in a corporation is owned, directly or indirectly, by or for any person. . . ."²⁵

3. Alter Ego

Aside from collusion and control, the Code sometimes equates two taxpayers to be one another's alter ego. Take, for instance, grantor trusts and single-member limited liability companies (LLCs). While these entities may each have their own employer identification numbers and keep their own separate set of books and records,²⁶ the Code denies the separate existence of these entities,²⁷ deeming these entities to be the alter egos of the grantor or member, as the case may be. For income tax purposes, the existence of these entities is completely ignored, and taxpayer transactions with these entities are accordingly disregarded.²⁸

23. See Lawrence Stern, *Attribution Rules' Effect on Stock Redemptions When Family Hostility Exists*, 38 Sw. L.J. 887 (1984) (discussing the role family discord plays in applying the stock attribution rules).

24. I.R.C. § 267(b)(2) (emphasis added).

25. *Id.* § 318(a)(2)(C) (emphasis added).

26. See, e.g., I.R.S. Notice 99-6, 1999-3 I.R.B. 12 (permitting a disregarded limited liability company (LLC) to separately calculate, report, and pay its employment tax obligation with respect to its employees under its own name and employer identification number).

27. See Treas. Reg. § 301.7701-3(b)(1) (for a single-member LLC that does not choose its tax classification, the default classification for all federal tax purposes is that of an entity disregarded as an entity separate from its owner); Treas. Reg. § 301.7701-2(a) (if a single-member LLC is disregarded, "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner").

28. Compare *Rothstein v. United States*, 735 F.2d 704, 709 (2d Cir. 1984) (recognizing a sale between a taxpayer and a grantor trust), with Rev. Rul. 85-13, 1985-1 C.B. 184 (ruling that a grantor trust cannot be regarded as a separate entity capable of entering into a transaction with a taxpayer). In general, commentators have agreed that the IRS position, rather than the Second Circuit decision, is better aligned with the language and purpose of the grantor trust rules. HOWARD M. ZARITSKY & NORMAN M. LANE, *FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS* ¶ 7.03[2] (2d ed. 1993); Mark L. Ascher, *When to Ignore Grantor Trusts: The Precedents, a Proposal, and a Prediction*, 41 TAX L. REV. 253, 279 n.132 (1986).

In sum, Congress recognizes that circumspection is warranted when a related taxpayer can readily collude, control, or pose as another taxpayer. In such instances, Congress employs heightened scrutiny and, depending upon circumstances, models tax outcomes to be in accordance with the underlying economic substance of these arrangements. Subpart B elaborates this recasting process.

B. Tax Consequences Stemming from Related-Party Transactions

Having identified those parties that it considers related, the Code next reconfigures transactions to match their economic substance. The tax consequences that result from this reconfiguring process are distinguishable from those that befall taxpayers conducting transactions at arm's length.

To illustrate this point, consider the following example: Suppose Mother owns one hundred shares of Google stock that she purchased several years ago for \$600 per share, and suppose further that Google currently trades at \$400 per share. If Mother were to sell her one hundred Google shares to Daughter for \$40,000, Mother would realize a \$20,000 loss (\$60,000 original cost basis less \$40,000 amount realized). If Mother and Daughter were unrelated, this loss would be allowed.²⁹ However, the Code labels Mother and Daughter as being related.³⁰ That being the case, the Code disallows Mother's loss in its entirety.³¹ Why? Via her relationship with Daughter, Mother is deemed to have retained a sufficient ownership interest in the Google stock being sold such that allowing a current loss is not considered appropriate.

Under the Code, the loss disallowance provision illustrated in the prior paragraph is not unique. To the contrary, subtitle A of the Code, which frames the entirety of the income tax, is replete with examples of this sort, namely, the curtailment or elimination of tax benefits that might otherwise arise with respect to related-party transactions. In general, related-party transactions are (1) ignored, (2) taxed more heavily, or (3) recast.

1. Related-Party Transactions That the Code Ignores

In some cases, the Code requires that related-party transactions (as defined) be ignored. There are many such examples of this practice, includ-

29. I.R.C. § 165(c) (2006).

30. *Id.* § 267(b)(1).

31. *Id.* § 267(a)(1). If Daughter subsequently sells the Google stock at a gain, such gain is only recognized to the extent that it exceeds Mother's prior disallowed loss. *Id.* § 267(d). Therefore, if Daughter later sold the one hundred Google shares for \$70,000, she would only have to recognize \$10,000 (\$70,000 less \$60,000 (\$40,000 cost basis plus the \$20,000 disallowed loss)).

ing related-party transactions that result in losses and that are between spouses and disregarded entities: (1) in the prior example, Daughter steps into Mother's shoes and, for purposes of computing future gains, is accorded Mother's tax basis in the Google stock;³² (2) if Spouse *A* sells property to Spouse *B*, Spouse *B* obtains Spouse *A*'s tax basis in such property;³³ and (3) if Taxpayer *X* sells property to a grantor trust in which she is deemed the owner, the trust obtains a carryover basis in the acquired assets.³⁴ When the application of any of the foregoing rules is triggered, for income tax purposes, the transaction is essentially considered a non-event.³⁵

2. Related-Party Transactions That the Code Taxes More Heavily

The Code considers some transactions between related parties to be potentially corrosive in nature. That being the case, upon the occurrence of such related-party transactions, a greater tax burden arises than if unrelated taxpayers had engaged in the very same transaction. To illustrate,³⁶ suppose Taxpayer *A* owns an asset with a five-year class life, having a \$2,000 adjusted tax basis, which is used exclusively in Taxpayer *A*'s trade or business. Taxpayer *A* sells this asset for its \$6,000 fair market value to Taxpayer *A*'s wholly owned company in return for a six-year, \$1,000-per-year installment note (plus market-rate interest). If Taxpayer *A* and the buyer were unrelated, Taxpayer *A* could report the entire \$4,000 of capital gains income over the term of the installment note;³⁷ meanwhile, the business that purchased the asset would be able to depreciate the purchased asset over the course of the next five years and obtain ordinary income tax deductions of \$6,000.³⁸ Given the relationship between Taxpayer *A* and his controlled company, however, the Code deems the foregoing outcome to be too taxpayer favorable (i.e., essentially the same taxpayer (Taxpayer *A* and his wholly owned company) is simultaneously securing the application of preferential capital gains rates and ordinary income tax deductions). Code § 1239 consequently requires Taxpayer *A* to report all the recognized income as ordinary rather than as capital gains.³⁹ Numerous other Code sections subscribe to the same principle, imposing a greater tax bur-

32. *Id.* § 267(d).

33. *Id.* § 1041(b)(2).

34. Rev. Rul. 85-13, *supra* note 28.

35. *See, e.g.*, I.R.C. § 707(b)(1) (disallowing a partner's losses associated with the sales or exchanges of properties to controlled partnerships).

36. This fact pattern is modeled after the fact pattern set forth in footnote 1 of *United States v. Parker*, 376 F.2d 402, 404 n.1 (5th Cir. 1967).

37. I.R.C. § 453(a)-(b).

38. *Id.* § 168(a).

39. *Id.* § 1239(a).

den on identical transactions undertaken by related parties relative to those undertaken by unrelated taxpayers.⁴⁰

3. *Related-Party Transactions That the Code Recasts*

Finally, the Code recasts some related-party transactions to align such transactions more closely with their economic substance. Consider the following situation: A company redeems twenty-five shares of stock from Taxpayer X, who owns 50% of a company's outstanding stock. Consider further that the other 50% shareholder, Taxpayer Y, is the taxpayer's spouse. Upon redemption of Taxpayer X's shares, Taxpayer X will own only 33.33% of the company's outstanding stock. As a practical reality, however, Taxpayer X, through his spouse's stock ownership, will remain in effective control of the company. As evidenced by the stock attribution rules found in Code § 318,⁴¹ the Code comprehends the reality of Taxpayer X's retained control. Accordingly, the Code recasts the putative redemption⁴² (which usually results in preferential capital gains income) as a distribution⁴³ (which usually results in dividend income, historically taxed at ordinary income tax rates).⁴⁴ This recasting process involving related-taxpayer transactions is another commonplace phenomenon under the Code.⁴⁵

C. *Compliance Tactics That Emerge*

In the income tax arena, there are several important compliance tactics that emerge from congressional dealings with related-party transactions. Consider that from its inception in 1913, the Code has grown in complexity.⁴⁶ Undoubtedly, part of the Code's complexity is attributable to an ever-increasing global economy.⁴⁷ Another factor directly bearing on the

40. See, e.g., *id.* §§ 453(d), (e) (denying the benefit of installment reporting in the context of certain related party sales).

41. *Id.* § 302(c)(1).

42. *Id.* § 302(b).

43. *Id.* § 302(d).

44. See Katherine Pratt, *Deficits and the Dividend Tax Cut: Tax Policy as the Handmaiden of Budget Policy*, 41 GA. L. REV. 503, 509–10 (2007) (“Until 2003, investors paid tax on both interest and dividends at ordinary income rates.”).

45. See, e.g., I.R.C. § 482 (the sales price of transactions between related parties are recast to be at arm's length); *id.* § 304 (a sale of stock from one controlled company to another controlled company is generally recast as distribution from the so-called acquiring company to the so-called issuing company).

46. See generally Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645 (2003) (pointing out the reasons why the Code has grown in complexity); Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673 (1969) (same).

47. See STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION

Code's complexity, however, has been an increased congressional recognition that related-party transactions have the potential to be anathema to the Code and its integrity.⁴⁸ Accordingly, over the ensuing decades, Congress has devoted an increasing number of Code sections to meet the challenges posed by related taxpayers and the transactions that they undertake.

The Code sections pertaining to related-party transactions come in many forms and varieties. A large number define the meaning of *relatedness* for purposes of particular Code sections.⁴⁹ Others spell out the implications associated with related-party transactions.⁵⁰ Finally, another subset of Code sections is designed to monitor compliance involving related-party transactions.⁵¹ Together, in the sphere of the income tax, this network of rules compels compliance on the part of related taxpayers.

In the income tax realm, has Congress achieved its goal of preserving the tax base from related-party manipulations? While there is no empirical evidence that directly supports the proposition that the Code adequately safeguards against abusive related-taxpayer transactions, a thorough examination of practitioner journals such as *Journal of Taxation*, *Journal of Accountancy*, *CPA Journal*, and *Practical Tax Strategies* does not reveal article titles suggesting that related-party transactions are a viable means to achieve income tax savings. To the contrary, journals such as these typically issue warnings to practitioners to be wary not to run afoul of related-party transactional rules.⁵²

Over the past century, Congress has learned that, in terms of related-party transactions, a three-prong compliance strategy is necessary: relatedness must be defined, consequences associated with such relatedness must be spelled out, and a monitoring system of some sort must be put in place. This triadic approach has proven to be an effective tool in fostering

8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, 93-100 (Comm. Print 2001); PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 16 (2005), available at <http://www.taxpolicycenter.org/taxtopics/upload/tax-panel-2.pdf>. There is a wide range of estimates of how much this complexity costs taxpayers annually, ranging from \$87 billion, see John L. Guyton, Adam K. Korobow, Peter S. Lee & Eric J. Toder, *The Effects of Tax Software and Paid Preparers on Compliance Costs*, 58 NAT'L TAX J. 439-41 (2005), to \$265 billion per year, see J. SCOTT MOODY, WENDY P. WARCHOLIK & SCOTT A. HODGE, *THE RISING COST OF COMPLYING WITH THE FEDERAL INCOME TAX* 9 (2005), available at <http://www.taxfoundation.org/files/sr138.pdf>.

48. See, e.g., 81 CONG. REC. 9019 (1937).

49. See *supra* Part II.A.

50. See *supra* Part II.B.

51. See, e.g., I.R.C. § 6038(a)(4) (2006) (requiring owners of "controlled foreign corporation[s]" to file annual information returns); Treas. Reg. § 1.707-3(c)(2) (1992) (requiring disclosure when a partnership transfers money or property to a partner within two years of a transfer of property by the partner to the partnership and the partner, for tax purposes, has treated the transfer as other than a sale).

52. See, e.g., Terrence Floyd Cuff, *Teruya Brothers and Related-Party Exchanges—How Much More Do We Know Now?*, 102 J. TAX'N 220, 228 (2005) ("In the interim, tax magicians who use related-party exchange to make gain disappear should be careful. The tax benefits of those related-party exchanges may disappear on audit as quickly as the magician's vanishing elephant.").

taxpayer compliance and preserving the income tax base. As the next part of our analysis elaborates, when it comes to ensuring the integrity of the transfer tax system, Congress should utilize the same compliance strategy.

III. RELATED-PARTY TRANSACTIONS AND TRANSFER TAXES

Evident from the prior discussion is that whenever and wherever possible to reduce their tax burdens, taxpayers are motivated to exploit their relatedness. In the sphere of the income tax, at almost every turn, Congress has instituted measures to counteract this phenomenon. In the transfer tax area, however, the same cannot be said; instead, attempts to protect against related parties colluding with one another are either nonexistent or halfhearted in nature.

In the transfer tax realm, Congress's lackluster efforts to account for taxpayer relatedness make little sense. By way of background, transfer taxes generally place a levy on the amount of wealth passing from one taxpayer to another taxpayer.⁵³ The Code places this levy on the taxpayer giving wealth,⁵⁴ not on the taxpayer receiving the wealth.⁵⁵ Despite this asymmetrical nature of transfer taxes, both the giving and receiving taxpayers share the same transfer tax-minimization agenda. Taxpayers giving wealth want to minimize their transfer tax costs so that more wealth is thereby available for them to retain or give away at a future time. Similarly, taxpayers receiving wealth want to minimize the transfer tax costs so that more wealth is available for them to receive in the future. Both the giving and receiving taxpayers will therefore seek to exploit their relatedness, using any and all possible means to achieve their common goal.

In the Subparts that follow, we analyze the mechanics of how several transfer-tax-saving devices operate, the viability of which are all predicated on the ability to exploit taxpayer relatedness. We divide our analysis into three categories: (A) the purposeful (yet temporary) diminishment of property value, (B) transfers into trust and the retention of indirect property control, and (C) sales of property between related parties.

53. See, e.g., Richard Schmalbeck, *Does the Death Tax Deserve the Death Penalty? An Overview of the Major Arguments for Repeal of Federal Wealth-Transfer Taxes*, 48 CLEV. ST. L. REV. 749, 749 (2000) ("In its current form, the federal estate tax imposes a transfer tax on the passage of assets from an estate to the decedent's heirs and beneficiaries. . . ."); Edward A. Zelinsky, *Transfer Taxation Without Transfer: Reflections on Employer-Provided Death Benefits, Section 2039, Disclaimers, New Forms of Wealth, and the Evolution of the Federal Estate Tax*, 58 TUL. L. REV. 974, 1028 (1984) ("Since the avowed purpose of federal estate taxation was to levy a tax on the transmission of wealth to each generation. . . .").

54. I.R.C. §§ 2001, 2501 (2006).

55. *Id.* § 102(a).

A. The Purposeful (yet Temporary) Diminishment of Property Value

The transfer tax system taxes the value of property that is either gifted or bequeathed.⁵⁶ The Code, however, does not define the word *value*. The applicable transfer tax regulations, however, define the phrase *fair market value* as follows: "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."⁵⁷

This definition anticipates a willing buyer and a willing seller who will each negotiate at arm's length, each operating to secure his own objectives (i.e., the seller wants to command the highest price possible, and the buyer wants to secure the lowest price possible). But application of this test to related parties is inherently flawed: it ignores the identity of the donee and his relationship to the donor.⁵⁸ Put differently, relationships may exist between the donor and donee that cause each party to act in a manner that is collaborative rather than self-interested, the latter of which is key to the successful application of the willing buyer-willing seller test. Furthermore, before, during, and after a transaction, the parties retain their relatedness, facilitating their abilities to act strategically in ways to promote their own interests at the government's expense. These flaws enable related parties to strategically arrange their affairs to diminish (at least on a temporary basis)⁵⁹ the fair market value of their properties and recoup such value at a later time.⁶⁰

The most common technique that taxpayers employ to achieve this end is the purposeful fragmentation of property.⁶¹ This technique is predicated on the rationale that the holder of a noncontrolling interest in an entity must contend with potentially recalcitrant co-owners and the harrowing

56. *Id.* §§ 2512, 2031.

57. Treas. Reg. § 20.2031-1(b); *see also id.* § 25.2512-1.

58. See Rev. Rul. 93-12, 1993-1 C.B. 202 (sanctioning taxpayers' ability to value each gift in isolation of other gifts made, whether or not such gifts are made to members of the same family).

59. See Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241, 255 n.54 (1988) ("Of course, in many of these cases, the economic loss attributable to the creation of minority interests is probably illusory, or else the transaction would not have been undertaken in the first place.").

60. See, e.g., Ronald H. Jensen, *The Magic of Disappearing Wealth Revisited: Using Family Limited Partnerships to Reduce Estate and Gift Tax*, 1 PITTSBURGH TAX REV. 155 (2004); Repetti, *supra* note 9, at 431-44; Mary Louise Fellows & William H. Painter, *Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 STAN. L. REV. 895 (1978); Gerzog, *supra*, note 9, at 776-81 (2008); Mitchell M. Gans, *Deference and Family Limited Partnerships: A Case Study*, in HECKERLING INST. ON EST. PLAN. ¶ 500 (Tina Portuondo ed., 2005).

61. For example, when fractional interests in real estate are gifted, a valuation discount applies to such fractionalized interest. *Estate of Whitehead v. Comm'r*, 33 T.C.M. (CCH) 253 (1974); *Propstra v. United States*, 680 F.2d 1248, 1253 (9th Cir. 1982); *Estate of Pillsbury v. Comm'r*, 64 T.C.M. (CCH) 284 (1992).

prospect of a self-interested majority owner.⁶² As a result, there is what is commonly known as a minority discount associated with transferring a noncontrolling interest in property or a business enterprise.⁶³ The amount of this valuation discount can be significant. When combined with the lack-of-marketability discount, the total discount is often in the 30% to 50% range.⁶⁴ Similar discounts, although generally of lesser magnitude, may also apply in the case of an interest in property that does not involve an entity.⁶⁵

Consider an example that demonstrates the application of a discount. Suppose a widow, *W*, owns all one hundred outstanding shares of Company *X*, which owns a piece of rental real estate worth \$1 million. On January 1, 2011, suppose that *W* gifts forty-nine shares of Company *X* to her son, *S*. In terms of valuing the forty-nine shares of Company *X* stock, application of the willing buyer–willing seller test is in order; under the test, valuation of the gifted stock interest will entail a discount. Assuming that *W* is entitled to a 40% discount, the forty-nine Company *X* shares will enjoy a gifted fair market value of \$294,000 (\$490,000 – (\$490,000 x .40)).

But gifts such as the one described above are not ordinarily one-time events. More specifically, *W* presumably gave the Company *X* shares to *S* with the expectation of giving *S* more such stock in the future by way of gift or bequest. Assuming that this presumption is correct, consider its

62. The discount for a minority interest accounts for the inability of a shareholder to control or influence decisions in a closely held corporation. See *Ward v. Comm'r*, 87 T.C. 78, 106 (1986) (“The courts have long recognized that the shares of stock of a corporation which represent a minority interest are usually worth less than a proportionate share of the value of the assets of the corporation. . . . The minority discount is recognized because the holder of a minority interest lacks control over corporate policy, cannot direct the payment of dividends, and cannot compel a liquidation of corporate assets.”); *Estate of Stevens v. Comm'r*, T.C.M. (RIA) 2000 053, 2000 301 (2000) (“The owners here are all family members, but it cannot be assumed that a family will always act as a unit in matters regarding the property.”); see also *Estate of Newhouse v. Comm'r*, 94 T.C. 193, 251–52 (1990) (“Control means that, because of the interest owned, the shareholder can unilaterally direct corporate action, select management, decide the amount of distribution, rearrange the corporation’s capital structure, and decide whether to liquidate, merge, or sell assets.”); Douglas K. Moll, *Shareholder Oppression and “Fair Value”: Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, 54 DUKE L.J. 293, 303 (2004) (“Thus, when a close corporation investor is treated unfairly, he ‘cannot escape the unfairness simply by selling out at a fair price.’”).

63. See, e.g., William S. Blatt, *Minority Discounts, Fair Market Value, and the Culture of Estate Taxation*, 52 TAX L. REV. 225, 225 (1997) (“In valuing blocks of corporate stock, courts often permit a minority discount—a reduction in value that reflects the difficulty of selling shares lacking corporate control.”).

64. Brant J. Hellwig, *Revisiting Byrum*, 23 VA. TAX REV. 275, 278–79 (2003). For an exhaustive and excellent summary of the discounts that courts have permitted taxpayers, see generally Louis Mezzullo, *Valuation of Corporate Stock*, 831-3d TAX MGMT. EST. GIFTS & TR. J. (BNA), at worksheet 1 (2007) (in a detailed chart, the author delineates for each case the minority discount, marketability discount, unspecified or combined discount, and the control premium, if any).

65. See, e.g., Anna C. Fowler, *Valuation of Undivided Interests in Realty: When Do the Parts Sum to Less than the Whole?*, 13 J. REAL EST. TAX’N 123 (1985) (discussing discounts applicable to fractional interests in real estate).

implications. Suppose that on January 1, 2015, *W* gifts *S* another two shares of Company *X* stock, and suppose further that the value of Company *X*'s property (namely, its rental real estate) has remained constant at \$1 million. Because the value of these shares would give *S* control of the company, no minority discount would be appropriate, and the value of the two shares would thus be reported at \$20,000 ($2\% \times \1 million).⁶⁶ When *W* subsequently dies, say on January 1, 2020, her estate would own the remaining forty-nine shares of Company *X* stock. As such, the block of Company *X* shares owned by *W*'s estate would constitute a minority interest and, for estate tax-reporting purposes, be valued at \$294,000 ($\$490,000 - (\$490,000 \times .40)$).⁶⁷ Assuming that *W*'s will bequeaths these shares to *S*, he will own all one hundred shares of Company *X* stock worth \$1 million (assuming, again, that the value of the underlying rental real estate of Company *X* has remained unchanged). For transfer tax-reporting purposes, however, the aggregate value of these three transfers (occurring January 1 in 2011, 2015, and 2020) was reported to be only \$608,000 ($\$294,000$ (2010 transfer) + $\$20,000$ (2015 transfer) + $\$294,000$ (2020 transfer)). Due to the apparent blind application of the willing buyer-willing seller test, \$392,000 ($\$1,000,000 - \$608,000$) of value embedded in Company *X* stock simply disappeared from the transfer tax base.

There are many permutations of the fractionalization technique just illustrated in the prior paragraph. *W* instead could have gifted twenty-five shares of Company *X* to each of her four children.⁶⁸ Were that the case, due to the application of discounts, each cache of twenty-five shares would be valued at \$150,000 ($\$250,000 - (\$250,000 \times .40)$), enabling the four gifts to be subject to transfer tax on \$600,000 ($4 \times \$150,000$) rather than \$1 million. At a later date, *W*'s four children, looking to maximize the value of each Company *X* stock interest, could join forces and sell such stock, likely commanding an aggregate \$1 million sales price.

66. At least one commentator has argued that such a block may be entitled to a premium. Jeffrey N. Pennell, *Valuation Discord: An Exegesis of Wealth Transfer Tax Valuation Theory and Practice*, 30 HECKERLING INST. ON EST. PLAN. ¶ 905.2 (1996). Cf. *Estate of Winkler v. Comm'r*, 57 T.C.M. (CCH) 373 (1989) (swing vote may be entitled to a minority discount, albeit smaller in magnitude than that accorded other minority interest shares); *Estate of Simplot v. Comm'r*, 249 F.3d 1191 (9th Cir. 2001) (refusing to take into account the proclivities of a particular purchaser in determining value under the hypothetical-purchaser model, which would suggest that a wing-vote position does not create additional value).

67. See, e.g., *Estate of Lee v. Comm'r*, 69 T.C. 860, 873-76 (1978) (a minority discount applied to a decedent's 40% stock interest in a company that was bequeathed to his spouse who already owned a 40% stock interest in the same company).

68. Treas. Reg. § 25.2512-2(e) (1976) (stating that gifted stock is to be valued "with reference to each separate gift" (emphasis added)); see also *Estate of Heppenstall v. Comm'r*, 8 T.C.M. (CCH) 136, 143 (1949) (block gifts of corporate shares must be valued independently of one another); I.R.S. Tech. Adv. Mem. 94-49-001 (Mar. 11, 1994) (contemporaneous gifts made to eleven donees of all the stock of a company should be valued on a gift-by-gift basis in isolation of the other gifts being made).

Over the years, taxpayers and their advisers have become astute in valuation techniques and manipulation of the willing buyer–willing seller test to their advantage.⁶⁹ Indeed, courses on the topic of valuation discounts abound, predominating the continuing estate planning education lecture circuit.⁷⁰ Furthermore, over the last decade, by far the most litigated transfer tax issue has been determining the fair market value of assets and the outermost boundaries of valuation discounts.⁷¹ While courts sometimes question whether such valuation discounting is permissible,⁷² the vast majority of courts instead question the amount of the permissible discounting.⁷³

Oblivious to the issue of taxpayer relatedness,⁷⁴ the willing buyer–willing seller test is subject to tremendous academic scorn and ridicule.⁷⁵

69. Espen Robak, *Recent Cases Suggest How to Maximize the Marketability Discount*, 31 EST. PLAN. 605 (2004); Edward D. Brown, *Maximizing Minority Discounts for Limited Partnerships in an Integrated Estate Plan*, 93 J. TAX'N 306 (2000); Howard M. Esterces, *Make Best Tax Use of FLPs and LLCs in Estate Planning*, 73 PRAC. TAX STRATEGIES 260 (2004); Larry W. Gibbs, *A Family Limited Partnership as the Centerpiece of an Estate Plan*, 131 TR. & EST. 52 (1992); see also Michael D. Mulligan & Angela F. Braly, *Family Limited Partnerships Can Create Discounts*, 21 EST. PLAN. 195 (1994).

70. Jeffrey N. Pennell, *It's Not Your Father's Buick, Anymore: Estate Planning for the Next Generation(s) of Clients*, SP053 ALI-ABA 1429 (2009); Gayle Evans, *Valuation Planning*, SP062 ALI-ABA 97 (2009); S. Stacy Eastland, *Family Limited Partnerships: Current Status and New Opportunities*, SP040 ALI-ABA 1017 (2009); David Pratt, *Update on Use of Family Limited Partnerships and Discount Planning*, SP037 ALI-ABA 399 (2009); Jonathan C. Lurie & Edwin G. Schuck, Jr., *Valuation*, SN070 ALI-ABA 231 (2008).

71. See Dennis L. Belcher & Mary Louise Fellows, *Report on Reform of Federal Wealth Transfer Taxes, Task Force on Federal Wealth Transfer Taxes*, 58 TAX LAW. 93, 203–17 (2004) (explaining how related taxpayers are apt to exploit the valuation process to minimize their transfer tax burden).

72. In extremely abusive situations, courts have disallowed discounting. See, e.g., *Griffin v. United States*, 42 F. Supp. 2d 700, 707 (W.D. Tex. 1998) (“the plaintiffs engaged in a clever and sophisticated scheme by which [the wife] was merely the intermediary through which the stock passed on its way to the ultimate beneficiary, the Trust” and, when viewed from this vantage point, precluded discount application); *Estate of Murphy v. Comm’r*, 60 T.C.M. (CCH) 645 (1990) (minority discount was held not applicable to stock of a closely held business even though the decedent, at the time of her death, owned slightly less than 50% of stock at her death; the court based its conclusion on the fact that the decedent transferred a 1.76% interest to her children eighteen days before her death with the sole intention of reducing the estate tax associated with her ownership). But see, e.g., *Estate of Frank v. Comm’r*, 69 T.C.M. (CCH) 2255 (1995) (permitting discounts in similar circumstances). Other courts have disallowed valuation discounts in those situations when the decedent had a retained interest in such transferred property and held such property includable in the decedent’s gross estate under Code § 2036. See, e.g., *Estate of Thompson v. Comm’r*, 382 F.3d 367, 382–83 (3d Cir. 2004) (taxpayer had retained sufficient indicia of control over transferred partnership property, resulting in its inclusion in the taxpayer’s gross estate); *Strangi v. Comm’r*, 417 F.3d 468, 475–78 (5th Cir. 2005) (same). For a complete synopsis of the current state of the law regarding the issue of estate inclusion, see Brant J. Hellwig, *On Discounted Partnership Interests and Adequate Consideration*, 28 VA. TAX REV. 531 (2009).

73. See Mezzullo, *supra* note 64 (outlining various percentage discounts that courts attribute to minority ownership interests).

74. The hypothetical buyer and seller are presumed to be unrelated to one another. *Ward v. Comm’r*, 87 T.C. 78, 108 (1986); *Estate of Andrews v. Comm’r*, 79 T.C. 938, 955–56 (1982); *Propstra v. United States*, 680 F.2d 1248, 1251–52 (9th Cir. 1982); *Minahan v. Comm’r*, 88 T.C. 492, 499 (1987).

75. See Gerzog, *supra* note 9.

Giving and receiving taxpayers both know that property fractionalization is a mere means to an end, namely, value maximization in the hands of receiving taxpayers. Property fractionalization is thus viewed as a mere “wrapper” that is easily unwrapped at a later time, outside of the view of the powerless IRS.⁷⁶

B. Transfers into Trust and the Retention of Indirect Property Control

For transfer tax purposes, even though the decedent did not have direct ownership rights at death, gross estate inclusion is nonetheless required if the decedent had retained access to or control over the transferred property.⁷⁷ For example, § 2036(a)(2) requires estate tax inclusion if a taxpayer makes a transfer and retains “the right . . . to designate the persons who shall possess or enjoy the property or the income therefrom.”⁷⁸ This kind of post-transfer control is deemed sufficient to treat the estate as if the decedent had retained outright ownership.

But the Code’s analytic framework, focused entirely upon control by the taxpayer (and no one else), is too narrow in scope, producing outcomes that cannot be reconciled. A case that epitomizes this point is an *inter vivos* trust where one’s spouse is appointed the trustee. Logic and reason, bolstered by statutory precedent,⁷⁹ would suggest that if a taxpayer grants his spouse rights over certain property, he is, by extension, essentially retaining these same rights for himself.⁸⁰

Consider the following illustration. Suppose a taxpayer establishes a trust for the benefit of his three daughters, naming his wife as trustee. Suppose further that each year the taxpayer makes contributions to the trust that qualify for the gift tax annual exclusion (currently \$13,000 per beneficiary).⁸¹ Finally, suppose that the taxpayer’s spouse is accorded un-

76. In abusive situations, particularly when a limited partnership is formed shortly before death, the IRS often chooses to ignore the limited partnership wrapper. *See, e.g.*, I.R.S. Tech. Adv. Mem. 97-19-006 (May 9, 1997) (two days before death, in an attempt to capitalize upon discounting techniques, the decedent formed a limited partnership; under such circumstances, the IRS held that valuation discounts were inappropriate); I.R.S. Tech. Adv. Mem. 97-23-009 (June 6, 1997) (same).

77. Of course, if a taxpayer directly owns title to a piece of property, the value of such property is included in the taxpayer’s estate. I.R.C. § 2033 (2006).

78. *Id.* § 2036(a)(2).

79. *See, e.g., id.* § 1041(a) (transfers between spouses are disregarded), § 672(c)(1) (for purposes of applying the grantor trust rules, defining *spouse* as a “related party”).

80. *See, e.g., White v. Fitzpatrick*, 193 F.2d 398, 400-01 (2d Cir. 1952) (even though husband gifted title to intellectual and real property to his wife, husband’s “informal retention of administrative control” negated the tax effects associated with such transfer). *See generally* Lloyd G. Soll, *Intra-Family Assignments: Attribution and Realization of Income*, 6 TAX L. REV. 435 (1951).

81. *See Crummey v. Comm’r*, 397 F.2d 82, 86 (9th Cir. 1968) (concluding that contributions to a trust qualify for the annual gift tax exclusion if trust beneficiaries have a present withdrawal right). For critiques of the annual exclusion and how taxpayers circumvent its application, see generally Bradley E.S. Fogel, *Back to the Future Interest: The Origin and Questionable Legal Basis of the Use of Crummey Withdrawal Powers to Obtain the Federal Gift Tax Annual Exclusion*, 6 FLA. TAX REV. 187 (2003); Walter D. Schwidetzky, *Estate Planning: Hyperlexis and the Annual Exclusion Rule*, 32

bridled discretion to distribute trust income and principal to the trust beneficiaries as she sees fit. If the taxpayer had created the same trust and appointed himself as trustee, his attempt to exclude the trust assets from his estate would have proven fruitless.⁸² Upon his demise—due to his ability to control beneficial enjoyment of the trust assets—the Code would have required estate tax inclusion in his estate of the then full fair market value of the trust assets.⁸³ With his wife at the helm of the trust, however, the same estate tax treatment is not accorded his estate under the Code. Instead, despite the taxpayer's apparent ability to still exercise control over the contributed trust assets, admittedly indirectly through his wife, no estate tax inclusion would result.⁸⁴

Often, the absence of estate tax imposition on trust contributions is justified based on the same transfer tax outcome being accorded outright gifts. Theoretically, in cases of outright gifts made to related parties, the

SUFFOLK U. L. REV. 211 (1998); and Robert B. Smith, *Should We Give Away the Annual Exclusion?*, 1 FLA. TAX REV. 361 (1993).

82. See, e.g., *United States v. O'Malley*, 383 U.S. 627, 634 (1966) (holding that a settlor's power to cause a trust to accumulate trust income results in estate tax inclusion).

83. See I.R.C. § 2036(a)(2) (2006).

84. See generally *id.* §§ 2036–38 (none require estate tax inclusion of assets owned by trust on the basis that the taxpayer's spouse is named as trustee).

The illustration posited in the text is not unique insofar as intrafamily transfers are concerned. Consider the fact that the Uniform Transfer to Minors Act (U.T.M.A.) is drafted to enable a person creating a custodial account to name herself as custodian without triggering the application of § 2036(a)(1). See UNIF. TRANSFER TO MINORS ACT § 14(c) (1983) (providing that the custodian may not use custodial assets to discharge the custodian's support obligation). While knowledgeable practitioners appreciate this legislative safeguard in the U.T.M.A., they recognize that it nevertheless does not avoid estate tax inclusion under § 2036(a)(2) or § 2038. See, e.g., Rev. Rul. 59-357, 1959-2 C.B. 212 (requiring estate tax inclusion if the donor appoints himself as custodian and the donor dies prior to the beneficiary attaining age twenty-one). To avoid the application of these estate-tax-inclusion sections, practitioners thus recommend that someone other than the donor be designated as custodian. Advised accordingly, a donor might designate her spouse as custodian and thereby avoid inclusion. Treating these two situations differently—inclusion where the donor is named custodian and no inclusion where the donor's spouse is named the custodian—lacks any theoretical justification.

Consider another commonplace scenario. A settlor can establish a trust for the benefit of his spouse with income payable for her lifetime. Because the settlor and the settlor's spouse are considered each other's alter egos under the Code's grantor trust rules—I.R.C. § 677(a)(1)—for income tax purposes, the trust entity would be ignored, resulting in its income being reportable on the settlor's individual income tax return. For estate tax purposes, however, this trust would be respected as a separate taxpayer not giving rise to estate tax inclusion, notwithstanding the fact that the settlor retained an income stream indirectly through his spouse. *But see McCabe's Estate v. United States*, 475 F.2d 1142 (Cl. Ct. 1973) (including such a trust in the grantor's gross estate based on the face that distributions were in fact made to the grantor). Estate tax inclusion, however, would result if the trust called for support payments to the spouse and, as a result, payments to the spouse discharged the settlor's support obligation. See, e.g., *Estate of Lee v. Comm'r*, 33 T.C. 1064 (1960); *but see Estate of Mitchell v. Comm'r*, 55 T.C. 576 (1970), acq. 1971-2 C.B. 3 (holding no estate tax inclusion even though the grantor's son was the trustee and had the discretion to use trust assets to discharge the grantor's support obligation of the grantor's spouse). The discontinuity of the grantor trust rules and the estate-tax-inclusion rules lacks any theoretical justification. See Robert T. Danforth, *The Tax Consequences of Gratuitous Bargain Sales*, 29 Tax Mgmt. Est., Gifts, & Tr. J. (BNA) 115, 115 (2004) (explaining how Congress should harmonize the grantor trust rules and the estate-tax-inclusion rules).

taxpayer still retains indirect control over the transferred property; and administratively, upon the taxpayer's demise, this indirect control could cause the then fair market value of such gifted property to be includable in the taxpayer's gross estate. To illustrate, suppose Mother gifts White Acre outright in fee simple to Son and suppose further that under the Code, Mother and Son are deemed related parties. The implication of being related is that Mother could exert influence over Son, particularly with respect to property that Mother gifted. Employing this logic, even after such property is transferred to Son, Mother could be deemed to have retained an interest in White Acre. Upon Mother's subsequent demise, § 2036(a)(2) could be amended to require the inclusion of White Acre's then fair market value in Mother's gross estate.

For two reasons, the estate-tax-inclusion outcome produced by the example in the prior paragraph is untenable. First, in instances of outright gifts, the related party's control (i.e., Son in the prior example) over such gifted property is so absolute in nature that it dwarfs whatever indirect control the taxpayer (i.e., Mother in the prior example) can exercise over such property. For example, a recipient of a gratuitous transfer such as the Son is at complete liberty to expend, gift, or even destroy such gifted property. Second, there is a practical constraint; in the recipient's hands, it is virtually impossible to trace the ongoing status of the gifted property. If the property gifted is cash, years after such transfer is made it would be a quixotic mission to determine if the donee expended the gifted cash on a vacation (resulting in the estate tax exclusion of such cash), purchased something of value such as jewelry (resulting in the estate tax inclusion of the purchased jewelry), or simply saved the cash (resulting in the estate tax inclusion of the original gift).⁸⁵

But important and consequential distinctions can be drawn between outright gifts and those made in trust controlled by related parties. The first important distinction is that the element of control is likely to be much more acute when property is held in trust. Consider the underlying nature of trust instruments: they are specially designed to conserve and

85. Were the retained-interest theory put into effect and prior outright gifts were subsequently included in the donor's gross estate, a valuation problem would loom. By way of background, an outright gift is taxable under the gift tax, I.R.C. § 2503(a), and for estate tax purposes is accounted for as an adjusted taxable gift, I.R.C. § 2001(b)(1)(B). However, there is a critical difference between the gift tax and estate tax regimes. In the case of the gift tax, the transferred asset is valued at the date of the gift, I.R.C. § 2512, whereas for estate tax purposes, valuation is generally determined at the date of death, I.R.C. § 2031(a). Were outright gifts subsequently includable in the decedent's gross estate, the transferred asset's appreciation from the date of transfer to the date of death would likewise be includable in the decedent's gross estate. Yet, if the donor truly relinquishes all control over the gifted asset at the time of transfer, she forfeits the opportunity to access or otherwise control the appreciation (as well as the underlying asset), making it inappropriate to use the date-of-death valuation that application of the estate tax generally requires.

maintain property over a specified time period.⁸⁶ During this specified time period, it is the fiduciary who ordinarily dictates beneficial enjoyment stemming from the trust property.⁸⁷ Therefore, if a related party is named as trustee, she controls beneficial enjoyment; and, by extension, so does the contributing taxpayer. Put differently, compared to the recipient of an outright gratuitous transfer, a trust beneficiary is not at liberty to expend, gift, or destroy the gifted property. Furthermore, trusts are specifically designed to keep trust property segregated from the trust beneficiary's other property.⁸⁸ This trust segregation characteristic eliminates the tracing problem associated with outright gifts (articulated in the prior paragraph). Upon the donor's demise, the property held in trust will be one or more of the following: the property specifically contributed into trust (i.e., White Acre in the prior example), its replacement property, or the income generated therefrom.

There is another item that sheds light on the fallacy of not expanding the purview of § 2036(a)(2) to include transfers made into trust when one or more related parties are designated fiduciaries. Under current law, if a settlor establishes a trust and reserves the right to remove and replace a trustee, possible inclusion can occur if the terms of the trust permit the settlor to choose as a successor a "[r]elated or subordinate party."⁸⁹ The assumption that underlies the estate-tax-inclusion outcome is that a trustee who is not independent is likely to be beholden to the settlor and adhere to

86. See RESTATEMENT (THIRD) OF TRUSTS § 2 (2001) ("A trust . . . is a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee.").

87. See AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATHCHER, SCOTT ON TRUSTS: THE LAW OF TRUSTS § 2.6 (4th ed. 1987) ("A trust is created only where the title to property is held by one person for the benefit of another.").

88. See JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 565-72 (5th ed. 1995).

89. The seminal estate tax case in this area of the law is *Estate of Wall v. Commissioner* which held that estate tax inclusion was not warranted merely because the decedent settlor could have replaced one corporate trustee with another corporate trustee; this potential ability to influence the trustee did not constitute a retained interest. 101 T.C. 300, 313 (1993). The seminal gift tax case in this area of the law is *Estate of Vak v. Commissioner*, which held that a settlor's power to change the trustees did not give the settlor control over the trust because the settlor could only replace the trustees with independent trustees that would not necessarily do his bidding. 973 F.2d 1409, 1414 (8th Cir. 1992).

Consider the fact that the Tax Court in *Wall* suggested that inclusion might be appropriate if there was evidence of a fraudulent side agreement between the settlor and the trustee. *Wall*, 101 T.C. at 313. This aspect of the decision is in direct conflict with *Byrum v. United States*, where the Supreme Court held that § 2036(a)(2) cannot apply unless the settlor had a legally enforceable right to control distributions. 408 U.S. 125, 151 (1972). Because, in the case of a side agreement referred to in *Wall*, the settlor does not retain a legally enforceable right to control distributions, inclusion should not result. Perhaps recognizing the questionable nature of the side-agreement passage in *Wall*, the Service did not adopt as a substantive principle the notion that such an enforceable agreement can produce inclusion. Instead, the Service adopted a safe harbor, under which it will not invoke the side-agreement argument if the instrument prohibits the settlor from removing the trustee and naming a subordinate or related party as a successor. See Rev. Rul. 95-58, 1995-2 C.B. 191

his wishes.⁹⁰ The settlor is deemed to have retained the right to designate beneficial enjoyment over the trust property, and this designation right runs afoul of § 2036(a)(2) and causes estate tax inclusion. By way of comparison, however, consider the outcome had the settlor, at the time of trust formation, selected a related party to serve as trustee (who would presumably also adhere to the settlor's wishes). In such a case, no estate tax inclusion of such trust property results. This difference in estate tax outcomes, which turns upon whether the related-party trustee was selected at trust inception or during its administration, seems virtually impossible to reconcile.

In sum, sometimes upon a transfer of property into trust when independent trustees are at the helm, the donor has severed all indicia of control over such property. Other times, however, the element of taxpayer control still lurks, particularly when one or more related parties (such as the donor's spouse) are nominated trustee and placed at the trust's helm. In the latter cases, this element of control should result in subsequent estate tax inclusion of such property in the donor's gross estate.⁹¹ This outcome is consistent with estate tax provisions requiring inclusion of that property over which the taxpayer can exercise indirect control.

C. Sales of Property Between Related Parties

By way of background, an arm's-length sale between two parties generally does not give rise to a transfer tax event.⁹² Conversely, a sale between related parties at a discount price usually constitutes a transfer tax event (e.g., if a father sells a \$100,000 condominium to his son for

90. See Rev. Rul. 95-58, *supra* note 89. Note that notwithstanding the fact that the IRS has crafted this safe harbor, courts have generally granted taxpayers more leeway in permitting a trust settlor to select successor trustees without the risk of estate tax inclusion. Compare *Byrum*, 408 U.S. at 148-49 (holding that a settlor's retention of the right to remove a trustee and replace the trustee with someone other than himself does not result in estate tax inclusion), with *United States v. O'Malley*, 383 U.S. 627, 634 (1966) (holding that because the settlor was a named trustee and the terms of the trust permitted the trust to accumulate or distribute income (i.e., control beneficial enjoyment), the trust property was includable in the settlor's gross estate).

91. See I.R.C. § 2036(a)(2) (2006). Under current law, a trust settlor can even name himself as trustee, and if the terms of the trust in question limit trust distributions to an ascertainable standard, no estate tax inclusion arises. See, e.g., Rev. Rul. 73-143, 1973-1 C.B. 407 (stating that where a settlor established a trust for the benefit of his two children, named himself as trustee, and the trust distributions were limited by an external standard ("support and education"), no estate tax inclusion resulted in the settlor's estate); *Jennings v. Smith*, 161 F.2d 74, 78 (2d Cir. 1947) (no inclusion where the settlor named himself trustee and retained the power to distribute, limited by the following standard: "in comfort and in accordance with the station in life to which [each beneficiary] belongs"). The administrative and case law outcomes just posited are nothing short of ludicrous; as a practical matter, it is evident that in these situations the trust settlor has retained tremendous latitude over the contributed trust property tantamount to control. Congress should accordingly consider revising §§ 2036(a)(2) and 2038 to require estate tax inclusion in such instances. See *infra* Part IV.

92. See, e.g., *Huber v. Comm'r*, 91 T.C.M. (CCH) 1132 (2006) (holding that stock was properly valued, and thus no gift tax was owed on its sale between related taxpayers).

\$75,000).⁹³ These latter so-called related-party bargain purchases (i.e., when the purchase price is less than the property's fair market value) are fertile grounds for IRS scrutiny and, in the minds of most conscientious estate planners, are not a viable estate planning technique.

But estate planners are a tenacious group, and if there exists a legitimate opportunity to exploit transactions between related parties, they will do so. Evidence for this proposition is manifest in the valuation process (*supra* Part III.A) and forms of property ownership (*supra* Part III.B). We now present evidence for this phenomenon in yet another form: related-party sales. These are sales that are specifically designed to avoid the transfer tax pitfalls of bargain sales yet secure significant transfer tax savings.

Before proceeding, some further background is in order. The income and transfer tax rules have historically not been "construed as though they were in *pari materia*" with each other.⁹⁴ In practical terms, what this denotes is that control may, for income tax purposes, mean one thing and, for transfer tax purposes, mean another. For the past several decades, taxpayers and their advisers have sought to capitalize on these differences,⁹⁵ a feat that has been made possible, in part, by the Code's failure in the transfer tax realm to fully account for taxpayer relatedness.

In the sales context, here is how taxpayers exploit their relatedness. In growing numbers, related taxpayers engage in a strategy known in the estate planning industry as a sale to an intentionally defective grantor trust.⁹⁶ The first step in this strategy is for the taxpayer to establish a trust. The terms of this trust must contain one or more provisions that make it a so-called grantor trust.⁹⁷ A grantor trust is ignored for income tax purposes (i.e., it is considered the grantor's alter ego) because the grantor, a related party, or both can exercise control over the trust property or its beneficial enjoyment.⁹⁸ Owing to its nature, the income and losses in-

93. See, e.g., *Dallas v. Comm'r*, 92 T.C.M. (CCH) 313 (2006) (holding that the taxpayer's bargain sale to trusts established for the benefit of his two sons was subject to gift tax on the difference between the amount paid for the stock transferred and its actual fair market value); see Danforth, *supra* note 84 (explaining the transfer tax consequences associated with such sales).

94. See, e.g., *Farid-Es-Sultaneh v. Comm'r*, 160 F.2d 812, 814-15 (2d Cir. 1947) ("the income tax provisions are not to be construed as though they were in *pari materia* with either the estate tax law or the gift tax statutes").

95. See generally John B. Huffaker & Edward Kessel, *How the Disconnect Between the Income and Estate Tax Rules Created Planning for Grantor Trusts*, 100 J. TAX'N 206 (2004) (explaining how estate planners capitalize upon differences between the income and estate tax rules).

96. See Michael D. Mulligan, *Power to Substitute in Grantor Does Not Cause Inclusion, with a Significant Caveat*, 109 J. TAX'N 32, 32 (2008) ("The 'intentionally defective irrevocable trust' (IDIT) has become an increasingly popular estate planning tool.").

97. See I.R.C. §§ 671-79 (2006) (statutory guidance of those trusts that qualify as being grantor in nature).

98. The seminal case in this area is *Helvering v. Clifford*, 309 U.S. 331 (1940). In *Clifford*, the taxpayer retained such indicia of control over the trust and its assets that the Supreme Court ruled that the trust could not be respected as an independent tax entity. *Id.* at 335 ("[T]he short duration of the

curred by a grantor trust are reported on the grantor's own income tax return (Form 1040) rather than on an income tax return for a trust (Form 1041).⁹⁹ For purposes of effectuating this estate-planning strategy, a properly drafted grantor trust must not contain any provision that results in the trust property being subsequently included in the grantor's gross estate.¹⁰⁰ The second step in this strategy entails the taxpayer contributing property to the trust. This contributed property is used as a down payment for an anticipated property purchase from the taxpayer.¹⁰¹ The third and final step of this strategy involves the taxpayer then selling property to the trust in return for a down payment (i.e., the initially contributed trust property) and the balance of the purchase price payable via an installment note.¹⁰²

While this multistep process appears somewhat complex (albeit, it is little more than a sale between a taxpayer and a self-created trust), estate planners and their clients have been richly rewarded for their efforts. Because the taxpayer is deemed to have sold property to himself, the sales event between the taxpayer and the grantor trust is deemed nontaxable in nature, making this whole arrangement a non-event for income tax purposes.¹⁰³ However, for transfer tax purposes, this arrangement proves to be a bonanza. First, with paying any gift tax, the taxpayer is able to "freeze" the value of the property being transferred into trust; any appreciation in the transferred property inures outside the taxpayer's gross estate.

trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by respondent all lead irresistibly to the conclusion that respondent continued to be the owner for purposes of § 22(a)."). Following the *Clifford* decision, the Treasury Department promulgated regulations that set forth the grantor trust rules. See Treas. Reg. 111, § 29.22(a)-21 (1946); Louis Eisenstein, *The Clifford Regulations and the Heavenly City of Legislative Intention*, 2 TAX L. REV. 327, 327 (1947).

99. See Treas. Reg. § 1.671-4(a)-(b) (as amended in 2006).

100. See Mulligan, *supra* note 96.

101. This contribution enables the trust to use money, aside from income, to fulfill its installment payment obligations. By way of contrast, if the trust only had the income it generated to fulfill its installment payment obligations, the IRS might rule that the trust is a grantor trust under § 677, possibly resulting in subsequent estate tax inclusion in the taxpayer's gross estate under § 2036. See, e.g., Rev. Rul. 68-183, 1968-1 C.B. 308 ("While, in form, [the] transaction purports to be a sale of [Company Y's] stock to a trust by the grantor, it is, in substance, . . . a contribution of [Company Y's] stock to the trust with a reservation by the grantor of annual payments of a fixed amount for life."). Compare Mitchell M. Gans & Jonathan G. Blattmachr, *Treatment of GRATs Under the Section 2036 Proposed Regulations—Questions Remain*, 107 J. TAX'N 143 (2007) (discussing the need for such a contribution or, in the alternative, a beneficiary's guarantee of the trust's obligation to the seller/settlor), with I.R.S. Priv. Ltr. Rul. 95-35-026 (May 31, 1995) (ruling—on facts pertaining to a sale to a defective grantor trust—that as long as the trust had sufficient assets of its own to meet its installment obligations, the transfer would not constitute a taxable gift).

102. What remains of critical importance is that the sales price must equal fair market value lest a taxable gift occur. See I.R.S. Priv. Ltr. Rul. 95-35-026 (May 31, 1995) ("[I]f the fair market value of the [asset] transferred to the [trust] equals the principal amount of the note, the sale of [the asset] to the [trust] will not result in a gift subject to gift tax.").

103. See Rev. Rul. 85-13, *supra* note 28 ("A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction."). Note that had the proposed sale transpired directly with the donee rather than to a grantor trust intended for donee's benefit, the donor would have clearly experienced a taxable event. I.R.C. § 1001(a).

Second, because of the grantor status of the trust, tax on the income earned by the trust is considered the taxpayer's obligation.¹⁰⁴ As such, the trust can continue to grow in value essentially on a tax-free basis. These two benefits produce magnificent transfer tax savings.¹⁰⁵

Consider the following example. Suppose that X establishes an irrevocable trust and suppose further that the terms of the trust provide X with a power of substitution (i.e., during the trust term, X can substitute title to property that he owns in his individual name for title to property of equivalent value owned by the trust). This substitution power will afford the trust grantor status.¹⁰⁶ Meanwhile, the terms of the grantor trust will provide that X will retain no power or hold no interest in the trust that would cause estate tax inclusion upon his demise.¹⁰⁷ Next, suppose X transfers \$100,000 of cash into the trust and then, a few weeks later, sells title to White Acre, which is worth \$1 million and generates \$100,000 of rental income annually, to the trust. Under the terms of the sale, the trust must make a \$100,000 down payment and then pay the \$900,000 unpaid balance in \$100,000 annual installments (representing a combination of principal and interest payments) over the next eleven years. Over the course of the next eleven years, the Code requires that X pay the income tax on the \$100,000 that the trust earns annually.

Employment of this sales strategy produces stunning transfer tax savings. When the installment note is finally paid off in Year 11, assume that the value of White Acre has appreciated to \$2 million. By making a \$100,000 taxable gift (X's initial cash contribution to the grantor trust), X is able to remove from his estate the entire return that White Acre generates in excess of the interest payments on the note owed to X. The Code's failure to account for the relatedness of the taxpayer to the grantor trust is a pivotal factor in permitting the success of this sales strategy.

Yet, even to a casual observer, the foregoing result is perverse. The Code appears to sanction the taxpayer engaging in a transaction with his alter ego (i.e., a grantor trust) thereby minimizing his overall transfer tax burden.¹⁰⁸ If the taxpayer engages in a transaction with himself, which is

104. See Rev. Rul. 2004-64, 2004-2 C.B. 9 (deciding that payment by the grantor of taxes on income earned by a grantor trust did not constitute a gift for federal gift tax purposes).

105. See generally Stephen R. Akers, Jonathan G. Blattmachr & F. Ladson Boyle, *Creating Intentional Grantor Trusts*, 44 REAL PROP. TR. & EST. L.J. 207 (2009) (summarizing the benefits of purposefully establishing grantor trusts to capture transfer tax savings).

106. See I.R.C. § 675(4)(C) (2006).

107. See Rev. Rul. 2008-22, 2008-16 I.R.B. 798 ("A grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate. . . .").

108. Other ways that taxpayers can freeze the value of property in their hands include making gifts and taxable sales. However, each of the foregoing freeze approaches involves a tax friction (in the case of a gift, the imposition of a gift tax; and in the case of a taxable sale, the imposition of an income tax). To be sure, the sale-to-trust technique does carry a gift tax risk: if the value of the sold

readily subject to manipulation,¹⁰⁹ the Code should not reward this action. Put differently, if the income tax rules have zero tolerance toward related-party transactions designed to subvert the income tax system, the transfer tax regime should adopt the same zero tolerance strategy unless there is a compelling reason to allow a contrary outcome.

Congressional attention to related-party concerns has largely focused upon the income tax domain. This article exposes the need for Congress to expand the Code's familiar related-party analytical framework to the transfer tax domain. In the next part, we will explore how Congress should expand related-party attribution rules in the transfer tax realm and the advantages associated with doing so.

IV. GRAFTING RELATED-PARTY CONCEPTS ONTO THE TRANSFER TAX SYSTEM

The transfer tax system has not divorced itself entirely from the recognition that related-party transactions warrant heightened scrutiny.¹¹⁰ For

asset is determined to be greater than the selling price, a taxable gift occurs. *See supra* note 93. Concern about this risk could be an effective deterrent, at least for some taxpayers. But even this risk has recently been undercut. In *Petter v. Commissioner*, 98 T.C.M. (CCH) 534 (2009), the Tax Court approved the use of a so-called value-definition clause. In the event that the value of the sold asset is determined to exceed the selling price, this clause directs that the excess pass to charity (qualifying for a gift tax deduction under § 2522), thereby eliminating any gift tax imposition. If such a clause is inserted in the terms of a sales document, on audit, the IRS has no incentive to raise the valuation issue.

In Rev. Rul. 86-41, 1986-1 C.B. 300, the Service concluded that a somewhat similar clause was invalid as a matter of public policy. *See also* *Ward v. Comm'r*, 87 T.C. 78 (1986) (adopting the same analysis). But the clause used in the revenue ruling and *Ward* differ from the clause in *Petter*. The clause in the ruling and in *Ward* both provided that the excess value should revert to the settlor, rather than charity (as provided in *Petter*). In short, the court in *Petter* may have been more receptive to the value-definition technique given the theoretical possibility that benefit would inure to charity. Nonetheless, to the extent the Tax Court was influenced by the presence of charity, the outcome is surprising. For, as a practical matter, charity is not likely to receive any benefit under such a clause. If the result in *Petter* is sustained, the IRS will have no incentive to raise valuation issues on audit, in which case charities will not receive any benefit (i.e., a charity can only receive a benefit if a court determines the value to be greater than the selling price). In any event, both Rev. Rul. 85-13, 1985-1 C.B. 185, which permits an income-tax-free sale to a grantor trust, and *Petter*, which eliminates gift tax risk, can—and should—be overruled by regulation. *See generally* Mitchell M. Gans & Jay A. Soled, *A New Model for Identifying Basis in Life Insurance Policies: Implementation and Deference*, 7 FLA. TAX REV. 569 (2006) (explaining the broad administrative latitude the IRS has to address problematic rulings and court decisions).

109. *See supra* note 2.

110. A case in point is the fact that courts generally assume that intrafamily transfers are gifts. *See, e.g.,* *Harwood v. Comm'r*, 82 T.C. 239, 258 (1984) ("Transactions within a family group are subject to special scrutiny, and the presumption is that a transfer between family members is a gift."), *aff'd*, 786 F.2d 1174 (9th Cir. 1986); *Frazee v. Comm'r*, 98 T.C. 554, 561 (1992) (citing to *Harwood* for the same proposition).

example, two transfer tax rules—one pertaining to the generation-skipping transfer tax¹¹¹ and the other to special valuation rules¹¹²—require that taxpayers account for their relatedness. As a result of these Code sections and several others,¹¹³ taxpayers confront curbs on their estate-planning liberties compared to taxpayers who are either more distantly related or not related at all. However, the existing body of law that pertains to taxpayer relatedness in the realm of transfer taxes is overly narrow in scope. Evidence for this narrowness is readily found in estate-planning devices cited earlier in this article that taxpayers have capitalized upon to exploit their relatedness.¹¹⁴

Due to the inadequacies of the status quo (where the transfer tax rules do not go far enough to address issues of taxpayer relatedness), this Article proposes the following: (A) for transfer tax purposes, the adoption of a broad and universal *related-party* definition; (B) the application of this definition to determine the transfer tax consequences associated with the valuation, control, and sales of property; and (C) the institution of a viable monitoring system that ensures taxpayer compliance.

A. *Adoption of a Universal Related-Party Definition*

In Part III, this article pointed out that related parties can be used as tools to achieve estate-planning objectives that taxpayers alone could not achieve. More specifically, in order to circumvent their underlying transfer tax obligations, taxpayers have been able to manipulate property values, retain indirect control over property, and engage in property transfers that masquerade as arm's-length transactions. Due to the absence of a universal *related-party* definition, employment of these devices has largely been carried out with impunity.

When it comes to the income tax, the Code offers numerous definitions of what constitutes relatedness.¹¹⁵ Each of these proffered definitions is contextual in nature, varying based upon the particular objective at hand.¹¹⁶ Aside from raising revenue, the transfer tax system strives to achieve many other objectives as well (e.g., eliminating wealth concentra-

111. See Treas. Reg. § 26.2632-1(c)(2)(i)(B) (as amended in 2005) (explaining that allocation of generation-skipping transfer tax exemption must be made after the estate-tax-inclusion period of the taxpayer's spouse).

112. See I.R.C. § 2702(a), (e) (2006).

113. See, e.g., *id.* § 2701(a)(1) (describing the transfer tax valuation implications associated with making transfers of certain interests in corporations and partnerships); see also Bridget J. Crawford, *The Profits and Penalties of Kinship: Conflicting Meanings of Family in Estate Tax Law*, 3 *PITT. TAX REV.* 1 (2005) (providing an excellent exposition on the meaning of the term *family* in the transfer tax context and considerations that Congress should keep in mind in refining the application of this term).

114. See *supra* Part III.

115. See *supra* Part II.A.

116. *Id.*

tions¹¹⁷ and making the tax system more progressive¹¹⁸). Despite its many objectives, for purposes of Code Chapters 11, 12, 13, and 14, which comprise the entirety of the transfer tax regime, one universal definition of *relatedness* should suffice, albeit apropos adjustments could be made on a section-by-section or case-by-case basis.

In crafting this *related-party* definition, Congress should consider the role that related parties have played and will continue to play if transfer tax transactions are left unchecked. This role is essentially that of a facilitator who will do whatever is necessary to help the taxpayer minimize his transfer tax burden. Why are related parties willing to go to virtually any length to assist the taxpayer? There are three answers to this question: loyalty, control, and financial gain. First, some related parties have a close blood relationship with the taxpayer (e.g., a child or grandchild); and as such, they are likely to be predisposed to adhere to the taxpayer's wishes. Second, other related parties are under the taxpayer's direct control (e.g., a wholly owned company) and, as such, adhere to the taxpayer's wishes. Finally, a related party and the taxpayer sometimes share a common financial goal and, as such, will act in a symbiotic fashion to minimize one another's tax burdens.

With this background in mind, the *related-party* definition should be expansive. The term *related party* should include any party who is apt to be loyal to the taxpayer, over whom the taxpayer can exercise control, or with whom the taxpayer shares a common financial destiny. Loyalty often stems from having common ancestry. Therefore, any *related-party* definition should include members of the taxpayer's family, including all of the taxpayer's decedents, ancestors, and siblings. Relative to the taxpayer, individuals within this family group are inclined to be faithful and reliable. Beyond loyalty, the *related-party* definition must account for issues of control; control is readily apparent with respect to any entity over which the taxpayer holds monopoly power (i.e., having a more than 50% interest therein). Finally, the *related-party* definition should include individuals/entities with whom the taxpayer's financial interests are coterminous (e.g., a single-member LLC or a grantor trust).

117. See, e.g., DUKEMINIER & JOHANSON, *supra* note 88, at 992 (describing the fact that the "levelling of great inherited fortunes" of wealth was one of the primary reasons propounded by the Roosevelt administration to maintain the estate tax); see also Repetti, *supra*, note 13, at 1494-1500 (reviewing all of the reasons that underlie estate tax imposition including raising revenue, preventing wealth concentrations and family dynasties, encouraging charitable giving, and making the income tax system more progressive); Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69, 87-99 (1990) (reviewing the reasons that underlie the institution of estate tax, including making the tax system more equitable and augmenting charitable giving).

118. See, e.g., Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259 (1993) (discussing how the estate tax serves to make the nation's overall tax structure more progressive).

In formulating the specifics of this *related-party* definition, Congress does not have to look far or start from scratch. To the contrary, Congress has considerable prior experience in defining the term *related party*; and therefore, it can easily use existing statutes as models, in particular the verbiage found in § 2704(c).¹¹⁹ This Code section broadly defines *control*,¹²⁰ *members of the family*,¹²¹ and *attribution*.¹²² Currently, under narrow circumstances, this Code section assists the IRS in the appropriate valuation of property.¹²³ Instead, Congress should make the application of the *related-party* definition universal throughout the transfer tax system.¹²⁴

B. Universal Application of the Related-Party Definition

In crafting the transfer tax consequences associated with related-party transactions, the congressional goal should be straightforward: to preserve the transfer tax base from erosion. To do so, the tax outcomes of related-party transactions should conform more accurately to their underlying economic substance.

A starting point to achieve this conformance objective would be for Congress to transform the willing buyer–willing seller test to take into account the relationship, if any, between transferors and transferees. Under current law, application of the willing buyer–willing seller test establishes property values based upon a fictional arm’s-length negotiation that would rarely, if ever, transpire between related parties.¹²⁵ Therefore, to produce a more accurate valuation process, Congress should modify its application to incorporate a three-step process:

- First, the Code should require the aggregation of the property interests held directly by the taxpayer and indirectly through related parties.
- Next, the willing buyer–willing seller test should apply to de-

119. Section 2704(c) appears to borrow heavily from one of the most expansive *related-party* definitions found in the Code, namely § 267(b), which is further amplified by § 267(c). Together §§ 267(b) and 267(c) frame the concept of taxpayer relatedness and capture notions of related-party loyalty, control, and mutuality of financial interests.

120. I.R.C. § 2704(c)(1) (2006).

121. *Id.* § 2704(c)(2).

122. *Id.* § 2704(c)(3).

123. *See generally id.* §§ 2701–04 (setting forth certain limitations on how related parties may value property).

124. Congress should also consider expanding the definition of *related parties* to include grantor trusts. In other words, a taxpayer and a grantor trust would be treated as one another’s alter ego (as is the case in the income tax system), resulting in estate tax inclusion of any asset held by a grantor trust. *See id.* § 2511 (2006) (making the gift tax outcome dependent upon grantor trust status). One possible exception to this proposed expansion would be with respect to so-called Mallinckrodt trusts, in which the trust beneficiary, rather than the taxpayer, controls all or a portion of the assets held in trust. *See id.* § 678(a) (2006).

125. *See supra* note 58.

termine the value of this amalgamated property interest (the taxpayer's interest combined with those interests held by the related parties).

- Finally, whatever percentage of the overall property enterprise that the taxpayer is transferring should then be multiplied against the value computed in the second step.

Adoption of this three-part test would account for the relationships between and among the parties and thereby produce a much more accurate value of the property being transferred. This result would better reflect the economic substance of the gratuitous transfer.¹²⁶

126. Admittedly, the foregoing proposal is not original. Several commentators and congressional committees have proffered similar proposals. See JOINT COMM. ON TAXATION, 110TH CONG., TAXATION OF WEALTH TRANSFERS WITHIN A FAMILY: A DISCUSSION OF SELECTED AREAS FOR POSSIBLE REFORM 40–45 (Comm. Print 2008); JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 2, 396–404 (Comm. Print 2005); H.R. REP. NO. 100-495, *reprinted in* 1987-3 C.B. 193, 275; 2 DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 386–88 (1984), *available at* [http://www.treasury.gov/resource-center/tax-policy/Documents/tres84v 2S-III.pdf](http://www.treasury.gov/resource-center/tax-policy/Documents/tres84v%20III.pdf); Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241, 254–57 (1988); Alan L. Feld, *The Implications of Minority Interest and Stock Restrictions in Valuing Closely-Held Shares*, 122 U. PA. L. REV. 934, 945–46 (1974); Mary Louise Fellows & William H. Painter, *Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 STAN. L. REV. 895, 924–25 (1978). To date, none of the foregoing proposals has gained legislative traction.

Another item to keep in mind is that the adoption of this proposed attribution rule would leave intact the discount associated with the lack of marketability. Courts have generally held marketability discounts appropos when the asset in question is not readily traded on established markets such as the New York Stock Exchange. See James Edward Harris, *Valuation of Closely Held Partnerships and Corporations: Recent Developments Concerning Minority Interest and Lack of Marketability Discounts*, 42 ARK. L. REV. 649, 656–660 (1989) (discussing the rationale underlying the marketability discount); *Lawson Mardon Wheaton, Inc. v. Smith*, 734 A.2d 738, 747 (N.J. 1999) (“A marketability discount adjusts for a lack of liquidity in one's interest in an entity, on the theory that there is a limited supply of potential buyers for stock in a closely-held corporation.”). Under current law, a marketability discount is permitted even in cases when a controlling interest is transferred. See *Estate of Curry v. United States*, 706 F.2d 1424, 1430–33 (7th Cir. 1983).

If the principle of marketability discounts is retained, Congress must consider how it will interact with the expanded related-party concept enumerated in our proposal. For example, a marketability discount could be denied where the donor and the donee together own a controlling interest, but under these circumstances, it appears inappropriate to deny a marketability discount. See *id.* There are two possible approaches to address this problem. First, a marketability discount could be determined by first aggregating all related party interests owned in the entity. Thus, if related parties own in the aggregate 80% of the outstanding stock of an entity, a transfer of, say, 10% of the stock might be valued—in terms of determining the marketability discount—as if 80% of the stock were the subject of the transfer. The underlying premise is that while marketability discount remains appropriate in the case of a controlling block, the size of the discount should diminish as the size of the ownership block increases. See *Estate of Trompeter v. Comm'r*, 87 T.C.M. (CCH) 851, *aff'd*, 170 F. App'x. 484 (2006). A second approach would be to deny marketability discounts as to those portions of an entity that own cash and marketable securities. To illustrate, consider cases in which a small portion of an entity's assets consists of an active business. In such cases, courts have permitted a marketability discount. See, e.g., *Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096 (2010) (finding that a family limited partnership qualified for the bona fide exception in § 2036 because approximately 15% of the assets required active management). A more straightforward approach could be accomplished by valuing an interest in the entity as if it consisted of both an active business and passive assets. Consis-

To illustrate, suppose Company *A* is worth \$1 million and its one hundred outstanding shares of stock are owned 80% by Jay and 20% by his daughter Kay. Suppose further that Jay wants to transfer twenty-five Company *A* shares to Kay. Under current law, the process of valuing the twenty-five Company *A* shares is conducted without taking into account the fact that Jay and Kay are father and daughter and, for gift-tax reporting purposes, most likely would result in a discounted share value.¹²⁷ Application of the proposed three-part valuation process set forth above, however, produces a different outcome. In practical terms, in determining the value of the twenty-five Company *A* shares being gifted, first Jay would have to aggregate his ownership interest with that of his daughter (80% plus 20%). The willing buyer-willing seller test would then apply to this 100% ownership interest, producing a \$1 million valuation. The overall stock percentage ownership that Jay is transferring (i.e., 25%) would then be multiplied against the value produced under the willing buyer-willing seller test (i.e., \$1 million). The \$250,000 valuation outcome is common sense; Jay would likely do whatever is necessary to preserve (rather than diminish) the value of his assets, particularly those assets being gifted to his beloved daughter.¹²⁸ Furthermore, on a going-forward basis, it's probable that Jay and Kay will work together as one in the handling of Company *A*'s business affairs.

When taxpayers establish *inter vivos* trusts and make contributions thereto, Congress should also account for the relationship, if any, that the taxpayer has to those serving as fiduciaries. In those cases in which the taxpayer and the fiduciary are related (as the term *related* is to be defined under the Code), it is apparent that in the vast majority of cases, the taxpayer is indirectly trying to retain control over the contributed trust property. Under these circumstances, the taxpayer would be deemed to have retained an interest in such trust assets, rendering such gifts incomplete.¹²⁹ If the taxpayer relinquishes this interest, the gift would be deemed complete;¹³⁰ alternatively, upon the taxpayer's death—because of the indirect

tent with this approach, a marketability discount could be allowed with respect to the entity's active-business component but denied in the case of the passive-asset component.

127. See *supra* Part II.A.

128. The adjective *beloved* is appropriate because a gift, by its nature, stems from an act of disinterested generosity. See *Comm'r v. LoBue*, 351 U.S. 243, 246 (1956) ("detached and disinterested generosity" motivates donors to make gratuitous transfers).

129. See *Treas. Reg.* § 25.2511-2(b) (1958) ("But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case.").

130. See *Treas. Reg.* § 25.2511-2(f) (as amended in 1983) ("The relinquishment or termination of a power to change the beneficiaries of transferred property, occurring otherwise than by the death of the donor (the statute being confined to transfers by living donors), is regarded as the event that completes the gift and causes the tax to apply.").

control that he has retained over the trust assets—the then fair market value of the trust assets would be includable in the taxpayer's estate.¹³¹

To illustrate, suppose Jay establishes a twenty-year trust for the benefit of his two daughters, Kay and May. Suppose further that the trustee is granted unbridled discretion to distribute income and principal to the trust beneficiaries. Were Jay to name himself as trustee, any trust contribution would be deemed to be an incomplete gift.¹³² During the trust term, if Jay relinquished his position as trustee, he would be deemed to have made a completed gift.¹³³ Alternatively, if Jay continued to serve as trustee until his demise, the fair market value of the trust assets would ultimately be included in his estate.¹³⁴ Under current law, to minimize his transfer tax exposure, Jay could name a related party, such as his spouse, Amy, to serve as trustee. However, under the proposed *related-party* definition, Jay and Amy would be considered related. Thus, were Amy named as trustee, Jay would be considered to have retained control over the trust property, resulting in an incomplete gift.¹³⁵ If Amy resigned or for any other reason whatsoever could not serve as trustee and was replaced by an independent trustee, Jay's gift would become complete.¹³⁶ Alternatively, if Amy continued to serve as trustee until Jay's death, the fair market value of the trust assets would then be included in Jay's gross estate.¹³⁷

Finally, for obvious reasons, transactions in which a taxpayer directly engages with himself or his alter ego are highly susceptible to manipulation. In the transfer tax realm, evidence for this proposition is best exemplified by taxpayers' use of grantor trusts as a transfer tax-savings device.¹³⁸ To eliminate possible abuses associated with grantor trust status, for both income and transfer tax purposes, Congress should treat all grantor trusts as within the taxpayer's control.¹³⁹ The presence of taxpayer control warrants deeming a gift being made relating to any and all trust contributions by the taxpayer or a person related to the taxpayer as incomplete.¹⁴⁰ Furthermore, either (i) during the taxpayer's lifetime, a gift should be deemed made if and when the grantor trust status terminates

131. I.R.C. § 2036(a)(2) (2006).

132. See Treas. Reg. § 25.2511-2(c) (1958) ("A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard.").

133. See *supra* note 130 and accompanying text.

134. See *supra* note 131 and accompanying text.

135. See *supra* note 132 and accompanying text.

136. See *supra* note 130 and accompanying text.

137. See *supra* note 131 and accompanying text.

138. See *supra* note 108 and accompanying text.

139. See *supra* note 124; see also Robert T. Danforth, *A Proposal for Integrating the Income and Transfer Taxation of Trusts*, 18 VA. TAX REV. 545 (1999) (proposing that Congress harmonize the tax treatment of trusts).

140. See *supra* note 129 and accompanying text.

(e.g., the trustee of such trust relinquishes the substitution-of-property power);¹⁴¹ or (ii) upon the taxpayer's demise, the trust assets should be included in the taxpayer's gross estate.¹⁴²

To illustrate, suppose Jay decides to sell appreciated property with an adjusted basis of \$100,000 and fair market value of \$1.1 million to a grantor trust. Under current law, the \$1 million gain (\$1.1 million less \$100,000) would not be taxed at the time of the sale. Upon Jay's demise, assuming the trust was properly drafted, such trust property would not be includable in Jay's gross estate.¹⁴³ Consider instead the consequences of treating Jay and the grantor trust as being related (i.e., its assets are deemed under Jay's control). The gain associated with the proposed sale would still not be taxed, and any contribution Jay made to the trust would be deemed incomplete.¹⁴⁴ If the trust subsequently relinquished or forfeited its grantor trust status, Jay would be deemed to have made a taxable gift of the trust assets.¹⁴⁵ Alternatively, if the status of the trust remained unchanged, the fair market value of the trust assets would be includable in Jay's gross estate upon Jay's demise.¹⁴⁶

Insofar as the tax consequences stemming from grantor trust status are concerned, by treating the assets of a grantor trust as under the taxpayer's control, Congress would harmonize the income and transfer tax systems. Bringing such uniformity to the income and transfer tax systems would reflect the economic realities that underlie grantor trust status (i.e., taxpayer's control warrants that the separate trust status be ignored for income tax purposes) and thereby bring consistency across the Code as to its tax treatment.

Related-party transactions require close scrutiny. Accounting for taxpayer relatedness more accurately depicts a transaction's economic substance (or lack thereof). Were Congress to institute a universal *related-party* definition in the transfer tax system, realities rather than fictions would dominate estate planning arrangements. But having a better theoretical framework in place is a hollow gesture unless complemented with a meaningful monitoring system. The next Subpart explores opportunities available to bolster taxpayer compliance.

141. See *supra* note 130 and accompanying text.

142. See *supra* note 131 and accompanying text.

143. See *supra* note 105 and accompanying text.

144. See *supra* note 132 and accompanying text.

145. See *supra* note 130 and accompanying text.

146. See *supra* note 131 and accompanying text.

C. The Institution of a Viable Monitoring System That Ensures Taxpayer Compliance

A tax system is only as good as the monitoring system it has in place. That being the case, if Congress were to introduce a universal *related-party* definition into the transfer tax regime, an accompanying oversight system should also be instituted. The introduction of a universal *related-party* definition alone would undoubtedly chill the atmosphere for certain aggressive estate planning techniques. Nevertheless, to ensure taxpayer compliance, the IRS must be in a position to fulfill its oversight duties with respect to the proposed *related-party* definition.

For starters, in order for the agency to achieve its oversight mission, Congress must supply the IRS with sufficient resources. Over the past several years, the IRS has seen its budget in inflation-adjusted dollars stagnate.¹⁴⁷ As a result of this budget stagnation and as the applicable exclusion amount has climbed to \$3.5 million (i.e., the amount of wealth each taxpayer, at death, can pass free of estate tax),¹⁴⁸ the IRS has curtailed the resources that the agency devotes to policing the transfer tax system.¹⁴⁹ While the estate tax audit rate has climbed (due mainly to the fact that so few estate tax returns are currently being filed),¹⁵⁰ the vast majority of gift tax returns are not examined,¹⁵¹ permitting many aggressive transfer tax positions to go unchallenged.

A problem related to the lack of IRS resources is that the gift tax system lacks necessary safeguards to protect against taxpayer noncompliance. Consider the fact that if taxpayers make gifts the value of which exceed

147. See, e.g., IRS OVERSIGHT BOARD, FY2010 IRS BUDGET RECOMMENDATION: SPECIAL REPORT 16–20 (June 2009), available at http://www.treas.gov/irsob/reports/2009/IRSOB_FY10_Budget_Report.pdf (setting forth the anemic dollar growth rate of the IRS's budget from 2002 through 2009 and exploring the reasons that the agency is in desperate need of additional funding).

148. I.R.C. § 2010(c) (2006).

149. Allen Kenney, *IRS Plans Significant Cuts to Estate Tax Program*, 2006 TAX NOTES TODAY 141-1 (July 24, 2006); see David Cay Johnston, *I.R.S. Will Cut Tax Lawyers Who Audit the Richest*, N.Y. TIMES, July 23, 2006, A16 (“The federal government is moving to eliminate the jobs of nearly half of the lawyers at the Internal Revenue Service who audit tax returns of some of the wealthiest Americans, specifically those who are subject to gift and estate taxes when they transfer parts of their fortunes to their children and others.”).

150. See Daniel Lorenzen, *Estate Tax Audit Risk—Updated*, TRUST & ESTATE LAWYER, (on file with the *Alabama Law Review*) available at http://webcache.googleusercontent.com/search?q=cache:glQZPql_6vMJ:www.tandelawyer.com/%3Fp%3D25+http://www.tandelawyer.com/%3Fp%3D25&cd=1&hl=en&ct=clnk&gl=us (Mar. 19, 2009) (“The data shows that a total of 47,298 estate tax returns were filed in 2008, and 8.1% of those were audited. RIA reports that this is up from the 2007 rate of 7.7%.”).

151. See I.R.S., DATA BOOK 2008, at 24 tbl.9a (2008) (indicating that the IRS audits .4% of all gift tax returns filed); see also David Joulfaian, *The Federal Gift Tax: History, Law, and Economics*, (Dep't of Treasury, Working Paper No. 100, Nov. 2007), <http://ssrn.com/abstract=940871> (presenting evidence that compliance with the gift tax has been lackluster); Jonathan Feinstein & Chih-Chin Ho, IRS, *Predicting Estate Tax Filings and Taxable Gifts*, in I.R.S. RES. BULL., PUB. 1500, 1, 47, 52 (estimating that approximately one-third of all gift tax payments are evaded).

their annual exclusion (currently \$13,000), they are supposed to file a gift tax return.¹⁵² Presently, however, there is no penalty associated with taxpayers' failure to file a gift tax return unless there is an actual gift tax due¹⁵³ (which is rarely the case because each taxpayer, during his lifetime, can transfer up to \$1 million free of gift tax).¹⁵⁴ Furthermore, transferees generally have no obligation to file information returns associated with the receipt of their gifts.¹⁵⁵ The absence of a meaningful filing requirement and an information requirement constitute the perfect taxpayer noncompliance formula.¹⁵⁶

A final item to consider is that both the gift tax return (Form 709) and the estate tax return (Form 706) request information about the transferee's relationship to the donor/decedent.¹⁵⁷ Notwithstanding the request for this information, there is no civil penalty associated with not supplying this information.¹⁵⁸ The absence of an explicit civil sanction casts doubts on the accuracy of the information that taxpayers may supply.

Congressional institution of a universal *related-party* definition in the transfer tax regime is thus a necessary first step to bringing integrity to the transfer tax system. In addition, the IRS should receive additional funding to enable the agency to do a better job of policing taxpayers' returns. Next, Congress should impose a penalty upon those taxpayers who do not timely submit gift tax returns—even in those circumstances when no gift tax is due—complemented by a requirement that transferees submit information returns reporting the receipt of gratuitous transfers that exceed the annual gift tax exclusion amount (currently \$13,000).¹⁵⁹ Finally, when

152. See I.R.C. § 6019 (2006).

153. See, e.g., I.R.C. §§ 6651(a)(1)–(2), 6662(b)(5) (2006). Each of these specified Code sections requires an actual gift tax due before the application of a penalty will be imposed.

154. I.R.C. § 2505(a) (2006).

155. Only foreign gift transferees have a reporting obligation to the government. See I.R.C. § 6039F (2006) (requiring a U.S. beneficiary of a foreign gift that exceeds a certain threshold to file an information return (i.e., Form 3520)).

156. See Tax Analysts, *IRS Republishes Fact Sheet on Third Party Reporting*, 2006 TAX NOTES TODAY 177-12

(Sept. 13, 2006) (“[E]xperience shows that taxpayers are much more likely to report their income when they receive third-party notification of payments they received.”); U.S. GEN. ACCOUNTING OFFICE, *TAX GAP: MANY ACTIONS TAKEN, BUT A COHESIVE COMPLIANCE STRATEGY NEEDED* 5 (1994), available at <http://archive.gao.gov/t2pbat3/151585.pdf> (“Information returns are a proven way to promote compliance and help [the] IRS find noncompliance.”); Michael C. Durst, *Report of the Second Invitational Conference on Income Tax Compliance*, 42 TAX LAW. 705, 707 (1989) (“Computer-based enforcement techniques, relying largely on information returns filed by payers of wages, interest, dividends, and other items, have provided valuable benefits by virtually eliminating noncompliance with respect to important categories of income.”); see also Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 695 (2007) (“[T]hird parties are routinely used by the tax system to verify the bona fides of taxpayer claims in diverse contexts involving reimbursed amounts and other receipts.”).

157. See FORM 709, sched. A; FORM 706, pt. 4.

158. But see *United States v. Mattox*, 689 F.2d 531, 532–33 (5th Cir. 1982) (suggesting possible criminal sanctions for purposefully and intentionally leaving a request for information blank).

159. See I.R.C. § 2503(b) (2006).

filing a transfer tax return, taxpayers should always have to report the taxpayer's relationship, if any, to the transferee and, if appropriate, bear a civil penalty if the proffered information is incomplete or inaccurate.

V. CONCLUSION

For decades, many prominent commentators have referred to the payment of transfer taxes as being voluntary in nature.¹⁶⁰ As evidenced by the vast number of devices and ploys readily available to taxpayers that enable them to circumvent application of these taxes, the so-called voluntary nature of transfer tax payments is not entirely a baseless disparagement. There are many reasons that transfer taxes remain mired in this sad state of affairs, but one of the foremost is the congressional failure to take taxpayer relatedness fully into account, particularly in comparison to Congress's vigilance in the income tax arena. This failure to take taxpayer relatedness into account is unfortunate, undermining the integrity of the transfer tax base and annually costing the Treasury Department billions of dollars in forgone transfer tax revenue.

If Congress is ever to have a meaningful transfer tax system, reform is in order. In the past, calls for such reform have been too timid. Instead, reform should be targeted at the root level with the institution of a universal transfer tax *related-party* definition, setting forth its implications and having a viable monitoring system in place. Congress should not approach transfer tax reform in a piecemeal fashion, attempting to close down one transfer tax-saving device at a time; this cat-chasing-mouse process will only result in frustration as clever taxpayers and their undaunted advisers will continue to formulate and develop new transfer tax-saving methodologies.

Undoubtedly, the institution of a universal *related-party* definition will not solve all the ills currently besetting the transfer tax system. However, if Congress takes the relatedness of taxpayers more fully into account, the transfer tax system will be far less voluntary in nature. And assuming that the nation shares the political belief that it needs a stable and revenue-generating transfer tax system in place, this would be a good thing.

160. See *supra* note 13.