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Sales to Grantor Trusts: A Case Study of What the IRS and Congress Can Do to Curb Aggressive Transfer Tax Techniques

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SALES TO GRANTOR TRUSTS: A CASE STUDY OF WHAT THE IRS AND CONGRESS CAN DO TO CURB AGGRESSIVE TRANSFER TAX TECHNIQUES

JAY A. SOLED* & MITCHELL GANS**

Sales to grantor trusts produce magnificent transfer tax savings. Such savings raise an important policy question: What can the IRS and Congress each do to eliminate this and other transfer tax savings devices that erode the transfer tax base? While this analysis does not pretend to have all the answers, it presents straightforward and practical solutions to many of the problems plaguing the nation's transfer tax system using sales to grantor trusts as a case study.

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I. INTRODUCTION

In the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Congress temporarily raised the applicable exclusion amount—the dollar figure that taxpayers can pass free of transfer tax (i.e., estate, gift, and generation-skipping transfer taxes)—from \$1 million to \$5 million.¹ This law is set to expire at the end of 2012, at which time the \$1 million applicable exclusion amount is scheduled to return.² In two years, if Congress wishes to maintain the \$5 million applicable exclusion amount and avoid costing the federal coffer billions of dollars in lost revenue, it will have to eliminate several of the most utilized tax-saving devices in estate planning.³ The devices currently under consideration for elimination include the so-called zeroed-out, grantor-retained annuity trusts (GRATs),⁴ minority and marketability valuation discounts for certain intrafamily transfers,⁵ and qualified personal residence trusts.⁶ These staples of the estate planning world have been part of the panoply of tools that practitioners have devised to minimize taxpayers' transfer tax burdens.

Notwithstanding congressional attention to the elimination of these mainstay planning tools, there has been no discussion in Washington, D.C. to date about eradicating other commonplace transfer tax-savings devices. One such device is known as a sale to a grantor trust, which can replace many of the devices under consideration for the congressional knife and

1. Pub. L. No. 111-312, § 303, 124 Stat. 3296 (2010) [hereinafter 2010 Tax Relief Act].

2. *Id.* §§ 101–03.

3. For a discussion pertaining to the possible elimination of several estate planning devices, see GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2011 REVENUE PROPOSALS (Feb. 2010), <http://www.treasury.gov/resource-center/tax-policy/Documents/greenbk10.pdf>.

4. See, e.g., James M. Delaney, *Split Interest Valuation: The Devil Is in the Detail*, 37 CAP. U. L. REV. 929, 954 (2009) ("With the evolution of the zeroed-out GRAT, the estate planning profession seems to have once again frustrated the goals of the Treasury.").

5. See, e.g., Brant J. Hellwig, *On Discounted Partnership Interests and Adequate Consideration*, 28 VA. TAX REV. 531, 533 (2009) ("Family limited partnerships have dominated the judicial landscape in the estate and gift tax arena for nearly a decade. . . . Their principal advantage lies in the prospect of significant estate and gift tax savings generated through the exploitation of discounts used to value equity interests in closely held entities."). See generally Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition in Its Fight Against the FLP*, 86 TAX NOTES 1461 (2000) (describing the legislative action needed to eliminate the tax advantages of the family limited partnership); Leo L. Schmolka, *FLPs and GRATs: What to Do?*, 86 TAX NOTES 1473 (2000) (proposing solutions to several tax loopholes including family limited partnerships).

6. See, e.g., Denver S. Gilliland, *Fractional Interests Make a Better QPRT*, 32 REAL PROP. PROB. & TR. J. 145, 180 (1997) ("[Qualified Personal Residence Trusts], as an exception to the Chapter 14 valuation rules, offer some significant estate tax planning opportunities.").

achieve similar transfer tax savings.⁷ While nothing is certain, estate planners will likely switch gears in the aftermath of the likely transfer tax system overhaul and use sales to grantor trusts, among other techniques, to fill the void left by the absence of comparable transfer tax-savings devices.⁸

In anticipation of taxpayers' attempts to minimize their transfer tax obligations, this analysis uses sales to grantor trusts as a case study of what can be done to protect the transfer tax base from erosion. In the sections that follow, we outline how the IRS and Congress should each respond to the emergence of sales to grantor trusts and other transfer tax-savings devices that ultimately become taxpayers' methods of choice to defeat their transfer tax obligations. In Section II, we overview how sales to grantor trusts operate and how they compare to other transfer tax savings devices. In Section III, we point out how such sales and other transfer tax savings devices are vulnerable to challenges by the IRS. In Section IV, we suggest ways that Congress can stem taxpayers' use of sales to grantor trusts and other planning devices designed to circumvent transfer tax obligations. In Section V, we offer our conclusions.

II. SALES TO GRANTOR TRUSTS: HOW THEY OPERATE AND COMPARE TO OTHER TRANSFER TAX MINIMIZATION TECHNIQUES

Close to a century ago, Congress instituted the estate tax;⁹ ever since then, taxpayers have sought creative ways to minimize their transfer tax burdens.¹⁰ In the estate planning sphere, some forms of taxpayers' "creativity" have been deemed impermissible by the courts;¹¹ however, other such forms have been sanctioned by the courts, and, as a result, they have been added to practitioners' stores of acceptable estate planning

7. See Robert T. Danforth, *A Proposal for Integrating the Income and Transfer Taxation of Trusts*, 18 VA. TAX REV. 545, 619 (1999) (discussing "the use of grantor trust status as a means of avoiding estate and gift taxes").

8. Compare George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977) (describing how, when it comes to transfer taxes, taxpayers have devised numerous ways to skirt their obligations), with Paul L. Caron & James R. Repetti, *The Estate Tax Non-Gap: Why Repeal a Voluntary Tax?*, 20 STAN. L. & POL'Y REV. 153 (2009) (describing how the estate tax imposes a significant transfer tax burden on most of the nation's largest estates).

9. Act of September 8, 1916, Pub. L. No. 64-271, § 2(b), 39 Stat. 756.

10. See, e.g., Richard Schmalbeck, *Avoiding Federal Wealth Transfer Taxes*, in RETHINKING ESTATE AND GIFT TAXATION 113 (William G. Gale, James R. Hines, Jr. & Joel Slemrod eds., 2001) (exploring some of the historical ways in which taxpayers have sought to alleviate their transfer tax burdens).

11. See, e.g., *Heyen v. United States*, 945 F.2d 359, 365 (10th Cir. 1991) (disregarding as a sham a taxpayer's use of twenty-seven unrelated straw people to obtain twenty-seven additional annual exclusions for gifts to the taxpayer's family).

devices.¹² To date, insofar as courts have not challenged the viability of sales to grantor trusts, such transactions fall squarely within the scope of the latter category. In the subsections below, (A) we explore how a sale to a grantor trust operates, and (B) we compare this technique to other transfer tax minimization techniques.

A. *How a Sale to a Grantor Trust Operates*

Utilized as a device to achieve transfer tax savings, a sale to grantor trust constitutes a complex arrangement. As set forth below, we outline how practitioners orchestrate this arrangement, its income tax and transfer tax implications, and why taxpayers have found its use attractive from a transfer tax perspective.

Before analyzing this complex arrangement, however, some basic fundamentals are in order. Subchapter J of the Code governs the income taxation of trusts and estates. Subpart E of Subchapter J sets forth special rules for grantor trusts and the fact that such trusts are essentially ignored for income tax purposes (i.e., in most instances, the grantor and the trust are treated as one-and-the-same taxpayer).¹³ I.R.C. §§ 673 through 679 set forth the criteria that result in part or all of a trust having grantor trust status.¹⁴ If a trust has grantor trust status, the tax-reporting obligations of such a trust are generally negligible.¹⁵

Although the separate existence of grantor trusts is generally ignored for income tax purposes, the same fate does not hold true for estate tax purposes. To the contrary, the assets in a grantor trust will not be included in the grantor's gross estate¹⁶ if properly drafted.¹⁷ This disparate tax treatment between income and estate taxes, in which the former ignores

12. See, e.g., Patrick T. Neil, "Bare"ly Legal: The Evolution of Naked Crummey Powers and a Call for Reform, 30 FLA. ST. U. L. REV. 923 (2003) (discussing how the Tax Court's decision in *Estate of Cristofani v. Comm'r*, 97 T.C. 74 (1991) sanctioned transfers made into a trust for the benefit of remote beneficiaries and how such transfers qualified for the present interest annual exclusion).

13. Treas. Reg. §§ 1.671-1(a) (as amended in 1980), 1.671-3(a)(1) (as amended in 1969); Rev. Rul. 57-390, 1957-2 C.B. 326. Compare *Rothstein v. United States*, 735 F.2d 704, 710 (2d Cir. 1984) (noting that for income tax purposes, a transaction between a taxpayer and a grantor trust should be respected and taxed accordingly), with Rev. Rul. 85-13, 1985-1 C.B. 184 (ruling that transactions between a grantor and a grantor trust cannot have income tax significance).

14. See Leo L. Schmolka, *Selected Aspects of the Grantor Trust Rules*, in THE NINTH ANNUAL INSTITUTE ON ESTATE PLANNING 1400 (1975) (discussing the criteria for treatment of a trust as a grantor trust).

15. See Treas. Reg. § 1.671-4 (as amended in 2006) (stating the tax obligations of grantor trusts).

16. See I.R.C. § 2033 (2006) (including in a decedent's estate those assets in which decedent held an interest).

17. Danforth, *supra* note 7, at 557.

grantor trusts' separate existence and the latter respects their separate existence, sets the stage for sales to grantor trusts.

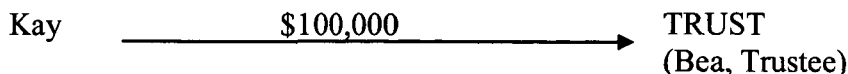
Consider how a sale to a grantor trust functions. Suppose Kay owns title to a piece of highly appreciating rental real estate with a current fair market value of \$1 million and an adjusted tax basis of \$200,000. Kay visits her local estate planning attorney, who renders the following advice: Kay should establish an irrevocable trust, the terms of which provide her with sufficient indicia of control that, for income tax purposes, make it a grantor trust; however, for transfer tax purposes, such indicia of control fall short of causing inclusion of the trust's assets in Kay's gross estate.¹⁸ Once Kay establishes the irrevocable trust with the precise terms described above, Kay's attorney advises her to make a \$100,000 cash contribution to the trust. Finally, Kay's attorney proposes that after a sufficient period of time after funding the trust, the trustee of the irrevocable trust, Bea, should purchase title to Kay's appreciating real estate using the \$100,000 cash as a down payment and issuing a nine-year promissory note (with \$100,000 annual principal payments plus applicable interest) to pay off the balance due.¹⁹ The entirety of this proposed transaction is represented by two simple diagrams as follows:²⁰

18. There are several ways to accomplish this goal. Probably the most common method is to employ I.R.C. § 675(4)(C), which provides that if a person, in a non-fiduciary capacity, has the power to switch title to assets in her own name with assets of equivalent value held by the trust, grantor trust status is appropriate. I.R.C. § 675(4)(C) (2006).

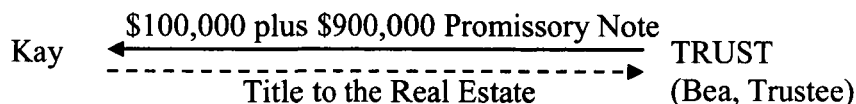
19. When a sale is made to a trust, the IRS may attempt to invoke I.R.C. § 2036 to bring the date-of-death value of the assets sold to the trust into the grantor's gross estate. Even if the grantor does not retain an interest in the trust or the right to control the management of the trust—the two predicates for invoking § 2036—the IRS may be able to sustain this argument. In essence, the argument would be based on the view that, in substance, the grantor's retained right to receive payments under the note constitutes a retained income stream. Thus, if death should occur before the note is fully paid, inclusion in the grantor's gross estate via § 2036 could occur. *See generally* I.R.C. § 2036 (2006) (providing in effect that, as a general matter, the section does not apply if the grantor's retained access ends before death).

If the IRS were to make this argument, the taxpayer would have two possible responses. First, the taxpayer could argue that the retention of the right to receive payments under a note generated by a sale does not constitute the retention of a right within the meaning of § 2036. *See Fidelity-Phila. Trust Co. v. Smith*, 356 U.S. 274, 280 n.8 (1958) (indicating in dicta that in the case of a sale, if payments need not necessarily derive from the property transferred and are not correlated to the income generated, the grantor should not be treated as having retained access); *see also* Rev. Rul. 77-193, 1977-1 C.B. 273 (applying the *Fidelity-Philadelphia* dicta, a case involving an annuity, to an installment sale). In the minds of many practitioners, one approach to satisfying the conditions set forth in *Fidelity-Philadelphia* is if the trust is first funded with sufficient money—often referred to as seed money. *See Becklenberg v. Comm'r*, 273 F.2d 297, 301-02 (7th Cir. 1959) (applying and upholding the ruling in *Fidelity-Philadelphia*). The difficulty with the seed money approach is that the amount of seed money necessary to satisfy the requirements of the dicta is not

STEP 1: Contribution to the Grantor Trust



STEP 2: Trust Purchases the Real Estate Using the Contributed Cash and a Promissory Note



clear. While many suggest that ten percent of the sales prices is sufficient, *see, e.g.*, Michael D. Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 EST. PLAN. 3, 8 (1996), there is no published authority to this effect. The other difficulty with the seed money approach is that in order to provide the trust with seed money, the grantor must make a taxable gift into a trust, and the size of this gift might give rise to the payment of gift tax. With the passage of the 2010 Tax Relief Act, *supra* note 1, this possible tax friction may no longer be a serious impediment insofar as every taxpayer now enjoys the equivalent of a \$5 million gift tax exemption, with married couples able to contribute \$10 million free of gift tax. I.R.C. § 2505(a) (2006); I.R.C. § 2010(c) (2006). Another approach used by practitioners to satisfy the *Fidelity-Philadelphia* dicta is a guarantee. Under this approach, the beneficiary of the trust guarantees that the note due to the grantor will be paid even if the trust is unable to make payments. The cases cited by the Supreme Court in *Fidelity-Philadelphia* suggest the viability of this approach. The “guarantee approach,” however, raises its own issues. For example, if the guarantor does not have sufficient assets, the guarantee may be seen as more of a façade than reality. *See* Estate of Fabric v. Comm’r, 83 T.C. 932 (1984) (finding that exclusion of the transferred assets from the gross estate was proper). Also, questions have been raised as to whether a fee must be charged for the guarantee and, if so, how much. Indeed, at one point, the IRS had suggested that in the absence of a fee, the guarantor should be treated as having made a taxable gift. *See* I.R.S. Priv. Ltr. Rul. 91-13-009 (Dec. 21, 1990) (holding that gift guarantees are considered taxable gifts).

A second possible defense to an IRS challenge is to rely upon the bona fide and full consideration exception to § 2036. Practitioners who counsel about this kind of sale are understandably cautious about relying on the bona fide exception, because (i) if the IRS is able to establish after the death of the grantor that the price was inadequate—even if minimally inadequate—the exception may not be available, and (ii) the IRS may argue that, even if the price was adequate, the tax-driven nature of the transaction renders the bona fide exception inapplicable. *Strangi v. Comm’r*, 417 F.3d 468 (5th Cir. 2005) (holding that assets were properly included in taxable estate); *Estate of Hughes v. Comm’r*, 90 T.C.M. (CCH) 630, 635 (2005) (holding that assets were not includable in gross estate because they lacked value).

20. In terms of practical reality, this proposed transaction may engender further complexities as most practitioners would probably recommend that Kay first transfer title to her real estate to a limited liability company, let some time expire, and then only sell a minority portion of her limited liability company membership interest to the trust. By “wrapping” title to her real estate in a limited liability company, Kay will likely command useful valuation discounts. *See infra* Section II.B.2. For heuristic reasons, we have purposefully chosen to ignore the additional complexity entailed by this sort of planning.

Kay's sale of her real estate title to a grantor trust engenders both income tax and transfer tax implications. Recall that the Code ignores the separate existence of a grantor trust for income tax purposes;²¹ in a practical sense, what this means is that the Code treats the trust as the grantor's alter ego.²² The IRS has long ruled that for income tax purposes, transactions that taxpayers engage in with themselves are not recognized.²³ That being the case, when Bea, in her fiduciary capacity as trustee of the grantor trust, purchases the real estate from Kay, Kay recognizes no gain or loss (i.e., Kay and Bea are deemed to be one and the same).²⁴ Consistent with the nonrecognition concept is that the trust would hold title to the purchased real estate with a carryover basis of \$200,000.²⁵ Due to the grantor trust status of the trust, the rental income earned by the trust during each year of its existence would be reportable on Kay's individual income tax return.²⁶ However, as installment note and interest payments are made to Kay, Kay would not incur any income tax liability, because the receipt of these payments would be ignored for income tax purposes.²⁷

For transfer tax purposes, assuming that the trust terms are properly drafted (i.e., they do not provide Kay with any retained indicia of control

21. See *supra* note 13 and accompanying text.

22. Craig D. Bell & Julie A. King, *Sweeping Up the Two Percent Floor: Scott v. United States and the Deductibility of Investment Advisory Fees*, 38 REAL PROP. PROB. & TR. J. 589, 594 (2003) ("[G]rantor trusts, . . . are historically treated as the alter egos of the grantors[]").

23. See Rev. Rul. 85-13, *supra* note 13; see also I.R.S. Priv. Ltr. Rul. 2002-47-006 (Nov. 22, 2002) (ruling that when an owner of two separate trusts transfers a life insurance policy from one trust to the other, the transaction will be disregarded for federal income purposes); I.R.S. Priv. Ltr. Rul. 2002-28-019 (Jul. 12, 2002) ("[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.").

24. See Rev. Rul. 85-13, *supra* note 13.

25. See *id.*

26. See Jonathan G. Blattmachr & Bridget J. Crawford, *Grantor Trusts and Income Tax Reporting Requirements: A Primer*, 16 PROB. & PROP. 18, 18 (2002) ([R]etention by a trust's grantor, or another person, of certain powers over trust property will cause that grantor (or other person) to be deemed to be the owner for income tax purposes of some or all of the trust property."); John B. Huffaker et al., *Is Income Tax Payment by Grantor-Owner of a Subpart E Trust a Taxable Gift?*, 82 J. TAX'N 202, 203 (1995) (indicating that the grantor of a grantor trust is the owner of the trust for federal income tax purposes even though he may receive none of the benefits of the trust); Jerry Kasner, *Defective IRS Reasoning on Gift Tax Consequences of a Defective Trust*, 66 TAX NOTES 1171, 1171 (1995) ("The income of the trust is taxed to the grantor, who is treated as the 'owner' of the trust for federal income tax purposes.").

27. See Rev. Rul. 85-13, *supra* note 13.

over the trust assets), title to the trust property and accumulated rental income should not be includable in Kay's gross estate at the time of her death.²⁸ That being the case, even if the real estate's fair market value soared to \$5 million, its entire value would escape inclusion in Kay's taxable estate.

The inconsistency between the income tax (which treats the trust as the grantor's alter ego) and the estate tax (which treats the trust as a stand-alone entity, separate from the grantor) is glaringly apparent and has long existed. Notwithstanding entreaties from academics and other commentators to harmonize the differences between the income and estate taxes,²⁹ this disparate tax treatment enables taxpayers to reap rich transfer tax savings.³⁰

The benefits of this disparate tax treatment are essentially twofold. First, during the trust term, taxpayers engaging in this technique are obligated to pay the trust's income tax.³¹ While the benefit of these payments inures to the trust beneficiaries, such payments are not considered transfers that are subject to gift tax.³² To illustrate, suppose in our previous example that the trust annually earns \$100,000 of rental income and that the effective income tax rate is forty-five percent. In the absence of the grantor trust rules, the trust bears the tax burden, resulting in the trust retaining only \$55,000 (\$100,000 of income less \$45,000 of taxes (\$100,000 × 0.45)). But the grantor trust nature of the trust, instead, obligates the grantor to pay the tax on the rental income,³³ resulting in the \$100,000 of rental income remaining intact and inuring to the benefit of the trust beneficiaries.

A second feature of this sales technique is that, for transfer tax purposes, it enables taxpayers to "freeze" the value of the transferred property.³⁴ To illustrate, return once again to our example in which Kay anticipated that the real estate in question would appreciate greatly in value. If it appreciated in her name, the initial fair market value plus its appreciation would be includable in Kay's gross estate. Instead, by making this sale, Kay will ultimately receive \$1 million (\$100,000 cash down

28. See I.R.C. §§ 2036–38 (2006).

29. See, e.g., Danforth, *supra* note 7.

30. See, e.g., Ronald D. Aucutt, *Installment Sales to Grantor Trusts*, SR034 ALI-ABA 1013 (2010) ("[A sale to grantor trust] is in effect an estate freeze technique that capitalizes on the lack of symmetry between the income tax rules governing grantor trusts and the estate tax rules governing includibility in the gross estate.").

31. I.R.C. § 671 (2006); see also Rev. Rul. 04-64, 2004-2 C.B. 7 (ruling that a settlor's payment of income taxes attributable to a grantor trust is not a taxable gift).

32. Rev. Rul. 04-64.

33. See *id.*

34. See, e.g., Karen Burke, *Valuation Freezes After the 1988 Act: The Impact of 2036(c) on Closely-Held Businesses*, 31 WM. & MARY L. REV. 67, 70 (1989) ("In its simplest form, an estate freeze involves the transfer of an interest representing future appreciation by an older generation transferor, coupled with the retention of another interest having a fixed value.").

payment and a promissory note worth \$900,000). This \$1 million figure represents a freeze of the amount includable in Kay's taxable estate.

The ultimate transfer tax savings associated with such sales can be intoxicating to taxpayers. Compare the overall tax consequences were Kay to (1) retain title to the real estate versus (2) sell this property to a grantor trust, using the following set of assumptions: Kay's real estate generates \$100,000 of rental income annually; its value gradually increases to \$5 million; the estate and income tax rates are each a flat forty-five percent; and Kay dies in Year 10 immediately after the promissory note has been paid in full.³⁵

Retention of the Real Estate: If Kay retained title to the real estate, \$5,550,000 would have been includable in her taxable estate (i.e., title to real estate worth \$5,000,000 plus the after-tax rental income of \$55,000 that the property annually generated (\$100,000 – \$45,000 (\$100,000 × 0.45)) over a ten-year period. The estate tax on \$5,550,000 would be \$2,497,500 (\$5,550,000 × 0.45), leaving a net amount of \$3,052,500 to Kay's family.

Sale to Grantor Trust: Suppose instead that Kay sold title to the foregoing real estate to a grantor trust. In this case, only \$1,000,000 would be includable in Kay's taxable estate (i.e., the initial \$100,000 cash down payment plus the aggregate \$900,000 principal payment),³⁶ producing an overall estate tax liability of \$450,000. Under this scenario, Kay's family would own title to \$5,000,000 of real estate, \$1 million cash from the rental income (free of income tax because Kay, under the grantor trust rules, bore this burden), plus the after-transfer tax cash bequest of \$550,000 (i.e., Kay's estate has \$1,000,000 from the aggregate installment payments less the presumed \$450,000 transfer tax obligation (\$1 million times the forty-five percent assumed transfer tax rate)), leaving a net amount of \$6,550,000 to Kay's family.

The significant wealth outcome variations produced under scenarios (1) and (2) illustrate a driving force behind taxpayers' motivations to use sales to grantor trusts.³⁷

35. For purposes of this illustration, assume that Kay had other assets in her estate that absorbed her entire applicable exclusion amount via I.R.C. § 2010.

36. For purposes of this problem, we assumed that Kay used the interest payments made on the promissory note to meet her annual income tax obligation arising with respect to the \$100,000 rental income that the trust generated. For example, if the promissory note's interest rate was ten percent, in addition to making its first installment payment of \$100,000, the trust would also pay Kay \$90,000 of interest (\$900,000 × 10%). Kay could use this interest income to meet her \$45,000 income tax obligation resulting from the grantor trust nature of the trust. In later years, when the principal balance of the promissory note is much smaller, the interest payments due to Kay will be correspondingly smaller as well (e.g., in Year 9, the trust's final payment would be \$110,000, consisting of \$100,000 of principal and \$10,000 of interest). In later years, the excess interest payments from earlier years could be used to meet the \$45,000 income tax obligation on the trust's annual rental income.

37. In the context of a sale to grantor trust scenario, Kay's beneficiaries will have a

B. Comparison to Other Estate Planning Minimization Techniques

In the past, in lieu of sales to grantor trusts, taxpayers sometimes used other estate planning techniques to minimize their transfer tax burdens.³⁸ The reason for taxpayers' reluctance to employ this technique centers upon a concern about inadvertently triggering gift tax liability should the value of the sold assets be determined to be in excess of the sales price. (This concern, however, will likely dissipate with the increase in the gift tax exemption of \$5 million adopted in 2010.)

As a general proposition, many taxpayers lack familiarity with how our tax system operates, and this lack of familiarity is particularly acute in the area of transfer taxes. Given this background, imagine the confusion that discussions of sales to grantor trusts must engender. For starters, tax professionals explaining how this technique operates will often refer to the purchasing trust as being "defective" for income tax purposes.³⁹ Why? This is because the terms of the trust are designed to achieve grantor trust status, and for the majority of the time that the income tax has been in existence, this status was steadfastly avoided.⁴⁰ This avoidance is due to the fact that the income of non-grantor trusts historically has been taxed at lower marginal tax rates than that of individual taxpayers, and the income of all grantor trusts was generally taxed at the grantor's higher marginal tax rates.⁴¹ Even though the Tax Reform Act of 1986 eradicated the tax bracket

lower tax basis in the real estate. More specifically, had Kay held title to the property until her death, her tax basis in the real estate would have equaled \$5 million in her beneficiaries' hands. See I.R.C. § 1014(a) (2006). By contrast, by engaging in this sale to grantor trust, Kay's beneficiaries would ultimately have a \$200,000 tax basis in the transferred real estate (i.e., Kay's initial cost basis). This tax basis differential can ultimately result in Kay's beneficiaries bearing a larger income tax burden if and when they were to sell this real estate. See I.R.C. § 1001(a) (2006). Note, however, that the law regarding the beneficiaries' basis is not entirely clear. See Jonathan G. Blattmachr, Mitchell M. Gans & Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149, 158–59 (2002) (suggesting that the tax basis in the beneficiaries' hands might, indeed, equal the sales price). But see I.R.S. C.C.A. 200937028 (Sept. 11, 2009) (rejecting this position).

38. See *supra* notes 4–6.

39. See, e.g., Stephen R. Akers, Jonathan G. Blattmachr & F. Ladson Boyle, *Creating Intentional Grantor Trusts*, 44 REAL PROP. TR. & EST. L.J. 207, 211 (2009) ("The term defective was applied first to grantor trusts when the grantor trust rules originally were adopted because, as a general matter, a grantor trust classification prevented income splitting. Avoiding grantor trust status was the typical taxpayer goal. Thus, before 1987 the trust was "defective" from the perspective that the trust income was taxable to the grantor instead of the trust or a trust beneficiary. That label has carried over to today, although now grantor trust status usually is viewed as beneficial.").

40. *Id.*

41. See generally Mark L. Ascher, *The Grantor Trust Rules Should Be Repealed*, 96 IOWA L. REV. 885 (2011).

advantage afforded to non-grantor trusts,⁴² the putative scourge of being a grantor trust has remained; hence, the moniker defective remains extant. Once a tax professional gets beyond explaining the fact that the trust is not truly defective, the professional then must explain the numerous steps entailed in arranging such trust sales.

Aside from taxpayers' tendencies to shy away from those tax-saving techniques that they cannot readily comprehend and that have a facade of artificiality, taxpayers have discovered recently the appeal of other techniques. The appeal of other techniques is commonly twofold: they enjoy the imprimatur of the IRS, Congress, and/or the courts; and they can produce more bountiful transfer tax savings relative to those offered by sales to grantor trusts.⁴³ Two such techniques are: (1) zeroed-out GRATs and (2) valuation discounts.

1. Zeroed-Out GRATs

The framework for a zeroed-out GRAT is found in I.R.C. § 2702, entitled "Special valuation rules in case of transfers of interest in trusts."⁴⁴ The statute provides that "[t]he value of any retained interest which is not a qualified interest shall be treated as being zero."⁴⁵ For example, under this rule, if a taxpayer contributes \$1 million into a trust established for the benefit of his children and retains a ten-year income interest (i.e., a nonqualified interest under the Code), the value of the retained income interest is deemed to be zero.⁴⁶ Accordingly, notwithstanding the taxpayer's retention of this valuable income right, the taxpayer will nevertheless be deemed to have made a taxable gift of the entire \$1 million trust contribution.⁴⁷ Congress devised this approach in order to eliminate an abusive strategy under which wealth could be moved to children and others without the full payment of gift tax.⁴⁸

42. See I.R.C. § 101(a) (2006).

43. See, e.g., Ellen K. Harrison, *A Comparison of Retained Annuities and Sales to Grantor Trusts*, WL SD10 ALI-ABA 763 (1998) ("In most cases, a GRAT may be structured to produce a minimal gift tax value . . .").

44. I.R.C. § 2702(a)(2)(A) (2006).

45. *Id.*

46. See *id.*

47. See I.R.C. § 2702(a)(1).

48. In the years leading up to the enactment of I.R.C. § 2702, taxpayers established grantor-retained income trusts (commonly known in the estate planning community as "GRITs"). In computing the value of a taxpayer's retained-income interest, the Code provided a rate of return equal to the I.R.C. § 7520 rate. This rate of return often made the taxpayer's retained interest appear robust and, in contradiction, the amount of the remainder interest (i.e., the gift) small. Meanwhile, the GRIT trustee could invest in growth assets that produced very little income; by engaging in this kind of investment strategy, the investment growth would inure to the trust beneficiaries and essentially escape any transfer tax

The statute provides a major exception to the general rule of treating the value of any retained interest as zero.⁴⁹ It does so by defining a "qualified interest" as including "any interest which consists of the right to receive fixed amounts payable not less frequently than annually."⁵⁰ By defining a qualified interest in this straightforward fashion, Congress thought it had eliminated opportunities for valuation abuse. Retained amounts that are "fixed" appear to be safe from taxpayer manipulation, and Congress affixed a rate of return on the contributed trust property equal to the I.R.C. § 7520 rate (a rate that is issued on a monthly basis and is equal to 120 percent of the federal midterm interest rate).⁵¹ The opportunity for taxpayers to game an arrangement of this sort seemed remote, because the value of the remainder interest could be determined with apparent accuracy.⁵²

Working within statutory parameters, crafty taxpayers instead designed GRATs to be the perfect transfer tax loophole. Taxpayers' strategy was simple: Contribute property that produced a rate of return in excess of the § 7520 rate and retain robust annuity payments such that the value of the retained interest essentially equaled the value of the remainder interest (e.g., contribute \$1 million into a trust but retain an interest therein slightly less than or equal to \$1 million, producing little or no taxable gift).⁵³ If the trust property produced a rate of return that was in excess of the § 7520 rate, assets would remain in the trust and could pass tax-free to the named trust beneficiaries.⁵⁴ If the trust assets failed to produce the § 7520 rate of return, nothing would be left in the trust, but because the up-front gift was deemed to be zero or de minimis, the taxpayer suffered no negative consequences for making this trust contribution.⁵⁵ This technique, known as a "zeroed-out GRAT," has become an essentially foolproof method of achieving transfer tax savings with no downside risk and even the Tax Court has tacitly sanctioned its use.⁵⁶

exposure. See generally Mitchell Gans, *GRIT's, GRAT's, and GRUT's: Planning and Policy*, 11 VA. TAX REV. 761 (1992) (explaining how taxpayers would exploit the use of GRITs in fashions designed to minimize their transfer tax burdens).

49. See I.R.C. § 2702(a)(2)(A) (2006).

50. I.R.C. § 2702(b)(1).

51. I.R.C. § 7520(a)(2) (2006).

52. See Grayson M. McCouch, *Rethinking Section 2702*, 2 FLA. TAX REV. 99, 99 (1994) ("In 1990, Congress added chapter 14 to the Code to address several gift and estate tax avoidance techniques that flourished under prior law." (footnotes omitted)).

53. KATHRYN G. HENKEL, *ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES AND SOLUTIONS* ¶ 22.03[2][b] (1997).

54. See I.R.C. §§ 2702 (a)(2)(B), 7520(a).

55. See I.R.C. § 2702(a)(2)(A).

56. See *Walton v. Comm'r*, 115 T.C. 589 (2000), *acq.*, IRS Notice 2003-72, 2003-2 C.B. 964 (ruling that for purposes of I.R.C. § 2702, if the transferor were to die during the term of the retained interest, annuity payments that were to continue to be made to the

Consider the following example. In September 2011, when the § 7520 rate was two percent, a taxpayer contributed \$1 million into a two-year GRAT and retained an annual annuity payment of \$520,562. As a result of retaining such a large annuity interest, the value of the retained interest was deemed equal to \$1 million, making the value of the corresponding taxable gift equal to zero (\$1 million trust contribution less \$1 million retained interest). At the end of Year 1, the taxpayer will receive an annuity payment of \$520,562, and after Year 2, the taxpayer will receive another annuity payment of \$520,562. At the end of the two-year period after making the two annuity payments, if nothing remains in the trust, the GRAT will prove unsuccessful. Conversely, at the end of the two-year period after making the two annuity payments, if something remains in the trust, the GRAT will prove successful, and whatever remains in the trust will transfer tax-free to the trust's named beneficiaries. Given the absence of a downside risk, it comes as no surprise that the establishment of zeroed-out GRATs has spiraled as their use is regularly promoted by estate planners.

2. Valuation Discounts

In addition to zeroed-out GRATs, another common estate planning technique is the use of valuation discounting. Such discounting can produce stellar transfer tax results.⁵⁷ Under this methodology, taxpayers typically gift or sell interests in closely held businesses. Consider the salient fact that the interests in such business enterprises are not publicly traded on a recognized exchange, and the owner of a non-controlling interest is unable to direct the management of the entity. For transfer tax purposes, the absence of a ready market coupled with a lack of control typically reduces the value of such closely held business interests—often producing so-called minority and marketability valuation discounts of thirty percent or more⁵⁸ under the traditional “willing buyer/willing seller” test.⁵⁹

transferor's estate constituted a qualified interest, thereby reducing the value of the remainder interest). Note, however, that the IRS insists that the preamble to the regulations under § 2702 does not contemplate that a GRAT can be zeroed out. *See* Tech. Adv. Memo. 2002-45-053 (Nov. 8, 2002).

57. *See generally* Brant J. Hellwig, *On Discounted Partnership Interests and Adequate Consideration*, 28 VA. TAX REV. 531 (2009); Mitchell M. Gans, *Deference and Family Limited Partnerships: A Case Study*, 39 INST. ON EST. PLAN. ¶ 500 (Tina Portuondo ed., 2005).

58. *See* Louis A. Mezzullo, *Valuation of Corporate Stock*, 831-3d TAX MGM'T PORTFOLIO worksheet 1 (2007); *see also* Brant J. Hellwig, *Revisiting Bryum*, 23 VA. TAX REV. 275, 278-79 (2003) (“With courts frequently sustaining combined minority-interest and marketability discounts in the range of 30-50% from proportionate value, the use of limited partnerships for estate-planning purposes is widely regarded as undermining the integrity of the estate tax.” (footnotes omitted)).

59. *See* Treas. Reg. § 20.2031-1(b) (1965) (“The fair market value is the price at

Consider the following example. A taxpayer has a \$1 million piece of rental real estate. She contributes this real estate to a limited liability company and then gifts a twenty-five percent membership interest in this limited liability company to each of her four children. Each membership interest is not traded on a public exchange and represents a minority interest in this enterprise; thus, rather than reporting a \$1 million taxable gift for gift tax reporting purposes, the taxpayer instead can likely show a taxable gift equal to \$600,000 (\$1,000,000 less \$400,000 (\$1,000,000 times forty percent discount attributable to the nature of the transferred membership interests)).⁶⁰ Essentially, by wrapping this property in the form of a limited liability company, the taxpayer is able to make \$400,000 of value disappear from the transfer tax base.⁶¹ Although this sleight of hand seems too good to be true, over a decade ago in a major concession to taxpayers, the IRS gave this technique its imprimatur of approval.⁶²

Properly structured zeroed-out GRATs and the use of valuation discounts illustrate that when it comes to transfer tax minimization techniques, taxpayers have had a myriad of options. What made these transfer tax savings options particularly attractive is that they presented taxpayers with little downside risk, and they were readily comprehensible.⁶³ As a result, for the past two decades, taxpayers have continuously exploited these and several other transfer tax savings techniques.⁶⁴

Assuming that Congress will at some point eliminate several of the most utilized estate planning techniques, including zeroed-out GRATs and valuation discounts, resourceful taxpayers will seek alternative means to minimize their transfer tax burdens. Therefore, they will likely turn to sales

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.”).

60. *Id.*

61. Karen C. Burke & Grayson M.P. McCouch, *Family Limited Partnerships: Discounts, Options, and Disappearing Value*, 6 FLA. TAX REV. 649, 650 (2004).

62. Rev. Rul. 93-12, 1993-1 C.B. 202.

63. While the sale of a non-controlling interest may present a downside risk—the IRS could argue that the sales price was inadequate and that a gift tax should therefore be paid—estate planners have devised strategies that minimize or eliminate such risk. *See, e.g.,* *Petter v. Comm’r*, 98 T.C.M. (CCH) 534 (2009) (rejecting the IRS’s attempt to revalue the sold/gifted units based on a clause inserted in the documents that would divert units to charity in the event of such a revaluation).

64. In the estate tax area, a quick review of continuing legal education programs signifies these techniques’ prominence. *See generally* Steve R. Akers, *Advanced Transfer Planning, Including Strategies to Maximize Benefits of GRATs and Sales to Grantor Trusts Given Recent Market Declines*, SR002 ALI-ABA 801 (2009); Lawrence P. Katzenstein, *Some Interest-Sensitive Estate Planning Techniques (with an Emphasis on GRATs and QPRTS)*, SR034 ALI-ABA 109 (2010); William D. Kirchick, *Using GRATs in a Down Economy*, SR013 ALI-ABA 211 (2009); David Pratt, *Update on Use of Family Limited Partnerships and Discount Planning*, SP037 ALI-ABA 399 (2009).

to grantor trusts and other tax-saving techniques, enduring the complexity and artificiality that such techniques engender. The IRS and Congress, however, do not have to be wallflowers and allow taxpayers free rein to subvert the transfer tax base. Instead, as discussed in the next two sections, the IRS and Congress have many weapons at their disposal to defeat such sales and other estate planning techniques.

III. WHAT THE IRS CAN DO TO MAINTAIN THE INTEGRITY OF THE TRANSFER TAX SYSTEM

The IRS has several weapons in its arsenal to defeat the kinds of transactions that Congress did not expressly authorize or sanction and that erode the transfer tax base.⁶⁵ In the sections that follow, we outline how the IRS is at liberty to (A) revoke and rewrite flawed revenue rulings, (B) craft new Treasury regulations, and (C) invoke the application of the codified economic substance doctrine. Using this latitude, the IRS can eliminate sales to grantor trusts and other techniques that subvert the transfer tax system.

A. Revoke and Rewrite Flawed Revenue Rulings

The IRS promulgates its administrative positions in several different forms, including revenue rulings, revenue procedures, notices, and announcements.⁶⁶ Among these forms, the IRS has historically articulated some of its most important positions via revenue rulings. "Revenue rulings are official interpretations by the Service, which are prepared in the Associate Chief Counsel Offices and published in the Internal Revenue Bulletin by the Service."⁶⁷ Such rulings represent the IRS's position on a particular set of facts and conclusions of law and are published with the intention that a particular issue will be handled with uniformity throughout the country.⁶⁸

Once the IRS issues a revenue ruling, the agency has the prerogative to change it. And despite the fact that the IRS can exercise this power retroactively,⁶⁹ it generally only exercises this power prospectively.⁷⁰ Many

65. The transfer tax base is very broad and is theoretically designed to capture all lifetime transfers, *see* I.R.C. § 2512 (2006), and include all property owned directly and indirectly at death, *see* I.R.C. §§ 2031, 2035–38 (2006).

66. *See generally* Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View from Within*, 46 DUQ. L. REV. 323 (2008) (former chief counsel for the IRS explaining the nature of administrative information that the IRS issues).

67. *Id.* at 330.

68. Treas. Reg. § 601.601(d) (as amended in 1987).

69. *See* *Dixon v. United States*, 381 U.S. 68, 74–75 (1965) (explaining why the IRS can retroactively apply its own rulings). *But see* *Silco, Inc. v. Comm'r*, 779 F.2d 282, 286–

times, the impetus underlying such administrative changes is a well-reasoned court ruling that results in an IRS loss;⁷¹ other times, the IRS will revoke a prior ruling if the agency believes its position is simply contrary to the existing state of the law.⁷²

When it comes to the tax consequences associated with sales to grantor trusts, the IRS has promulgated Revenue Ruling 85-13, which ironically lays the foundation for the acceptability of such transactions.⁷³ *Rothstein v. United States*⁷⁴ is the case that led the IRS to issue this revenue ruling.⁷⁵ In *Rothstein*, the taxpayer had established an irrevocable trust in which the taxpayer's wife was the sole trustee and his children were the income beneficiaries.⁷⁶ Several years after establishing the trust, the taxpayer purchased shares of stock in a closely held corporation from the trustee, using as consideration an unsecured promissory note.⁷⁷ Subsequent to this exchange (which, according to the taxpayer's position, did not give rise to taxable income), the taxpayer liquidated the closely held corporation.⁷⁸ By using the shares' purchase price (i.e., the amount of the note) as the shares' cost basis, the taxpayer then claimed that the corporate liquidation gave rise to a short-term capital loss.⁷⁹

In adjudicating this case, there were two issues that required resolution. The first was whether the terms of the trust were such that it should be classified as a grantor trust, and the second was the tax consequences that flowed from this classification.⁸⁰

87 (5th Cir. 1986) (taxpayer's position upheld based upon a reliance on previously issued revenue rulings); *Rauenhorst v. Comm'r*, 119 T.C. 157, 170, 172 (2002) (finding that, generally, the Tax Court treats a revenue ruling as a concession by the IRS that the agency must either withdraw or modify before it can take a contrary position).

70. See Treas. Reg. § 601.601(d)(2)(v)(c) (as amended in 1987) ("Where Revenue Rulings revoke or modify rulings previously published in the Bulletin the authority of I.R.C. § 7805(b) of the Code ordinarily is invoked to provide that the new rulings will not be applied retroactively to the extent that the new rulings have adverse tax consequences to taxpayers.").

71. See, e.g., *Estate of Wall v. Comm'r*, 101 T.C. 300, 312-13 (1993) (resulting in the IRS's revocation of Rev. Rul. 79-353, 1979-2 C.B. 325, and replacing it with Rev. Rul. 95-53, 1995-2 C.B. 191, the terms of which are consistent with the *Wall* decision).

72. See, e.g., Rev. Rul. 93-12, 1993-1 C.B. 202 (acknowledging, after suffering a series of court defeats over a period of several years, that minor and marketability discounts are permissible for gratuitous transfers of closely held business interests).

73. See *supra* note 13 and accompanying text.

74. *Rothstein v. United States*, 574 F. Supp. 19 (D. Conn. 1983), *rev'd*, 735 F.2d 704 (2d Cir. 1984).

75. See *id.*; Rev. Rul. 85-13, 1985-1 C.B. 184.

76. *Rothstein*, 574 F. Supp. at 20.

77. *Id.* at 20-21.

78. *Id.* at 21.

79. *Id.*

80. *Id.* at 22.

At the district court level, the IRS prevailed: the court ruled that because the grantor could indirectly borrow from the trust, the trust was a grantor trust.⁸¹ The court further found that the taxpayer had a carryover tax basis in the corporate shares (i.e., equal to the tax basis in the hands of the grantor trust) and disallowed the taxpayer's putative loss on the corporate liquidation.⁸² To illustrate this with numbers, if the trust had a \$10 basis per share in the corporation in question and the purchase price paid by the grantor was \$100 per share, the court would rule that the purchasing taxpayer had a \$10 basis per share. If the taxpayer then liquidated the corporation and the liquidation proceeds were \$30 per share, the taxpayer would have experienced a \$20 gain per share (i.e., \$30 – \$10).

The U.S. Court of Appeals for the Second Circuit reversed the district court's decision.⁸³ While it agreed with the lower court's classification analysis (i.e., the instrument in question established a grantor trust), it disagreed with the consequences that stemmed from this classification.⁸⁴ Writing for the majority, Judge Friendly read the grantor trust statute in a literal fashion, claiming that it attributed items of income, deductions, and credits from a grantor trust to its grantor.⁸⁵ In all other respects, the terms of the Code were fully applicable, including the provisions stating that a sales transaction gives rise to gain or loss,⁸⁶ and an asset's purchase price constitutes its cost basis.⁸⁷ Accordingly, on the corporate liquidation, the court allowed the taxpayer a loss, because the amount of the liquidation proceeds were less than the taxpayer's cost basis in his shares.⁸⁸ For illustration purposes once again, if the trust had a \$10 basis per share in the corporation in question and the purchase price was \$100 per share, the Second Circuit would rule that the purchasing taxpayer had a \$100 basis per share. If the taxpayer then liquidated the corporation and the liquidation proceeds were \$30 per share, the taxpayer would experience a \$70 loss per share (i.e., \$30 – \$100).⁸⁹

81. *Id.* at 23.

82. *Id.*

83. *Rothstein v. United States*, 735 F.2d 704, 710 (2d Cir. 1984).

84. *See id.* at 708–09.

85. *See id.* at 709 (“[Section] 671 dictates that, when the grantor is regarded as ‘owner,’ the trust’s income shall be attributed to him—this and nothing more.”).

86. I.R.C. § 1001.

87. I.R.C. § 1012 (2006 & Supp. III 2009).

88. *Rothstein*, 735 F.2d at 710.

89. Although the sale of the corporate stock by the trustee to the taxpayer gave rise to a gain, this gain was apparently able to be reported on the installment method, a fact that apparently irritated the government. *See id.* (“The Government’s grievance apparently derives from the fact that, . . . neither the taxpayer nor the trust had reported a capital gain on the sale of the IDI shares in 1964.”). Congress has since put a limitation on the use of the installment method in this context. I.R.C. § 453(e) (2006). *See, e.g., Shelton v. Comm’r*, 105 T.C. 114, 120 (1995) (In return for an installment note, a taxpayer sold the stock of a closely

After suffering a defeat at the hands of the Second Circuit, the IRS hastily issued Revenue Ruling 85-13, announcing that it would not follow the *Rothstein* decision, because it recognized the separate existence of a grantor trust for tax reporting purposes.⁹⁰ In other words, the agency would continue to ignore all dealings that a taxpayer had with respect to a grantor trust, including the recognition of gains and losses and tax basis determination issues.⁹¹

In retrospect, the IRS should have applauded the *Rothstein* outcome. The Second Circuit's holding makes clear that transactions between a taxpayer and a grantor trust should not be ignored. While its holding might seem to invite opportunities for abuse (e.g., taxpayers could engage in transactions with their alter egos (grantor trusts)), losses arising between related parties are traditionally disallowed;⁹² and, if necessary, Congress could have crafted a provision requiring that gains arising from such related-party transactions could not be used to absorb capital losses or net operating losses.

As long as Revenue Ruling 85-13 is retained, it will serve to sanction the use of sales to grantor trusts. As such, it will enable taxpayers to use such sales as tools to chisel away at their transfer tax obligations. As with any revenue ruling that taxpayers use as a mechanism to defeat their tax obligations, the IRS should examine the merits of the ruling and the risks associated with revoking it. An analysis by the IRS would likely reveal that the agency should revoke Revenue Ruling 85-13—and for that matter, any other revenue ruling that taxpayers use to defeat legitimate tax obligations—and let the *Rothstein* decision stand.⁹³ Put differently, the IRS should not allow itself to be a wallflower, passively watching as the federal coffers are drained.

held business to related parties who subsequently liquidated the company; the Tax Court held that this liquidation was a second disposition and, as such, was subject to I.R.C. § 453(e), which “was enacted as a response to the use by taxpayers of installment sales to a related intermediary in order to defer recognition of gain while at the same time effectively realizing appreciation on the property by means of a resale to a party outside the ‘related group’ for an immediate payment.”).

90. Rev. Rul. 85-13, 1985-1 C.B. 184.

91. *See id.*

92. I.R.C. § 267(a) (2006).

93. Note the fact that a longstanding revenue ruling followed by the issuance of a contrary regulation does not undercut an agency's deference claim. *See, e.g., Smiley v. Citibank (S. D.), N.A.*, 517 U.S. 735, 740-41 (1996). Instead of issuing new regulations, if the IRS simply issued a new revenue ruling, it would only be entitled to limited deference. *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

B. Craft New Treasury Regulations

The IRS has a potent weapon at its disposal against which taxpayers in general have a difficult time avoiding. Specifically, in interpreting the Code, the IRS can issue regulations that command deference from the courts. We analyze below (1) the current deference standard and its application and (2) the latitude that deference affords the IRS in responding to transfer tax avoidance techniques such as sales to grantor trusts.

1. The Current Deference Standard and Its Application

The origin of how courts defer to administrative agency decisions is long, difficult, and complex to trace.⁹⁴ However, the current deference standard, embodied in *Chevron U.S.A., Inc. v. Natural Resources Defense Counsel, Inc.*,⁹⁵ and reinforced by the recent Supreme Court decision in *Mayo Foundation for Medical Education & Research v. United States*,⁹⁶ is relatively easy to understand and apply.

By way of background, the IRS is able to issue “legislative” regulations (i.e., regulations that frame a specific body of law) in accordance with a specific delegation from Congress.⁹⁷ Under the general authority of I.R.C. § 7805(a), the service can also issue “interpretative” regulations (i.e., regulations that offer guidance as to what a specific statutory body of language means or signifies).⁹⁸ The courts had applied different levels of deference to these two types of regulations.⁹⁹ In *Mayo Foundation*, the

94. See generally Mitchell M. Gans, *Deference and the End of Tax Practice*, 36 REAL PROP. PROB. & TR. J. 731 (2002) (describing the history of judicial deference to administrative interpretations).

95. *Chevron U.S.A., Inc. v. Natural Res. Def. Counsel, Inc.*, 467 U.S. 837 (1984).

96. *Mayo Found. for Med. Educ. & Research v. United States*, 131 S.Ct. 704 (2011).

97. See Kristin E. Hickman, *Agency Specific Precedents: Rational Ignorance or Deliberate Strategy?*, 89 TEX. L. REV. 89, 104 (2011) (explaining the history of regulations issued pursuant to a general grant of authority and specific grant of authority); see also I.R.C. § 1502 (2006) (authorizing the Treasury Department to promulgate regulations that delineate how those corporations that qualify can file tax returns on a consolidated basis); N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON LEGISLATIVE GRANTS OF REGULATORY AUTHORITY 1, 2–6 (Nov. 3, 2006), available at <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1121Report.pdf> (estimating that there are approximately 550 such provisions in the Code).

98. See *Tutor-Saliba Corp. v. Comm'r*, 115 T.C. 1, 7 (2000) (“An interpretive regulation is issued under the general authority vested in the Secretary [of the Treasury] by section 7805, . . .”); Comment, *Denying Retroactive Effect to Invalidation of Administrative Rules*, 12 STAN. L. REV. 826, 830–31 n.25 (1960) (“Treasury regulations, often classified as interpretive, are regarded as merely stating the Treasury’s construction of the statute.”).

99. See *Mayo Found.*, 131 S.Ct. at 713; (“In two decisions predating *Chevron*, this Court stated that ‘we owe the [Treasury Department’s] interpretation less deference’ when it is contained in a rule adopted under that ‘general authority’ than when it is ‘issued under a

Supreme Court stated that the same standard of deference, the *Chevron* standard, should apply to both types of regulations.¹⁰⁰

In determining whether an administrative agency's statutory construction should be upheld, the Supreme Court in *Chevron* enunciated a two-step analysis.¹⁰¹ Step one is to determine whether "the intent of Congress is clear"; if it is, ". . . the agency[] must give effect to the unambiguous expressed intent of Congress."¹⁰² Step two occurs only if the intent of Congress is unclear (i.e., the statute is silent or ambiguous with respect to a specific issue); in those situations, "the question for the court to determine is whether the agency's answer is based on a permissible construction of the statute."¹⁰³ Regarding step two, the Supreme Court, in another case, noted that "we defer to the Commissioner's regulations as long as they 'implement the congressional mandate in some reasonable manner.'"¹⁰⁴ Accordingly, only when an agency's construction of an unclear statute is unreasonable does judicial deference to an agency's rule-making authority end.¹⁰⁵

Swallows Holding, Ltd. v. Commissioner is an illustrative case that demonstrates how the application of the *Chevron* standard applies to Treasury Department regulations.¹⁰⁶ The facts contained in *Swallows Holding* are straightforward: the taxpayer was a Barbados corporation that owned U.S. rental property.¹⁰⁷ This rental property generated income and experienced concomitant deductions; however, the taxpayer failed to file tax returns for tax years 1993, 1994, 1995, and 1996, delaying such submissions until 1999.¹⁰⁸

I.R.C. § 882(c)(2) provides that a foreign corporation "shall receive the benefit of the deductions . . . allowed to it . . . only by filing or causing to be filed . . . a true and accurate return, in the manner prescribed in subtitle F . . ."¹⁰⁹ On the basis of this section, because the taxpayer failed to file timely

specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision."'). See generally Gans, *supra* note 94 (describing the history of judicial deference to administrative interpretations).

100. *Mayo Found.*, 131 S.Ct. at 714.

101. *Chevron*, 467 U.S. at 842-43.

102. *Id.*

103. *Id.* at 843.

104. *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 219 (2001) (quoting *United States v. Correll*, 389 U.S. 299, 307 (1967)).

105. *Swallows Holding, Ltd. v. Comm'r*, 515 F.3d 162, 169 (3rd Cir. 2008).

106. See *id.* at 162. See generally Mark E. Berg, *Judicial Deference to Tax Regulations: A Reconsideration in Light of National Cable, Swallows Holding, and Other Developments*, 61 TAX LAW. 481 (2008) (discussing judicial deference in light of recent cases including *Swallows Holding*).

107. *Swallows Holding*, 515 F.3d at 165.

108. *Id.*

109. I.R.C. § 882(c)(2) (2006).

tax returns for the tax years in question, the IRS denied the taxpayer the normally allowable deductions.¹¹⁰

In 1957, many years subsequent to the passage of § 882(c)(2), the IRS issued regulations pertaining to this rule but did not require that a tax return be filed by a set time.¹¹¹ Over three decades later, the IRS again issued regulations pertaining to this rule; this time, however, in order for a taxpayer to secure the deductions allowable under the Code, the IRS set forth a general filing deadline of eighteen months from the time of the return's due date.¹¹² The issue before the U.S. Court of Appeals for the Third Circuit was the validity of this regulation that adopted a defined filing deadline.¹¹³

In commenting on the appropriate deference standard, the Third Circuit cited to the Supreme Court decision in *United States v. Mead Corp.*,¹¹⁴ declaring that the “*Chevron* deference is appropriate only in situations where ‘Congress would expect the agency to be able to speak with the *force of law*.’”¹¹⁵ Under I.R.C. § 7805(a), the Third Circuit observed that Congress directly invited the IRS to promulgate regulations; that being the case, the agency was delegated the authority to make law.¹¹⁶ Having laid this groundwork, the Third Circuit then concluded that “the resulting regulation is entitled to the *Chevron* deference if it survives *Chevron*’s two prong inquiry.”¹¹⁷

Under step one of *Chevron*, the Third Circuit decided that the statute was written ambiguously (i.e., I.R.C. § 882(c)(2)’s filing requirement used the phraseology *in the manner prescribed in subtitle F*, but the statute failed to elaborate on whether this phraseology contained a temporal component).¹¹⁸ In light of this statutory ambiguity, the Third Circuit proceeded to conduct step two of *Chevron* and sought to determine the reasonableness of the IRS’s actions.¹¹⁹ In conducting its reasonableness analysis, the Third Circuit offered the following observation: generally, “[r]ules represent important policy decisions, and should not be disturbed if ‘this choice represents a reasonable accommodation of conflicting policies

110. *Swallows Holding*, 515 F.3d at 172.

111. See Treas. Reg. § 1.882-4 (as amended in 1990); 22 Fed. Reg. 8377 (Oct. 24, 1957).

112. See Treas. Reg. § 1.882-4(a)(3)(i).

113. *Swallows Holding*, 515 F.3d at 164.

114. 533 U.S. 218, 229 (2001).

115. *Swallows Holding*, 515 F.3d at 168 (quoting *Mead*, 533 U.S. at 229).

116. *Id.*

117. *Id.* at 169–70 (citing *McNamee v. Dep’t of Treasury*, 488 F.3d 100 (2d Cir. 2007); *Hosp. Corp. of Am. v. Comm’r*, 348 F.3d 136 (6th Cir. 2003); *Bankers Life & Cas. Co. v. United States*, 142 F.3d 973 (7th Cir. 1998); *United States v. Cook*, 494 F.2d 573 (5th Cir. 1974)).

118. *Id.* at 170.

119. See *id.* at 170–72.

that were committed to the agency's care by the statute"¹²⁰ With this observation in mind, the Third Circuit upheld the regulation's validity, ruling that it was eminently reasonable since the regulation helped the agency fulfill its oversight responsibilities.¹²¹ In a closing comment, the Third Circuit added that "*Chevron* recognizes the notion that the IRS is in a superior position to make judgments concerning the administration of the ambiguities in its enabling statute."¹²²

On numerous other occasions after *Chevron*, the Supreme Court has reiterated the deference that IRS regulations should command and the latitude with which the IRS can craft such regulations. Indeed, in *Mayo Foundation for Medical Education & Research v. United States*,¹²³ not only did the Supreme Court reiterate the Treasury Department's ability to amend its own regulations if troubled by a court's resolution of an outcome,¹²⁴ it clarified the universality of the *Chevron* decision:

The principles underlying our decision in *Chevron* apply with full force in the tax context. . . . Filling gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the ones other agencies must make in administering their statutes. . . . We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other regulations.¹²⁵

The *Mayo Foundation* decision represents a culmination of sorts for the *Chevron* deference standard.¹²⁶ In instances of statutory ambiguity, *Mayo Foundation* explicitly invites administrative agencies, including the IRS, to promulgate reasonable regulations that support the agency's position (even if the agency previously embraced a contrary position).¹²⁷

120. *Id.* at 171 (quoting *United States v. Shimer*, 367 U.S. 374, 382–83 (1961)).

121. *Id.* at 172.

122. *Id.*

123. *See generally Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704 (2011).

124. *Id.* at 712–13.

125. *Id.* at 713 (citations omitted).

126. Note that the Supreme Court's decision in *Mead* endorsed the use of the *Chevron* deference standard but in the context of interpretive tax regulations. *See, e.g., Swallows Holding*, 515 F.3d at 168 (relying, as indicated in the text, on *Mead* for the proposition that *Chevron* controls in this context).

127. The only time that an administrative agency's latitude to craft regulations would not be afforded deference would be in those instances when the statute in question was held to be unambiguous. *See Home Concrete & Supply, LLC v. United States*, 634 F.3d 249, 257 (4th Cir. 2011) (holding that because the statute in question was determined to be unambiguous, *Chevron* deference was not applicable).

In the next section, we explore ways in which the IRS should accept the Supreme Court's invitation and draft treasury regulations that defeat transfer tax avoidance techniques such as sales to grantor trusts, regardless of whether the taxpayer's position was previously sanctioned by the courts.¹²⁸

2. The Latitude Afforded the IRS in Responding to Transfer Tax Avoidance Techniques

In instances when Congress unambiguously provides taxpayers with methods to reduce their transfer tax burdens, the IRS must permit such methods to go unchallenged.¹²⁹ Indeed, it would be unconstitutional for an agency that is part of the executive branch to invalidate or overrule an unambiguous statute enacted by Congress.¹³⁰ For example, I.R.C. § 2702 permits taxpayers to form qualified personal residence trusts.¹³¹ In terms of transfer tax savings, even if the IRS dislikes the transfer tax savings that these trusts are able to achieve, the agency is at a loss to challenge the viability of such trusts.¹³²

In contrast, consider those situations in which Congress has either not spoken or has spoken ambiguously and taxpayers are exploiting such congressional silence or statutory ambiguities. In these cases, via § 7805(a), Congress has delegated to the IRS the ability to draft regulations that curtail such exploitation.¹³³ In the paragraphs that follow, we suggest regulations that the IRS could draft that would put an end to sales to grantor trusts and possibly other transfer tax exploitation devices as well.

Let's start with sales to grantor trusts. There are at least two different regulations that the IRS could promulgate that would have a significantly chilling effect on taxpayers using this technique.

128. See, e.g., Treas. Reg. § 26.2601-1 (as amended in 2010). After experiencing a court defeat in *Simpson v. United States*, 183 F.3d 812 (8th Cir. 1999), the IRS rewrote this particular regulation to largely mirror its litigation position. As one author of this paper observed many years ago, "[i]n effect, rather than continuing to litigate with taxpayers, the government declared victory by regulation." Gans, *supra* note 94, at 746. In effect, deference cases such as *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967 (2005), enable the Treasury Department to rewrite tax regulations in a way that overrules judicial defeats.

129. See *Chevron*, 467 U.S. at 842-43 ("If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.").

130. *Cf. id.*

131. See I.R.C. § 2702 (2006); see also McCouch, *supra* note 52, at 99 (discussing special valuation rules).

132. See *Chevron*, 467 U.S. at 842-43.

133. See *supra* Section III.B.1.

The first regulation would expand the application of I.R.C. § 2036. Consider the fact that if a taxpayer transfers property into a trust and retains an income right to the property transferred, such a retained right causes estate tax inclusion of the transferred property.¹³⁴ Insofar as sales to grantor trusts are concerned—where the income generated on the property sold generally is used to satisfy the installment payment obligations—how do tax practitioners currently avoid the application of § 2036? They instruct taxpayers to first contribute “seed money” to the trust, wait, and then use this seed money as a down payment to purchase the property owned by the grantor.¹³⁵ At least until now, tax practitioners have expressed confidence that adding seed money to the process eliminates § 2036 concerns.¹³⁶ However, the IRS has the liberty to append the following provision to the § 2036 regulations: Taxpayers who, in exchange for a promissory note, sell or exchange property to a trust will be considered to have retained an interest in such transferred property until such note is satisfied. This proposed provision is aligned with the underlying purpose of § 2036, which is to bring back into a taxpayer’s gross estate those assets in which taxpayers retain either a direct or indirect interest, or both direct and indirect interests in transferred property.¹³⁷ In the case of a sales to a grantor trust, there is compelling evidence that the transferred trust property is the most critical resource that sustains installment note payments, and as such, the grantor has obviously retained an interest therein.¹³⁸

The second regulation would target the “bona fide sale” exception to § 2036.¹³⁹ Under this exception, the Code nullifies the application of § 2036 “in case of a *bona fide* sale for an adequate and full consideration in money or money’s worth.”¹⁴⁰ The Code specifically uses the adjective *bona fide* to

134. See I.R.C. § 2036(a).

135. Mulligan, *supra* note 19; Louis A. Mezzullo, *Freezing Techniques: Installment Sales to Grantor Trusts*, 14 PROB. & PROP. 16, 19 (2000).

136. At least two commentators have argued that seed money is not a necessary predicate to avoid I.R.C. § 2036 application. See Elliot Manning & Jerome M. Hesch, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 INST. ON EST. PLAN. ¶ 16 (2000).

137. See I.R.C. § 2036.

138. As suggested, there is dictum in an old Supreme Court decision, *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274, 277 (1958), to the effect that the use of seed money can be used to negate the application of I.R.C. § 2036. Because the relevant portion of the decision in *Fidelity-Philadelphia* is not a holding, but only dictum, the IRS would be free to take a different approach by regulation. See Nat’l Cable & Telecomms. Ass’n v. Brand X Internet Servs., 545 U.S. 967 (2005). Were the agency to adopt new regulations, it should withdraw or qualify Rev. Rul. 77-193, 1977-1 C.B. 273 (offering tacit endorsement of the dictum found in *Fidelity-Philadelphia*).

139. See I.R.C. § 2036(a).

140. *Id.*

modify the noun sale.¹⁴¹ As recent cases have concluded, this language suggests that the exception should not be available unless there is a sufficient non-tax purpose for undertaking the transaction.¹⁴² Based on these cases, the IRS should add the following provision to the bona fide sale exception: When there is a sale between the taxpayer and a party who is unrelated to the taxpayer (as defined in § 267(b)), the bona fide sale exception automatically applies; in all other cases, there is a rebuttable presumption that a sale is not bona fide unless the taxpayer is able to present clear and convincing evidence to the contrary (i.e., there was a legitimate business purpose underlying such sale). In the case of most sales to grantor trusts, this bona fide element will be absent, because the motivation of the taxpayer-grantor for entering into this transaction is clearly grounded in transfer tax savings rather than a legitimate business purpose.

If the IRS promulgated the foregoing recommended Treasury regulations, some commentators might assert that the IRS would be overstepping its bounds. However, consider how the agency has recently proposed regulations that are designed to put an end to the use of private annuities as devices to achieve transfer tax savings.

A private annuity is a transaction where a taxpayer exchanges property with another taxpayer (usually a younger member of the transferor's family) in return for an unsecured promissory note requiring periodic payments until a set price is met or the transferor of the property dies.¹⁴³ In a series of prior judicial decisions spanning the course of several decades, courts have held that such exchanges should be treated as open transactions, applying the annuity proceeds first against the tax basis of the exchanged

141. See *Estate of Schutt v. Comm'r*, 89 T.C.M. (CCH) 1353, 1364 (2005) ("In probing the presence or absence of a bona fide sale and corollary legitimate and significant nontax purpose, courts have identified various factual circumstances weighing in this analysis. These factors include whether the entity engaged in legitimate business operations, whether property was actually transferred to the entity, whether personal and entity assets were commingled, whether the taxpayer was financially dependent on distributions from the entity, and whether the transferor stood on both sides of the transaction.").

142. See, e.g., *Estate of Thompson v. Comm'r*, 382 F.3d 367, 383 (3d Cir. 2004); *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004); *Estate of Bongard v. Comm'r*, 124 T.C. 95, 122–23 (2005); *Estate of Hillgren v. Comm'r*, 87 T.C.M. (CCH) 1008, 1014 (2004); *Estate of Stone v. Comm'r*, 86 T.C.M.(CCH) 551, 578–79 (2003); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331, 1336–37, 1343 (2003); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641, 1648 (2002). If I.R.C. § 2036 exception instead read "in case of a sale for an adequate and full consideration in money or money's worth," it would have strongly implied that nonbusiness reasons could motivate such sale and, in those instances, that such transactions would have qualified under this exception.

143. John K. Pierre, *Using Intra-Family Sales in Estate Freezing: The Prospects in the Year 2000 and Beyond for Private Annuities and Self-Cancelling Installments Notes*, 24 S.U. L. REV. 207, 208 (1997); John G. Brant, *A New Look at the Private Annuity*, 22 COLO. LAW. 733 (1993).

asset and regarding the exchanges as taxable when received only after full basis recovery has been achieved.¹⁴⁴ In 1953, the IRS acceded to this position and issued Revenue Ruling 53-239.¹⁴⁵ In 1954¹⁴⁶ and again in 1963,¹⁴⁷ the IRS made two unsuccessful attempts to have Congress adopt provisions that would have triggered, upon property exchange, an immediate tax upon the entire realized gain. In 1969, the IRS issued Revenue Ruling 69-74,¹⁴⁸ which retracted Revenue Ruling 53-239 and declared gain resulting from the private annuity exchange to be taxable to the transferor in a ratable fashion (i.e., each annuity payment would simultaneously constitute a return of basis and a taxable gain).¹⁴⁹ But in a reversal of its own position, in 2006, the IRS issued proposed Treasury Regulation 1.1001-1(j)(1).¹⁵⁰ This proposed regulation overrules existing case law and the agency's own administrative guidance, treating the value of the annuity as an amount realized under I.R.C. § 1001 and triggering immediate taxation of the entire realized gain.¹⁵¹ By promulgating this Treasury regulation, the IRS has effectively eliminated any opportunity for taxpayers to postpone taxable gains on dispositions associated with private annuities; as a practical matter, the IRS's actions have severely curbed the use of private annuities as an estate planning device.¹⁵²

If the IRS can deliver the death knell to private annuities, there is no reason it cannot do the same for grantor trusts and other aggressive transfer tax savings devices. Aside from the proposed regulations we recommend, there are a host of other Treasury regulations—too numerous to expand upon here—that the IRS could issue that would put the brakes on many such devices.¹⁵³ *Chevron* and *Mayo Foundation* have paved the path for the

144. See, e.g., *Comm'r v. Kann's Estate*, 174 F.2d 357, 358–59 (3d Cir. 1949) (holding that an individual's unsecured promise to pay an annuity to another has no fair market value for the purpose of computing capital gain); *Lloyd v. Comm'r*, 33 B.T.A. 903, 904–05 (1936) (holding that a promise to make future payments has no fair market value until actual payments are made).

145. 1953-2 C.B. 53.

146. H.R. REP. NO. 83-1337, at A286 (1954), reprinted in 1954 U.S.C.C.A.N. 4025, 4111; S. REP. NO. 83-1622, at 116 (1954), reprinted in 1954 U.S.C.C.A.N. 4629, 4749.

147. H. COMM. ON WAYS & MEANS, 88TH CONG., PRESIDENT'S 1963 TAX MESSAGE 134 (Comm. Print 1963) (statement of the Secretary of the Treasury).

148. 1969-1 C.B. 43.

149. See *id.*

150. Exchanges of Property for an Annuity, 71 Fed. Reg. 61,441 (proposed Oct. 18, 2006).

151. Alan S. Lederman, *Proposed Regulations on the Tax Treatment of Private Annuities Would Generally Make Them Unattractive*, 106 J. TAX'N 175, 175–76 (2007).

152. See generally *id.* (explaining why private annuities are no longer a practical tax-saving device).

153. For example, via Treasury regulations, the IRS should seek to overturn the outcome in *Petter v. Comm'r*, 98 T.C.M. (CCH) 534 (2009). In *Petter*, the Tax Court approved the use of a so-called value definition clause. *Id.* at 544. This clause provided that

IRS to follow; hesitancy on the agency's part to take action is proving costly to the fisc.

C. *The Economic Substance Doctrine and Transfer Taxation*

When a taxpayer sells an item to a grantor trust (i.e., the taxpayer's alter ego), the transaction on its face appears driven entirely for tax avoidance purposes.¹⁵⁴ Therefore, this naturally raises the question of how the Code should treat these sales and others that lack economic substance from the perspective of the income tax.

By way of background, the IRS and courts have historically denied taxpayers losses, credits, and other benefits otherwise allowable under a literal reading of the Code and regulations if the transactions that gave rise to these tax benefits lacked economic substance.¹⁵⁵ In tax parlance, this gloss on the Code became known as the economic substance doctrine.¹⁵⁶ Despite the IRS's success in using the economic substance doctrine to

in the event the value of a sold asset is determined to exceed the selling price, the excess would pass to charity. *Id.* at 537. By passing the excess to charity and qualifying for a gift tax charitable deduction under I.R.C. § 2522, the taxpayer avoids any gift tax imposition. *Id.* at 538. If such a clause is inserted into a sales document, the IRS has no incentive to raise valuation issues on audit, because no gift tax revenue can be generated. Given the deleterious nature of value-definition clauses in terms of undermining transfer tax enforcement, the IRS should craft Treasury regulations that nullify their effect and render them void ab initio as a matter of public policy based on a codification by regulation of the decision rendered in *Comm'r v. Proctor*, 142 F.2d 824, 827 (4th Cir. 1944) (holding a clause designed to defeat gift tax imposition if a tax audit resulted in increased value of the gift to be void against public policy).

154. See generally *supra* Section II.A (describing tax implications regarding sales to grantor trusts).

155. Many commentators pin the origin of the economic substance doctrine to *Gregory v. Helvering*, 293 U.S. 465 (1935), which states:

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of [the statutory provision], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

Id. at 470.

156. See Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 9 (2000); David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW 235, 245 (1999); David A. Weisbach, *An Economic Analysis of the Anti-Tax Avoidance Doctrines*, 4 AM. L. & ECON. REV. 88, 89 (2002).

defeat abusive tax-minimization strategies, there have been many questions over the years regarding its application.¹⁵⁷

By adding section 7701(o) to the Code,¹⁵⁸ the Health Care and Education Reconciliation Act of 2010 clarified the contours of the economic substance doctrine. Under I.R.C. § 7701(o), for a transaction to have economic substance, taxpayers must meet a twofold test.¹⁵⁹ First, the transaction must change (apart from Federal income tax effects) the taxpayer's economic position (the objective prong of the test).¹⁶⁰ Second, the taxpayer must have a substantial purpose (apart from Federal income tax effects) in engaging in the transaction (the subjective prong of the test).¹⁶¹ If a taxpayer fails to meet both the objective and subjective prongs of the economic substance doctrine, the tax benefits afforded under Subtitle A of the Code with respect to a transaction are not allowable.¹⁶² For example, in an endeavor to secure a noneconomic tax loss, if a taxpayer devises a strategy to artificially increase an asset's tax basis, the IRS would be at liberty to invoke § 7701(o) to disallow the putative loss associated with the asset's artificially-inflated tax basis.¹⁶³

Despite the seeming breadth of § 7701(o), there are defined boundaries to its application. The section's legislative history, for example, reveals that Congress did not seek to negate or reclassify those transactions that had long-standing judicial and administrative acceptance, even if the choices engendered in these transactions were driven by comparative tax advantages.¹⁶⁴ Second, § 7701(o)(5)(B) states that the economic substance

157. In particular, several courts embraced the view that "a transaction would be respected for tax purposes if it had *either* economic substance or a nontax business purpose." Martin J. McMahon Jr., *Living with the Codified Economic Substance Doctrine*, 2010 TAX NOTES TODAY 158-2 (Aug. 2010) (emphasis added).

158. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067-68 (2010) (codified as amended at I.R.C. § 7701(o) (West Supp. 2010)).

159. See I.R.C. § 7701(o)(1).

160. I.R.C. § 7701(o)(1)(A).

161. I.R.C. § 7701(o)(1)(B).

162. I.R.C. § 7701(o)(5)(A).

163. Prior to the passage of I.R.C. § 7701(o), the IRS commonly used the economic substance doctrine to defeat taxpayers' tax-minimization schemes that were devoid of economic substance. See, e.g., *ACM P'ship v. Comm'r*, 157 F.3d 231, 252 (3d Cir. 1998) (denying, on the basis of the economic substance doctrine, a corporate taxpayer's losses associated with a partnership created for the purpose of generating a capital loss to offset the corporation's capital gain). See generally *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (Fed. Cl. 2007), *aff'd in part, rev'd in part, vacated in part*, 598 F.3d 1372 (Fed. Cir. 2010) (holding that the contribution of offsetting option positions to a partnership followed by a later property distribution from the partnership to the partners did not have economic substance and, for tax purposes, could therefore not be respected).

164. See STAFF OF JOINT COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL 44 (Comm. Print

doctrine should not apply to an individual taxpayer's personal transactions; accordingly, § 7701(o) only applies to those transactions entered into in connection with a trade or business or an activity engaged in for profit.¹⁶⁵

The limitations associated with the breadth of § 7701(o) seem to signify that it does not apply to gratuitous transfers such as gifts and bequests, which, by their very nature, lack economic substance.¹⁶⁶ Indeed, the statute itself appears to contemplate that a taxpayer may enter into a transaction for the purpose of securing a transfer-tax advantage without running afoul of the provision. Given the courts' rejection of the antecedent case-law doctrine in the transfer-tax context,¹⁶⁷ and the reality that transfers for estate-planning purposes are often inherently tax-driven,¹⁶⁸ the statute's failure to focus on transfer-tax savings is not unexpected. Nevertheless, as a matter of sound tax policy and to expand its effectiveness, it would make sense to alter § 7701(o)'s focus to also include targeting abusive transfer-tax strategies.

Sales of assets to grantor trusts potentially constitute a class of such transactions when the invocation of an expanded § 7701(o) would be particularly compelling. Why? While the sale to grantor trust has one foot in the transfer tax realm and is specifically designed to minimize transfer

2009) (offering four examples of permissible tax planning, such as the choice between capitalizing a business enterprise with debt rather than with equity).

165. I.R.C. § 7701(o)(5)(B).

166. See *Comm'r v. Duberstein*, 363 U.S. 278, 285 (1960) (quoting *Comm'r v. Lo Bue*, 351 U.S. 243, 246 (1956); *Bogardus v. Comm'r*, 302 U.S. 34, 41 (1937)) (internal quotations omitted) (noting that a gift stems from "disinterested generosity" rather than from "the incentive of anticipated benefit" of an economic nature); see also *Estate of Cristofani v. Comm'r*, 97 T.C. 74, 84 (1991) (indicating that the fact that a gift was motivated by tax concerns did not prevent the taxpayer from enjoying the annual exclusion); Richard M. Lipton, 'Codification' of the Economic Substance Doctrine—*Much Ado About Nothing?*, 112 J. TAX'N 325, 329 (2010) ("This means that estate and gift planning transfers, which invariably lack a business purpose, are not affected by the codification of the economic substance doctrine.").

167. See, e.g., *Estate of Strangi v. Comm'r*, 293 F.3d 279, 281–82 (5th Cir. 2002) (rejecting an IRS argument based on the case law doctrine of economic substance in the transfer tax context). For cases in which the courts did take into account business purpose in the transfer tax context, however, see, e.g., *Holman v. Comm'r*, 601 F.3d 763, 770 (8th Cir. 2010) (although not relying upon I.R.C. § 7701(o) (the passage of which postdates the fact pattern of this case), the U.S. Court of Appeals for the Eighth Circuit held that for gift tax valuation purposes, because the supposed business entity in question conducted "no 'business,' active or otherwise," the valuation of its interests had to be determined under I.R.C. § 2703(a) because the bona fide business arrangement exception rule under § 2703(b) did not apply); *Fisher v. United States*, No. 1:08-cv-0908-LJM-TAB, 2010 WL 3522952, at *3–*4 (S.D. Ind. Sept. 1, 2010).

168. See *Estate of Cristofani v. Comm'r*, 97 T.C. 74, 84 (1991) (recognizing that the gift transaction before the court was tax motivated, but nonetheless upholding the tax treatment sought by the taxpayer).

taxes,¹⁶⁹ it has another foot entirely in the income tax sphere insofar as the operative document (i.e., an installment sales agreement between the taxpayer and the trustee of the grantor trust) denotes that the transaction in question is a bona fide economic arrangement between two disinterested parties.¹⁷⁰ It is with respect to this latter "foot" that an expanded § 7701(o) would offer the IRS an opportunity: it might then be able to use this Code section to attack the nonrecognition of gain sought by the taxpayer, even though a possible reading of other sections of the Code might produce a contrary result.¹⁷¹

Recall how the typical sale to grantor trust operates. The taxpayer contributes funds to a grantor trust; using these funds as a down payment, the trustee of the grantor trust purchases an appreciating asset from the taxpayer, paying the balance of the purchase price with an installment note. The trust earns income, and the taxpayer remains liable for the tax upon that income. On the installment note, the trustee of the grantor trust makes principal and interest payments until the note is fully satisfied.¹⁷² An expanded § 7701(o) could be a highly effective weapon in the IRS arsenal in combating these abusive transactions.

When it comes to revising the economic substance doctrine (now codified in § 7701(o)) to defeat taxpayer transactions that intertwine gratuitous transfers with business transactions, there exists historical precedence. For example, consider the long lineage of gift-leaseback jurisprudence.¹⁷³ The facts in these cases often followed a common pattern: Taxpayers establish non-grantor trusts with their children as beneficiaries; taxpayers then gift title to real property to these trusts; these trusts, in turn, lease the contributed real property back to the taxpayers.¹⁷⁴ The whole

169. See John B. Huffaker & Edward Kessell, *How the Disconnect Between the Income and Estate Tax Rules Created Planning for Grantor Trusts*, 100 J. TAX'N 206, 206 (2004).

170. See *id.* at 210.

171. The agency has unfortunately drawn flawed conclusions (epitomized in Rev. Rul. 85-13, 1985-1 C.B. 184) as to what should be the appropriate tax outcome. As previously discussed, see *supra* notes 63-70 and accompanying text, the IRS should revoke Rev. Rul. 85-13 and thereby remove its tacit endorsement that transactions between taxpayers and grantor trusts fail to give rise to any income tax implications. Alternatively, the IRS should issue notice that with respect to those transactions deemed to lack economic substance, the agency will no longer be bound by Rev. Rul. 85-13.

172. See *supra* Section II.A (explaining the foundation and advantages of how grantor trusts operate).

173. See, e.g., Scott W. Brinkman, *Gifts and Leasebacks: Is Judicial Consensus Impossible?*, 49 U. CIN. L. REV. 379 (1980); G. L. Cohen, *Transfers and Leasebacks to Trusts: Tax and Planning Considerations*, 43 VA. L. REV. 31 (1957); Robert J. Peroni, *Untangling the Web of Gift-Leaseback Jurisprudence*, 60 MINN. L. REV. 735 (1984); Rona J. Rosen, *Gift-Leaseback Transactions: An Unpredictable Tax-Savings Tool*, 53 TEMP. L.Q. 569 (1980).

174. In tax parlance, these particular trust vehicles were known as *Clifford* trusts,

purpose of this arrangement was to enable contributing taxpayers (whose income was subject to high marginal tax rates) to secure rent deductions and assign the corresponding rental income to related taxpayers, namely, their children, whose income was subject to low marginal tax rates.¹⁷⁵

On numerous occasions, the IRS challenged the validity of such gift-leaseback arrangements.¹⁷⁶ In several instances, the IRS's position was upheld: Courts ruled that because income assignment was the force driving these arrangements, the transaction in question failed the business purpose test.¹⁷⁷ In many other instances, these arrangements were held to be bona fide, and taxpayers were allowed deductions for their rental payments.¹⁷⁸ What the sale-leaseback lineage of cases signifies is that the IRS would be within its historical prerogative to use an expanded § 7701(o), as it has previously used the business purpose doctrine to challenge gratuitous transfers cloaked as legitimate business transactions.

With respect to sales to grantor trusts, if the IRS invoked an expanded § 7701(o), the effects would be salutary. Taxpayers are currently at liberty to engage in such sales in ways that enable them to manipulate the tax system to their advantage. Aside from the sale of appreciating assets to a grantor trust, for example, consider the flexibility that taxpayers enjoy when the

eponymously named after *Helvering v. Clifford*, 309 U.S. 331 (1940). Typically, these trusts were irrevocable with terms of ten years and two days and with property reverting back to the taxpayer after the designated trust term lapsed.

175. See I.R.C. § 1 (2006) (progressive tax rate structure). *But see* I.R.C. § 1(g) (2006) (taxing unearned income of children under age 19 at their parents' highest marginal tax bracket).

176. See Rev. Rul. 54-9, 1954-1 C.B. 20, *modified on other grounds*, Rev. Rul. 57-315, 1957-2 C.B. 624, stating thus:

Accordingly, it is held that the transfer of real property to a trust for a 10-year period for the benefit of grantor's children with his wife as one of two trustees, with the corpus to go to the grantor's wife in the event of his death prior to the expiration of a 10-year period, and with a privilege of leasing back such property from the trustees constitutes a transfer in form rather than substance. Rental payments made to the trust by the grantor will not constitute deductible business expenses. The grantor will remain the owner of the property during the term of the trust for purposes of Federal income and gift taxes, and the rental payments when made will constitute gifts.

Rev. Rul. 54-9, 1954-1 C.B. 20

177. See, e.g., *Matthews v. Comm'r*, 520 F.2d 323, 324 (5th Cir. 1975) (sale-leaseback lacked economic reality and thus the rent deductions associated with the lease were disallowed); *Perry v. United States*, 520 F.2d 235, 236 (4th Cir. 1975) (sale-leaseback transaction was ignored because it lacked business purpose).

178. See, e.g., *Brown v. Comm'r*, 180 F.2d 926, 929 (3d Cir. 1950) (rent payments constituted legitimate business obligations and as such, were deductible); *Skemp v. Comm'r*, 168 F.2d 598, 600 (7th Cir. 1948).

terms of an irrevocable trust that has grantor trust status no longer suit the taxpayer's needs or desires. In those circumstances, a taxpayer can establish a new irrevocable trust that also has grantor trust status with more favorable terms and have its trustee purchase the prized assets of the irrevocable trust with the unfavorable terms.¹⁷⁹ Despite the lack of economic substance engendered by such transactions, such transactions (and others like them) have remained shielded from taxation to date.¹⁸⁰ The addition of an expanded § 7701(o) to the IRS's arsenal of weapons would presage the possible end of these taxpayer-friendly outcomes.

As indicated, in the sphere of transfer taxation, § 7701(o) currently has limited application. Congress should consider expanding the application of § 7701(o) to make it applicable to abusive transfer tax arrangements. Admittedly, distinguishing abusive from non-abusive transactions will not be easy. Nevertheless, a sale to a grantor trust arrangement should readily fall on the abusive side of the line.

IV. WHAT CONGRESS CAN DO TO MAINTAIN THE INTEGRITY OF THE TRANSFER TAX SYSTEM

Even if the IRS does its job and monitors tax compliance and the courts do their job in adjudicating disputes between the IRS and taxpayers, the transfer tax system will fail to achieve its intended goals of curtailing inherited wealth and raising tax revenue,¹⁸¹ unless Congress plays a more active role in promoting the integrity of the transfer tax system. First, Congress should eliminate absurdities that make the transfer tax system appear farcical to ordinary taxpayers. Second, when Congress learns of a statutory flaw or oversight, it should act with alacrity to remedy the problem.

A. *Eliminating Absurdities from the Transfer Tax System*

Many Code provisions are designed to make the tax system more administrable, efficient, and equitable.¹⁸² In theory, these provisions are grounded in logic and common sense; however, in practice, some of these very same tax provisions have spawned elaborate estate planning techniques that have shrouded the transfer tax system with absurdities, thus

179. See Rev. Rul. 2007-13, 2007-1 C.B. 684.

180. See, e.g., I.R.S. Priv. Ltr. Rul. 2005-18-061 (May 6, 2005); I.R.S. Priv. Ltr. Rul. 2005-14-001 (Apr. 8, 2005); I.R.S. Priv. Ltr. Rul. 2002-47-006 (Nov. 22, 2002).

181. See, e.g., James R. Repetti, *Democracy, Taxes and Wealth*, 76 N.Y.U. L. REV. 825, 825 (2001).

182. STANLEY S. SURREY, *PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES* 25-27 (1973).

subverting its public stature. The subsections below highlight three such emblematic provisions.

1. The Grantor Trust Rules

Taxpayers who engage in sales transactions with grantor trusts often marvel at the fact that the Code sanctions their use in ways that produce tremendous transfer tax savings. At the core, what must truly astonish taxpayers is that they can sell appreciated property to an irrevocable trust in which they lack any meaningful indicia of control (hence, such trust assets are not part of their gross estate); however, due to the antiquated grantor trust rules, the taxability of such transactions is ignored.¹⁸³ The stunning tax savings that such sales produce cast a harsh light on the interrelationship of the income and transfer tax systems,¹⁸⁴ strongly beckoning Congress to take remedial action.

On the one hand, Congress should consider large-scale reform and attack the root of the problem. The Tax Reform Act of 1986 compressed the income tax bracket structure for both estates and trusts¹⁸⁵ and also introduced the “kiddie tax,” a system whereby the unearned income of minor taxpayers is essentially taxed at their parents’ highest marginal tax rates.¹⁸⁶ Together, bracket compression and the kiddie tax have largely eliminated the need for the grantor trust rules (which, in large part, were designed to curtail taxpayers’ ability to assign income to other taxpayers, such as estates, trusts, and minor children whose incomes, at least in the past, were generally subject to lower marginal tax rates).¹⁸⁷ Combine this obsolescence with the fact that the grantor trust rules are now being used as devices to defeat taxpayers’ transfer tax obligations, and what becomes evident is that Congress should take decisive action and repeal these rules,¹⁸⁸ retaining them only in those instances when the trust in question is revocable.¹⁸⁹

On the other hand, if Congress were to lack the courage or the political will to scrap the grantor trust rules in their entirety, it could institute limited reform measures. More specifically, Congress could amend the Code to provide that all sales between taxpayers and grantor trusts constitute taxable

183. See *supra* Section II.A.

184. See Danforth, *supra* note 7, at 546.

185. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 101(a), 100 Stat. 2085, 2096–97.

186. *Id.* § 1411(a) (enacting I.R.C. § 1(g)).

187. See, e.g., Roswell Magill, *What Shall Be Done with the Clifford Case?*, 45 COLUM. L. REV. 111 (1945) (explaining taxpayers’ motivations for utilizing trusts as an income tax-savings device).

188. This proposal largely mirrors a proposal recommended by another commentator. See Ascher, *supra* note 41, at 888.

189. *Id.* at 930.

events.¹⁹⁰ By imposing a tax friction on such transactions, most taxpayers would no longer use sales to grantor trusts as a device to circumvent their transfer tax obligations.

2. The Annual Exclusion for Present Interest Gifts

In order to avoid having small or token gifts subject to gift tax, Congress instituted the annual gift exclusion found in I.R.C. § 2503(b).¹⁹¹ Under this Code section, “present interest gifts” are excluded from gift tax, and the donor need not file a gift tax return.¹⁹² To qualify for this exclusion, such gifts cannot exceed a specified dollar threshold, which is adjusted annually for inflation (in 2011, this dollar amount is \$13,000).¹⁹³

To illustrate the mechanics of the present interest rule, consider the following two fact patterns. In 2011, if a mother gifts \$13,000 to her daughter, no gift tax is due, and the mother need not file a gift tax return. Suppose instead that the mother makes an identical \$13,000 gift, but this time she places the cash in trust for her daughter’s benefit. Under these circumstances, the present interest gift tax exclusion would not apply (i.e., the gift into a trust constitutes a future interest),¹⁹⁴ and the mother would have to file a gift tax return and either use a portion of her lifetime gift tax exemption (currently, \$5 million)¹⁹⁵ or, if the mother’s lifetime gift tax exemption were exhausted, pay gift tax.¹⁹⁶

Taxpayers have not responded idly to the present interest exclusion. Under the terms of most inter vivos trusts that are irrevocable, taxpayers have fashioned a window period of withdrawal (usually thirty days), during which trust beneficiaries can withdraw contributed gifts.¹⁹⁷ As long as notice of this window period is given, this window period of withdrawal

190. This adjustment could most likely be done by adding a new section to I.R.C. § 1001. This subsection would direct that transactions between taxpayers and all grantor trusts, except those trusts that are revocable, would be recognized.

191. I.R.C. § 2503(b) (2006); H.R. REP. NO. 72-708, at 29–30 (1932); S. REP. NO. 72-665, at 41 (1932).

192. I.R.C. § 6019 (2006).

193. I.R.C. § 2503(b)(2).

194. See Treas. Reg. § 25.2503–3(a) (as amended in 2011) (“‘Future interest’ is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time.”).

195. See I.R.C. § 2505(a)(1) (2006).

196. See I.R.C. § 2501(a)(1) (2006).

197. Malcolm A. Moore, *Crummey Trusts*, in 26 PHILIP E. HECKERLING INSTITUTE ON ESTATE PLANNING ¶ 203.1 (John T. Grubatz ed., 1992); Bradley E.S. Fogel, *The Emperor Does Not Need Clothes—The Expanding Use of “Naked” Crummey Withdrawal Powers to Obtain Federal Gift Tax Annual Exclusions*, 73 TUL. L. REV. 555, 571 (1998); Kent Mason, *An Analysis of Crummey and the Annual Exclusion*, 65 MARQ. L. REV. 573, 593 (1982).

appears to transform otherwise future interest trust contributions into present interest gifts qualifying for the annual exclusion. In *Crummey v. Commissioner*,¹⁹⁸ this creative strategy was given a judicial imprimatur of legitimacy; indeed, the eponymously named *Crummey* withdrawal powers are probably the most commonly incorporated feature of virtually every newly minted inter vivos irrevocable trust.¹⁹⁹

Crummey withdrawal powers operate to readily defeat the underlying purpose of the gift tax annual exclusion—namely, to shelter taxpayers from the administrative inconvenience of having to account for those gifts that are considered de minimis in nature, such as birthday, wedding, and holiday presents. As a result of widespread *Crummey* power usage, vast amounts of wealth escape from the transfer tax base. Furthermore, its usage makes a mockery of the present interest exclusion.²⁰⁰ Left unchecked, the use of *Crummey* withdrawal powers siphons large sums of dollars from the transfer tax base and casts the transfer tax as a Maginot Line of sorts that can be easily circumvented.

However, a minor legislative change could make *Crummey* withdrawal powers a thing of the past. Simply put, Congress could declare that any and all direct and indirect contributions to irrevocable trusts fail to qualify for the present interest exclusion.²⁰¹ Institution of this simple provision would be the death knell for *Crummey* withdrawal powers and simultaneously strengthen the integrity of the transfer tax system.

198. *Crummey v. Comm’r*, 397 F.2d 82 (9th Cir. 1968).

199. See, e.g., Henry B. Greenberg, *Estate and Gift Issues Relating to Irrevocable Trusts*, DITM MA-CLE 1-1 (2009) (explaining how practitioners should incorporate *Crummey* provisions into irrevocable trusts); L. Henry Gissel, Jr., *Closing Thoughts for This Century on Crummey and Other Irrevocable Trusts (Including Insurance Trusts)*, SE35 ALI-ABA 521 (1999) (“*Crummey* clauses are a familiar estate planning device.”).

200. 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 Exclusion*, 6 FLA. TAX REV. 189, 193 (2003) (“It cannot be argued that *Crummey* powers are anything other than a ruse.”); John L. Peschel, *Major Recent Tax Developments in Estate Planning*, in 33 U.S. CAL. TAX INST. ch. 14, ¶ 1401 (1981) (“[T]he *Crummey* power, in theory, has a strong legal basis but, in practice, emits an equally strong odor of sham.”); Willard H. Pedrick, *Crummey Is Really Crummy!*, 20 ARIZ. ST. L.J. 943, 948 (1988) (“[T]he [*Crummey*] withdrawal right is transparently a flim flam.”); Benjamin N. Henszey, *Crummey Power Revisited*, TAXES: THE TAX MAGAZINE, FEB. 1981, at 76, 77 (“[T]he IRS is aware that the [*Crummey*] power is a sham in most cases.”); DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S REVENUE PROPOSALS 130 (Feb. 1998), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/grmbk98.pdf> (noting that “the *Crummey* power is essentially a legal fiction”).

201. Cf. TASK FORCE ON FED. WEALTH TRANSFER TAXES, REPORT ON REFORM OF FEDERAL WEALTH TRANSFER TAXES 97 (2004), available at <http://www.abanet.org/tax/pubpolicy/2004/04fwtt.pdf> (describing a similar legislative proposal).

3. The Generation-Skipping Transfer Tax Exemption

Current law provides that a generation-skipping transfer (GST) tax applies if certain events transpire (as defined by the Code to be a taxable distribution, a taxable termination, or a direct skip)²⁰² in which assets pass to "skip persons" (i.e., essentially a transferee who is two or more generations younger than the transferor).²⁰³ In those instances when a GST tax event occurs, GST tax is applicable.²⁰⁴ The GST tax rate is set to equal the highest marginal estate tax rate.²⁰⁵

The legislative purpose behind instituting the GST tax was to defeat attempts by wealthy taxpayers and their families to circumvent the estate tax.²⁰⁶ As an example, suppose a taxpayer establishes a trust for the lifetime benefit of his child with the remainder to his grandchild. The terms of this lifetime trust provide the child with the following rights and privileges: an income stream, principal distributions in accordance with an ascertainable standard, lifetime and testamentary special powers of appointment, and the annual ability to withdraw the greater of \$5,000 or five percent of the trust corpus. Notwithstanding that during the child's lifetime, he could potentially reap rich financial benefits from the trust, the trust's property would not be includable in the child's gross estate upon the child's death for purposes of the federal estate tax.²⁰⁷ Such transfers and others like them were and continue to be the targets of the GST tax, which imposes a tax in instances (such as the one posited in the above example) when gratuitous wealth transfers are not subject to tax at every generational level.²⁰⁸

To curtail the application of the GST tax to only those instances when taxpayers and their families were truly seeking to circumvent their transfer tax obligations in a significant fashion, Congress added a limited exemption to the GST tax.²⁰⁹ Its application enables taxpayers to transfer a certain dollar amount (currently, \$5 million) free of the GST tax.²¹⁰ For instance, a taxpayer can make a \$5 million gift to a grandchild without incurring a GST tax.²¹¹

Notwithstanding congressional intentions of providing a limited exception to GST tax application, taxpayers have capitalized upon the GST

202. I.R.C. § 2611(a)(1)–(3) (2006).

203. I.R.C. § 2613(a) (2006).

204. I.R.C. § 2641(a) (2006).

205. *Id.*

206. STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 564–66 (Comm. Print 1976) (explaining the need to introduce the generation-skipping transfer tax).

207. *See* I.R.C. § 2033.

208. *See supra* notes 200–02 and accompanying text.

209. *See* I.R.C. § 2631(a) (2006).

210. I.R.C. § 2631(c); I.R.C. § 2010(c)(3)(A).

211. *See* I.R.C. § 2631(c); I.R.C. § 2010(c)(3)(A); I.R.C. § 2613(a).

tax exemption in ways that Congress probably never envisioned. Indeed, taxpayers exploiting this exemption can pass wealth, free of GST tax, not only to so-called “skip” people who are two generations below them (such as grandchildren) but also to much more distant generations such as great-grandchildren and great-great-grandchildren.²¹² This ability to pass property to very distant generations without the application of a GST tax combined with the eradication by most states of their rules against perpetuities has given rise to an era of dynasty trust formation.²¹³ Utilizing the GST tax exemption, wealthy families can now establish trusts, funded with millions of dollars, which are essentially insulated from transfer tax for possibly centuries and millenniums to come.²¹⁴

But there is a relatively easy fix to the dynasty trust problem. Congress can limit GST tax exemption allocation to those instances in which the property in question vests with a skip person not more than two generations below the transferor (i.e., the transferor’s grandchildren). If property vests or could vest with a skip person more remote (e.g., great-grandchildren), Congress could prohibit taxpayers from making a valid GST exemption allocation.²¹⁵ By narrowing the application of the GST tax exemption in this fashion, Congress would protect the transfer tax base and help eradicate the wealth disparities that dynasty trusts generate.²¹⁶

In sum, the three devices summarized above—use of grantor trusts, *Crummey* withdrawal rights, and dynasty trusts—do not exhaust the field of tax absurdities, but they are representative of the systemic problems inherent in the Code. These absurdities generate taxpayer cynicism, which

212. See I.R.C. § 2631(c); I.R.C. § 2613(a).

213. See, e.g., Lawrence W. Waggoner, *Message to Congress: Halt the Exemption for Perpetual Trusts*, 109 MICH. L. REV. FIRST IMPRESSIONS 23, 23–24 (2010) (decrying the use of perpetual trusts by wealthy taxpayers); Robert H. Sitkoff & Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356, 410–11 (2005) (finding that roughly \$100 billion in trust assets had flowed into trusts governed by state law that allow perpetual or near-perpetual trusts and that impose no state income tax on trust income produced by funds originating from out of state).

214. See Waggoner, *supra* note 213, at 23–24.

215. See STAFF REPORT OF JOINT COMM. ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 393, available at <http://www.house.gov/jct/s-2-05.pdf> (Several years ago, the Joint Committee on Taxation made this recommendation.).

216. See, e.g., Ray D. Madoff, *America Builds an Aristocracy*, N.Y. TIMES July 10, 2010, available at <http://www.nytimes.com/2010/07/12/opinion/12madoff.html> (bemoaning the surge of dynasty trust use in United States). Another proposal worthy of consideration would be for Congress to institute a federal law adopting the rule against perpetuities. See Mitchell Gans, *Federal Transfer Taxation and the Role of State Law: Does the Marital Deduction Strike the Proper Balance?*, 48 EMORY L.J. 871, 879 (1999) (“To remedy [the problem of perpetual trusts], a federal rule limiting the duration of exempt trusts, . . . would be necessary.”).

in turn causes taxpayers to believe that the whole transfer tax system is rife with corruption, i.e., nothing more than a charade in which only those “not in the know” are forced to participate.

*B. Act with Alacrity to Remedy Legislative
Shortcomings and Oversights*

One of the most interesting things about the problems confronting the transfer tax system is that they are hiding in plain sight. For example, virtually any practitioner journal or programming agenda of any estate planning continuing legal education series offers readily available planning devices that exploit legislative shortcomings and oversights.²¹⁷ The effects of this publicity are twofold. First, the public discourse and exchange of ideas helps to refine these devices, making them less susceptible to IRS challenge and attack. Second, the very act of publicizing these planning devices provides them with an aura of legitimacy, lending traction and credence to their acceptability.

The availability of this knowledge is in sharp contrast to the tax shelter problem that beset the nation during the 1990s. Consider the fact that during the 1990s, tax practitioners were dispensing numerous putative tax-saving strategies that were costing the nation billions of dollars of lost tax revenue annually.²¹⁸ Part of the success of these strategies was that this subterfuge was clandestine,²¹⁹ indeed, as part of these arrangements, participating taxpayers were often required to sign nondisclosure agreements. The clandestine nature of these arrangements allowed them to flourish, particularly, because many of these strategies eluded detection upon audit. Once these methodologies were brought to light, the IRS and then the courts agreed that these arrangements lacked economic substance,

217. See, e.g., Steve R. Akers, *Estate Planning in 2010 and Beyond: Now What?*, SS007 ALI-ABA 1 (2010); S. Stacy Eastland, *Some of the Best Estate Planning Ideas We See Out There*, CS004 ALI-ABA 29 (2010); Lawrence P. Katzenstein, *Some Interest-Sensitive Estate Planning Techniques (with an Emphasis on GRATS and QPRTS)*, SR042 ALI-ABA 151 (2008); Domingo P. Such, III, *Advance Transfer Tax Planning Issues for Estate Planning for the Family Business Owner*, SS008 ALI-ABA 597 (2010).

218. See COMM. ON HOMELAND SEC. & GOV'T AFFAIRS, *THE ROLE OF PROFESSIONAL FIRMS IN THE UNITED STATES TAX SHELTER INDUSTRY*, S. REP. NO. 109-54, at 11 n.21 (2005), available at <http://www.gpo.gov/fdsys/pkg/CRPT-109srpt54/html/CRPT-109srpt54.htm> (reporting that, according to the General Accounting Office, a recent IRS consultant estimated that between 1993 and 1999, the IRS lost on average between \$11 billion and \$15 billion each year from abusive tax shelters).

219. See Chin-Chin Yap, *The Tax Shelter Game*, 59 TAX LAW. 1021, 1022 (2006) (“Likewise, the results of enforcement efforts to stem the tide of abusive tax shelters are speculative at best in the secretive, elastic, and innovative world of the tax shelter industry.”).

largely putting an end to their existence.²²⁰ In the aftermath of the financial damage that such techniques caused the government, Congress subsequently instituted various disclosure measures designed to curb the reoccurrence of such tax shelters and to put the IRS on notice regarding the use of these and similar income tax shelter techniques.²²¹

But in the transfer tax sphere, Congress has not exercised this same vigilance. This is evidenced by the fact that Congress has a readily available road map—via practitioner journals and continuing education legal lecture series—of the most utilized transfer tax savings devices. There are a host of reasons why Congress has taken little or no action to defeat such devices, but the primary one is lack of political will. Although the transfer tax system remains an easy target for scorn and ridicule if it continues to be littered with loopholes and silly absurdities such as those described in the prior subsection, constituents are not interested in paying more taxes. This dislike of the transfer tax system has translated into complete inaction toward making it any sounder, allowing it to remain dysfunctional. Indeed, over the past decade, there have been numerous proposals championed to eliminate the transfer tax system in its entirety²²² or to strip it of any effectiveness.²²³

At some future point in time, if Congress wants to make the transfer tax system more effective, it can readily do so by closing publicized loopholes. Establishing a transfer tax oversight commission that reports annually to Congress would be a step in the right direction. Assuming that the commission's recommendations are taken seriously, quick congressional action to close down transfer tax planning strategies will have a significant salutary effect: It will drive practitioners to be less vocal about their planning ideas and exploitation devices, and in the absence of these techniques being tested and refined in the public domain, it will have a tremendous chilling effect upon their use.

In the realm of transfer tax reforms that Congress should undertake, the suggestions outlined above are but a smattering of the plethora of changes

220. Karen C. Burke & Grayson M.P. McCouch, *COBRA Strikes Back: Anatomy of a Tax Shelter*, 62 TAX LAW. 59, 60 (2008).

221. Taxpayers are required to disclose the details of reportable transactions in which they participate by filing IRS Form 8886, "Reportable Transaction Disclosure Statement," with the IRS Office of Tax Shelter Analysis in Ogden, Utah. Treas. Reg. § 1.6011-4(d) (2010). At least one commentator has praised the effectiveness of such disclosure requirements. See Ronald A. Pearlman, *Demystifying Disclosure: First Steps*, 55 TAX L. REV. 289, 323 (2002) (asserting that disclosure measures are a "powerful tax enforcement tool" leading to "enhanced compliance").

222. See, e.g., Death Tax Repeal Permanency Act of 2005, H.R. Res. 202, 109th Cong. (2005) (calling for the elimination of the transfer tax system).

223. See, e.g., Permanent Estate Tax Relief Act of 2006, H.R. Res. 885, 109th Cong. (2006) (raising the exemption to \$5 million and setting the top estate tax rate equal to the capital gains tax rate).

that should be legislatively instituted. Notwithstanding this fact, if the above few recommendations were instituted and an oversight commission was put into place, ordinary taxpayers would most likely take their transfer tax obligations more seriously, resulting in greater taxpayer compliance. Correspondingly, the transfer tax system would become much better positioned to accomplish its intended goals of curtailing inherited wealth and raising revenue.²²⁴

V. CONCLUSION

As evidenced by statistical data, transfer taxes apply to only the wealthiest slice of taxpayers.²²⁵ These same taxpayers have ample resources to secure professional advice and to devise ways to minimize their transfer tax burdens. And for close to a century,²²⁶ they have received a healthy return on their professional advice investment, reaping huge transfer tax savings.²²⁷

A sale to grantor trust represents one planning device that has gained traction in the estate planning community and will likely gain in popularity as Congress is possibly poised to put the brake on other techniques. As the popularity of this technique gains momentum, it threatens the vibrancy of the transfer tax system by reducing its capacity to raise revenue and to curb accumulations of inherited wealth.²²⁸ Other transfer tax savings devices play this same destructive role, and new device formulations no doubt loom on the horizon.

In its existing arsenal, the IRS has weaponry at its disposal to defeat these transfer tax savings devices. In particular, under *Chevron*, the Supreme Court has accorded the IRS significant latitude to draft Treasury regulations that can eliminate many of these planning devices.²²⁹ The only question is how far the IRS can go in successfully employing this strategy without generating the perception that it is overreaching.

The strength of statutory language, rather than regulations, however, ultimately dictates the soundness of any tax system. That being the case, Congress must be vigilant and nimble in crafting legislation and should curb taxpayers' ability to game the system. Furthermore, once Congress

224. See Repetti, *supra* note 181.

225. For most years that the estate tax has been in effect, its application has been limited to two percent of the nation's wealthiest individual taxpayers. Darien B. Jacobson, Brian G. Raub & Barry W. Johnson, *The Estate Tax: Ninety Years and Counting*, IRS PUBLICATIONS, June 22, 2007, at 118, available at <http://www.irs.gov/pub/irs-soi/ninetyestate.pdf>; Jane G. Gravelle, *CRS Updates Estate Tax Options Report*, 2010 TAX NOTES TODAY 114-23 tbl.1 (2010).

226. See Act of September 8, 1916, Pub. L. No. 64-271, 39 Stat. 756.

227. See Schmalbeck, *supra* note 10.

228. See Repetti, *supra* note 181.

229. See *Chevron*, 467 U.S. at 864-66.

learns that taxpayers have devised methods to breach the system, it must react with deliberate speed to close such statutory gaps.²³⁰

A case study is typically representative of a larger phenomenon and, as such, can be an effective tool in analyzing important policy issues. Examining a sale to grantor trust is such a case study. This technique represents a broad spectrum of transfer tax savings strategies, and the use of this device illuminates those reform measures that are necessary to improve and overhaul the transfer tax system. Like any case study, however, its ultimate effectiveness is determined by whether those with political power heed its lessons and actually apply them.

230. Rhetorical question: After the court decision in *Walton v. Commissioner*, 115 T.C. 589 (2000), *acq.* 2003-2 C.B. 964, which sanctioned the use of zeroed-out GRATs, why has Congress not yet taken action to close this gaping loophole?

