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GRIT's, GRAT's and GRUT's: Planning and Policy

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I. INTRODUCTION

On November 5,1990, legislation of vital importance to the estate-planning community was enacted.[1] Adding chapter 14 to the Internal Revenue Code ("Code"),[2] the legislation adopted a comprehensive framework for dealing with various estate-freeze techniques, which taxpayers had been utilizing for the purpose of minimizing — and, in some cases, avoiding — transfer-tax liability.[3] One technique explicitly targeted in the new legislation is the gran-

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[1] Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990).

[2] I.R.C. §§ 2701-2704. [Hereinafter, all references to "section," "Code," and "I.R.C.," are from the Internal Revenue Code of 1986 as amended, unless otherwise noted.]

[3] H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess. 1134 (1990), reprinted in 1990 U.S.C.A.N 2374, 2839. For a description of the progress that this legislation and its antecedent proposals made as they worked their way through Congress, see John H. Gardner, Estate Freezes 1990 and Beyond: The Story of the Repeal of Section 2036(c) and the Valuation Rules That Took Its Place, 69 Taxes 3 (1991).

tor retained income trust (the "GRIT").

The GRIT is a variation on the inter vivos gift, which has long been used by taxpayers as an estate-planning strategy designed to reduce transfer-tax liability.[4] While Congress has sought to eliminate the transfer-tax advantages inherent in the making of inter vivos gifts, it has not been entirely successful.[5] However inappropriate as a matter of policy, the inter vivos gift remains a viable and important technique for achieving transfer-tax savings.[6] In the 1980's, tax planners began to realize that the GRIT was a particularly attractive method by which to effect an inter vivos gift, making the GRIT one of the most popular estate-planning strategies.[7]

In appropriate circumstances, the GRIT could produce more wealth for its remainderman than a comparable outright gift might produce for a donee.[8] In essence, the GRIT would be structured to require that trust income be paid to the grantor for a period of years designated in the trust instrument. Upon the expiration of this period of years, the trust would terminate, and the corpus would pass to the remainderman.

At the creation of the trust, the grantor would be treated as having made a taxable gift equal to the discounted present value of the remainder interest. Upon the termination of the trust, no further transfer tax would be imposed, assuming the grantor was still alive. The comparative attractiveness of the GRIT relative to an outright gift resulted from the assumptions made by the Internal Revenue Service in computing the discounted present value of the GRIT's remainder interest. Part II of this article explores the nature of the comparative advantages that had been enjoyed by the GRIT, as well as the connection between these advantages and the

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[4] See, e.g., Dep't of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth; General Explanation of the Treasury Department Proposals, 85-9257, 85-11352, Volume 2 at 376 (Nov. 1984).

[5] See, e.g., Theodore S. Sims, Timing Under a Unified Wealth Transfer Tax, 51 U. Chi. L. Rev. 34 (1984) (suggesting that while Congress has made substantial progress toward eliminating the disparity between the estate tax and the gift tax, it has not been entirely successful in eliminating the advantages taxpayers manage to secure by making inter vivos gifts).

[6] See, e.g., Joseph M. Dodge, Redoing the Estate and Gift Taxes Along Easy-to-Value Lines, 43 Tax L. Rev. 241 (1988); Theodore S. Sims, supra note 5; Harry L. Gutman, Reforming Federal Wealth Transfer Taxes After ERTA, 69 Va. L. Rev. 1183, 1217 (1983).

[7] See, e.g., F. Ladson Boyle, Evaluating Split-Interest Valuation, 24 Ga. L. Rev. 1, 6 (1989); Jonathan G. Blattmachr & Mitchell M. Gans, An Analysis of the TAMRA Changes to the Valuation Freeze Rules: Part I, 70 J. Tax'n 14 (1989).

[8] See, e.g., Harry F. Lee, The Economics of a GRIT, 68 Taxes 555 (1990).

assumptions made by the Service for purposes of valuing the remainder interest.

Concerned about taxpayers exploiting the GRIT's advantages, Congress began to focus on the GRIT in 1988 and returned to it again in 1990. Congress limited the potential tax benefits of the GRIT in 1988, and then attacked it much more aggressively in 1990. Under section 2702, which was added to the Code as a part of chapter 14 in 1990, it is no longer permissible to determine the amount of the taxable gift triggered at the creation of a GRIT through the application of a discount. Instead, the section makes the taxable gift equal to the entire value of the property contributed to the GRIT. In effect, the section values the remainder interest for gift-tax purposes without taking into account the period of years that must expire before the remainderman becomes entitled to possess the trust corpus. In Part III of this article, the approaches adopted by Congress in 1988 and 1990 are reviewed. Part IV argues that section 2702 is not a neutral solution to the problems presented by the GRIT.

Section 2702 does not treat all trusts under which the grantor retains an interest in the same fashion. Where, unlike the GRIT, the grantor retains the right to receive from the trust each year either a fixed sum or a fixed percentage of the value of the trust corpus as determined from year to year, the section permits the application of a discount for purposes of computing the amount of the taxable gift (i.e., the value of the remainder interest). A discount is permitted in this context on the rationale that neither of these trusts — popularly known as the grantor retained annuity trust (GRAT) where the grantor retains the right to receive a fixed sum and the grantor retained unitrust (GRUT) where the grantor retains the right to receive a fixed percentage of trust corpus — permits the kind of exploitation taxpayers had managed to achieve with the GRIT. In addition, section 2702 is entirely inapplicable in the case of a GRIT holding as its only asset the grantor's personal residence, also presumably because of the limited potential for taxpayer abuse inherent in such a trust. In Parts V, VI and VII of this article, respectively, the advantages and disadvantages of the GRAT, the GRUT, and the personal-residence GRIT are examined.

The estate-tax treatment applicable in the case of a GRIT has been, and remains, straightforward. Where the grantor dies prior

to the expiration of the income interest, the entire value of the GRIT corpus is includible in the grantor's gross estate under section 2036.[9] In contrast, whether section 2036 applies and its method of application are not as well defined in the case of a GRAT or a GRUT. Parts VIII and IX analyze the authorities that have applied section 2036 to trusts under which the grantor has retained the right to recover a fixed sum or a fixed percentage of trust corpus each year, offering alternative methods for applying the section to trusts of this type. Finally, the article argues that the advantages inherent in the GRAT and the GRUT make it appropriate to apply the section in this context in order to achieve neutrality.

II. The GRIT's Advantages Prior to the Enactment of Section 2702

Prior to the enactment of section 2702, taxpayers were able to achieve substantial transfer-tax savings by creating a GRIT. The grantor of a GRIT would retain the right to receive the income from the property transferred to the trust for a period of years designated in the trust instrument. At the creation of the GRIT, a taxable gift equal to the value of the remainder interest would be deemed to occur.[10] The income interest, having been retained by the grantor, would not be subject to the gift tax.[11] If the grantor survived the income-retention period, the trust corpus would pass to the remainderman without the imposition of any additional gift or estate tax,[12] producing a transfer-tax advantage for the grantor.

If the grantor died during the income-retention period, the value of the trust corpus as determined on the date of the grantor's death would be includible in her gross estate[13] — rendering unavailable any transfer-tax advantage that the grantor had hoped to achieve in creating the GRIT. Thus, at the time of creating a GRIT, a taxpayer could not be certain that the advantages — or

[9] I.R.C. § 2036.

[10] See Robinette v. Helvering, 318 U.S.184 (1943); Smith v. Shaughnessy, 318 U.S. 176 (1943); Treas. Reg. § 25.2511-1(e) (1958); Sims, supra note 5, at 46.

[11] See Robinette v. Helvering, 318 U.S.184 (1943); Smith v. Shaughnessy, 318 U.S. 176 (1943); Treas. Reg. § 25.2511-1(e); Sims, supra note 5, at 46.

[12] See, e.g., Richard B. Covey, Practical Drafting 403-22, 1338-45 (1984 & Supp. 1988); Dan T. Hastings, Grantor Retained Income Trust, 12 Prob. Notes 92 (1986).

[13] I.R.C. § 2036(a)(1).

gaming benefits — offered by the GRIT would in fact be realized.

This part of the article examines the advantages inherent in the GRIT prior to the enactment of section 2702, suggesting that the GRIT produced three types of distinct advantages where the assumptions underlying the IRS valuation tables[14] proved to be inconsistent with the reality of investment performance.

First, where the tables utilized a discount rate that was unrealistically high relative to the rate available in the market, an understatement in the amount of the taxable gift triggered at the creation of the GRIT would occur. The resulting advantage will be referred to as "rate benefit."

Second, the tables failed to take into account the possibility that the trustee of a GRIT might invest in a vehicle that would produce a return consisting, in part, of appreciation (principal within the meaning of the trust-accounting rules under state law[15]). When the trustee invested in such a vehicle, the appreciation would pass to the remainderman free of transfer tax. This opportunity to pass appreciation to the remainderman on a transfer-tax-free basis will be referred to as "appreciation benefit."

Third, where the investment vehicle held in the GRIT produced appreciation, the GRIT enjoyed an additional advantage over a comparable outright gift that was distinct from appreciation benefit. This additional advantage will be referred to as "leverage benefit." Although leverage benefit was present only where the investment vehicle produced appreciation and could be viewed as subsumed within appreciation benefit, it is useful to analyze the two benefits separately.

A. *Rate Benefit (or Loss)*

Since, prior to the enactment of section 2702, the amount of the taxable gift deemed to occur at the creation of a GRIT was equal to the present value of the remainder interest, the selection of an appropriate discount rate was critical. When the IRS tables were predicated on a discount rate that was high in relation to the rate obtainable in the marketplace, the tables would produce an undervaluation of the remainder, resulting in an understatement in the

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[14] See Treas. Reg. § 25.2512-5(f).

[15] See, e.g., Revised Uniform Principal and Income Act § 3(b)(1), 7B U.L.A. 154-155 (1962).

amount of the taxable gift.

Consider, for example, a transfer of one dollar to a one-year GRIT at a time when the table rate was 10% and the rate available in the marketplace was 5%.[16] The table rate of 10% would have produced a value with respect to the remainder of 90.9¢ ($1 / 1.05). In contrast, the application of the 5% market rate would have produced a value for the remainder of approximately 95.2¢ ($1 / 1.05). An economist or valuation expert, if asked to value the remainder at the time the GRIT was created, would have applied the market rate of 5% and, therefore, concluded that the value of the remainder was higher than the value produced by the table rate. A taxpayer interested in transferring wealth while minimizing his transfer-tax cost might well have used a GRIT in this case, given that the table rate exceeded the market rate. For the transfer of an asset the remainder, with a value of 95.2¢ (determined through the application of the rate available in the marketplace) should have produced a taxable gift of 95.2¢. But since the table rate would have produced a value, as well as a taxable gift, of only 90.9¢, the differential in rates would create rate benefit.

Rate benefit is perhaps more clearly illustrated by comparing the GRIT to an outright gift. If the grantor in the preceding example had made an outright gift of 90.9¢ instead of creating a GRIT, the donee would have had 95.44¢ (90.9 x 1.05) at the end of one year. In contrast, the one-year GRIT would have placed $1 in the hands of the remainderman at the end of the same one-year period. Thus, the GRIT would have produced more wealth for the remainderman than the outright gift would produce for the donee, even though the gift-tax cost associated with these two methods of transfer would have been identical.

It was also possible for the discount rate to work to the disadvantage of taxpayers — producing what might be called "rate loss." This would occur when the rate available in the marketplace was greater than the table rate. So, for example, assume the contri-

[16] It is assumed that the grantor's estate would have been entitled to receive trust income for the entire year even if the grantor had died during the course of the year. In the absence of such an entitlement on the part of the grantor's estate, the value of the remainder interest would have been greater. In all of the examples hypothesized in this article, it will be assumed that the grantor's estate had been entitled to receive what the grantor would have received had he survived the trust term. Under I.R.C. § 2702, however, such an entitlement is, in effect, ignored. See infra note 83.

bution of $1 to a one-year GRIT at a time when the market rate was 10% and the table rate was 5%. Given the table rate, the value of the remainder, and the amount of the taxable gift, would have been 95.2¢ ($1 / 1.05), while the application of the market rate would have produced a value for the remainder of 90.2¢. Thus, where the table rate was below the market rate, an overvaluation of the remainder and consequently an overstatement in the amount of the taxable gift occurred.

A grantor who created a GRIT would, of course, not be able to predict at the time of creating it the rate of return that trust investments would actually produce. As a consequence, it could not be determined at the time of creation whether rate benefit or loss would in fact result. It has been suggested that this inability to predict whether rate benefit or loss would be experienced diminished the planning potential inherent in the GRIT, thus rendering it an unobjectionable wealth-transfer technique as a matter of policy.[17]

The premise underlying this suggestion is that regardless of the relationship between the table rate and the market rate, it was equally probable that rate benefit or rate loss would occur. This is erroneous. For a grantor, before deciding to create a GRIT, would obviously compare the rates available in the marketplace with the rate utilized in the tables, opting for the GRIT only when there was a high probability that the actual rate of return would prove to be less than the table rate.

Even though a prudent grantor would only create a GRIT when the relationship between the market rate and the table rate was favorable, it was, of course, always possible for the market rate to increase during the term of the GRIT — resulting in less rate benefit than anticipated or, even perhaps, rate loss. Nevertheless, it was certainly more probable that rate benefit, rather than rate loss, would materialize when the table rate was unrealistically high in relation to the market rate at the time of creating the GRIT. Consequently, although it could not be predicted with certainty at the time of creating a GRIT whether rate benefit or loss would result, a prudent grantor would only use the GRIT to achieve rate benefit where it was highly probable that the actual rate of return

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[17] See Louis S. Harrison, The Effective Use of GRITs To Reduce the Gross Estate, 68 Taxes 524, 526 (1990).

would turn out to be less than the table rate.

While it was generally not possible to predict with certainty whether rate benefit or loss would result, the rate available in the market at the time the GRIT was created could, in some circumstances, be "lock-in" — thus assuring that rate benefit would be achieved if the market rate was less than the table rate at that time. Assume, for example, the grantor and her family were inclined to invest in, and retain until redemption, fixed-income obligations having a maturity of ten years. If the grantor created a ten-year GRIT that would hold obligations with such a maturity, the rate of return predicted at the outset would prove to be accurate, unless the trustee sold the obligations prior to redemption or the obligor failed to make payment upon maturity. Thus, in circumstances such as these, assuming neither a sale by the trustee nor a default by the obligor, the market rate available at the time of the creation of the GRIT would, as a practical matter, be "locked-in." As a consequence, whether rate benefit would be achieved — and if so, the magnitude of the benefit — could be determined with reasonable certainty at the time of the creation of the GRIT.

Comparing the anticipated rate of return and the rate utilized in the table was complicated by the availability of various investment vehicles in the marketplace offering different rates of return. For example, it might have been possible to find, at a time when the table rate was 10%, an investment offering an 8% rate of return and another investment offering a 12% rate of return. Which of these rates would have been appropriate to use in making the comparison with the table rate?

The differential in risk associated with the different investments available in the market accounts for the disparity in rates. As the risk inherent in an investment increases, the rate of return it offers must obviously also increase in order to attract investors.[18] This relationship between risk and rate of return must be explored in the context of valuing a remainder interest under a GRIT.

Contrast, for example, two remainder interests under two differ-

[18] See, e.g., Jeffrey N. Gordon & Lewis A. Kornhauser, Efficient Markets, Costly Information, and Securities Research, 60 N.Y.U. L. Rev. 761, 778-80 (1985); H. Kerzner, Understanding Corporate Bonds 2 (1990); Roger G. Ibbotson & Rex A. Sinquefield, Stocks, Bonds, Bills, and Inflation: Historical Returns, The Financial Analysts Research Foundation, University of Virginia (1979, 1984).

ent GRIT's (GRIT I and GRIT II). The trustee of GRIT I invested in a fixed-income obligation yielding 10%; the trustee of GRIT II invested in a fixed-income obligation (perhaps a junk bond) yielding 18%. The greater risk inherent in the investment acquired by the trustee of GRIT II would generate an additional return for the grantor in his capacity as income beneficiary. Yet, if the risk translated into an actual decline in the value of the investment, that decline would be borne by the remainder interest.[19] Since the remainder interest under GRIT II was, without compensation, required to bear a greater risk than the remainder interest under GRIT I, the ex-ante value of the remainder interest under GRIT II is less than the value of the remainder interest under GRIT I.

Because the remainder interest is required to bear all of the risk, it is appropriate to discount the remainder by a rate reflective of the level of risk undertaken.[20] In other words, the present value of the right to receive a sum of money in the future subject to a risk for which the market sets x% as appropriate compensation should be determined by using a discount rate of x%. Thus, in the case of GRIT I, the value of the remainder should be determined by using a discount rate of 10%, which was the rate of return offered by the investment held in GRIT I; similarly, the appropriate discount rate for the remainder interest under GRIT II is 18%.

Given this relationship between risk and value, considering the level of risk that the grantor (or her family) would ordinarily be inclined to assume was necessary. In effect, the extent to which the grantor and her family were averse to risk would determine the potential for rate benefit or loss and concomitantly the appropriateness of using a GRIT. Consider a GRIT created when the tables utilized a 10% rate. Assuming the grantor and her family were comfortable investing in fixed-income obligations yielding 8%, the opportunity to achieve rate benefit might well have convinced the grantor to create a GRIT. Where the grantor was comfortable with the greater risk associated with investing in 12% bonds, the potential for rate loss might have deterred the grantor from creating a GRIT.

The rate benefit that would have occurred with an investment in 8% bonds and the rate loss that would have occurred with an in-

[19] See, e.g., Revised Uniform Principal and Income Act § 3(b)(1), 7B U.L.A. 155.
[20] See, e.g., Boyle, supra note 7, at 28.

vestment in 12% bonds can be illustrated by comparing the GRIT with an outright gift. If the grantor had created a one-year GRIT, the taxable gift would been approximately 90.9¢ ($1 / 1.1). At the termination of the GRIT, one year after its creation, the remainderman would have received one dollar. In contrast, the donee of a comparable outright gift of 90.9¢ would have had, if invested at 8%, 98.172¢ at the end of one year (90.9¢ x 1.08); and, if invested at 12% for one year, $1.01808 (90.9¢ x 1.12).

A family inclined to invest in the 8% bonds would probably have been motivated by the opportunity for rate benefit to create a GRIT; for, at the end of the one-year period, the remainderman of the GRIT would have had one dollar, whereas the donee of a comparable outright gift (invested at 8%) would have had only 98.172¢. On the other hand, a family inclined to invest in the 12% obligations would probably have opted for an outright gift rather than a GRIT; for, at the end of the one-year period, while the remainderman of a GRIT would have had only one dollar, the donee would have had (assuming a 12% investment) $1.01808. In effect, the more willing the family might have been to tolerate investment risk, the less likely it would have encountered opportunities to enjoy rate benefit. Conversely, families who would have chosen more conservative investments in order to minimize risk would have encountered more opportunity for rate benefit.

Typically, investors do not maintain a portfolio of investments generating a uniform rate of return. Instead, they usually are more comfortable diversifying, holding investments that offer different levels of risk and concomitantly different rates of return. Where a GRIT was contemplated, predicting whether rate benefit would occur was complicated by the variety of returns generated by the different investments held by the grantor/donor. While a low-yield investment (relative to the table rate) would have made an excellent candidate for a GRIT, a high-yield investment (relative to the table rate) would not. As a consequence, interest in transferring a particular investment — or indifference about which investment to transfer — was critical to the decision whether to use a GRIT or make an outright gift.

For example, assume a person deciding between a GRIT and an outright gift, at a time when the table rate was 10%, held two investments: investment A, yielding 8%, and investment B, yielding 12%. The relative attractiveness of the GRIT depends upon which

of the investments the donor preferred to transfer. In making the analysis, it was necessary to contrast the wealth that a GRIT would place in the hands of the remainderman with the wealth that a comparable outright gift would place in the hands of a donee, taking into account the anticipated return on the particular investment chosen for transfer. The table below reflects, with respect to both investment A and B, the amount of wealth that a remainderman would have had upon the termination of a one-year GRIT funded with $1; it also reflects for both investments the amount of wealth that a donee of a comparable outright gift of 90.9¢ (comparable because the taxable gift deemed to occur upon the creation of the GRIT would have been 90.9¢, given the table rate of 10%[21]) would have had after a year.

Amount of wealth held by the transferee at the end of one year:

GRIT using investment A	$1.00
GRIT using investment B	$1.00
Outright gift of investment A	$.98172 (90.9 x 1.08)
Outright gift of investment B	$1.01808 (90.9 x 1.12)

As the table makes clear, a donor/grantor willing to transfer investment A but not investment B would have been well advised to create a GRIT; for a GRIT containing investment A would have placed more wealth in the hands of the remainderman than a comparable outright gift of investment A would have produced for the donee. In contrast, a donor/grantor willing to transfer investment B but not investment A should have made an outright gift. For a donor/grantor indifferent about which investment to transfer, an outright gift of investment B would have been the most effective alternative.

From the viewpoint of the Treasury, an unrealistically high table rate during one period would not balance out an unrealistically low table rate during a different period. For, as suggested, taxpayers presumably made the decision to use a GRIT or effect an outright gift only after having compared the table rate with the market rate — choosing the GRIT only when the relationship between the market rate and the table rate made it likely that rate benefit

[21] $1 / 1.10 = approximately 90.9¢.

would occur. In other words, prudent taxpayers would opt for the GRIT when the table rate was high in relation to the rates available in the market, leading to a systematic loss for the Treasury. In order to limit the opportunity that taxpayers had to exploit any disparity between the market rates and the table rate, it was necessary for the table rate to either realistically reflect or be less than the rates available in the market. To accomplish this, Congress amended section 7520 in 1988 in order to make the table rate more sensitive to the rates available in the market.[22]

To determine whether the table rate was greater than, equal to or less than the market rate, it was necessary to choose in making the analysis between a before-tax and an after-tax market rate. An economist or valuation expert would have chosen an after-tax rate. For the remainder interest subject to valuation entitled the remainderman to receive tax-free dollars upon the termination of the income-retention period.[23] To determine the amount that must be set aside today such that it would grow to some greater sum of tax-free money in the future, an after-tax rate must be used.

To illustrate, assume the rate available on tax-free bonds had been 7%, the rate available on a taxable bond (of comparable quality) had been 10% and the income-tax rate had been 30%. In these circumstances, the value of the right to receive a dollar of tax-free money in one year would be approximately 93.46¢. In other words, if one had invested 93.46¢ in a tax-free bond paying interest at the rate of 7%, one dollar of tax-free money would have been available at the end of a year ($.9346 x 1.07). If the taxable rate of 10% had been utilized for valuation purposes instead, the value of the right to receive a dollar in one year would have been 90.9¢ ($1 / 1.10).

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[22] See I.R.C. § 7520 as amended by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 5031, 102 Stat. 3342, 3668. As amended, § 7520 sets the rate to be utilized for purposes of valuing certain interests under a trust at 120% of the applicable federal midterm rate, as determined under § 1274(d), which is adjusted monthly to reflect changes in the market rate. It would seem that the § 7520 rate is inappropriately high. Compare the § 7520 rate with the lower rate required under I.R.C. § 7872, (applicable in the case of interest-free or below-market loans.) See Boyle, supra note 7, at 18, 22. Ironically, to the extent that § 7520 set the table rate at too high a level, it failed to completely eliminate the opportunity for rate benefit that taxpayers had enjoyed prior to its enactment.

[23] The grantor, of course, would be subject to tax on the trust's income. I.R.C. § 677. And, presumably, upon termination of the trust, the remainderman would receive the corpus tax free. It should be noted, however, that the remainderman's basis in any asset received from the trust would be determined under I.R.C. § 1015, which could result in a gain upon a subsequent disposition by the remainderman.

But, of course, an investment of 90.9¢, if invested in a taxable bond paying 10%, would not have grown to one dollar of tax-free money in a year. For although the interest earned during the year would have brought the invested fund to a dollar, the income tax obligation of 30% on the interest would have left the investor with an amount significantly less than a dollar. Thus, in determining the value of the right to receive tax-free money in the future, it is appropriate to use an after-tax discount rate.

Although not a likely situation,[24] what rate would a valuation expert have used if the tax-free rate available in the market had been inappropriately low in relation to the taxable rate available in the market? Assume, for example, that the rate on tax-free bonds had been 6%, the rate on taxable bonds (of comparable quality) had been 10% and that the tax rate had been 30%. In this case, the appropriate discount rate would have been 7%. Inasmuch as the marketplace offered a 10% taxable investment, which after the payment of a 30% tax would have left an investor with a 7% return, a valuation expert would have used a 7% discount rate; he would have disregarded the possibility that a lower rate, 6%, could have been earned, just as he would have disregarded the possibility that the money could have been left in the proverbial mattress earning no interest.

When the tax-free rate available in the market had been inappropriately high in relation to the taxable rate available in the market, the taxable rate should have been disregarded. So if, in the preceding example, the tax-free rate had been 8%, instead of 6%, a valuation expert would have used the 8% rate for discount purposes. The availability of a 10% before-tax rate, which on an after-tax basis is the equivalent of a 7% rate, would obviously not have attracted a prudent investor away from the 8% available on a tax-free investment.[25] Thus, the value of money, in this environment, should be determined on the basis of an 8% discount rate.

In determining the appropriate discount rate, it was necessary to take into account the income-tax bracket of the remainderman.

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[24] See, e.g., Boris I. Bittker, Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?, 16 San Diego L. Rev. 735 (1979) (suggesting that the tax-exempt bond yield is typically greater than the after-tax yield of taxable bonds).

[25] But see id.(suggesting that investors are in fact willing to acquire taxable bonds with an after-tax yield less than an available tax-exempt yield).

This is made apparent when the valuation question is properly posited: How much money must the remainderman put aside in order for it to grow to some amount of tax-free money in the future?

For example, assuming the tax-free rate available in the market had been 8%, the taxable rate available in the market had been 10% and the remainderman's tax bracket had been 15%, the appropriate discount rate would have been 8.5%. For the value of tax-free money in the future to a remainderman in a 15% tax bracket should be determined on the basis of a method that would maximize the remainderman's after-tax return. An investor in a 15% tax bracket would have chosen a 10% taxable investment, which would be the equivalent of 8.5% on an after-tax basis, rather than an 8% tax-free investment. If, on the other hand, the remainderman had been in a 30% tax bracket, the appropriate discount rate would have been 8%. An investor in a 30% tax bracket could only earn, on an after-tax basis, 7% when investing in a vehicle that generated a taxable return of 10%. Such an investor, seeking to maximize his after-tax return, would have chosen an investment generating a tax-free return of 8%. Thus, the value of a remainder interest (entitling the remainderman to tax-free money in the future) is determined, in part, by the remainderman's tax bracket.

The appropriateness of using the after-tax rate of return available to the remainderman/donee in analyzing the rate-benefit issue may be observed by examining the GRIT in relation to an outright gift. In the case of a GRIT, the grantor was required to bear the burden of the income tax on trust income,[26] entitling the remainderman to receive the corpus of the trust upon its termination free of any income tax. In contrast, the donee of an outright gift bears the burden of the income tax imposed on the earnings generated by the gifted sum. Consequently, in order for the donee of a comparable outright gift to derive as much wealth from the gift as the GRIT remainderman would have been entitled to receive upon termination of the trust, the donee would have been required to earn an after-tax rate of return equal to the table rate. And, of course, where the after-tax return available to a donee was less than the table rate, the GRIT produced more wealth for the remainderman

[26] I.R.C. § 677.

than a comparable outright gift would have produced for a donee.[27] Thus, in comparing the relative benefits of a GRIT and an outright gift, it was necessary to consider the after-tax rate of return available to the remainderman/donee.

In sum, rate benefit could be achieved through the use of a GRIT when the rate utilized in the Internal Revenue Service's tables was high in relation to the rates available in the marketplace. Conversely, rate loss would be experienced when the table rate was low relative to the marketplace rate. In making the comparison of rates for purposes of deciding whether or not to use a GRIT, it was necessary to use an after-tax market rate; for what was at issue was the value of the remainderman's right to receive a sum of *tax-free* money in the future. Finally, the determination of the highest after-tax market rate available to the remainderman involved a consideration of the tax-exempt rate available in the marketplace, the taxable rate available in the marketplace and the income-tax bracket of the remainderman.

B. Appreciation Benefit

The IRS tables assumed that all of the return generated by the corpus of a GRIT, or by any type of trust, would be in the form of income.[28] Since the terms of the GRIT required that all income be distributed to the grantor, the value the tables assigned to the remainder was based upon the premise that the number of dollars given to the trustee of the GRIT at creation would equal the number of dollars distributable to the remainderman at termination. Where, however, the GRIT trustee invested the corpus in a vehicle that produced appreciation (i.e., principal), that appreciation

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[27] To illustrate, assume a grantor contemplates the contribution of $100 to a one-year GRIT at a time when the table rate is 10%. The taxable gift deemed to occur upon the creation of such a GRIT equals $90.90. At the end of the one-year term, the remainderman would be entitled to receive $100 of corpus (assuming the corpus neither appreciated nor depreciated during the course of the year). If the grantor makes a comparable outright gift of $90.90 instead, the donee must realize an after-tax return of 10% (the table rate) in order to have $100 (the amount the GRIT remainderman would be entitled to receive) at the end of one year. If the donee enjoyed an after-tax return less than 10%, the donee would have less wealth attributable to the gift than the GRIT remainderman would have at the end of the year.

[28] While a GRIT might generate appreciation, state law would treat any such appreciation as principal, not income, which passed to the remainderman upon termination of the trust. See Revised Uniform Principal and Income Act § 3(b)(1), 7B U.L.A. 155 (1962).

passed to the remainderman at termination,[29] contrary to the premise underlying the tables and without the imposition of transfer tax.

For example, assume the transfer of $1 to a one-year GRIT at a time when the table rate had been 10%. Assume further that the trustee of the GRIT invested the corpus in a vehicle that produced a return during the one-year income-term of 10% (10¢), all of which was appreciation belonging under state law to the remainderman. Thus, at the termination of the trust, one year after its creation, the remainderman would receive $1.10.

With a 10% return available in the market, an economist or valuation expert would have concluded that the value at the time of the trust's creation of the right to receive $1.10 (i.e., the amount the remainderman would receive) one year later had been $1 ($1.10 / 1.10). Yet, according to the Service's tables, the value of the remainder at the time of creation had been 90.9¢ ($1 / 1.10). In other words, the erroneous assumption made by the tables that all of the return would be in the form of income and therefore inure to the benefit of the grantor produced an undervaluation of the remainder — and concomitantly an understatement in the amount of the taxable gift of 9.1¢ (the value of $1, which an economist would assign to the remainder, minus the value of 90.9¢, assigned by the tables, equals 9.1¢) — even though the table rate was equal to the market rate.

Appreciation benefit occurred only where the investment vehicle chosen by the trustee produced appreciation.[30] And while appreciation benefit became more substantial as the investment vehicle produced more appreciation, its practical potential was limited. Once the total return (income and appreciation) actually produced by the investment vehicle exceeded the rate utilized in the tables, rate loss occurred; and though any additional return in the form of appreciation would have produced additional appreciation benefit, it would also have produced additional rate loss, placing a practical limit on the potential for appreciation benefit.[31]

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[29] Id.

[30] Where the investment vehicle chosen by the trustee depreciated in value, the GRIT would suffer a disadvantage relative to an outright gift. For an illustration of this disadvantage, see the discussion of leverage benefit infra notes 48-52 and accompanying text.

[31] To illustrate, assume that a grantor contributed $100 to a one-year GRIT at a time when the table rate equaled 10%. In addition, assume that the trustee chose an investment

C. *Appreciation Benefit: The Tax Court Approach*

Although not unlimited, the potential for taxpayers to enjoy appreciation benefit was significant because trustees typically have discretion to invest in a wide variety of vehicles capable of producing mostly (or perhaps even exclusively) appreciation.[32] In a recent decision, the Tax Court considered a GRIT where it was predictable at the point of creation that virtually the entire return produced by the corpus would be in the form of appreciation. In

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vehicle producing a 20% return during the one-year term, consisting of 10% income and 10% appreciation. Since the amount of the taxable gift upon creation of the GRIT would be equal to $90.90 ($100 / 1.10), an outright gift of $90.90 would have been comparable. At the end of the year, the GRIT remainderman would have $110 in wealth, whereas the donee of a comparable outright gift would have had $109.08 (90.90 x 1.20). Quite obviously, the GRIT would have been more effective in this context, placing in the remainderman's hands $.92 more in wealth than the outright gift would have placed in the donee's hands. The extra wealth generated by the GRIT for the remainderman is attributable to leverage benefit (discussed infra notes 48-52 and accompanying text). The GRIT remainderman would enjoy appreciation of 10% on the entire trust corpus of $100, while the donee of the outright gift would have enjoyed appreciation only on the gifted amount of $90.90. Given that leverage benefit explains the disparity in outcome, it must be that whatever appreciation benefit is present is offset by rate loss. Put differently, the rate loss that results on account of the appreciation (i.e., because the total rate of return, income and appreciation, exceeded the table rate) is of no consequence, given that all of the appreciation would pass to the remainderman free of transfer tax.

Computing the rate loss and the appreciation benefit is necessary to prove this proposition. The rate loss is equal to $7.57, computed by comparing the present value of the right to receive the corpus of $100 at the end of the one-year term on the basis of a 10% discount rate (the table rate) with the present value of such a right on the basis of a 20% discount rate (the actual rate of return, inclusive of income and appreciation). The present value, using a 10% discount rate, equals $90.90; the present value, using a 20% discount rate, equals $83.33; thus, the difference between the two values, i.e., the rate loss that results from the use of a table rate of 10% when the actual rate of return is equal to 20%, is $7.57.

The appreciation benefit is also equal to $7.57. The amount of corpus generating appreciation for the remainderman is $100. However, only $90.90 of this amount generates appreciation benefit, for the appreciation generated by the remaining $9.10 constitutes leverage benefit. Thus, the amount of appreciation available to the remainderman at the end of the year attributable to the $90.90 amount is $9.09 ($90.90 x .10). The present value of the right to receive $9.09 at the end of the year, assuming the use of a discount rate of 20% (the actual return enjoyed), is equal to $7.57 ($9.09 / 1.2).

[32] Although trustees are usually required to formulate investment policies that protect both the income beneficiary and the remainderman, see Revised Uniform Principal and Income Act § 2, 7B U.L.A. 155 (1962); Kenneth L. Hirsch, Inflation and the Law of Trusts, 18 Real Prop., Prob. & Tr. J. 601 (1983), this was not a constraint as a practical matter. The grantor might explicitly authorize investments that do not produce income; alternately, the grantor might select a friendly trustee who would not fear a suit by the grantor on account of the trustee's investment decisions.

O'Reilly v. Commissioner,[33] the grantor transferred stock in a closely held corporation to the trustee of a GRIT. The trust instrument authorized the trustee to retain the stock contributed by the grantor.[34] Prior to the creation of the GRIT, the corporation paid a dividend that was very low (less than 2/10 of 1 per cent of the value of the stock) though it did increase by an insignificant amount after the GRIT was created.[35] The grantor valued the remainder interest for gift-tax purposes by using the Service's valuation tables,[36] which at the time of the gift were predicated on a 10% rate.

The Service took the position that the right retained by the grantor to receive dividend income had no value and should therefore be disregarded for gift-tax purposes, arguing by implication that the entire value of the stock was attributable to its capacity to produce appreciation.[37] Thus, it was inappropriate, in the Service's view, to permit utilization of the tables, under which the retained right to receive dividend income would be deemed to have value. Under this rationale, the value of the gift (the remainder) should have been equal to the value of the stock contributed to the GRIT without any discount for the grantor's retained income interest. Valuing the gift on this basis would reflect the reality that practically the entire return generated by the stock during the term of the trust would pass as appreciation, together with the stock itself, to the remainderman, a reality that was likely to eventuate since the grantor and the trustee intended that the stock would remain in the GRIT until its termination.[38]

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[33] 95 T.C. 646 (1990).

[34] Id. at 648.

[35] Id. at 652.

[36] Treas. Reg. § 25.2512-5(f), Table 1B.

[37] As a practical matter, the value of closely held stock has, in fact, not ordinarily been attributable to the capacity of the corporation to pay dividends. For, because of the concern about double taxation with respect to dividends, closely held corporations typically have not paid substantial dividends. As a consequence, the value of closely held stock has been essentially attributable to the potential for appreciation and the opportunity, if present, to control the corporation — control permitting the stockholder to determine, *inter alia*, the salary she is to receive for services rendered to the corporation in her capacity as an employee. With the recent proliferation of S corporations, concern about double taxation is obviously diminishing. As a consequence, closely held corporations may well be inclined to pay more substantial dividends, making the value of the stock attributable to a greater extent than in the past to the capacity of the corporation to pay dividends.

[38] *O'Reilly*, 95 T.C. at 652.

Rejecting the Service's argument, the Tax Court held that the value of the remainder was to be determined by the tables. The court agreed with the Service that the grantor and the trustee contemplated that the stock would remain in the GRIT, thus producing an insignificant amount of dividend income for the grantor. Nevertheless, the court refused to invoke the line of cases authorizing, where the reality of the circumstances dictate, a deviation from the tables.[39]

As both the court and the Service framed the issue, the value of the remainder was either to be determined by the tables or under the line of cases authorizing a deviation from the tables. In the view of both the court and the Service, deviating from the tables would have produced a value of zero for the income interest and a value for the remainder interest equal to the entire value of the stock contributed to the GRIT. In other words, deviation would have resulted in ignoring the income interest and in effect allocating its value to the remainder interest. Having thus framed the issue, the court refused to deviate from the tables. Ignoring the income interest would have been inconsistent with reality: the income interest had some value, however low, given the corporation's dividend record.[40]

Thus, neither of the alternatives the court perceived as available to it — to apply the tables, which would substantially overvalue the income interest and undervalue the remainder interest, or to assign a value to the remainder equal to the value of the entire corpus — would produce results reflective of reality. One alternative would yield an undervaluation of the remainder; the other an overvaluation. It was in the context of these unsatisfactory alternatives that the court chose to apply the tables and consequently undervalued the remainder.

Although an unconventional one, another alternative was per-

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[39] See Berzon v. Commissioner, 63 T.C. 601 (1975), aff'd, 534 F.2d 528 (2d Cir. 1976); Rosen v. Commissioner, 48 T.C. 834 (1967), rev'd, 397 F.2d 245 (4th Cir. 1968).

[40] *O'Reilly*, 95 T.C. at 653. The court also pointed out that the remainderman could not receive the corpus until the termination of the income term and that therefore it would be inappropriate to assign a value to the remainder equal to that of the corpus. Id. However, the present value of a remainder should equal the value of the corpus when all of the return generated by the corpus will inure to the benefit of the remainderman. And the mere fact that the return to be generated by the corpus will not be given by the trustee to the remainderman until the trust terminates should not alter the conclusion that the value of the remainder is equal to the value of the corpus.

haps available to the court. It could have rejected the tables as unrealistic and sought instead to assign a reality-based value to the remainder. It would then have made some prediction about the appreciation that might occur with respect to the stock while held in the GRIT, predicated upon the stock's rate of appreciation prior to the creation of the GRIT. The amount of the taxable gift would be equal to the value, determined at the time of the creation of the GRIT, of the right to receive the stock upon the expiration of the income term with the anticipated appreciation being taken into account in valuing the stock.

If this valuation approach had been used by the court, the effect would have been to deny the grantor the appreciation benefit that he secured through the court's application of the tables. Consider, for example, the transfer of stock with a value of one dollar to a one-year GRIT at a time when the tables utilized a 10% rate. Assume that the stock, prior to the creation of the GRIT, had always generated a dividend of 2% and appreciation of 8%.[41]

In this example, an economist or valuation expert would have predicted that the value of the stock one year after the creation of the GRIT would be $1.08 ($1 plus appreciation of 8%, or 8¢). And, of course, the present value (using the table rate of 10%) of the right to receive stock with a value of $1.08 one year later would be approximately 98.81¢ ($1.08 / 1.10). Thus, under this approach, the amount of the taxable gift at the creation of the GRIT would be 98.18¢. If, on the other hand, the court's approach were used, the amount of the taxable gift would be approximately 90.9¢ ($1 / 1.10). The difference in the amount of the taxable gift under the court's approach and under the approach suggested results from the court's application of the tables, which, of course, fail to take appreciation into account. In short, the court's approach would produce an understatement in the amount of the taxable gift, which constitutes appreciation benefit.[42]

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[41] The example in text hypothesizes a total return generated by the stock of 10%, which is equal to the rate used by the tables. Because, in this example, the table accurately predicts the rate of return available in the marketplace; neither rate gain nor rate loss is present. The example has been intentionally structured to eliminate rate benefit or loss, thus focusing exclusively on appreciation benefit.

[42] See *O'Reilly*, 95 T.C. at 652-653. It should be pointed out that the court decided *O'Reilly* in December 1990 after Congress enacted chapter 14 of the Code. Perhaps, the decision of the court might have been different if its holding were to be applicable to newly

In *O'Reilly*, it was predictable at the time the GRIT was created that appreciation would result. For the corpus of the GRIT consisted of closely held stock, which often offers a mix of an insubstantial dividend component and a compensating appreciation component that, by comparison to the dividend component, is substantial. Indeed, the stock in *O'Reilly* had been producing a dividend of less than 2/10 of 1%, suggesting that a very substantial part of the stock's value was attributable to its capacity to generate appreciation.

Despite the presence of a substantial appreciation component, the court applied the tables and thereby made it possible for the taxpayer to achieve appreciation benefit. In justifying its decision, the court observed that the opportunity for appreciation existed in the case of publicly traded stock as well — noting, in effect, that many public issues also offer a mix of an insubstantial dividend component and a compensating appreciation component. The court was apparently of the view that the tables would apply and that appreciation benefit could therefore be secured in the case of publicly held stock. Given this view, it was reluctant to adopt an approach that would reject the tables and thereby deny appreciation benefit in the case of closely held stock. The regulations, in the court's perception, did not contemplate different approaches for closely held and publicly traded stock — which the court apparently thought sensible, since they can both offer similar potential for appreciation.[43]

Although the court viewed itself as constrained by the regulations to apply the tables irrespective of the type of investment vehicle at issue, it revealed by implication its discomfort with the failure of the regulations to distinguish stock from fixed-income obligations. As the court implied, stocks usually offer a low dividend yield in relation to the interest rate available on fixed-income obligations. Stocks, however, compensate for this by offering a greater potential for appreciation. Given this greater potential for appreciation inherent in stocks, the value of a remainder interest would be higher if the trustee invested in stock rather then fixed-income obligations — for, under state law, any appreciation that

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created GRIT's.

[43] Id.

might be realized would belong to the remainderman.[44]

Yet the tables assigned a value to the remainder without regard to the nature of the investment vehicle. In requiring application of the tables, the regulations simply assume that appreciation would not occur, whether the trustee invested in stock or fixed-income obligations.[45] Obviously, a more realistic approach would distinguish between appreciation-oriented and income-oriented investments, with the potential for appreciation taken into account in valuing the remainder.

Utilizing different valuation approaches, however, for investments with different potential for appreciation would create practical difficulty. If, for example, the grantor had contributed cash to a GRIT, it would not have been possible to make a prediction about the potential for appreciation until the trustee selected an investment vehicle. Even if the grantor had contributed non-cash assets to the GRIT, the trustee might have sold it and invested in an investment vehicle having a potential for appreciation different from that of the contributed asset. With trustees usually having the discretion to alter the composition of trust investments during the trust term, the value of a remainder interest cannot be fixed upon the creation of a trust. Indeed, as a trustee acquires a new investment with an appreciation potential different from the one it replaces, the value of the remainder changes. Given that, in reality, the potential for appreciation and therefore the value of a remainder interest fluctuates as the composition of trust investments is altered, it would have been difficult, if not impossible, to determine the value of the remainder at the time the GRIT was created if the investment's potential for appreciation had to be considered.

The practical difficulty of accounting for appreciation in valuing a remainder might not have been encountered in all contexts. When, for example, the trustee was required to retain an investment vehicle contributed by the grantor, the potential for appreciation offered by the contributed vehicle could have been taken into account without difficulty. Indeed, in *O'Reilly*, the court found that the trustee and the grantor contemplated that the closely held stock contributed to the GRIT would be retained by the trustee.

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[44] See, e.g., Revised Uniform Principal and Income Act § 3(b)(1), 7B U.L.A. 155 (1962).

[45] While a fixed-income obligation will appreciate if interest rates decline, it is ordinarily more likely that appreciation will be experienced in the case of stock.

Having made this finding, the court might have taken the potential for appreciation into account without concern about the value of the remainder fluctuating as the composition of trust investments changed.

In sum, the valuation tables assumed that all of the return produced by GRIT investments would be in the form of income and therefore pass to the grantor. This assumption proved to be erroneous where some part of the return generated by GRIT investments was in the form of appreciation that under the instrument (or state law[46]) would be distributable to the remainderman at termination of the trust. As a consequence, appreciation accruing on GRIT investments that passed to the remainderman was not subjected to transfer tax. In *O'Reilly*, where virtually the entire return consisted of appreciation, the court's decision to apply the valuation tables resulted in a substantial tax-free transfer of wealth to the remainderman. The opportunity to pass appreciation to the remainderman on a tax-free basis was not, however, without limit. Once the total return produced by the trust equalled the table rate, additional appreciation did not, because of the resulting rate loss, produce any additional advantage.[47]

D. Leverage Benefit

In the case of an outright gift, none of the appreciation generated by the gifted property, once the gift has been made, is included in the donor's estate or treated as a taxable gift made by the donor. Put simply, post-transfer appreciation is not subject to transfer tax. Indeed, a critical tax advantage inherent in inter vivos gifts is the opportunity to exclude such appreciation from the donor's transfer-tax base.[48]

With respect to a GRIT, appreciation occurring after the creation of the trust was similarly excluded from the grantor's transfer-

[46] See, e.g., Revised Uniform Principal and Income Act § 3(b)(1), 7B U.L.A. 155 (1962).

[47] While, in this context, appreciation benefit attributable to any additional appreciation would be offset by rate loss, the additional appreciation would generate leverage benefit. Thus, some affirmative advantage would be enjoyed where trust investments generated appreciation, even though the total return exceeded the table rate. See supra note 31 and accompanying text.

[48] See, e.g., U.S. Treasury Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth— General Explanation of the Treasury Department Proposals, supra note 4, at Volume 2 at 376.

tax base.[49] By using a GRIT as a wealth-transfer vehicle, however, a grantor might have been able to exclude a greater amount of appreciation from his transfer-tax base than would have been possible with a comparable outright gift. This comparative advantage offered by the GRIT, which is referred to here as "leverage benefit," only materialized when the trust corpus generated appreciation and might therefore be viewed as subsumed within appreciation benefit. Indeed, in the previous examples illustrating appreciation benefit, no attempt was made to clarify that the appreciation benefit identified consisted, in part, of leverage benefit. It may, however, be helpful analytically to view leverage benefit as a distinct advantage.[50]

In order to illustrate leverage benefit as a distinct advantage, it is necessary to contrast the GRIT with a comparable outright gift. Assume, for example, that a grantor transferred $100 to a one-year GRIT at a time when the tables utilized a 10% rate and the rate available in the marketplace was also 10%.[51] Assume further that the trustee invested the corpus in a vehicle that would produce 10% of appreciation ($10) and no income during the one-year term of the GRIT. The value of the remainder, and thus the amount of the taxable gift, would have been $90.90 at the time of the creation of the GRIT (100 / 1.1). The donee of a comparable outright gift of $90.90 would have had $100 in wealth at the end of one year, assuming the gifted sum generated a return of 10%. The GRIT, on the other hand, would have produced $110 for the remainderman at the end of one year ($100 of corpus conveyed to the trustee plus 10% or $10 of appreciation); and, so, the GRIT, in this case, would have placed $10 more in the hands of the remainderman than the comparable outright gift would have placed in the hands of a donee.

This $10 advantage offered by the GRIT relative to an outright

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[49] See supra notes 28-47 and accompanying text.

[50] In certain contexts, appreciation benefit and leverage benefit operate somewhat differently. Where the total return enjoyed by the trust (income and appreciation) was in excess of the table rate, appreciation benefit attributable to any additional appreciation would be offset by additional rate loss. Nevertheless, the additional appreciation would produce leverage benefit, an affirmative advantage that would not be offset by rate loss or any other disadvantage. See supra note 31.

[51] Because the market rate and the table rate were equal, neither rate benefit nor loss would be possible.

gift may be viewed as consisting of two components. One component is appreciation benefit. The 10% return generated by the corpus of the GRIT would have been in the form of appreciation. And since, in calculating the value of the remainder, the tables erroneously assumed that there would be no appreciation — i.e., that the $100 of corpus conveyed to the trustee at creation of the GRIT would be equal to the amount to be distributed to the remainderman at termination — the 10% of appreciation in fact generated would have passed to the remainderman without the imposition of transfer tax. One might therefore conclude that the entire $10 benefit offered by the GRIT had been attributable to appreciation benefit (appreciation at the rate of 10% on the $100 corpus). However, it is preferable to view the appreciation benefit as equal to only $9.09 of the total benefit of $10 (10% of $90.90); that is the amount of appreciation that would have been generated by a comparable outright gift of $90.90. The other component of the $10 benefit is leverage benefit, which is equal to 91¢. The 91¢ of leverage benefit is attributable to the fact that $100 of corpus would have been generating appreciation, rather than the $90.90 that would be generating appreciation in the case of an outright gift.[52]

Stated differently, the remainderman of the GRIT in this example would have had in effect $100 of assets producing appreciation for her benefit. In contrast, the donee of a comparable outright gift would have had only $90.90 in assets producing appreciation. Thus, the GRIT offered the remainderman leverage benefit: the advantage of having an extra $9.10 of assets ($100 - 90.90) at work generating appreciation. And, in this example, where appreciation of 10% had been generated, leverage benefit of 91¢ resulted. In sum, leverage benefit only occurred in the context of appreciation and could be more easily observed by contrasting the GRIT with a comparable outright gift.

In the case of depreciation in the value of the GRIT corpus, rather than appreciation, leverage loss would have occurred. And like leverage benefit, leverage loss could also be observed by contrasting the GRIT with a comparable outright gift.

Consider, for example, a contribution of $100 to a one-year GRIT at a time when the tables utilized a 10% rate and the marketplace rate was also at 10%. Assume that during the one-year

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[52] See Harrison, supra note 17, at 526 n.13.

term the value of the investment selected by the trustee decreased by 50%, though it did generate 10% (or $10) of interest income at the end of the year. The tables would have assigned a value to the remainder at the point of creation of the GRIT of approximately $90.90 ($100 / 1.1), thus, producing a taxable gift of $90.90 at the creation of the GRIT.

At the end of the one-year term, the remainderman of the GRIT would have had in his possession an asset with a value of $50 (the corpus having declined in value from $100 to $50 during the course of the year). In contrast, the donee of a comparable outright gift (i.e., a gift of $90.90) would have had $54.55 in her possession at the end of the year (interest at the rate of 10% on $90.90, which would equal 9.09, plus $45.45, which represents the original gifted sum of $90.90 as diminished by 50% of depreciation in value).

In this example, the outright gift would have been more effective as a wealth-transfer vehicle. Despite the equality in gift-tax cost, the outright gift would have placed more wealth in the hands of the donee than the GRIT would place in the hands of the remainderman. What makes the outright gift more effective in this example is that, in the case of a GRIT, an asset with a value of $100 would have been at risk and the 50% decline in the value of the investment would have resulted in a $50 diminution in value for the remainderman. On the other hand, in the case of the outright gift, the donee would have had only $90,90 of investment at risk, thus producing a diminution in value of only $45.45 as a result of the 50% decline.

Thus, leverage loss resulted when the value of the asset held in the GRIT decreased, just as leverage benefit occurred when the value of the corpus increased. In both cases, the fact that a greater amount of assets was at risk when the GRIT was utilized was responsible for producing the leverage effect.

E. The Reversionary-Interest Technique

Grantors who created GRIT's commonly retained a reversionary interest that would entitle the grantor's estate to receive the trust's corpus if the grantor died within the income-retention period.[53]

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[53] A grantor could enjoy the benefits offered by a reversionary interest by retaining, instead, a power of appointment. See, e.g., Priv. Ltr. Rul. 8727031 (April 3, 1987).

The purpose for retaining a reversionary interest was twofold: 1) to make certain that the marital deduction would be available as an offset in the event the GRIT corpus became includible in the grantor's gross estate, and 2) to make the GRIT more tax-effective by reducing the gift-tax cost associated with its creation.[54]

A concern about the availability of the marital deduction would arise because, under section 2036, the value of the entire corpus of the GRIT, as determined on the date of the grantor's death, would be includible in the grantor's estate where the grantor died during the income-retention period. Since the remainder interest under a GRIT would pass to a beneficiary who was not the grantor's spouse,[55] the marital deduction was not available to offset the section 2036 inclusion.[56] But where the corpus of the trust reverted to the grantor's estate in the event of the grantor's death within the income-retention period, the corpus could pass under the grantor's will to the grantor's spouse (assuming the appropriate provisions were contained in the will) and therefore generate a marital deduction, in effect offsetting the section 2036 inclusion.[57]

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[54] I.R.S. Notice 89-99, 1989-2 C.B. 422, in implementing I.R.C. § 2036(c) (repealed by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388) sought to limit the benefits offered by a reversionary interest, imposing a 25% ceiling on the value of any reversionary retained under a GRIT. See also Lee, supra note 8.

[55] It would have been inappropriate to designate the grantor's spouse as the remainderman under a GRIT. For if, at the termination of the GRIT, the corpus passed to the grantor's spouse, transfer tax would be imposed at the time of the spouse's death (or earlier in the case of an inter vivos gift) on the portion of the corpus not consumed by the spouse — making any extra wealth produced by the GRIT for the remainderman (relative to an outright gift) subject to transfer tax. In effect, therefore, the benefits offered by the GRIT were forfeited where the grantor's spouse was the remainderman. If, on the other hand, the GRIT corpus passed upon termination of the trust to a beneficiary who was not the grantor's spouse, no transfer tax would be imposed on the spouse or the spouse's estate in connection with any unconsumed corpus. See I.R.C. § 2036. But see infra note 57, where it is suggested that the use of a contingent remainder in favor of the grantor's spouse could avoid an underutilization of the marital deduction.

[56] See I.R.C. § 2056 which requires that an interest must pass to the decedent's surviving spouse in order to qualify for the marital deduction.

[57] Because of the availability of the marital deduction, the grantor of a GRIT could be certain that a death within the income-retention period would not translate into a greater estate-tax liability than would have been incurred had she not created a GRIT. Thus, while grantors of a GRIT hoped to enjoy rate benefit, appreciation benefit and leverage benefit, they could be assured that a death within the income-retention period would not result in a forfeiture of the marital deduction. Rather it would simply cause a failure to realize the GRIT's benefits. As a consequence, the GRIT was viewed as offering advantages that could be enjoyed if the grantor survived the income-retention period and posing no disadvantage should the grantor fail to survive the income-retention period.

Ordinarily, where a person dies owning a reversionary interest, the value of the interest must be included in the gross estate under section 2033.[58] Retaining a reversionary interest in the GRIT context, however, did not increase the amount includible in the grantor's gross estate, since the entire corpus of the trust would be includible under section 2036 where the grantor died within the income-retention period even if the grantor did not retain a reversionary interest. By making the marital deduction available, the retention of a reversionary interest created a savings in estate tax where the grantor died within the income-retention period, without resulting in any additional inclusion in the grantor's gross estate.

The second purpose for retaining a reversionary interest in connection with a GRIT related to the computation of the taxable gift triggered upon its creation. By retaining a reversionary interest, the grantor of a GRIT would reduce the amount of the taxable gift deemed to occur at inception,[59] reflecting the reality that a grantor who retains a reversionary interest under a trust she creates has made a lesser gift than a grantor who creates a trust under which no reversionary interest is retained. Given that the opportunity to enjoy rate benefit, appreciation benefit, and leverage benefit was not adversely affected by including a reversionary interest in the GRIT,[60] the reduction in the amount of the taxable gift achieved on account of its inclusion enhanced the GRIT's attractiveness.

Because the retention of a reversion improved upon the effectiveness of the GRIT, it also made the GRIT more attractive relative to an outright gift. More specifically, the inclusion of a reversion would augment the potential for the GRIT to generate rate benefit. It accomplished this by elevating the "break-point rate" (i.e., the point at which rate benefit ceased to be available) to a

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It should be noted that another marital-deduction strategy was available. If the terms of the GRIT conferred a contingent remainder upon the grantor's spouse which would become possessory only upon the death of the grantor within the income-retention period, any inclusion under § 2036 would be offset by the marital deduction. And, of course, if the grantor survived the income-retention period, the spouse's contingent remainder would not become possessory, thus avoiding the negative outcome discussed at supra note 55.

[58] See, e.g., Estate of Henry v. Commissioner, 4 T.C. 423, 444-46 (1944), aff'd, 161 F.2d 574 (3d Cir. 1947); Treas. Reg. § 20.2031-7(d).

[59] See Treas. Reg. § 25.2511-2(b).

[60] And, of course, as suggested, the use of a reversionary interest would make certain that the marital deduction would be available.

level above the table rate.

Consider, for example, a case where the rate of return available in the market was equal to the table rate. In this context, a GRIT not containing a reversion would produce the same amount of wealth for the remainderman as a donee would derive from a comparable outright gift.[61] Thus, rate benefit would not occur. Where the GRIT did contain a reversion however, equality between the market rate and the table rate would result in rate benefit. The retention of a reversion would reduce the amount of the taxable gift deemed to occur upon the creation of the GRIT, thus causing a concomitant reduction in the amount of the comparable outright gift. As a consequence, a rate of return equal to the table rate would produce for the donee of a comparable outright gift less wealth than the remainderman would be entitled to receive upon termination of the GRIT. The extra wealth made available to the remainderman, which constitutes rate benefit, was attributable to the elevation in the "break-point rate" to a level above the table rate.

To illustrate, assume that a grantor contributed $100 to a one-year GRIT that did *not* contain a reversion at a time when both the table rate and the market rate had been 10%. The amount of the taxable gift deemed to occur upon creation of the trust would have been equal to $90.90. At the end of the one-year term, assuming neither appreciation nor depreciation in the value of the corpus, the remainderman would have been entitled to receive $100. If the grantor had made an outright gift of $90.90 instead, the donee would likewise have had $100 in wealth at the end of the same one-year period. Thus, because the actual rate of return was equal to the table rate, neither rate benefit nor loss would have materialized.

If, however, the grantor had incorporated a reversionary interest in the GRIT, the amount of the taxable gift of $90.90 would have been reduced to some lower amount, with the amount of the reduction being a function of the probability of the grantor's death occurring within the income-retention period (i.e., the probability that the GRIT corpus would in fact revert back to the grantor's

[61] It has been assumed that the investment vehicles available in the market would not generate appreciation. With this assumption made, there would be no opportunity for appreciation or leverage benefit.

estate). The amount of a comparable outright gift would have been the lower amount. Assuming again that the donee earned a return of 10% (the table rate), she would have had at the end of one year less than $100, which is the amount that the remainderman would have been entitled to receive upon termination of the GRIT.[62] Thus, with the reversion included, the remainderman would have derived more wealth from the GRIT than a donee would have derived from a comparable outright gift even though the market rate equalled the table rate. In other words, rate benefit would have been enjoyed in this example because the reversion increased the "break-point rate" to a level above the table rate.

In sum, the inclusion of a reversionary interest would improve a GRIT in two critical ways. First, it would enable the grantor's estate to qualify for the marital deduction, which would offset the section 2036 inclusion triggered if the grantor died within the income-retention period. Second, it would reduce the amount of the taxable gift deemed to occur upon creation of the GRIT and, as a result, increase the potential for rate benefit.

III. The GRIT's Advantages: Congress' Response

Concerned about taxpayers taking advantage of the faulty assumptions underlying the valuation tables, Congress began to focus its attention on GRIT's. In 1988, it amended section 2036(c)[63] to impose in effect a durational limit on GRIT's.[64] At the same time, it amended section 7520 to incorporate a requirement that the table rate be adjusted periodically to reflect changes in the rates available in the marketplace.[65] In 1990, Congress retroactively repealed section 2036(c) and replaced it with chapter 14 of the Code, leaving intact, however, the 1988 amendment to section 7520.[66]

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[62] Assuming a rate of return of 10%, it would be necessary to invest $90.90 in order to have $100 at the end of one year. Thus, given that the comparable outright gift would be less than $90.90, the donee would have less than $100 at the end of the year.

[63] Congress enacted I.R.C. § 2036(c) to deal with estate-freeze issues. The 1987 legislation left the GRIT intact. See Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330-1382. See also Bruce J. Bettigole, Use of Estate Freeze Severely Restricted by Revenue Act of '87, 68 J. Tax'n 132 (1988).

[64] See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 3031, 102 Stat. 3342, 3634-3637.

[65] Id. at § 5031, 102 Stat. 3668-3669.

[66] See Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, §§ 11601-11602, 104 Stat. 1388-490.

Section 2702, which is contained in chapter 14, makes the GRIT, to a large extent, no longer feasible. The discussion that follows, after first briefly examining the approach Congress adopted in 1988, will be devoted to a consideration of the 1990 amendment.

A. *1988 Amendments*

The 1988 amendment to section 2036(c) created a durational limit on GRIT's through the operation of a general rule that, if applicable, eliminated all of the advantages the GRIT previously enjoyed and a safe-harbor exception that did not permit the grantor's income interest to exceed ten years in duration. Under the general rule, a taxable gift would be triggered upon the termination of the grantor's income interest equal to the value of the corpus as determined at that time.[67] In effect, the general rule treated the grantor of a GRIT as if the transfer to the remainderman occurred upon the termination of the grantor's income interest. Thus, the amount of the transfer for transfer-tax purposes would be equal to the value of the corpus passing on the date of termination to the remainderman. If applicable, the general rule made rate benefit, appreciation benefit, and leverage benefit entirely unavailable. Since the entire amount passing to the remainderman at termination would be subject to transfer tax, the opportunity to pass on a tax-free basis more wealth to the remainderman than a comparable outright gift would produce for a donee had been eliminated.

Indeed, where the general rule applied, the GRIT would suffer a disadvantage as compared to an outright gift. Although, like the donor of an outright gift, the grantor of a GRIT would be required to pay a gift tax at inception, the additional taxable transfer triggered upon termination of the GRIT had no counterpart in the case of an outright gift. Put differently, the donor of an outright gift would be required to pay a gift tax at the time of making the gift, but would be entitled to exclude from her transfer-tax base

[67] See I.R.C. § 2036(c)(4)(D)(iv) (1986), as in effect prior to its repeal by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388. Parenthetically, a reduction in the amount of the taxable gift deemed to occur upon termination of the grantor's income interest was permitted in order to avoid double tax. The amount of the reduction was equal to the amount of the taxable gift triggered at the creation of the GRIT. See I.R.C. § 2036(c)(4)(D)(iii) as in effect prior to its repeal by the 1990 Act.

post-gift appreciation and income. In contrast, while the grantor of a GRIT would also be required to pay a gift tax upon creating the GRIT, she would not be permitted to exclude income and appreciation accruing during the term of the trust.

Given the adverse consequences of falling within the general rule, the safe-harbor exception was critical to the survival of the GRIT as an estate-planning technique. Under the safe-harbor exception, no additional transfer would be deemed to occur upon the termination of the grantor's income interest. Consequently, as long as the conditions required by the statute for application of the exception were satisfied, all of the benefits previously offered by the GRIT would remain available. However, since it was necessary in order to qualify for the exception to structure the trust to terminate not more than ten years after its creation,[68] the magnitude of the benefits previously offered by the GRIT would no longer be as great — the magnitude of the GRIT's benefits being directly related to the length of its term.[69] Thus, the 1988 amendment to sec-

[68] In order to qualify for the safe-harbor exception, it was also necessary for the income interest retained by the grantor to be determined solely with reference to the trust's income and for the grantor not to be a trustee. See I.R.C. § 2036(c)(6) (1986) as in effect prior to its repeal by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388.

[69] To illustrate, assume a grantor contributed $100 to a one-year GRIT at a time when the table rate was 10% and the rate of return available in the market was 5%. The amount of the taxable gift deemed to occur upon creation of the trust, and the amount of the comparable outright gift as well, would be equal to $90.90. At the end of one year, the GRIT remainderman would be entitled to receive (assuming neither appreciation nor depreciation in the value of the corpus) $100. In contrast, the donee of a comparable outright gift would have only $95.44 at the end of one year (reflecting the 5% market rate of return). Thus, the remainderman would receive $4.56 more in wealth than the donee would have even though the gift-tax cost associated with both methods of transfer was identical.

If the GRIT's term had been two years instead, the amount of the taxable gift deemed to occur upon creation of the trust, and the amount of the comparable outright gift as well, would have been equal to $82.64. At the end of two years, the GRIT remainderman would have been entitled to receive (assuming again neither appreciation nor depreciation) $100. At the end of two years, the donee of a comparable outright gift would have only $91.08 ($82.64 x 1.05 x 1.05). Thus, the two-year GRIT would have produced $8.92 more in wealth for the remainderman than the comparable outright gift would have produced for the donee, even though the gift-tax cost associated with both methods of transfer would have been identical.

In short, the magnitude of the benefits offered by the GRIT — i.e., the amount of extra wealth that the GRIT would produce for the remainderman relative to the amount of wealth that a comparable outright gift would produce for the donee — increased as the term of the GRIT lengthened. In the example hypothesized, the extra wealth received by the remainderman of the one-year GRIT relative to a comparable outright gift would be $4.56,

tion 2036(c) limited the advantages of the GRIT by forcing grantors, through the operation of the general rule and the safe-harbor exception, to retain the right to income for a term not exceeding ten years.

The amendment of section 7520 was designed to make the table rate more sensitive to the rates available in the market.[70] This amendment, still in place, requires the table rate to be adjusted monthly to reflect movements in the rates available in the market. The mechanism adopted to accomplish this makes the table rate equal to 120% of the average yield available in the market on U.S. obligations having a maturity from three to nine years.

The effect of the amendment to section 7520 on GRIT's was mixed. On the one hand, the new requirement to adjust the table rate monthly to reflect movements in the market improved upon the less flexible system previously utilized for setting the table rate.[71] With the table rate adjusted on a monthly basis, the opportunity previously enjoyed by taxpayers to take advantage of the table rate by creating a GRIT when the available market rate fell significantly below the table rate was limited. A constantly updated table rate reduced the likelihood of a substantial disparity developing between the table rate and the rates available in the market.

On the other hand, despite the monthly adjustment, the table rate produced through application of the section 7520 mechanism was, and still is, high in relation to the yield available on many investments offered in the market. And, of course, an inflated table rate made it possible for taxpayers to enjoy rate benefit, thus contributing to the viability of the GRIT. This deficiency in the section 7520 mechanism was exacerbated by Congress' apparent failure to take into account the income-tax effect in the setting of the table rate. Given that rate benefit was achievable as long as the after-tax rate of return produced by the GRIT's investments proved to be less than the table rate, it would have been necessary

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whereas the extra wealth received by the remainderman of a two-year GRIT would have been $8.92.

[70] See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 5031, 102 Stat. at 3668.

[71] Prior to the 1988 amendment of I.R.C. § 7520, it was necessary for the regulations to be amended in order to adjust the table rate. In fact, the table rate had been at 10% since 1983. See, e.g., Treas. Reg. § 25.2512-5 (in 1984).

in order to maintain the integrity of the rate-benefit comparison made by taxpayers for the table rate to be an after-tax rate. In other words, with taxpayers analyzing the rate-benefit issue by comparing the table rate with the after-tax return available in the market, Congress' failure to place the table rate on an after-tax basis expanded the opportunity for taxpayers to enjoy rate benefit — further contributing to the viability of the GRIT.

In sum, the amendments adopted by Congress in 1988 focusing on the GRIT problem both limited and expanded the opportunity for taxpayers to enjoy the GRIT's advantages. The amendment to section 2036(c), in effect, made it necessary for grantors creating a GRIT to retain the right to income for a period not extending beyond ten years, thus limiting the advantages that the GRIT had previously made available to taxpayers. The amendment to section 7520 affected GRIT's in two different ways. In making the table rate adjustable on a monthly basis, Congress reduced the likelihood of substantial disparities developing between the table rate and the rates available in the market. This, of course, limited the opportunity for taxpayers to enjoy rate benefit. In failing, however, to make the table rate low enough, Congress made it likely that rate benefit could be achieved and thereby encouraged taxpayers to create GRIT's. Thus, the 1988 amendments did not eliminate the GRIT as an estate-planning technique.

B. *Congress Revisits the GRIT*

In 1990, Congress turned its attention to the GRIT once again. While leaving the 1988 amendment to section 7520 intact, it repealed section 2036(c) in its entirety (retroactive to the date of its enactment) and replaced it with chapter 14 of the Code.[72] The approach adopted in section 2702 comprehensively attacks the advantages of the GRIT. Though the section does permit taxpayers to enjoy some of the advantages offered by the GRIT in one limited context,[73] it largely eliminates the GRIT as a tax-effective method for transferring wealth.

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[72] See the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388-490, 491-501 (codified as amended at 26 U.S.C. § § 2701-2704 (1991)).

[73] For a discussion of the personal-residence GRIT, see infra notes 95-105 and accompanying text and notes 158-213 and accompanying text.

1. *The Zero-Value Rule*

Prior to the enactment of section 2702, the grantor of a trust who retained an interest was not treated as having made a taxable gift of the retained interest.[74] The amount of the taxable gift deemed to occur upon the creation of the trust would be equal to the value of the property contributed to the trust reduced by the value of the retained interest.[75] The underlying rationale was that it was not appropriate, insofar as the retained interest was concerned, to view the grantor as having depleted her estate, which is ordinarily the justification for applying the gift tax.[76]

To eliminate the advantages of the GRIT, Congress adopted in section 2702 a new method for treating retained interests in the gift-tax context.[77] Under the section, a retained interest is, as a general rule, deemed to have a value of zero and therefore no longer entitles the grantor of a trust to a reduction in the amount of the taxable gift triggered upon the funding of the trust. In effect, where the general rule applies, the retained interest is treated as if it were not retained. Where, however, the retained interest is a "qualified interest" (a term defined in the section[78]), the general rule does not apply.[79] Instead, the rules in effect prior to the enact-

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[74] See Treas. Reg. § 25.2511-1(e).

[75] Id.

[76] See Dickman v. Commissioner, 465 U.S. 330, 339 (1983).

[77] I.R.C. § 2702.

[78] Id. § 2702(b). See also Treas. Reg. 25.2702-3.

[79] See I.R.C. § 2702. Section 2702 applies where an individual makes a transfer in trust to or for the benefit of her "family" and retains an interest in the trust; it also applies where the individual does not retain an interest in the trust, provided that an "applicable family member" retains an interest in the trust. See Treas Reg. § 25.2702-1(a). The term "family" is defined as the ". . .individual's spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any brother or sister of the individual, and any spouse of the foregoing." Treas. Reg. § 25.2702-2(a)(1). The term "applicable family member" is defined as the individual's spouse, sibling, a ancestor of the individual or the individual's spouse, and the spouse of any such ancestor. I.R.C. §§ 2701(e), 2704(c)(2). To illustrate, assume A created a trust prior to the enactment of § 2702 requiring that income be paid to A for life and then, upon the death of A, to A's son, B, for life, with the remainder payable upon the death of B to B's child C. Assuming A and B are both alive and that B now makes a gift of his income interest, I.R.C. § 2702's zero-value rule would apply with respect to both A's and B's income interest. In other words, because A is an applicable family member of B, it would seem that A's income interest should be deemed to have a value of zero for purposes of computing the taxable gift made by B in connection with the gift of his income interest. See Treas. Reg. § 25.2702-1(b), which provides that the amount of a taxable gift should be computed by ". . . subtracting the value of the interests retained by the transferor or any appli-

ment of section 2702 apply, thus permitting the grantor to reduce the amount of the taxable gift triggered upon creation of the trust by the value, as determined through application of the tables, of the retained interest.

The term "qualified interest" is defined in the section as any one of the following: 1) the right to receive fixed amounts annually or more often (i.e., an annuity interest); 2) the right to receive annually or more often a fixed percentage of the value (determined annually) of the trust corpus (a unitrust interest); or 3) any noncontingent remainder interest as long as all of the other interests under the trust constitute a qualified interest by virtue of the grantor's entitlement to receive the requisite fixed sum or fixed percentage annually or more often.[80]

Given that the income interest retained upon the creation of a GRIT is not in the nature of an annuity or unitrust interest and is not a noncontingent remainder, section 2702 treats the grantor of a GRIT as if no interest under the trust were retained. In other words, because an income interest does not constitute a qualified interest, its retention triggers the section's zero-value (or general) rule.

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cable family member from the value of the transferred property." In the example under consideration, it is not clear whether it is the entire corpus of the trust or merely B's income interest that constitutes the transferred property.

In any event, it would seem that the statute contemplates that the amount of B's taxable gift should include a component for the value of A's income interest, given that A is an applicable family member and is retaining an interest in the trust that is not a qualified interest. See § 2702(a). As a matter of, policy, however, there would appear to be little justification for including in the computation of B's taxable gift a component for the value of A's interest. In doing so. the statute in effect seeks to bring within its scope trusts created prior to its enactment. And, perhaps more importantly, it creates the potential for double taxation. Any income in fact received by A that is not consumed will ultimately be subjected to transfer tax, even though B is apparently required to pay a gift tax on the value of A's interest at the time B makes a gift of his interest. In addition, should A make a gift of his income interest after B completes his gift, A would of course be viewed as having made a taxable gift. It would seem that an adjustment would be necessary in order to prevent double taxation. The regulation designed to prevent double taxation (Treas. Reg. § 25.2702-6) does not, however, address the issue. See S. Stacy Eastland & Stephen L. Christian, Proposed Valuation Regulations Provide Harsh Results Under Adjustment and Lapse Rules, 75 J. Tax'n 364, 366 (1991).

[80] See I.R.C. § 2702. It should be noted that the regulations take a flexible approach in defining the term "fixed amounts." See Treas. Reg. § 25.2702-3(b)(1)(ii), which provides that the grantor is deemed to have retained the right to receive a "fixed amount" as long as the amount does not escalate by more than 20% each year. See also Treas. Reg. § 25.2702-3(c)(1)(ii) for a similarly flexible definition of the term "fixed percentage."

Consequently, as Congress contemplated in formulating the section 2702 approach, the GRIT is no longer feasible as a practical matter. For, under the zero-value rule, a grantor who creates a GRIT is treated as having made a taxable gift equal to the entire value of the property contributed to the trust at inception. Yet the income generated by the trust during the income-retention period flows back to the grantor to be included (unless consumed) in her gross estate. Quite obviously, if the grantor, instead of creating a GRIT, made an outright gift of the property that she contemplated contributing to the GRIT, the gift-tax cost would be the same and, most importantly, none of the income accruing after the completion of the gift would be includible in the grantor's gross estate. Thus, with section 2702 in place, not only does the GRIT no longer enjoy an advantage relative to an outright gift, but it in fact suffers a comparative disadvantage.[81]

2. *GRAT's and GRUT's Under Section 2702*

In providing that annuity and unitrust interests are not subject to the zero-value rule, section 2702 has focused attention on two types of trusts that ordinarily would not have been used in the non-charitable context in the past: the "GRAT" (grantor retained annuity trust) and the "GRUT" (grantor retained unitrust).[82] In the case of the GRAT, the grantor retains the right for a period of years specified in the trust to receive an annuity amount each year from the trust. In the case of the GRUT, the grantor retains the right, also for a specified number of years, to receive a fixed percentage of the value of the corpus as determined each year. Since the interest retained by the grantor under both a GRAT and a GRUT is a qualified interest, the zero-value rule does not apply. Instead, the value of the retained interest is determined under the same approach that would have obtained prior to the enactment of section 2702, through the application of the valuation tables. The amount of the taxable gift deemed to be made by the grantor upon creating the trust is reduced by the value of the retained interest,

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[81] For a further discussion with respect to the neutrality of § 2702, see infra notes 106-133 and accompanying text.

[82] In the charitable context, annuity and unitrust interests are commonly retained. See I.R.C. § 664(b).

as so determined.[83]

[83] Prop. Treas. Reg. § 25.2702-3(e), 56 Fed. Reg. 14321, 14324 (April 9, 1991), contained two examples that were inconsistent. Although the inconsistency has been eliminated in the final regulations, a possible attack on the validity of the final regulations makes it appropriate to explore the proposed regulations and the alterations that have been effected in the drafting of the final regulations. In Prop. Treas. Reg. § 25.2702-3(e), example (5), the grantor retained the right to receive annuity payments over a period of ten years, with the payments continuing to be made to the grantor's estate if the grantor died within the ten-year term. The conclusion reached in the example was that the annuity interest for the entire ten-year term constituted a qualified interest. In other words, the value of the annuity interest — which, because it was a qualified interest, could be subtracted from the value of the property contributed to the trust in arriving at the taxable gift deemed to occur at the creation of the trust — was determined without taking into consideration the possibility that the grantor might die before the expiration of the ten-year term.

In Prop. Treas. Reg. § 25.2702-3(e), example (1), the grantor retained the right to receive annuity payments over a period of ten years, with the remainder payable to the grantor's child upon the expiration of the ten-year term. If, however, the grantor died within the ten-year term, the entire corpus of the trust was to be paid to the grantor's estate. The conclusion reached in the example was that the annuity interest constituted a qualified interest, the value of which was to be determined — for purposes of computing the amount of the taxable gift at inception — by taking into account the possibility that the grantor might die within the ten-year term. In addition, the example concluded that the right of the grantor's estate to receive the corpus in the event of the grantor's death within the ten-year term was not a qualified interest and was therefore deemed to have a value of zero — i.e., did not result in a reduction in the amount of the taxable gift triggered at the creation of the trust.

In essence, what made the conclusions reached in these two examples inconsistent was that in example (1) the possibility of the grantor's death occurring within the ten-year term was taken into account in arriving at the value of the qualified interest, whereas in example (5) it was not. It would seem that the possibility that the grantor might die within the term ought to have been disregarded in both cases. For, in neither case, was the grantor deprived of the economic benefit inherent in the annuity payments if the grantor died within the ten-year term. And, in neither case, as a consequence, was it possible for the grantor's gross estate to be determined without in effect being required to include the value of the annuity payments.

In example (5), the trustee was required to continue making the annuity payments to the grantor's estate for any portion of the ten-year term remaining after the grantor's death, thus triggering an inclusion under I.R.C. § 2033. And, in example (1), the entire corpus reverted back to the grantor' estate if the grantor died within the term, also triggering an inclusion under § 2033 — the inclusion subsuming within it the value of the remaining annuity payments.

It would seem that the approach taken in example (5) is preferable. That is to say, a reduction in the taxable gift at the creation of the trust on the assumption that the grantor would receive the economic benefit of the annuity payments for the full term would not create the potential for transfer-tax avoidance that I.R.C. § 2702 was designed to eliminate. In both cases (example (1) and example (5)), the full economic value of the annuity payments would be includible in the grantor's gross estate, thus making it appropriate to value the qualified interest at inception by assuming that the grantor would definitely receive annuity payments for the full term.

As suggested, the inconsistency between these two examples has been eliminated in the final regulations. Treas. Reg. § 25.2702-3(e). Example (1) is retained in the final regulations

The zero-value rule was designed to prevent taxpayers from exploiting the GRIT's advantages. Since neither the GRAT nor the GRUT offers the same opportunity for exploitation, Congress' decision not to make the rule applicable to an annuity interest under a GRAT or a unitrust interest under a GRUT is understandable. In the ensuing discussion, each of the advantages that the GRIT had enjoyed will be examined in order to clarify the extent to which the advantage is not achievable with a GRAT or a GRUT.

Consider first appreciation and leverage benefit. Whether the return enjoyed by a GRIT was in the form of income or principal was critical. In order for the GRIT to produce appreciation or leverage benefit, it was necessary for the corpus of the trust to appreciate in value. Where appreciation did occur, it would pass to the remainderman upon termination of the trust. Where, however, the return on the GRIT's investments consisted of income, it would pass to the grantor. In essence, the form of the return (income or appreciation) would determine the identity of the recipient. Thus, the conversion, effected by carefully selecting the GRIT's investments, of a dollar of income into a dollar of appreciation would result in deflecting that dollar from the grantor to the remainderman. This conversion, which was accomplished without the imposition of any additional transfer tax, constituted appreciation and leverage benefit.

In contrast, the distinction between income and principal is irrelevant in the context of a GRAT or a GRUT. In the case of the GRAT, the amount the grantor is entitled to receive each year is fixed at inception, thus making the form of the trust's return, as

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without any modification. Reg. § 25.2702-3(e), example (1). Example (5), however, has been modified substantially. Example (5) now concludes that, even though the trust instrument requires that the payments to be made to the grantor are to continue for the balance of the designated ten-year term if the grantor dies during the term, the grantor's retained interest only constitutes a qualified interest to the extent of the right to receive the payments for the ten-year term or until the grantor's prior death. In other words, under the final regulations, a grantor who retains the right to receive a fixed number of payments that, according to the trust instrument, will continue to be made to the grantor's estate if the grantor should die before all of the payments have been made is to be treated for gift-tax purposes as if the trust instrument provided for the cessation of payments upon the grantor's death. Given that all of the payments required to be made to the grantor's estate if the grantor should die during the trust term will be includible in grantor's gross estate under § 2033, there is no reason for subjecting the grantor to the gift tax with respect to any portion of the retained right. Indeed, unless Treas. Reg. § 25.2702-6 is interpreted as permitting an adjustment at the time of the grantor's death in this context, double taxation will result.

well as the amount of the return, irrelevant to the determination of the amount payable to the grantor.[84] In the case of the GRUT, the amount the grantor is entitled to receive each year is equal to a fixed percentage, designated at inception, of the value of the corpus as determined on an annual basis. The amount payable to the grantor is a function of the trust's *total* return, income and appreciation, making the composition of the trust's return irrelevant to the computation of the grantor's annual entitlement. As a consequence, a GRAT or a GRUT that generates appreciation cannot deflect wealth from the grantor to the remainderman. Thus, neither a GRAT nor a GRUT offers the opportunity for appreciation or leverage benefit.

To illustrate the unavailability of appreciation and leverage benefit in the context of a GRAT or a GRUT, consider whether either of these benefits would have been achieved by the taxpayer in *O'Reilly*[85] had a GRAT or a GRUT been utilized instead of a GRIT. As will be recalled, the GRIT in *O'Reilly* held closely held stock that, it was anticipated, would produce little or no dividend income. In holding that the taxpayer could value the retained income interest for gift-tax purposes by using the tables, the court in effect permitted a reduction in the amount of the taxable gift deemed to occur upon the creation of the trust to reflect the fact that the grantor would be receiving dividends. But, of course, it was anticipated that the grantor would receive little or no dividend income. Instead, the return generated by the stock would presumably be in the form of appreciation that would pass to the remainderman. With virtually all of the trust's return anticipated to be in

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[84] The regulations do contemplate that the grantor of a GRAT might be entitled to receive under the trust instrument trust income where it exceeds the annuity amount. See Treas. Reg. § 25.2702-3(b)(1)(iii). This regulation provides that while the retention of the right to receive any GRAT income in excess of the annuity amount does not taint the annuity amount — i.e., render it an interest that is nor qualified — the right to receive excess income itself is not a qualified interest. As a consequence, the value of the right to receive excess income would be deemed to be zero. The application of the zero-value rule in this context might potentially create double taxation: At the creation of the trust, the value of the right would be deemed to be zero, thus producing a taxable gift; and any excess income in fact received by the grantor would generate additional transfer tax at the grantor's death or upon a subsequent gift (assuming the grantor did not consume it). Thus, even though some grantors might find the retention of the right to receive excess income psychologically attractive, the potential for double taxation suggests that the right should not be retained. But cf. Rev. Rul. 84-25, 1984-1 C.B. 191.

[85] 95 T.C. 46 (1990).

the form of appreciation, it would seem appropriate to treat the grantor as having made a taxable gift equal to the entire value of the stock contributed to the trust. In treating the grantor as if a lesser taxable gift had been made, the court enabled the grantor to deflect wealth to the remainderman on a tax-free basis, thus creating appreciation and leverage benefits.

If the grantor had contributed the stock to a GRAT or a GRUT instead, appreciation and leverage benefits would not have been available. For the amount distributable annually to the grantor under a GRAT or a GRUT would not have been affected by the composition of the trust's return. In other words, a decision by the corporation to retain its earnings rather than to make a dividend distribution would not translate into a tax-free deflection of wealth from the grantor to the remainderman. In short, appreciation and leverage benefits could not have been realized in *O'Reilly* with the use of a GRAT or a GRUT.

While neither the GRAT nor the GRUT presents any opportunity for appreciation or leverage benefit, they do make it possible for rate benefit to be achieved. The character of rate benefit in the GRAT or GRUT context, however, is substantially different from its character in the GRIT context. In the case of a GRIT, rate benefit would occur where the table rate exceeded the actual rate of return produced by the trust. On the other hand, as will be discussed, a GRAT enjoys an advantage over a comparable outright gift — i.e., rate benefit occurs — where the actual rate of return produced by the trust exceeds the table rate.[86] And inasmuch as the 1988 amendments to section 7520 make the table rate high in relation to the rate available on some investments in the market, the potential for taxpayers to enjoy rate benefit through the use of a GRAT is somewhat limited. The GRUT offers even less potential for rate benefit than the GRAT. In the case of a GRUT, there is ordinarily no opportunity for rate benefit to be achieved; where, however, the trust instrument provides that the unitrust payment to the grantor is to be made each year some period of time after the date on which the amount payable to the grantor is fixed for that year, some rate benefit is achievable.[87] Put simply, the opportunity to enjoy rate benefit in the context of a GRAT or a GRUT

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[86] See infra notes 133-148 and accompanying text.
[87] See infra notes 152-157 and accompanying text.

is not as substantial as it was in the case of a GRIT.

As suggested, the grantor of a GRIT could enhance the potential for rate benefit by retaining a reversionary interest.[88] Retaining a reversionary interest would reduce the amount of the taxable gift deemed to occur upon the creation of the GRIT, thus increasing the attractiveness of the GRIT relative to a comparable outright gift.[89]

Although the retention of a reversionary interest would enhance the potential for rate benefit, it did not increase the grantor's estate-tax cost. If the grantor survived the income-retention period, the corpus would pass under the terms of the trust to the remainderman; the reversionary interest would evaporate — i.e., never become possessory — and would, therefore, not trigger any inclusion in the grantor's gross estate. If, on the other hand, the grantor failed to survive the income-retention period, the reversionary interest would entitle the grantor's estate to receive all of the corpus of the trust; it would not, however, generate any additional estate-tax cost since the entire corpus of the trust would be includible in the grantor's gross estate under section 2036 even in the absence of a reversionary interest.[90] The contingent nature of the reversion was critical: By making the reversion contingent upon whether or not the grantor survived the income-retention period, the grantor secured a reduction in the amount of the taxable gift triggered at the creation of the trust without incurring the risk of any additional estate-tax cost.

In enacting section 2702, Congress took specific aim at the reversionary-interest technique that had been utilized by taxpayers in structuring GRIT's. The section eliminates the gift-tax benefit inherent in the reversionary-interest technique by providing that a contingent reversionary interest is not a qualified interest.[91] Thus, if a grantor of a GRAT or a GRUT were to retain a contingent reversionary interest of the same type that had been retained in the GRIT context — i.e., one structured so that it would evaporate in the event the grantor survived the annuity-retention or uni-

[88] See supra notes 53-62 and accompanying text.

[89] Id.

[90] See supra notes 53-62 and accompanying text.

[91] I.R.C. § 2702(b)(3). It is possible for a noncontingent reversionary interest to constitute a qualified interest as long as the other interests in the trust constitute qualified interests as well.

trust-retention period — the zero-value rule would apply. As a consequence, the grantor would be treated for gift-tax purposes as if the reversionary interest were not retained, thereby making unavailable the kind of gift-tax benefit inherent in the retention of a reversionary interest that had been enjoyed in the GRIT context prior to the enactment of section 2702.

This is not to suggest, however, that it would be imprudent in all cases for the grantor of a GRAT or a GRUT to incorporate a contingent reversionary interest in the trust instrument. Indeed, a grantor concerned about making optimal use of the marital deduction would in all likelihood be inclined to retain a reversionary interest contingent upon the death of the grantor occurring within the annuity-retention or unitrust-retention period.[92] In the absence of such a reversion, no marital deduction would be available (assuming the remainderman is not the grantor's spouse) to offset the section 2036 inclusion in the grantor's gross estate that would be triggered if the grantor died within the annuity-retention or unitrust-retention period. Where, on the other hand, a contingent reversion is retained, the grantor can direct through a provision in her will that the corpus of the trust pass upon her death to her spouse, which would make the marital deduction available to offset any section 2036 inclusion. Thus, while the retention of a contingent reversionary interest produces no gift-tax benefit, it does have significance for estate-tax purposes in that it permits the marital deduction to be utilized with respect to the property passing under the trust.

Although it remains possible for a grantor to retain a noncontingent reversion without triggering the zero-value rule,[93] a grantor of a GRAT or a GRUT would not ordinarily, as a practical matter, retain such a reversion. Unlike the contingent reversion, a noncontingent reversion would necessarily result in the GRAT or GRUT corpus being included in the grantor's gross estate, whether the grantor died before or after the expiration of the annuity or unitrust interest.[94] And since the effect of including the corpus in the

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[92] For a discussion about the use of a contingent reversionary interest in order to avoid underutilization of the marital deduction in the GRIT context, see supra notes 53-62 and accompanying text.

[93] I.R.C. § 2702(b)(3).

[94] See id. See also I.R.C. § 2033.

gross estate would be to treat the grantor as if the trust had never been created, a grantor would not be able to derive rate benefit, or any other benefit, from a GRAT or a GRUT containing a noncontingent reversionary interest.

In sum, section 2702 has, to a large extent, eliminated the opportunities taxpayers had previously enjoyed through the use of a GRIT. The section, in essence, accomplishes its objective by making the zero-value rule applicable in the case of a GRIT but not in the case of a GRAT or a GRUT. Since neither the GRAT nor the GRUT offers the same advantages that the GRIT had offered, section 2702 significantly reduces the potential for taxpayer abuse in this context.

3. *The Personal-Residence Exception*

While section 2702 was designed to prevent taxpayers from continuing to exploit the advantages offered by the GRIT, the section does not entirely eliminate the GRIT. Where the trust corpus consists exclusively of the personal residence of the person holding a term interest in the trust,[95] the personal-residence exception (contained in section 2702(a)3(A)(ii)) renders the section inoperative.[96] It remains possible, therefore, to create a GRIT without triggering section 2702's zero-value rule, so long as the conditions necessary for qualifying under the personal-residence exception are satisfied.[97] If the exception applies, the value of the interest in the trust retained by the grantor is determined through the application of the tables, just as the value of the income interest in a GRIT had been determined under the tables prior to the enactment of section 2702. Concomitantly, the amount of the taxable gift triggered at the creation of the trust, which is equal to the value of the remainder interest, is determined under the tables as well.

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[95] See I.R.C. § 2702(c)(3). This section defines "term interest" as a life interest or as an interest for a term of years.

[96] Under I.R.C. § 2036(c) as in effect prior to its repeal, personal-use property was not be viewed as an "enterprise" and would, therefore, not be trigger application of the section. See John R. Cummins, Turney P. Berry & Martin S. Weinberg, Immediate Action Needed in Light of IRS' Expansive Definition of "Enterprise," 71 J. Tax'n 276 (1989). Presumably, the exception for personal-use property made in § 2036(c) was within the contemplation of Congress when it created the personal-residence exception contained in § 2702.

[97] For a further discussion of the implications of the personal-residence exception, see infra notes 158-213 and text accompanying notes.

Given that Congress was motivated in enacting section 2702 by its concern about the potential for abuse inherent in the GRIT, why did it create the personal-residence exception? Perhaps, Congress was of the view that the exception would be *de minimis* in character. Whereas taxpayers might contribute unlimited sums of money (or property) to a GRIT prior to the enactment of section 2702, the personal-residence exception implicitly places a limit, as a practical matter, on the amount that can be contributed to a personal-residence GRIT: The trust cannot contain any asset other than the personal residence of the person holding a term interest in the trust (i.e., typically the grantor).[98] While taxpayers remain free, of course, to invest substantial portions, if not all, of their wealth in a residence in order to maximize the benefits associated with a personal-residence GRIT, it is not likely that taxpayers would choose on the basis of the personal-residence exception to invest more of their wealth in their residence than they would otherwise be inclined to invest. Thus, the potential for abuse inherent in the exception is limited.

While the limitation on abuse implicit in the exception makes it easier to defend the exception as a matter of policy, the exception may well produce inequitable results. Taxpayers with greater wealth tend to own more valuable residences. In addition, wealthy taxpayers might not be made as psychologically uncomfortable as less wealthy taxpayers by the contribution of their residence to a

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[98] See Treas. Reg. § 25.2702-5(a). This treasury regulation provides that I.R.C. § 2702 does not apply in the case of a personal residence trust, which is defined as a trust that is not, according to its terms, permitted to hold any asset other than one residence to be used as the personal residence of the term holder. Treas. Reg. § 25.2702-5(b). Since the regulations provide that an individual may have two personal residences simultaneously, it is possible for an individual to be the term holder in two personal residence trusts at the same time. See id.

Where a trust holds property in addition to the personal residence of the term holder, it will not constitute a personal residence trust. It may nevertheless be possible to avoid application of § 2702 in the case of such a trust. Treas. Reg. § 25.2702-5(a) provides that a personal residence trust is not subject to § 2702 even though it holds property in addition to the term holder's personal residence as long as the trust constitutes a qualified personal residence trust. In essence, a qualified personal residence trust is a personal residence trust that is permitted to hold a limited amount of cash for the purpose of enabling the trust to pay for its expenses, for improvements to the residence and for the cost of acquiring the residence. See Treas. Reg. § 25.2702-5(c). In short, except in the case of a qualified personal residence trust — which, as suggested, is permitted to hold a limited amount of cash — the personal-residence exception is unavailable where the trust is to hold any asset in addition to the term holder's (i.e., the income beneficiary's) personal residence.

trust. For both reasons, the benefit of the exception is, as a practical matter, disproportionately available to taxpayers who have greater wealth.

Congress' decision to create the personal-residence exception may also derive from the limited nature of appreciation benefit available in a personal-residence GRIT. To make this clear it would be helpful to contrast the potential for appreciation benefit inherent in a personal-residence GRIT with the opportunity for appreciation benefit that had been available in the case of a GRIT containing closely held stock prior to the enactment of section 2702.

In a closely-held-stock GRIT, like the one before the court in *O'Reilly*, if the corporation elected not to make a dividend distribution, the value of the stock would grow to reflect the increase in the corporation's retained earnings. Since the grantor (and/or her family) would ordinarily control the dividend-distribution question in the case of closely held stock, the potential for taxpayers to convert income into appreciation was substantial. In effect, an election by the corporation not to make a dividend distribution would convert income that would otherwise be distributable to the grantor into appreciation ultimately passing to the remainderman. Indeed, assuming the corporation elected not to make any dividend distributions during the entire term of the trust, the grantor's income interest in the trust would not entitle her to receive any portion of the trust's return. Instead, all of the return generated by the trust during its term would inure to the benefit of the remainderman, thereby deflecting wealth from the grantor to the remainderman.

The personal-residence GRIT does not permit the same tax-free deflection of wealth. With the grantor entitled to receive the trust's income, any payment of rent made by the grantor to the trustee would be returned to the grantor as a distribution of income. In effect, the grantor's estate would be enriched by any such distribution. The assumption made by the tables at the creation of the trust, that the grantor would receive amounts from the trust that upon subsequent transfer would be taxable, proves accurate. The income received by the grantor (if not consumed) would eventually become subject to transfer tax, either at the time of the grantor's death or at the time of an earlier inter vivos gift. In other words, any rent paid by the grantor to the trustee would not convert into appreciation that passes on a tax-free basis to the

remainderman.

If, on the other hand, the grantor simply had the right under the trust instrument to live in the residence on a rent-free basis (not being required to pay rent and concomitantly not being entitled to receive income distributions from the trust), there would still be no opportunity to effect such a tax-free conversion of income into appreciation. For, with the grantor paying no rent, no return would be earned by the trust, making it impossible for conversion to occur.[99] Thus, the personal-residence GRIT, unlike a GRIT holding closely held stock, does not permit the grantor to deflect wealth to the remainderman on a tax-free basis by converting income into appreciation.[100]

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[99] The statement in text that the trust would not enjoy any return unless the grantor paid rent to the trustee does not take into account the possibility that the value of the residence might increase during the term of the trust. If such an increase occurred, it would, of course, constitute a return enjoyed by the trust, ultimately inuring to the benefit of the remainderman.

[100] Congress' concern about preventing taxpayers from effecting a tax-free deflection of wealth is also reflected in the tangible-property exception, provided for in I.R.C. § 2702(c)(4). Under this exception, the retention of a term interest in tangible property is not subject to the zero-value rule. Instead, the value of such a term interest is determined conventionally: Its value is equal to the price at which it would be sold to an unrelated third party.

In order to qualify for the exception, the regulations require that two conditions be satisfied: 1) that the failure to exercise any right under the term interest not result in increasing the value of the property passing to the remainderman at the expiration of the term interest; and 2) that the property subject to the term interest not be of a character that would make it eligible for either depreciation or depletion (with the eligibility question determined by assuming that the property is used in a trade or business or held for the production of income, even if in fact the property is otherwise used). Treas. Reg. § 25.2702-2(c)

As the regulations make clear, these two conditions are designed to prevent taxpayers from using the exception in order to avoid the zero-value rule in contexts that would permit wealth deflection to occur. It is hypothesized in Treas. Reg. 25.2702-2(d), example 8, that a remainder interest in a painting is transferred by A to B, with A retaining the right to use the painting for a period of ten years. In explicating the rationale for applying the exception, the regulation states: "However, because of the nature of the property, A's failure to exercise A's rights with regard to the painting would not be expected to cause the value of the painting to be higher than it would otherwise be at the time it passes to B."

In making the tangible-property exception inapplicable in the case of depreciable property, the regulations go somewhat beyond the explanation offered by the Senate Finance Committee with respect to the exception. The Senate Finance Committee Report (S. Rep. (unnumbered) 101st Cong., 2d Sess. 58 (1990) (an unofficial Senate report to accompany S. 3209)) mentions, as examples, two types of assets that would qualify for the exception: a painting and an undeveloped parcel of real estate. The Report then goes on to limit the availability of the exception, providing that it should not apply in the case of depletable property. The regulations extend this limitation on the exception to prohibit it from apply-

While it may well be that Congress created the personal-resi-

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ing in the case of depreciable property as well.

Presumably, the concern underlying the regulations' extension of the limitation relates to the opportunity inherent in depreciable property to deflect wealth to the remainderman. Consider, for example, the contribution of a piece of equipment to a trust that entitles the grantor to use the equipment for a period of years. The value of the equipment at the time it passes to the remainderman is a function of the way in which the grantor uses the equipment. Indeed, if the grantor chose not to use the equipment at all and if, by virtue of the nature of the equipment, it did not decline in value in the absence of usage, no decline in value would occur during the grantor's term on account of usage. On the other hand, the more the grantor did use the equipment, the less value it would have at the termination of the trust.

If the regulations permitted the exception to be applied in this context, the value of the grantor's retained interest would be equal to the price that an unrelated purchaser would be willing to pay. Since an unrelated purchaser of the right would presumably decide upon an appropriate price by assuming maximum usage of the equipment and since the grantor might well forego using the equipment entirely, the application of the exception could result in substantial wealth deflection. The value of the remainder interest, as determined through application of the unrelated-purchaser formulation, would take into account an anticipated decline in the value of the asset attributable to a prediction of maximum usage. But if, contrary to the prediction, the grantor chose not to use the asset, the unrelated-purchaser formulation would result in an undervaluation of the remainder interest. Put differently, the unrelated-purchaser formulation would fail to take into account the wealth deflection that would occur in the event the grantor failed to use the equipment. By making the exception inapplicable in this context, the regulations would subject the grantor's retained interest in the equipment to the zero-value rule — thus treating the grantor for gift-tax purposes as if no interest were retained and thereby precluding the grantor from achieving a tax-free deflection of wealth.

While the Senate Finance Committee Report does not explicitly focus on depreciable property, the position taken in the regulations with respect to depreciable property does appear to be consistent with the statute. The statute makes the exception applicable where ". . . the nonexercise of rights under a term interest in tangible property would not have a substantial effect on the valuation of the remainder interest in such property . . ." See I.R.C. § 2702(c)(4). In other words, the exception, according to the statute, does not apply where the grantor can, through the exercise of any right, affect the value of the property passing to the remainderman. In the depreciable-property context, it would seem that the grantor's decision to use or not to use the property could have a substantial impact on the value of the property ultimately passing to the remainderman. Thus, the approach taken in the regulations with respect to depreciable property does appear to be consistent with the statute. But see Dale W. Wickham & Francis A. Lavelle, Gift Tax Valuation of GRIT's of Personal Residences or Depreciable Property: A Policy Critique of Proposed Treasury Regulations, 53 Tax Notes 339 (1991).

In making depreciable property ineligible for the tangible-property exception, the regulations can produce odd results. Consider, for example, the contribution of equipment having a useful life of five years to a ten-year GRIT. Obviously, at the end of the GRIT's term, the equipment would no longer have any value. If the anticipated decline in value were taken into account in valuing the remainder interest for gift-tax purposes, the taxable gift deemed to occur at the creation of the trust would be zero — reflecting the reality that what ultimately passes to the remainderman is of no value. But, with the tangible-property exception unavailable, the zero-value rule applies, making the taxable gift deemed to occur at the

dence exception because of its perception that the personal-residence GRIT offers taxpayers not as much benefit as had been achievable previously through the use of a GRIT, this is not to suggest that the personal-residence GRIT offers no advantage. The rate-benefit analysis in the context of a personal-residence GRIT is no different from the rate-benefit analysis made by a grantor contemplating a GRIT prior to the enactment of section 2702.[101] Where the table rate in effect at the time of the creation of the trust is higher than the rate of return that the residence would generate in the market (if held as an investment), the personal-residence GRIT produces rate benefit.[102] And with the table rate high in relation to the rates made available by at least some investments in the market, as a result of the 1988 amendment to section 7520, the opportunity to enjoy rate benefit inherent in the personal-residence GRIT could prove to be substantial.

In addition, the reversionary-interest strategy used prior to the enactment of section 2702 remains viable in the context of a personal-residence GRIT. Retaining a contingent reversionary interest, the grantor of a personal-residence GRIT is able to reduce the taxable gift triggered at the creation of the trust — thereby enhancing the potential for rate benefit — as well as avoid the risk of underutilizing the marital deduction.[103]

Appreciation and leverage benefits also remain viable in the context of a personal-residence GRIT. Where the residence appreciates in value during the term of the trust, the appreciation ultimately inures to the benefit of the remainderman. As a result, the remainderman could potentially receive more wealth upon the termination of the GRIT than the donee of a comparable outright gift would have in hand at the expiration of a period of time equal to

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creation of the trust equal to the entire value of the equipment at that time. Thus, while one might reasonably conclude that the depreciable nature of the equipment should cause a reduction in the amount of the taxable gift in order to reflect the effect of depreciation on the value of the property ultimately passing to the remainderman, cf. Treas. Reg. § 1.170A-12 (requiring that the value of a remainder interest in real estate be reduced to take into account depreciation for purposes of computing the amount of the charitable deduction), the regulations render the tangible-property exception unavailable and, as a consequence, apply the zero-value rule precisely because the property is depreciable.

[101] For a discussion of rate benefit, see supra notes 16-27 and accompanying text.

[102] For a further discussion of rate benefit in the context of a personal-residence GRIT, see infra notes 158-213 and accompanying text.

[103] See supra notes 53-62 and accompanying text.

the GRIT term.[104] In other words, just as the GRIT prior to the enactment of section 2702 could produce more wealth for the remainderman than a comparable outright gift would produce for the donee where appreciation occurred, so, too, appreciation may render the personal-residence GRIT more effective than a comparable outright gift. It is not possible, however, for the grantor of a personal-residence GRIT to realize the magnitude of appreciation benefit that had been available prior to the enactment of section 2702 with, for example, a GRIT containing closely held stock. Thus, while appreciation benefit and leverage benefit are achievable with the personal-residence GRIT, the potential magnitude of these two benefits in the context of a personal-residence GRIT is not as great as the magnitude of appreciation and leverage benefit taxpayers managed to create prior to the enactment of section 2702.[105]

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[104] To illustrate, assume that a grantor contributes a residence with a value of $100 to a one-year personal-residence GRIT at a time when the table rate is at 10%. Assume further that, during the course of the one-year term, the residence would, if rented, produce a rate of return in the form of rent of 8% and that it produces 2% of appreciation. Upon the termination of the GRIT, the remainderman would be entitled to receive the residence, which at that time would have a value of $102 (because of the appreciation, the residence would increase in value from $100 to $102 during the course of the year). If the grantor made a comparable outright gift of the residence instead of creating a GRIT, the amount of wealth attributable to the gift that the donee would have at the end of one year would only be $100: The amount of the comparable outright gift would be equal to $90.90 (which is the amount of the taxable gift that the grantor would be deemed to have made if the GRIT were created), which would grow during the one-year period to $100, assuming a rate of return of 10% (including rental income and appreciation). The extra wealth made available to the GRIT remainderman is attributable to appreciation and leverage benefit.

[105] Where a remainder interest in a residence is contributed to charity, the amount of the charitable deduction, which is equal to the value of the remainder interest, is reduced in order to reflect anticipated depreciation. See I.R.C. § 170(f)(4); Treas. Reg. § 1.170A-12. In contrast, neither the gift-tax sections of the code nor the gift-tax regulations provide for depreciation to be taken into account in determining the amount of the taxable gift deemed to occur in connection with a gift of a remainder interest in a residence (or in any other type of asset) — perhaps on the rationale that the potential for the residence to appreciate is also disregarded.

It would seem that the value of a remainder interest in a residence ought not to be dependent on whether the determination is made in the context of computing the amount of a charitable deduction or the amount of a taxable gift. If it is appropriate to disregard depreciation on the rationale that appreciation is similarly disregarded, then depreciation should be ignored, whether in the context of computing a charitable deduction or the amount of a taxable gift. If, on the other hand, it is appropriate to take depreciation into account, then it is appropriate to do so in both contexts. Put differently, either the method used in computing the charitable deduction under § 170 with respect to the contribution of a remainder

IV. Section 2702: Is It A Neutral Solution?

The formulation of transfer-tax policy is based, in part, on a concern about neutrality.[106] That is, a critical goal underlying the transfer-tax system is to minimize as much as possible its influence upon the way in which taxpayers effect wealth transfers.[107] Given the many ways in which the Code influences the method and timing of transfer chosen by taxpayers,[108] one might fairly conclude that the concern with neutrality is of more significance in the theoretical realm than in the context of the reality of the wealth-transfer rules Congress has created.[109] Nevertheless, neutrality remains an important policy objective and a standard upon which to measure the appropriateness of transfer-tax provisions.[110]

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interest in a residence results in an undervaluation because it takes depreciation into account or the method used in computing the amount of the taxable gift in the case of a transfer of a remainder interest in a residence results in an overvaluation because it fails to take depreciation into account.

[106] See U.S. Treasury Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth— General Explanation of the Treasury Department Proposals, supra note 4, at Volume 1 at 13; Gutman, supra note 6, at 1217; Dodge, supra note 6, at 286-287.

[107] See, e.g., U.S. Treasury Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth— General Explanation of the Treasury Department Proposals, supra note 4, at Volume 1 at 13; Gutman, supra note 6, at 1217; Dodge, supra note 6, at 287.

[108] See Sims, supra note 5, at 39-52 (suggesting that taxpayers can still achieve transfer-tax advantages by making inter vivos gifts). Also, it would seem that the present structure of the unified credit (I.R.C. § 2010) distorts the testamentary scheme opted for by transferors in a great many instances. In order for a married couple to make certain that a forfeiture of one of their unified credits does not occur, the wills customarily provide that the unified-credit equivalent be placed in a by-pass trust, popularly known as a credit-shelter trust. See Don W. Llewellyn, Kenneth J. Levin & Gail Levin Richmond, Computing the Optimum Marital Deduction: Is a Zero-Tax Formula Appropriate, 24 Real Prop., Prob. & Tr. J. 331, 332 (1989). While such an arrangement does assure the couple that their unified credits will be effectively utilized, it is, in many instances, not the dispositive scheme that the couple would choose in the absence of the transfer-tax system. See Task Force on Transfer Tax Restructuring, Report on Transfer Tax Restructuring, American Bar Association Section of Taxation, reprinted in 41 Tax Law. 395, 398 (1988) (where it is suggested that the unified credit, or its exemption equivalent, be transferrable from one spouse to the other, thus eliminating the need for the credit-shelter trust); Edward C. Halbach, Jr., An Accessions Tax, 23 Real Prop., Prob. & Tr. J. 211, 221 (1988).

[109] In 1976, Congress did make a substantial effort in the direction of eliminating the disparities between the estate tax and the gift tax, the effect of which was to make the transfer-tax system more neutral. But more reform is needed if the system is to be made entirely neutral. See Sims, supra note 5, at 35.

[110] See U.S. Treasury Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth— General Explanation of the Treasury Department Proposals, supra note 4, at Volume 1 at 13.

An important application of the principle of neutrality is concerned with whether — and, if so, the extent to which — a particular tax provision might distort a taxpayer's decision to effect a transfer by inter vivos or testamentary gift.[111] This application of the principle requires that an inquiry be made into the advantages and disadvantages of an inter vivos gift as compared to a testamentary gift. Where, for example, the particular provision under consideration imposes a tax cost on these two methods of transfer that is not identical, a well-advised taxpayer would take the differential into account in deciding which method to utilize. And so a provision creating such a differential in cost would, to the extent it motivated taxpayers to select a method that they would not otherwise choose, be distortionary or non-neutral.

Under current law, inter vivos gifts enjoy certain advantages not available in the testamentary setting. The most important of these advantages is the exclusion from the donor's transfer-tax base of all income and appreciation accruing after the inter vivos gift is accomplished.[112] The potential for distortion — or non-neutrality — inherent in this advantage is not, however, without limit.

In order to secure the advantage, a taxable gift must be effected. And this, of course, ordinarily results in an obligation to pay a gift tax.[113] In requiring that a gift tax be paid at the point of making an inter vivos gift, the Code is in effect simply accelerating the time for the payment of estate tax.[114] Given the time-value of

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[111] See U.S. Treasury Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth— General Explanation of the Treasury Department Proposals, supra note 4, at Volume 2 at 376; Gutman, supra note 6, at 1217; Sims, supra note 5, at 35-38.

[112] In addition to the exclusion discussed in text, two other advantages are available in the context of an inter vivos gift. First, of course, the annual exclusion is only applicable to inter vivos gifts. I.R.C. § 2503. Second, because the tax base is computed differently for a taxable gift and the taxable estate, the transfer-tax cost attributable to the making of an inter vivos gift is less than the transfer-tax cost that would be generated by an equal amount of taxable estate. More specifically, whereas the amount passing to the legatee as well as the estate tax itself are subject to estate tax, only the amount passing to the donee in the case of an inter vivos gift is subject to gift tax; the gift tax itself is not subject to transfer tax unless the donor dies within three years of having made the gift. I.R.C. § 2035(c). See Sims, supra note 5, at 39.

[113] If the donor has not previously utilized her unified credit (I.R.C. § 2505), the making of a gift will not trigger an obligation to pay a gift tax. Nevertheless, using a unified credit by making an inter vivos gift does, in effect, cause the donor to incur a cost: After having made the gift, the donor will no longer have available the use of the credit to shelter future gifts of other assets and the income and appreciation those assets might generate.

[114] Inasmuch as gift-tax payments are creditable toward the donor's estate tax under

money, a taxpayer interested in making an inter vivos gift in order to secure the exclusion of post-gift appreciation and income might well choose not to make such a gift upon learning of the gift-tax or, "accelerated estate tax" it would create. In short, the disadvantage of having to pay an accelerated estate tax (i.e., a gift tax) in effect offsets and thereby renders non-distortionary the advantage of the post-gift exclusion.[115]

In the case where a grantor created a trust and retained an income interest for life, the gift tax was imposed on the value of the remainder on the date of the creation of the trust. The value of the life estate, prior to the enactment of section 2702, was not made subject to gift tax.[116] Since only a portion of the value of the property contributed to the trust was subject to gift tax, it would have been inappropriate — or distortionary — to permit the exclusion of post-gift income and appreciation. Limiting this distortion, section 2036 provided (and still does) that the exclusion is unavailable where a grantor retains a life estate.[117] It accomplishes this result by requiring that the value, as determined on the date of death, of the property contained in the trust be included in the grantor's gross estate.[118]

It had been argued that the combined effect of section 2036 and

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I.R.C. § 2001(b), it is appropriate to view the gift tax as simply an accelerated, or perhaps an estimated, estate tax.

[115] See Dodge, supra note 6, at 286. There are two other disadvantages associated with the making of an inter vivos gift: First, whereas the basis for income tax purposes of an asset received as an inter vivos gift is equal to, as a general matter, the donor's basis (I.R.C. § 1015), the basis of an asset received as a testamentary gift is equal to its fair market value on the date of the decedent's death; second, a donor making an inter vivos gift loses control over the gifted asset.

Parenthetically, it may well be that the time-value-of-money disadvantage discussed in text and the basis disadvantage offset in some rough sense the three advantages of making an inter vivos gift (which are discussed supra at note 112 and accompanying text). See Task Force on Transfer Tax Restructuring, Report on Transfer Tax Restructuring, American Bar Association Section of Taxation, reprinted in 41 Tax Law 395, at 403-404 (1988) (suggesting that the advantages and disadvantages associated with making inter vivos gifts may create an offset, thus resulting in "rough justice"). If they do, neutrality is accomplished. For the control issue is a non-tax or psychological concern; and if the tax rules leave the decision whether or not to make a gift for the donor to resolve on the basis of non-tax concerns — such as discomfort with relinquishing control or, on the other hand, the altruistic pleasure one derives from making a gift during life — the tax rules are free of distortion.

[116] See Robinette v. Helvering, 318 U.S.184 (1943); Treas. Reg. § 25.2511-1(e); Sims, supra note 5, at 46.

[117] I.R.C. § 2036.

[118] Id.

the gift-tax rule requiring the payment of a gift tax on the value of the remainder at the creation of the trust was itself distortionary.[119] A grantor motivated by non-tax concerns to create a trust with a retained life estate would probably be deterred from doing so after learning of the applicable transfer-tax rules. After all, would it not be prudent for such a grantor to make an outright gift instead? Although an outright gift would also generate a gift tax, it would at least enable the grantor to exclude from her transfer-tax base post-gift income and appreciation.

Two alternative approaches, designed to create more neutral results, had been suggested. Under the first alternative, no gift tax would be imposed at the creation of the trust.[120] At the grantor's death, the entire value of the trust corpus would be included in the gross estate, thus subjecting to tax all income and appreciation accruing between the date of the creation of the trust and the date of the grantor's death. And if the grantor were to make an inter vivos transfer of the income interest, a gift tax would be imposed at that time on the entire value of the trust corpus, including all income and appreciation accruing up to that point.

Under this alternative, the need to pay gift tax at the creation of the trust is avoided, but only at the cost of being subject to transfer tax on the post-creation income and appreciation. The imposition of this cost is what makes this alternative neutral. For it is precisely this cost that all taxpayers in effect bear whenever they decide not to make an outright gift. If this alternative were adopted, taxpayers retaining their assets until death (thereby avoiding the obligation to pay a gift tax) would be on an equal tax footing with those choosing to create a trust with a retained life estate.

Under the second alternative, a gift tax would be imposed at the creation of the trust on the value of the property conveyed to the

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[119] See Sims, supra note 5, at 48-9.

[120] See American Law Institute, Federal Estate and Gift Taxation (1969), reprinted in 1976 Staff of the House Comm. on Ways and Means, 94th Cong., 2d Sess., Background Materials on Estate and Gift Taxation 183, 365 (Comm. Print 1976); U.S. Treasury Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth— General Explanation of the Treasury Department Proposals, supra note 4, at Volume 2 at 378-9; Task Force on Transfer Tax Restructuring, Report on Transfer Tax Restructuring, American Bar Association Section of Taxation, reprinted in 41 Tax Law 395, at 404 et seq. (1988); Dodge, supra note 6, at 287-8.

trustee, without reduction for the value of the income interest retained by the grantor.[121] In order to maintain parity with an outright gift — i.e., avoid distortion — none of the income[122] or appreciation accruing after the creation of the trust would be included in the grantor's transfer-tax base. And no further gift tax would be imposed on the grantor were she to make an inter vivos transfer of the retained income interest, just as the donor of an outright gift is not subject to any additional transfer tax after having paid the gift tax at the point of making the gift.

These approaches would not only eliminate the disincentive associated with the creation of a trust where the grantor retains a life estate. They would also, if applied where the grantor retains a term of years, eliminate the benefits offered by a GRIT and therefore create neutrality in this context as well.

The first alternative, requiring in the life-estate context that the date-of-death value of the trust corpus be included in the gross estate, treats the grantor for transfer-tax purposes as if she did not create a trust. To treat a grantor who retains a term of years in a similar fashion, it would be necessary to view the transfer as occurring for tax purposes at the expiration of the term (or on the date of the grantor's death were she to die prior to the expiration of the term) rather than at the creation of the trust.

Taxing the transfer in accordance with this view would eliminate the advantages inherent in the GRIT — rate benefit, leverage benefit and appreciation benefit.[123] The valuation abuse made possible by a GRIT could occur only because the Service's valuation tables, applied at the time of the creation of the trust, failed to predict how the investment contributed to the trust would perform. Where, however, the property contributed to the trust becomes subject to transfer tax on its value at the expiration of the term of years (or the earlier death of the grantor), the tax is imposed on the basis of the reality of investment performance rather than a

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[121] See Jerome Kurtz & Stanley S. Surrey, Reform of Death and Gift Taxes, 70 Colum. L. Rev. 1365, 1375-6 (1970).

[122] Income received by the grantor during her life could presumably be removed from her taxable estate by providing the estate with a deduction equal in amount to the income she had received. It would perhaps be necessary to increase the deduction in order to take into account the earnings enjoyed by the grantor on the amounts of income she received from the trustee and invested.

[123] For a discussion of these benefits, see supra notes 16-52 and accompanying text.

mere prediction.

Under the second alternative as well — which requires the payment of a gift tax on the entire value of the property contributed to the GRIT and permits an exclusion for post-transfer income and appreciation — the GRIT would no longer offer any advantages. Indeed, the GRIT and the outright gift would be treated identically for both gift- and estate-tax purposes, thus eliminating any tax-based incentive to create a GRIT.

In enacting section 2702, Congress adopted a variation on the second alternative. Under the section, the grantor's retention, upon creating a trust, of a life estate or a term of years does not result in a reduction of the amount of the taxable gift — as it did prior to the enactment of the section. In other words, the entire value of the property contributed to the trust is made subject to gift tax, with the retained interest being ignored. And so, in this respect, section 2702 incorporates the second alternative. In one important respect, however, current law deviates quite significantly from the second alternative: When it enacted section 2702, Congress made no change in section 2036(a),[124] thus continuing to subject to estate tax all income[125] and appreciation accruing after the creation of the trust; had Congress adopted the second alternative in its entirety, none of this appreciation or income would be subject to transfer tax.

The failure to provide an exclusion for income and appreciation accruing during the term of the trust, while requiring that the entire amount contributed to the trust upon its creation be subject to gift tax, results in its own distortion. This, parenthetically, is surprising given that a desire to achieve neutrality was, at least in part, what motivated Congress to enact section 2702. Grantors who, for non-tax reasons, wish to create a trust while retaining a life estate or a term of years may well be deterred from doing so once they learn of Congress' decision not to create an exclusion for income and appreciation accruing after the creation of the trust.

Section 2702 treats the retained life estate or term of years as if it had a value of zero for gift-tax purposes — or, to put it differ-

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[124] But, of course, it did repeal I.R.C. § 2036(c).

[125] Income received by the grantor during the term of the trust would be included in the grantor's estate under I.R.C. § 2033, to the extent the grantor did not consume it during her life.

ently, as if the grantor made a gift of it. Yet all of the income the grantor receives from the trust is, to the extent not consumed, included in her gross estate.[126] In addition, if the grantor were to make an inter vivos transfer of the life estate or term of years at some point in time after having created the trust, any increase in the value of the transferred interest accruing between the date of the trust's creation and the date of later transfer would be subject to gift tax — even though a gift tax had been imposed on the full value of the property contributed to the trust at inception.[127] In

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[126] Given that the grantor will be required to include in her gross estate under § 2033 all income received from the trust (to the extent not consumed), double taxation may result. To prevent this from occurring, it would be necessary to eliminate from the grantor's adjusted taxable gifts the value of the life estate, which entered into the computation of the taxable gift triggered at the creation of the trust by virtue of the zero-value rule. Although it would seem appropriate to permit the value of the life estate to be eliminated from adjusted taxable gifts (see Rev. Rul. 84-25, 1984-1 C.B. 191), it is not clear whether or not such an adjustment will be available.

[127] Under I.R.C. § 2701 where the zero-value rule has been applied to a retained interest, the subsequent transfer of the retained interest triggers an adjustment that is designed to prevent double taxation from occurring. While I.R.C. § 2702 does not on its face provide for such an adjustment, Treas. Reg. § 25.2702-6 does incorporate an adjustment mechanism. The regulation permits a reduction to be taken in the amount of the taxable gift deemed to occur at the point of the later transfer. The amount of the reduction is equal to the lesser of 1) the increase in the amount of the taxable gift at inception that is attributable to the application of the zero-value rule or 2) the amount of the taxable gift deemed to occur at the point of later transfer (with a special rule contained in the regulation to deal with allocating the annual exclusion between the gift of the retained interest and other gifts made during the year in which the transfer of the retained interest occurs).

To illustrate, consider a grantor who creates a trust and retains the right to income for life. Assume that the value of the life estate at the point that the trust is created is equal to $10 and that, when its value has increased to $100 (an increase resulting from appreciation in the value of the corpus), the grantor makes a gift of the life estate. Under the zero-value rule, the amount of the taxable gift deemed to occur at inception with respect to the life estate is equal to $10. If the annual exclusion is disregarded, the taxable gift deemed to occur at the time the grantor subsequently transfers the life estate is equal to its value at that time, $100; the regulation would permit the grantor to reduce the amount of the taxable gift by $10, which is the increase in the amount of the taxable gift occurring at inception that is attributable to the application of the zero-value rule. Thus, the total amount subject to tax in connection with the creation and subsequent transfer of the life estate is $100 ($10 at the creation of the trust and, taking into account the reduction of $10 permitted under the regulation, $90 at the point of subsequent transfer) — making all of the appreciation of $90 that accrued in the value of the life estate between the date of the trust's creation and the date of the later transfer subject to tax.

It is interesting to note that § 2702 is silent on the question of an adjustment, whereas the statute itself, in the case of § 2701, provides for it. Although earlier versions of the bill had contained an adjustment feature in the context of a retained life estate, the bill as passed only addressed the issue in the § 2701 context. One might infer from Congress' silence in the

the case of a life estate (or, in the case of a term of years, where the grantor dies during the term), all appreciation accruing during the trust's existence would also be included in her gross estate under section 2036, again despite the earlier payment of a gift tax on the entire amount contributed to the trust.[128]

In effect, the GRIT not only lost the advantages it enjoyed as compared to an outright gift under prior law but indeed now suffers a comparative disadvantage. In addition, a trust where the grantor has retained a life estate is at a similar disadvantage, although, even prior to the enactment of section 2702, the life-estate trust was taxed more harshly than an outright gift. To illustrate, compare a contribution of $1 to a GRIT or a life-estate trust with an outright gift of $1. In all cases, the amount of the taxable gift under current law would be $1. Yet, even if the trustee and the donee were to invest in a manner so that they would receive the

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final version of the bill that it affirmatively decided to eliminate such an adjustment in the case of § 2702, though it is unlikely that Congress intentionally chose to create the double-taxation result that would ensue in the absence of an adjustment. And so, it is understandable that the regulation would attempt to import into § 2702 an adjustment feature somewhat analogous to the adjustment that Congress created in § 2701.

[128] Another example of the distortion resulting from the enactment of I.R.C. § 2702 involves the retention by the grantor of the discretion to distribute income among different beneficiaries. Consider, for example, a grantor who creates a trust with a ten-year term. Assume that, during the term of the trust, the income is payable to such of the grantor's descendants as the grantor may in the exercise of discretion determine appropriate; upon the expiration of the ten-year term, the principal is to be distributed to the grantor's children then living in equal shares.

When the trust is created, the amount of the taxable gift is equal to the value of the property contributed to the trust without reduction for the value of the income interest: While, prior to the enactment of § 2702, the income interest would not have been subject to gift tax on account of the right retained by the grantor to alter the beneficial enjoyment of the income interest (Treas. Reg. § 25.2511-2(c)), the retention of a discretionary interest with respect to income — which is not a qualified interest — is now subject to the zero-value rule (Treas. Reg. § 25.2702-2(d), example 6).

Despite the fact that under § 2702 the entire value of the property conveyed to the trustee at the outset is subject to gift tax, each payment of income during the term of the trust that the grantor in her discretion directs triggers a taxable gift (Treas. Reg. § 25.2511-2(f)) without any adjustment or reduction to reflect the gift-tax treatment imposed at the inception. Treas. Reg. § 25.2702-6(c), example 6. Thus, the transfer of income is subjected to gift tax twice: once when the trust is created and again when income is distributed. A grantor inclined on the basis of non-tax motivations to create a trust of the kind hypothesized here would in all probability, after learning of the double taxation that would result upon the payment of each income distribution, decide not to go forward with the plan — the inclinations of the grantor being disturbed (i.e., distorted) by the potential for double taxation inherent in § 2702.

same return, the GRIT and life-estate remainderman would have less wealth at the termination of the trust than the donee of the outright gift would have at the end of the same period. For while the donee of the outright gift is entitled to all of the income and appreciation generated by the gifted sum of $1, some portion of the return generated by the corpus of $1 must be given to the grantor in the case of the GRIT or life-estate trust. Thus, the distortion favoring the GRIT under prior law has been turned around, making current law (which favors the outright gift) distortionary as well; and, with respect to the life-estate trust, the distortion favoring the outright gift under prior law has simply been compounded.[129]

In sum, it would seem that grantors inclined to create a trust with a retained term of years or life estate might well be deterred from doing so because of the transfer-tax rules applicable to these trusts. Indeed, in the future, these types of trusts will presumably only be created by grantors having non-tax motivations that are sufficiently strong to overcome the tax disadvantages they offer or by grantors who are ignorant of these disadvantages.

While the aggressive tax rules now applicable to a grantor creating a trust with a retained term of years may be somewhat desirable as a matter of policy, the approach taken with respect to life-estate trusts would seem entirely inappropriate. In the case of the term-of-years trust (or GRIT), prior law was obviously deficient. No policy rationale was offered — or indeed could have been offered — to support the advantages inherent in these trusts under prior law.[130] Those grantors who were either well advised or particularly knowledgeable enjoyed these advantages. In contrast, those who were not as knowledgeable or as well advised incurred a greater transfer-tax cost. The resulting inequity placed in question, at least to some extent, the integrity of the transfer-tax system.

[129] Under prior law, a grantor who created a life-estate trust would be required to pay a gift tax on the value of the remainder interest, which was distortionary given that post-transfer income and appreciation were nevertheless subject to tax. Current law, on the other hand, requires that such a grantor pay a gift tax on the entire value of the property contributed to the trust. See, I.R.C. § 2702. And so, because there is still no exclusion for post-transfer income and appreciation, current law is even more distortionary.

[130] Prior to 1987, the opportunities inherent in a GRIT were without statutory limit. With the enactment of I.R.C. § 2036(c) in 1987, Congress sought to diminish the benefits offered by the GRIT. See, Blattmachr and Gans, supra note 7.

Although other approaches could have eliminated the advantages of the GRIT without creating distortion in the other direction[131] — i.e., a bias against these trusts — the approach Congress adopted in enacting section 2702 does achieve its objective. Grantors will no longer create trusts with a retained term of years in order to secure a transfer-tax savings. One might conclude, as Congress apparently did, that the distortion created by the approach adopted is a price worth paying in order to eliminate the GRIT as a tax-planning strategy. Perhaps, however, Congress ought to reconsider its failure to create a post-transfer exclusion. For, as suggested, the enactment of such an exclusion would render the GRIT neutral: It would, as under current law, enjoy no comparative advantages; but, unlike current law, it would not suffer any comparative disadvantage.

In the case of life-estate trusts, on the other hand, the distortion inherent in current law is not at all justifiable. Unlike the GRIT, the life-estate trust did not enjoy any advantages under prior law. Indeed, as suggested, they suffered a disadvantage in that they triggered a gift-tax obligation at the time of creation but did not produce the post-transfer exclusion available in the context of an outright gift. Thus, prior to the enactment of section 2702, the transfer-tax treatment of the life-estate trust was distortionary. Section 2702 has compounded this distortion. With respect to the GRIT, the distortion created by the enactment of section 2702 is at least somewhat justified by the need to eliminate the comparative advantages it had enjoyed. The life-estate trust, however, enjoyed none of these advantages. Since the grantor's income interest did not terminate prior to the death of the grantor, all post-transfer income and appreciation was includible in the grantor's estate — treating the grantor for transfer-tax purposes, in effect, as if she retained until death ownership of the property contributed to the trust.[132]

It would seem, therefore, that Congress made the scope of section 2702 unnecessarily expansive. Had the section been limited to

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[131] What is referred to as the second alternative in text would have eliminated the advantages without creating distortion.

[132] See, I.R.C. §§ 2033, 2036. Income received by the grantor from the trustee would, of course, be included in the grantor's estate, if not consumed, under I.R.C. § 2033. The appreciation would be included under I.R.C. § 2036.

the term-of-years trust (the GRIT), the valuation abuse enjoyed by taxpayers would have been eliminated without subjecting the life-estate trust — which enjoyed none of the GRIT advantages — to such a harsh set of transfer-tax rules that they are no longer feasible as a practical matter. In short, Congress' objective in enacting section 2702 was to close down the GRIT as a tax-savings strategy. By making the section applicable to the life-estate trust as well, however, Congress made the rules applicable to these trusts even more distortionary without any justification for doing so.[133]

V. GRAT's Versus Gifts

A. *GRAT's in a Tax-Free Environment*

In ascertaining whether the GRAT offers an advantage or disadvantage relative to an outright gift, it is necessary to consider the effect of the income tax. Whether the tax imposed on the income generated by the trust during its term is borne by the grantor or the remainderman could be determinative. To begin the discussion without taking into account the complexity that the income tax creates, it will be assumed, at first, that all of the investment vehicles that the grantor, the trustee or the grantor's family might choose are tax exempt.

In this context, the GRAT would be in parity with the outright gift where the yield generated by the investment vehicle chosen equalled the table rate in effect at the time of the creation of the trust. Consider, for example, a grantor contributing $100 to a one-year GRAT and retaining the right to receive a $10 payment at the

[133] If the scope of I.R.C. § 2702 were limited to trusts where the grantor retained a term of years, a problem might arise in the case of a retained life estate followed by a subsequent transfer of the life estate. In this context, it would be necessary to take into account, at the time of the transfer of the life estate, the appreciation accruing since the creation of the trust. Otherwise, post-transfer appreciation would be excludable even though less than the entire value of the property contributed to the trust had been subject to gift tax. Indeed, if the post-transfer appreciation were not taken into account, the GRIT would, in effect, remain available — except that it would have to be accomplished in two steps. Although, under current law, post-transfer appreciation becomes subject to tax if the life estate is transferred within three years of the grantor's death (I.R.C. § 2035), all appreciation accruing from the date of the creation of the trust is entirely disregarded if the grantor survives for the three-year period. For a provision requiring that appreciation accruing during the term of the trust be taken into account at the time the life estate is gifted, see I.R.C. § 2036(c), as it existed prior to its repeal by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1383.

end of the year. Assuming both the table and tax-free market rates are 10%, the amount available for distribution to the remainderman at the end of the year would be $100 (the $10 in interest received by the trustee would be paid to the grantor at the end of the year, leaving the corpus of $100 for distribution to the remainderman). In this example, the amount of the taxable gift deemed to occur at the creation of the trust would be approximately $90.91 (the amount contributed to the trust, $100, less the present value of the annuity, approximately $9.09). If the grantor were to make an outright gift of $90.91 instead and the donee were to invest the gifted sum in a tax-exempt bond yielding 10%, the donee would have approximately $100 at the end of the year. Thus, the GRAT and the outright gift produce the same amount of wealth for the transferee where the after-tax rate of return earned by the trust is equal to the table rate.[134]

If the only investment vehicle available in the market were yielding less than the table rate of 10%, the outright gift would produce more wealth for the donee than the GRAT would produce for the remainderman. If the tax-free market rate were 8%, the GRAT remainderman would be entitled to receive $98 at the end of the year (the trustee, having received $8 in interest, would be required to pay the grantor $10 at the end of the year, which would leave $98 for distribution to the remainderman). In contrast, were the donee of an outright gift of $90.91 to invest for one year in a

[134] In all of the examples discussed in this article, the question of mortality is not considered. In other words, the possibility that the grantor might die during the term of the trust is not taken into account in determining the amount of the taxable gift deemed to occur at the creation of the trust. According to Treas. Reg. § 25.2702-3(e), example (5), it is necessary to increase the amount of the taxable gift triggered at the creation of a GRAT in order to reflect the possibility that the grantor might die during the trust term. Surprisingly, the regulation requires such an increase even where the trust instrument provides that the annuity payments are to continue to be made to the grantor's estate if the grantor should die during the trust term. For a further discussion of the regulation and its validity, see supra note 83. Assuming the regulation is valid, it will be necessary for a GRAT to earn a return that is slightly greater than the table rate in order to be in parity with a comparable outright gift. In other words, the increase in the taxable gift caused by taking mortality into account would produce a concomitant increase in the amount of the comparable outright gift. Consider the question in terms of the two-pot framework adopted in the ensuing discussion in text. The increase in the taxable gift brought about by taking into account the possibility that the grantor might die during the trust term increases the amount deemed to be placed in the remainderman's pot and decreases by an equal amount the amount deemed to be placed in the annuity pot. As a consequence, if the trust were to earn the table rate, a slight deficiency would occur in the annuity pot.

tax-exempt bond yielding 8%, she would have $98.18172, thus making the outright gift the more effective wealth-transfer strategy in this context.

Conversely, where the only available investment in the market yields an after-tax rate of return in excess of the table rate, the GRAT would place more wealth in the hands of the remainderman than the outright gift would generate for the donee. If the tax-free market rate were 12%, the GRAT remainderman would be entitled to receive $102 at the end of the year (having received interest in the amount of $12, the trustee would be required to pay the grantor $10 at the end of the year, which would leave $102 for distribution to the remainderman). On the other hand, the donee of an outright gift of $90.91 would only have $101.8192 at the end of the year, assuming the gifted sum were invested to earn an after-tax rate of return of 12%.

It might be helpful to conceptualize the advantage and disadvantage of the GRAT relative to a comparable outright gift by viewing the trustee of the GRAT as creating two pots of money at the time the trust is funded. One pot would contain an amount equal to the taxable gift deemed to occur at the creation of the trust — the remainderman's pot. The other pot would contain the balance of the contributed funds — the annuity pot. The annuity pot would grow during the term of the GRAT, if trust investments were to yield a rate of return equal to the table rate, such that it would discharge the annuity obligation owed to the grantor — leaving neither a surplus nor a deficiency. The remainderman's pot, which would ultimately be distributed in its entirety to the remainderman, would grow so that at the point of distribution the remainderman would receive the same amount that the donee of a comparable outright gift would have at that time (assuming both the donee and the trustee invested in tax-exempt bonds yielding a rate of return equal to the table rate).

As demonstrated, the GRAT enjoys an advantage over the outright gift when the rate of return available in the market is greater than the table rate. In terms of the two-pot conceptualization, the annuity pot, in this context, would grow to a sum in excess of the amount necessary to discharge the annuity obligation to the grantor. This excess would spill into the remainderman's pot and ultimately inure to the benefit of the remainderman, a benefit that would not be available to the donee of a comparable outright gift.

On the other hand, where the rate of return available in the market is less than the table rate, the GRAT suffers a disadvantage relative to the outright gift. The amount in the annuity would not be sufficient to discharge the annuity obligation to the grantor; the deficiency would have to be made up by the remainderman's pot, causing the remainderman to suffer a loss that the donee of an outright gift would not be required to bear.

To illustrate the two-pot analysis in the context of the example just discussed, consider the case where the tax-free rate available in the market is 10%, the same as the table rate. The remainderman's pot would contain $90.91; and the annuity pot would contain $9.09. Given that the trust would generate a tax-free rate of return of 10%, the annuity pot would contain $10 at the end of the one-year term, which is equal to the annuity amount that the trustee would be required to give the grantor. The remainderman's pot would contain (still assuming a tax-free return of 10%) $100 at the end of the one-year term. Thus, in this case, the pots reflect that the GRAT is in parity with the outright gift in the sense that the donee of a comparable outright gift ($90.91) would also have $100 in wealth at the end of the year.

In the case where the available market rate is 8%, the annuity pot, again holding $9.09 at the time of the creation of the trust, would only have $9.8172 at the end of the one-year term (9.09 x 1.08). Since the trustee would be required to pay the grantor an annuity amount of $10, a deficiency of $.1828 would occur in the annuity pot. This deficiency would have to be made up from the remainderman's pot, thus inuring to the detriment of the remainderman. Of course, if an outright gift of $90.91 were made instead, the donee would earn the market rate of 8% on this amount but would not be required to bear the burden of the deficiency. Thus, the disadvantage that the GRAT suffers relative to the outright gift in this context is attributable to the requirement that the remainderman bear the responsibility for this deficiency.

Consider the case where the tax-free market rate is 12% (still assuming that the table rate is 10%). In this context, the annuity pot, again holding $9.09 at the inception of the trust, would contain $10.1808 at the end of the year (9.09 x 1.12). The trustee would be required to use $10 of this amount to discharge the annuity obligation to the grantor. The excess, $.1808, would fall into the remainderman's pot and be given to the remainderman. In effect,

the remainderman would enjoy the 12% return on the sum of $90.91 placed in the remainderman's pot, just as the donee of a comparable outright gift would be able to invest $90.91 in a vehicle yielding 12%. In addition, the remainderman would receive the surplus in the annuity pot, which is attributable to the trust earning 12% on its investments rather than the 10% rate assumed by the tables. This 2% surplus produced on the amount in the annuity pot would, of course, not be available in the case of an outright gift. The advantage enjoyed by the GRAT over the outright gift in this context consists of the opportunity to pass this surplus to the remainderman without the imposition of any transfer tax, an opportunity not available in the case of an outright gift.

B. GRAT's in a Taxable Environment

In each case examined thus far, it was assumed that the trustee of the GRAT invested in tax-exempt bonds. As a consequence, it was not necessary to consider the effect of the income tax. Assuming the trustee invests in a taxable investment, at what rate of return is the GRAT in parity with the outright gift? And at what rate of return does the GRAT enjoy an advantage or suffer a disadvantage relative to the outright gift?

1. Tax Borne by Trust

To answer these questions, it must first be determined whether the income-tax burden is to be borne by the grantor or the remainderman. Where the income earned on trust investments during the term of the GRAT is taxable to the trust (which, in effect, would place the burden of taxation on the remainderman), it is necessary for the trust to enjoy an after-tax rate of return equal to the table rate in order for the GRAT to be in parity with the outright gift. Where the after-tax return is greater than the table rate, the GRAT is at an advantage over the outright gift. Conversely, where the after-tax return is less than the table rate, the GRAT suffers a disadvantage relative to an outright gift. To illustrate, assume that the income earned on trust investments, which are of a taxable character, is subject to tax at the trust level and that an income-tax rate of 33⅓% is in effect. If the table rate at the time of the creation of the trust is 10%, it would be necessary for trust investments to yield 15% in order for the GRAT to be in parity with an

outright gift. In other words, with a taxable yield of 15%, the annuity pot would have neither a surplus nor a deficiency. For, where the income-tax rate is 33⅓%, a taxable yield of 15% is the equivalent of an after-tax yield of 10%; and, as previously suggested, where the after-tax yield is equal to the table rate, the annuity pot will grow such that it will permit the trustee to discharge the annuity obligation without creating a surplus or a deficiency.

Assuming the contribution of $100 to a one-year GRAT at a time when the table rate is 10% and the retention of the right to receive an annuity of $10 at the end of the year, the annuity pot would contain $9.09 at inception. If trust investments generated a taxable return of 15% and the trust were required to bear the burden of an income-tax rate of 33⅓%, the amount in the annuity pot at the end of the year (after the payment of the trust's income tax) would be $10 — which is the amount required to discharge the annuity obligation to the grantor. The amount in the remainderman's pot, after the payment of the income tax, would be $100, or the amount that the donee of a comparable outright gift would have at the end of one year (assuming the donee also invested in taxable vehicles yielding 15% and were subject to an income-tax rate of 33⅓%). Thus, with an after-tax yield equal to the table rate and the burden of the income tax borne at the trust level, the GRAT and the outright gift are in parity.

If the investment vehicles available in the market yielded a taxable return of less than 15%, the GRAT would suffer a disadvantage relative to an outright gift. At the end of the one-year term, the annuity pot would contain less than $10, thus requiring that the remainderman's pot make up the deficiency. In contrast, the donee of a comparable outright gift would, of course, not be responsible for any such deficiency. As a consequence, having received at inception the same amount deemed to be placed in the remainderman's pot and having presumably earned the same return as that enjoyed by the trust, the donee would have a greater amount of wealth than the remainderman of the GRAT at the end of the one-year period. Thus, where the after-tax return is less than the table rate, the burden imposed on the remainderman's pot to compensate for the deficiency in the annuity pot constitutes the disadvantage that makes the GRAT less attractive than the outright gift.

If investment vehicles available in the market yielded a taxable

return of more than 15% (and thus an after-tax return that is greater than the table rate), the GRAT would enjoy an advantage over the outright gift. At the end of the one-year term, the annuity pot would contain more than $10, the amount the trustee must pay to the grantor. The surplus in the annuity pot would fall into the remainderman's pot. Given that the amount in the remainderman's pot would be equal to the amount that the donee of a comparable outright gift would have at the end of the year (assuming that the donee invested in a vehicle yielding the same return as that enjoyed by the trust), the addition of the surplus in the annuity pot to the remainderman's pot — an addition that would, of course, be unavailable to the donee of an outright gift — reflects the advantage offered by the GRAT over the outright gift in this context.

2. *Tax Borne by Grantor*

Thus far, the premise underlying the discussion of the comparative advantages (or disadvantages) of the GRAT has been that income generated by the trust during its term is either taxable to the trust (in which case the burden of taxation is ultimately borne by the remainderman) or tax-exempt. If it is now assumed that the income earned on trust investments is not tax-exempt and that the burden of taxation is to be borne by the grantor,[135] the GRAT continues to enjoy an advantage over the outright gift even as the after-tax rate of return falls below the table rate. The GRAT retains its advantage in this context on account of the interaction of the gift tax and the income tax. The income earned by the donee of an outright gift on the gifted sum is obviously taxable to the donee; and, of course, if the donor were to make additional gifts to the

[135] If Section 677 is applicable, trust income is taxable to the grantor. Whether an annuity constitutes an interest in income within the meaning of I.R.C. § 677 and therefore triggers application of the section is an issue that the courts resolve on a case-by-case basis. See, e.g., Stern v. Commissioner, 747 F.2d 555 (9th Cir. 1984); Lafarque v. Commissioner, 689 F.2d 845 (9th Cir. 1982); Weigl v. Commissioner, 84 T.C. 1192 (1985). If it is determined that § 677 is inapplicable, trust income is taxed in the usual manner to the trust or the beneficiaries depending upon the distributions made by the trustee; and the annuity payments received by the grantor presumably constitute some mixture of return of capital, capital gain (perhaps) and annuity (in effect, interest) income. See Rev. Rul. 69-74, 1969-1 C.B. 43. But see Estate of Bell v. Commissioner, 60 T.C. 469 (1973), where the court held that all of the gain had to be recognized at the outset, rather than as each annuity payment was received; 212 Corporation v. Commissioner, 70 T.C. 788 (1978).

donee in an amount equal to the income-tax liability of the donee attributable to the investment income generated by the gifted sum, these additional gifts would constitute taxable gifts. In contrast, where income earned during the term of the GRAT is taxable to the grantor, the grantor's payment of the income tax does not trigger a taxable gift — thus producing in effect a transfer of wealth to the remainderman that is not subject to transfer tax.

To illustrate, assume a grantor contributes $100 to a one-year GRAT at a time when the table rate is 10% and retains the right to receive an annuity of $10 at the end of the year. The amount of the taxable gift deemed to be made at the creation of the trust would be $90.91. And so the amount of the comparable outright gift would be $90.91.

Assuming that the only investment available in the market were yielding a taxable return of 6% and that the applicable income-tax rate were 33⅓%, the donee of the outright gift would earn $5.45 on the gifted sum during the course of the year (90.91 x .06) and would be required to pay an income tax of $1.8181 on these earnings. The donee would have after-tax earnings of $3.64; thus, at the end of the year, the donee would have wealth in her hands attributable to the gift in the amount of $94.546.

If the same assumptions are used, the remainderman of the GRAT would receive more wealth from the trust at the end of its one-year term. Assuming a 6% return on trust investments, trust earnings would equal $6 for the year ($100 x .06). With the grantor being responsible for the payment of the income tax on these earnings, the trustee would have $96 available for distribution to the remainderman after having paid the grantor the annuity amount of $10. Thus, in this example, even though the after-tax rate of return is less than the table rate, the GRAT produces more wealth for the remainderman (i.e., $96) than the comparable outright gift does for the donee (i.e., $94.546).

The additional amount of wealth of $1.454 ($96 minus $94.546) produced by the GRAT in this example results from the fact that the responsibility for the payment of the income tax with respect to trust earnings is borne by the grantor. In the case of the outright gift, in contrast, the donee —not the donor — bears the burden of the income tax imposed on the earnings generated by the gifted sum. If the grantor's payment of the income tax on GRAT earnings triggered a taxable gift, the GRAT would not enjoy any

advantage over the outright gift in this context. And so, the comparative advantage enjoyed by the GRAT flows from the failure of the Code to impose a gift tax on the payment by the grantor of the income tax on trust earnings.

In the example under consideration, the comparative advantage that the GRAT offers is equal to 2% of $90.91 (the amount deemed to be placed at inception in the remainderman's pot) or $1.818. This advantage is readily observable when the GRAT is contrasted with an outright gift. The donee of a comparable outright gift of $90.91 would only earn 4% on an after-tax basis (still assuming an income-tax rate of 33 ⅓%), whereas the amount in the remainderman's pot in the case of the GRAT grows at a 6% rate that — because of the grantor's responsibility for the payment of the income tax — is in effect an after-tax rate. Thus, at the end of the one-year term, the remainderman's pot contains $1.818 (2% of $90.91) more than the amount that would be held by the donee of a comparable outright gift.

This advantage, however, is not without its cost. Since the after-tax rate of return enjoyed with respect to the amount deemed to be placed originally in the annuity pot (i.e., $9.09) is also, in effect, 6% and since the assumed table rate is 10%, a deficiency in the annuity pot equal to $.3636 (4% of $9.09) must be compensated for out of the remainderman's pot. In the case of an outright gift, of course, no such deficiency would burden the donee. Thus, the 2% advantage accruing in the remainderman's pot that the GRAT offers over the outright gift ($1.818) is offset by the deficiency in the annuity pot of $.3636, which encumbers the remainderman's pot, making the net advantage of the GRAT equal to — or, put differently, producing additional wealth for the GRAT remainderman, as compared to the donee of the outright gift, in the amount of — $1.454 ($1.818 minus $.3636).

As the market rate of return decreases below the table rate, the deficiency in the annuity pot that must be compensated for out of the remainderman's pot increases. In addition, as the rate of return available in the market decreases, the amount of income tax on that return decreases, thus reducing the magnitude of the benefit inherent in imposing on the grantor the burden of paying the income tax on trust earnings. In other words, a decreasing rate of return translates into a diminished advantage and an increased cost. In fact, it is possible that the rate of return could decrease to

a point where the disadvantage of compensating for the deficiency in the annuity pot would exactly offset the advantage inherent in shifting the burden of the income tax on trust earnings to the grantor. Quite obviously, when this point is reached, the GRAT no longer enjoys any advantage over the outright gift. Indeed, if the rate of return were to fall below this offset point, the GRAT would begin to suffer a comparative disadvantage.

In sum, where the responsibility for the payment of the income tax on trust earnings is imposed on the grantor, the GRAT may enjoy an advantage over a comparable outright gift even if the actual rate of return proves to be less than the table rate. But this advantage is offset by the disadvantage of any deficiency that may occur in the annuity pot, given that the burden of any such deficiency must be borne by the remainderman. Thus, as the actual rate of return falls below the table rate, producing a deficiency in the annuity pot, the attractiveness of the GRAT begins to diminish — with the outright gift ultimately becoming more attractive if the actual rate of return decreases to a point sufficiently below the table rate.

C. *Strategizing the GRAT*

If the mechanism contained in the Code for establishing the table rate produces a table rate that is high in relation to the yield available on investments in the market, the attractiveness of the GRAT is diminished, as it becomes more difficult to locate an investment vehicle yielding a return in excess of the table rate. Additionally, even if such an investment is located, a high table rate limits the potential for a surplus in the annuity pot, inasmuch as the magnitude of the surplus is directly related to the difference between the table rate and the investment yield. Indeed, it would not be unreasonable to conclude that the attractiveness of the GRAT has been significantly limited by the relatively high rates produced by the Code's rate-setting formula.[136]

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[136] See I.R.C. § 7520. Section 7520 requires that the rate be set at 120% of the I.R.C. § 1274(d) midterm rate. The table rate, as so determined, is substantially less than the rate that is required to be utilized for purposes of I.R.C. § 7872, which deals with the appropriateness of the rate of interest charged on loans. See, e.g., Boyle, supra note 7, at 18. Inasmuch as the annuity obligation owed to the grantor could be viewed as a loan, it is difficult to justify the substantial disparity in rates applicable to the GRAT under I.R.C. § 7520 and to loans under I.R.C. § 7872. Put differently, why should the judgment Congress made

This is not to suggest, however, that the Code's rate-setting formula has rendered the GRAT entirely ineffective as a wealth-transfer strategy. Despite the formula, it is possible to locate investments in the market that yield a return in excess of the table rate. For example, closely held business interests typically produce a rate of return that is high in relation to other types of investments that offer less risk, making the GRAT an effective method by which to transfer these interests.[137]

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about the level of interest necessary to avoid transfer-tax liability in the context of loans under I.R.C. § 7872 not be followed in the context of a GRAT?

The answer perhaps is that Congress is of the view that the GRAT is essentially a device that has no non-tax purpose. Or perhaps the current state of the law with respect to GRAT's simply reflects an overreaction by Congress to the potential for abuse inherent in GRIT's under prior law.

Another alternative explanation for the disparity in rates relates to a critical difference between a GRAT and a loan. In the case of a loan, the borrower is required to pay the § 7872 rate to the lender even if the borrowed funds are used to acquire an investment that produces a return that proves to be less than the § 7872 rate. On the other hand, in the case of a GRAT, if the trust fails to earn the table rate, the resulting deficiency in the annuity pot could in effect reduce the amount flowing back to the grantor. Once the deficiency in the annuity pot fully absorbs the contents in the remainderman's pot, any additional deficiency is suffered by the grantor, the remainderman not being under any obligation — unlike the borrower in the case of a loan — to make certain that the grantor receives the annuity amounts. In other words, the grantor of a GRAT is at greater risk than a lender and should perhaps be compensated for this greater risk by a higher interest rate, thus making it appropriate to require a higher rate in the case of a GRAT than in the case of a loan.

[137] See Frank H. Easterbrook & Daniel R. Fischel, Close Corporations and Agency Costs, 38 Stan. L. Rev. 271, 272 (1986) (suggesting that closely held corporations must offer a higher rate of return in order to attract capital). See also Rev. Rul. 68-609, 1968-2 C.B. 327 (discussing the rate of return that one might reasonably expect to earn in the case of a closely held business interest). In addition, the rate of return produced by a minority interest in a closely held business tends to be greater than the rate of return available in the case of a non-minority interest. The extra return offered by a minority interest is attributable to the greater risk inherent in such interests. To illustrate, assume that a taxpayer contemplating a gift owns all 100 shares of a corporation's outstanding stock. Assume further that the total value of the corporation (i.e., the price that a purchaser would pay if acquiring all of the outstanding shares) is $100 and that each share generates a total annual return (dividend and appreciation) of $.10. If the taxpayer made an outright gift of all of the shares, the taxable gift would be equal to $1 for each share or $100. The donee's return, as determined with reference to the value of the gifted stock, would be 10%. If, however, the taxpayer made an outright gift of only 30 of his 100 shares, the taxable gift would be less than $1 for each share by virtue of the reality that a minority interest suffers certain disadvantages relative to a non-minority interest. Assuming these disadvantages have the effect of reducing the value of the 30 shares by one-third, the taxable gift triggered in connection with a gift of 30 shares would be only $20. Given that each of the 30 shares would nevertheless generate a return of $.10, the total return enjoyed by the donee would be equal to $3, producing a return for the donee (as determined with reference to the value of the gifted stock) of 15%.

Also, even though the Code sets the table rate at a high level, the opportunity to "lock-in" the table rate makes the GRAT attractive to taxpayers. Consider a fifteen-year GRAT that is created at a time when the table rate is low relative to the rates expected to be available in future years; a taxpayer who creates a GRAT in this situation is gambling that the rate of return generated by trust investments over the fifteen-year term will exceed the table rate in effect at the creation of the trust. If rates do in fact increase over the fifteen-year term and, as a consequence, the trust's return does exceed the table rate in effect at inception, a surplus in the annuity pot results, producing more wealth for the remainderman than a comparable outright would produce for a donee.

A risk-free variation on "lock-in" involves the creation of a GRAT providing for an annuity amount that actually eliminates the taxable gift. What is critical to the zero-taxable-gift GRAT is that it does not require the grantor to undertake the risk that a deficiency in the annuity pot might occur and thereby render it less effective than a comparable outright gift. With the taxable gift deemed to occur at the GRAT's creation equal to zero, it would be impossible for a comparable outright gift (i.e., a gift of zero) to be more effective than the GRAT in terms of placing wealth in the hands of the transferee. An outright gift of zero would place no wealth in the hands of the donee. And, quite obviously, a zero-taxable-gift GRAT could not create a less effective result, whatever the magnitude of the deficiency in the annuity pot. The zero-taxable-gift GRAT, therefore, enjoys an important advantage over a GRAT that triggers a taxable gift at inception: While offering the opportunity for a surplus, it does not create the risk of a deficiency ordinarily associated with the creation of a GRAT.

To illustrate, consider the contribution of $1,000,000 to a fifteen-year GRAT where the grantor retains the right to receive an annuity payment of $116,830 at the end of each year during the term of the trust.[138] Assuming the table rate is 8%, the present value of the

Thus, as suggested, the rate of return generated in the case of a minority interest in a closely held business tends to exceed the rate of return made available by a non-minority interest. Put differently, because of the greater risk inherent in the ownership of a minority interest, the rate of return it generates must be greater than the rate of return available in the case of an interest posing a lesser risk.

138 Taxpayers concerned about encountering litigation with the Service over the value of the property contributed to the trust will presumably establish the annuity as a percentage

remainder interest, or the amount of the taxable gift deemed to occur upon the creation of the trust, is equal to zero.[139] If the trust enjoys a return equal to the table rate of 8% throughout its entire term, trust assets will be exhausted by the fifteen annuity payments made to the grantor, leaving no assets for distribution to the remainderman upon termination. A return of less than 8% would similarly produce no wealth for the remainderman.

If the trust were to earn a return in excess of 8%, it would have sufficient assets to permit it to make all of the annuity payments to the grantor and a distribution to the remainderman upon termination, effectively passing wealth to the remainderman (the surplus in the annuity pot) without the imposition of any transfer tax. Indeed, if the trust were to earn approximately 11.6%, its earnings would be sufficient to cover the fifteen annuity payments made to the grantor, leaving the entire amount of $1,000,000 contributed to the trust at inception for distribution to the remainderman upon termination — even though no taxable gift is triggered upon the creation of the trust.

The zero-taxable-gift GRAT offers a unique opportunity for tax savings. If the trust's actual return exceeds the table rate in effect at inception, the resulting surplus in the annuity pot passes to the remainderman on a tax-free basis. And while no wealth passes to the remainderman if the trust's actual return is equal to or less than the table rate, an outright gift of zero would not have produced any wealth for the donee either. The zero-taxable-gift GRAT permits the grantor to effectively "lock-in" the table rate without incurring any gift-tax cost[140] and without undertaking the

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of the value of the property contributed to the trust as finally determined for gift tax purposes. A zero-taxable-gift GRAT structured in this fashion will not generate any gift liability irrespective of the valuation position that the Service might take. Although this approach might appear to have public policy overtones (see Priv. Ltr. Rul. 9133001 (January 31, 1990)), it appears to have been validated by the regulations. See Treas. Reg. § 25.2702-3(b)(2).

[139] See I.R.S. Notice 89-60, 1989-1 C.B. 700; I.R.S. Notice 89-24 1989-1 C.B. 660. It should be noted that, as in all other examples considered in this article, mortality has not been taken into account. For a further discussion of the mortality issue, see supra notes 83 and 134.

[140] In the zero-taxable-gift GRAT considered in text, it would seem that an estate tax advantage might also be achieved if the grantor were to die within the annuity-retention period. To illustrate, assume that by the time of the grantor's death (which occurs during the grantor's fifteen-year term) the trust corpus has appreciated to a value of $2,000,000. Under Rev. Rul. 82-105, 1982-1 C.B. 133, the amount includible in the grantor's gross estate

risk that a comparable outright gift might prove to be more effective.[141]

As a matter of policy, it would seem that a grantor who confers upon the remainderman the opportunity to enjoy all of the return in excess of the table rate that is generated by a trust over a period of years should be treated as having made a taxable gift. If the gift tax is not imposed in this context, a diminution in the value of the grantor's estate can be achieved (assuming the trust's return exceeds the table rate) on a tax-free basis. Given that the purpose of the gift tax is to prevent taxpayers from using inter vivos arrangements to effect a tax-free diminution in the gross estate,[142] it

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by virtue of I.R.C. § 2036 would be equal to the capitalized amount necessary to produce a return equal to the annuity amount based upon the table rate in effect at the time of the grantor's death. For a further discussion of the ruling, see infra notes 216-227 and accompanying text. Assuming the table rate is equal to 8% at the time of death, the amount includible under § 2036, according to the ruling, would be $1,460,375 (the annuity amount of $116,830 / the table rate in effect at the time of death of 8%) — provided the grantor did not retain a reversionary interest in the trust, which, if retained, would result in the entire corpus being included in the grantor's gross estate under I.R.C. § 2033.

Thus, in this example, it appears that the Service would require an inclusion in the grantor's gross estate that is less than the entire value of the corpus on the date of death. Yet, if the grantor did not create the GRAT, the entire value of the asset contributed to the trust, as determined on the date of the grantor's death, would be includible in the grantor's gross estate under § 2033. Inasmuch as the creation of the GRAT did not trigger a taxable gift, it would seem inappropriate as a matter of policy to permit the grantor to eliminate from her estate any portion of the appreciation accruing in the assets contributed to the trust. Unless the methodology adopted in the ruling is altered, taxpayers may well be attracted to the zero-taxable-gift GRAT by the opportunity it offers to eliminate appreciation from the grantor's gross estate without the imposition of the gift tax — as well as by the opportunity it offers to shift wealth to the remainderman on a gift-tax-free basis should the grantor survive the annuity-retention period.

[141] Given the reasoning in text, it would seem that it would always be advisable for the grantor of a GRAT to zero out the taxable gift in order to avoid the risk that an outright gift might prove to be more effective. Consider, for example, a GRAT where the annuity is set at an amount that causes the remainder to have a value of $1. With only $1 in the remainderman's pot, even a minimal deficiency in the annuity pot would result in producing no wealth for the remainderman at the termination of the trust. In contrast, the donee of a comparable outright gift of $1 would have the $1 together with the earnings it generated. Thus, the grantor of a GRAT that triggers a taxable gift is required to assume the risk that a deficiency will occur in the annuity pot, which would make the outright gift more effective. Put differently, if a deficiency of even a slight magnitude does in fact occur in the case of a GRAT triggering a taxable gift of $1, no wealth is passed to the remainderman — whereas an outright gift would have placed wealth in the hands of the donee — even though the grantor is treated as having made a taxable gift. Prudent grantors will presumably avoid this risk by zeroing out the taxable gift.

[142] See Dickman v. Commissioner, 465 U.S. 330, 339 (1983).

would seem that the creation of a GRAT ought to trigger a taxable gift irrespective of the level at which the annuity amount is set.

This could be accomplished by amending the Code to provide that, in all cases, a taxpayer who creates a GRAT is deemed to have made a taxable gift equal to some minimum percentage of the value of the assets contributed to the trust.[143] So, in the example just considered, if the minimum percentage were, say, 10%, the contribution of $1,000,000 to the GRAT would trigger a taxable gift of $100,000.[144] Such a provision would eliminate the opportunity presently available to achieve a diminution in the value of one's estate on a risk-free basis. If the grantor in the example under consideration made an outright gift of $100,000 instead of creating a GRAT, the grantor would at least be assured that the donee would have $100,000 in wealth plus the earnings generated by that wealth. In contrast, the GRAT, which under the rule suggested would also trigger a taxable gift of $100,000, could result in no wealth passing to the remainderman if the deficiency in the annuity pot became large enough to absorb the contents in the remainderman's pot. Thus, under the suggested rule, a grantor of a GRAT could no longer eliminate risk entirely by zeroing out the taxable gift. If a deficiency in the annuity pot were to develop, the amount of wealth passing to the remainderman would be less than the amount of wealth that could have been generated for the donee of a comparable outright gift.

The suggested rule would not only eliminate the risk-free opportunities presently available. It would also produce transfer-tax results that are more reflective of economic reality. The grantor of a GRAT confers a valuable right on the remainderman even where the annuity amount is set at a level that zeroes out the taxable gift. In other words, the right to receive the portion of a trust's return in excess of the table rate in effect at the creation of the trust is something that one would ordinarily expect to produce a valuable

[143] For a similar rule applicable in the case of a transfer of an interest in a corporation or partnership, see I.R.C. § 2701(a)(4).

[144] With such a rule in effect, the grantor would presumably choose to reduce the annuity to an amount that would cause the present value of the remainder interest to equal $100,000. For, if the grantor failed to do this, trust assets that could be passed to the remainderman upon termination of the trust without incurring any additional transfer tax would instead flow back to the grantor — in the form of unnecessarily inflated annuity payments — ultimately to be included in the grantor's estate.

consideration upon transfer in the marketplace. Although it might well be difficult to determine with any precision the value of such a right, it would seem to have more than the zero value assigned to it under current law. To ignore, as transfer-tax law presently does, the economic reality that the grantor of a zero-taxable-gift GRAT confers a valuable right on the remainderman would appear to be inappropriate.

D. *Section 7872 as an Alternative*

Taxpayers contemplating the use of a GRAT ought to consider as an alternative strategy an outright gift combined with a loan to the donee. Because the table rate applicable in the case of a GRAT is higher than the section 7872 rate required in the context of a loan, the gift-loan technique may well enjoy an advantage over the GRAT.

Consider a taxpayer contemplating the contribution of $100 to a one-year GRAT under which the grantor would be entitled to receive an annuity of $10 at the end of the year. Assuming a table rate of 10%, the annuity pot would hold $9.09 and the remainderman's pot would hold $90.91. In order to produce a surplus in the annuity pot, trust investments would have to yield a return in excess of 10%; a return of less than 10% would produce a deficiency in the annuity pot; and a return of exactly 10% would produce neither a surplus nor a deficiency, leaving the remainderman with the amount deemed to be placed initially in the remainderman's pot together with the 10% return it generated during the one-year term, i.e., $100.

Contrast these results with those obtainable were a gift-loan technique utilized instead. Using such a technique, the grantor would make an outright gift of $90.91 to the donee and would loan the donee $9.09 (the amount that would have been deemed to have been placed in the annuity pot had the GRAT been employed) for a one-year period at an interest rate that would satisfy section 7872, a rate that would be less than the table rate applicable in the case of a GRAT.[145] The amount of the taxable gift, as in the case of the GRAT, would be equal to $90.91. Assuming the only invest-

[145] See, e.g., Rev. Rul. 91-41, 1991-31 I.R.B. 12; Rev. Rul. 91-39, 1991-27 I.R.B. 6; Rev. Rul. 91-35, 1991-22 I.R.B. 22; Rev. Rul. 91-29 1991-18 I.R.B. 13; Rev. Rul. 90-52, 1990-2 C.B. 192; and Rev. Rul. 90-22, 1990-1 C.B. 158.

ment available in the market offered a return of 10%, the donee would have at the end of the year the amount initially gifted to her of $90.91 plus a return of 10%, which would total $100 (90.91 x 1.10). In addition, the donee would have what in effect constitutes a surplus equal to the difference between the 10% return enjoyed on the borrowed sum of $9.09 and the lesser interest charge (set at a rate that would satisfy section 7872) owed to the grantor on that borrowed sum — a surplus that, given the 10% rate of return, would not be generated for the remainderman in the context of the GRAT.

Thus, because the table rate to be utilized in the case of a GRAT is greater than the section 7872 rate, the gift-loan technique, without generating any additional gift-tax cost, would place more wealth in the hands of the donee than the GRAT would produce for the remainderman. Put differently, as a result of using the gift-loan technique, instead of a GRAT, the rate of return that must be enjoyed in order to create a surplus effect is reduced.

The change in tax-planning direction brought about by the enactment of section 2702 is not without irony. Prior to enactment, the GRIT enjoyed quite a considerable advantage over the outright gift where the rate of return was less than the table rate.[146] With section 2702 in place, the GRIT is, to a large extent, eliminated and its replacement,[147] the GRAT, only offers a rate-based advantage over the outright gift where the rate of return exceeds the table rate. And even this advantage disappears — indeed turning into a disadvantage — when one takes into account the reality that the section 7872 rate is less than the table rate applicable to a GRAT and that taxpayers can secure the benefits inherent in this lesser rate by using the gift-loan technique suggested. While, as a matter of policy, the elimination of the GRIT and its advantages is sound, it does seem difficult to defend the requirement that a higher rate must be used in connection with a GRAT than in the case of a loan.[148]

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[146] See supra notes 16-27 and accompanying text.

[147] The GRUT is, of course, an alternative replacement for the GRIT. For a discussion of the GRUT, see infra notes 149-157 and accompanying text.

[148] But see supra note 136. In addition, it is perhaps appropriate to require that a higher rate be used in the case of a GRAT, inasmuch as the GRAT does offer the opportunity to shift to the grantor the burden of paying income tax on trust earnings. See supra note 135 and accompanying text.

VI. GRUT's Versus Gifts

As in the case of the GRAT, whether the grantor or the remainderman is to bear the burden of the income tax must be taken into account in examining the extent to which, if any, the GRUT enjoys an advantage over the outright gift. For the moment, however, it may be helpful to isolate out the income-tax issue. And so, in commencing the discussion, it will be assumed that none of the income earned on GRUT investments during its term is subject to income tax.

A. *GRUT's in a Tax-Free Environment*

If all of the GRUT investments are tax exempt, the GRUT does not enjoy any advantage over the outright gift. To conceptualize this proposition in concrete terms, consider the two-pot analysis. As in the case of the GRAT, the amount deemed to be placed in the remainderman's pot is equal to the amount of the taxable gift triggered at the time of the creation of the trust. The amount deemed to be placed in the other pot, which will be referred to as the unitrust pot, is equal to the balance (i.e., the difference between the amount contributed to the GRUT and the amount deemed to be placed in the remainderman's pot).

To illustrate, assume a grantor contributes $100 to a GRUT retaining the right to receive three annual payments each equal to 10% of the value of the corpus of the trust as determined at the time of payment, with the first such payment to be made one year from inception. Under the tables,[149] the amount of the taxable gift is equal to $72.90. Accordingly, the amount deemed to be placed in the remainderman's pot is $72.90; and the balance of $27.10 is deemed to be placed in the unitrust pot. The value that the table assigns to the unitrust amount is equal to the sum of the amounts of contributed capital that the grantor will receive back from the trust each year: $10 from the trust one year from inception (10% of $100), $9 from the trust at the end of the second year (10% of the remaining principal of $90) and $8.10 at the end of the third year (10% of the remaining of $81), for a total of $27.10.

Unlike the annuity table, the unitrust table makes no assumptions about the rate of return to be earned on trust investments.

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[149] See Treas. Reg. § 1.664-4.

Instead, it implicitly applies as a discount rate the rate of return actually earned on trust investments. In the unitrust context — unlike the GRAT, where the grantor is entitled to receive a fixed sum of money in the future irrespective of the trust's actual rate of return — both the unitrust interest and the remainder interest grow in accordance with the rate of return generated by trust investments, making it possible to view the two interests (or the two pots) as if they were joined together as partners entitled to an aliquot share in the earnings of the partnership, i.e., the trust. The present value of the right to receive amounts in the future from the unitrust pot, as well as from the remainderman's pot, is equal to the amount deemed to be placed in the pot at inception as long as the actual rate of return produced by trust investments is used as the discount rate. For the present value of the right to receive in the future $X plus a return of Y% is, assuming a discount rate of Y%, equal to $X. Thus, in making the present value of the unitrust interest equal to the amount of contributed principal the grantor is entitled to receive, the table implicitly applies as a discount rate the actual rate of return, whatever that rate may prove to be.

Consider the amounts that the grantor would be entitled to receive in the example under consideration if an annual rate of return of, say, 20%, were produced. At the end of the first year, the grantor would be entitled to receive $12 (10% of $120, the amount initially contributed to the trust together with $20 in trust earnings enjoyed during the first year). During the second year, the amount remaining in the trust, after the $12 payment to the grantor, would be equal to $108 and would grow by the end of the second year to $129.60 ($108 plus a return of 20%, or $21.60). At the end of the second year, the grantor would be entitled to receive 10% of this sum, i.e., $12.96. During the third year, the amount held in the trust would be equal to $116.64 ($129.60 minus the amount paid to the grantor at the end of the second year, $12.96). Assuming this amount were to grow at the rate of 20% during the third year, the amount in the trust at the end of the third year would be equal to $139.968 ($116.64 plus a return of 20%, or $23.328). At the end of the third year, the grantor would be entitled to receive 10% of this sum, i.e., $13.97.

With the two-pot analysis, the nature of the unitrust interest is revealed in more concrete terms, facilitating a comparison of the

GRUT with an outright gift. As suggested, under the two-pot analysis, the amount deemed to be placed in the unitrust pot at inception would be equal to $27.10. During the first year, the amount deemed to be held in the unitrust pot, $27.10, would earn $5.42, assuming a return of 20%, which would leave $32.52 in the unitrust pot at the end of the first year. At that point, the grantor would be entitled to receive from the unitrust pot a return of contributed capital in the amount of $10 plus earnings in the amount of $2 (20% of $10), leaving a balance in the unitrust pot of $20.52. During the second year, the $20.52 deemed held in the unitrust pot would grow, assuming an earnings rate of 20%, to $24.624. At the end of the second year, the grantor would be entitled to receive from the unitrust pot a return of contributed principal of $9 plus earnings of $3.96, having accrued at the rate of 20% on the $9 of contributed principal for a two-year period. During the third year, the remaining $11.66 deemed held in the unitrust pot would generate earnings of $2.33 (20% of $11.66), making available for distribution to the grantor at the end of the third year a total of $13.99. This amount represents a return of contributed principal of $7.10 and the 20% earnings it generated during each of the three years it was deemed held in the unitrust pot.

Just as the unitrust pot grows to permit the grantor to receive a return of contributed capital together with a rate of return equal to that generated by trust investments, so too does the remainderman's pot grow to permit the remainderman to receive her entitlement together with the same rate of return. In effect, the remainderman's pot and the unitrust pot can be viewed as two interests in a partnership, each enjoying a return equal to that generated by the trust.

When viewed in this fashion, it is clear that the GRUT offers neither an advantage nor a disadvantage relative to an outright gift.[150] In the example under consideration, an outright gift of $72.90 would be comparable, since that is the amount that would be deemed to be placed in the remainderman's pot were a GRUT

[150] If, however, as Treas. Reg. § 25.2702-3(e), example (5) requires, mortality is taken into account, the GRUT would appear to always be at a slight disadvantage relative to an outright gift. See supra note 83 for a discussion of the regulation. For, if mortality is considered, the amount of the taxable gift deemed to occur at the creation of the GRUT is increased, which would cause a concomitant increase in the amount of the comparable outright gift. See supra note 134 for a discussion of this issue in the context of a GRAT.

utilized — or, in other words, the amount of the taxable gift that would be triggered if a GRUT were created. Assuming the donee of a comparable outright gift (i.e., $72.90) were to enjoy, like the GRUT, a yield of 20%, the amount of wealth in the hands of the donee attributable to the gift at the end of three years would be equal to $125.97 (72.90 x 1.2 x 1.2 x 1.2). And, of course, with a return of 20% generated by GRUT investments, the amount deemed to be held in the remainderman's pot, $72.90, would grow at the rate of 20% each year, making available for distribution to the remainderman at the end of three years an amount also equal to $125.97. The GRUT and the outright gift are in parity because, unlike the GRAT, there is no potential for the remainderman's pot to be burdened by a deficiency or to be augmented by a surplus in the unitrust pot. In short, the remainderman's pot grows, as would the wealth held by the donee of an outright gift, in accordance the rate of return enjoyed on the particular investment selected, thus placing the same amount of wealth in the hands of the GRUT remainderman as a comparable outright gift would produce for a donee.

The parity existing between a GRUT and an outright gift would not hold, however, if the donor, in addition to making an outright gift, simultaneously made a loan to the donee. To illustrate, assume that, in the example under inquiry, an outright gift of $72.90 were combined with a loan from the donor to the donee of $27.10 (the amount that would be deemed to be placed in the unitrust pot were a GRUT utilized) bearing an interest rate equal to that required under section 7872. Assume further, in order to maintain the integrity of the comparison, that the loan would be repaid over a three-year period in a manner such that each repayment would coincide with the payment that the grantor would receive from the unitrust pot if a GRUT were utilized. If the rate of return produced on the donee's investments were in excess of the section 7872 rate, the donee would obviously realize a profit on the borrowing equal to the difference between the rate of return actually enjoyed by the donee and the section 7872 rate. Conversely, if the rate of return on the donee's investments were less than the section 7872 rate, the borrowing would result in a loss for the donee equal to the difference between the two rates. The possibility of realizing such a profit or loss would, of course, not be present in the case of a GRUT, the remainderman being entitled to nothing

more (and nothing less) than whatever rate of return the trust enjoyed on the $72.90 deemed to be placed in the remainderman's pot. Thus, a gift-loan combination of the kind suggested would not be in parity with the GRUT.

B. *GRUT's in a Taxable Environment*

In the discussion of GRUT's thus far, the impact of the income tax on trust earnings has been ignored. If it is now assumed that the trustee holds investments producing income that is subject to tax, the conclusion that the GRUT and the outright gift are in parity must be reexamined. The premise underlying parity has been that the remainderman's pot (i.e., the remainderman) and the unitrust pot (i.e., the grantor) both enjoy a rate of return equal to that enjoyed by the trust. Where, however, the two pots produce an after-tax rate of return that is not equal, the GRUT and the outright gift will not be in parity. For parity to be maintained, the earnings generated in each pot must bear the burden of the income tax attributable to those earnings.

If some portion or all of the GRUT's earnings are taxable to the grantor,[151] the after-tax rate of return enjoyed by the grantor will be less than the after-tax rate of return produced for the remainderman — thus creating a shift in wealth from the grantor to the remainderman that is not subject to transfer tax. This shift, should it occur, results in an advantage for the GRUT relative to the outright gift, similar to the advantage enjoyed by the GRAT over the

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[151] GRUT earnings would likely be taxable to the grantor under I.R.C. § 677. Treas. Reg. § 1.664-1(a)(4) (as amended in 1984) strongly implies that a charitable remainder unitrust having the grantor as the recipient of the unitrust payment could be treated as a grantor trust subject to § 677. See also Priv. Ltr. Rul. 9015049 (Jan. 16, 1990), where the Service concluded that § 677 was applicable in the case of a charitable remainder unitrust because the trust was required to make mortgage payments with respect to which the grantor was personally liable; Priv. Ltr. Rul. 8051076 (Sept. 24, 1980), where the Service concluded that, in the case of a charitable lead unitrust, § 677 was applicable with respect to corpus items because principal was to revert to the grantor at termination of the trust. In addition, one might infer from Rev. Rul. 76-273, 1976-2 C.B. 268 (applying I.R.C. § 2036 to a charitable remainder unitrust that made unitrust payments to the grantor on the rationale that the grantor in effect retained an income interest in the trust) that the Service would view the grantor of a GRUT as having retained an income interest in the trust sufficient to trigger application of § 677. Even if § 677 were inapplicable, GRUT earnings would be taxable to the grantor under I.R.C. § 662 on account of the distributions made to the grantor from the trust each year. Cf. Smith v. Westover, 89 F. Supp. 432, 434-35 (S.D. Cal. 1950), aff'd per curiam, 191 F.2d 1003 (9th Cir. 1951).

outright gift where GRAT earnings are taxable to the grantor.

Consider the example just discussed. As suggested, assuming trust earnings are not subject to income tax, the amount in the remainderman's pot available for distribution to the remainderman at termination of the trust (occurring three years after its creation) is equal to $125.97. If it is now assumed that trust earnings are subject to income tax and that all of its earnings are taxable to the grantor, the amount in the remainderman's pot available for distribution to the remainderman at termination of the trust is still equal to $125.97. Yet the donee of a comparable outright gift (i.e., $72.90) who, like the trust, earned a taxable return of 20% would, at the end of three years, obviously have less than $125.97 as a result of having received the gift; for, in order to grow from $72.90 to $125.97 in three years, an annual after-tax return of 20% must be produced. Thus, the imposition of the income tax on the grantor with respect to trust earnings effects a shift of wealth from the grantor to the remainderman without the imposition of transfer tax, making the GRUT a more attractive wealth-transfer strategy than the outright gift.

C. *Interval GRUT's*

In the example used to illustrate the GRUT, it was assumed that the grantor was entitled to receive her unitrust payment at the beginning of each year coincident with the determination of the value of the trust. It is conceivable, however, that a trust instrument might provide that the distribution be made some time after the valuation of trust assets.[152] So, for example, the trust instrument might provide that, say, 10% of the value of trust assets be distributed to the grantor at the end of each calendar year but that the determination of the amount to be distributed, which is accomplished by valuing trust assets, be made at the beginning of the calendar year. Where this approach is taken, the regulations require that the table rate be applied in order to account for the postponement of the unitrust payment for a period beyond the date on which it is determined or fixed.[153]

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[152] See Treas. Reg. § 1.664-4(b)(2).

[153] See id. Treas. Reg. § 1.664-4(b)(2) provides that where the trust instrument postpones payment beyond the date of its determination, the unitrust percentage designated in the trust instrument must be reduced for valuation purposes. In effect, this reduction treats the

By creating an interval between the date the unitrust amount is determined and the date of its payment, the grantor precludes the unitrust pot from fully participating in trust earnings during the interval. As suggested, as a general matter, no assumptions are made about the rate of return to be enjoyed on GRUT investments in determining the portion of contributed principal that is deemed to be placed in the remainderman's pot (i.e., the present value of the remainder interest) and the unitrust pot (i.e., the present value of the grantor's interest). The underlying premise is that both pots fully participate in the earnings of the trust. But where, as a result of an interval created in the trust instrument, the right of one of the pots to participate fully in trust earnings is suspended for a period of time, a determination must be made of the present value of the right to receive a sum that is fixed on one date but paid on a later date. Such a determination requires an assumption about rate of return, for it is always necessary to apply a discount rate in determining the present value of the right to receive a fixed sum in the future.

To illustrate, assume the contribution of $100 to a GRUT that is to terminate one year after its creation and that the grantor retains the right to receive 11% of the value of the corpus of the trust. If the valuation of trust assets and the payment to the grantor were required to be made at the outset, the amount of the taxable gift triggered upon the creation of the trust would be $89 ($100, the amount contributed to the trust, minus $11, the amount of contributed principal immediately returnable to the grantor). If the corpus were to be valued at the time of payment to the grantor, the taxable gift triggered at inception would still be equal to $89: The present value of the right to receive $11 one year in the future together with a return that is reflective of the return enjoyed by the trust is equal to $11, given the premise underlying the regulations[154] that the discount rate to be applied should be equal to the rate of return actually produced by the trust.

In contrast, if the valuation of trust assets were required by the trust instrument to be made at the outset with the payment to the grantor deferred until the point of trust termination, the regula-

grantor as if she received the unitrust amount on the date it is determined and then loaned it back to the trust for an interest rate equal to the table rate.

[154] Treas. Reg. § 1.664-4.

tions[155] would require the use of a discount rate for purposes of calculating the value of the unitrust and remainder interests.[156] Assuming a table rate of 10%, the regulations would assign a value to the unitrust interest of $10 (and a value to the remainder interest of $90). For the present value of the right to receive the fixed sum of $11 one year in the future is, with a discount rate of 10%, equal to $10.

As a practical matter, such a GRUT (which will be referred to as the "interval GRUT") functions like a GRAT, since the amount distributable to the grantor is fixed on one date but not payable to the grantor until some subsequent date. An interval GRUT is capable of producing a surplus or a deficiency in the unitrust pot, making it possible for the interval GRUT to enjoy an advantage or suffer a disadvantage relative to a comparable outright gift. If the rate of return enjoyed by the trust exceeds the table rate, the resulting surplus inures to the benefit of the remainderman. If, on the other hand, the trust's rate of return is less than the table rate, the resulting deficiency must be borne by the remainderman.

So, in the example just discussed, a tax-exempt 20% rate of return would, given the one-year interval between the time the unitrust payment is fixed and the time of payment, result in a surplus of $1. For the $10 amount set aside in the unitrust pot would grow during the course of the year to $12, which, after the payment of the unitrust amount of $11 to the grantor, would leave a $1 surplus in the remainderman's pot. As in the case of a GRAT, this surplus reflects the advantage enjoyed by an interval GRUT over a comparable outright gift. In addition, with the actual rate of return produced by the trust greater than the table rate, the interval GRUT also enjoys an advantage over a non-interval GRUT (i.e., where the payment to the grantor is required to be made on the same date that the value of the trust corpus is determined), since a non-interval GRUT is incapable of producing a surplus in the unitrust pot.

While the interval GRUT is similar to the GRAT, there are significant differences between the two. Where the actual rate of return is greater than the table rate, the surplus that inures to the

[155] Treas. Reg. § 1.664-4(b)(2).

[156] See, e.g., I.R.S. Notice 89-60, 1989-1 C.B. 700 (which sets forth in Table F various table rates, to be used for purposes of valuing the interests under a GRUT where the trust instrument provides for an interval between valuation and payment).

benefit of the remainderman will be greater in the case of a GRAT than in the case of the interval GRUT. There are two reasons for this difference: 1) the amount in the unitrust pot not entitled to fully participate in trust earnings (i.e., an amount fixed on one date but payable on a later date) will never be greater than the unitrust payment required to be made for that year, and 2) whereas the GRAT remainderman is entitled to retain the entire surplus, the remainderman of the interval GRUT is required, in effect, to give back to the grantor a portion of the surplus.

As an example, consider the contribution of $100 to a two-year GRUT where the grantor is entitled to receive 11% of the value of the corpus as determined on the date of funding in the case of the first year and as determined on the first day of the second year in the case of the second year. Although the payment that the grantor is entitled to receive is determined at the beginning of each year, the trust instrument requires the payment to be made on the last day of each of the two years. Assume further that the table rate is 10% and that the trust enjoys an after-tax rate of return equal to 20%.

Under the regulations,[157] a table rate of 10% requires the grantor's entitlement to receive 11% of the corpus to be treated as if it were a 10% entitlement because of the one-year interval between the determination of value and payment (the present value of the right to receive an 11% payment one year in the future is equal 10% where the discount or table rate that is applied is equal to 10%). The amount deemed to be placed in the unitrust pot at inception is equal to $19, the grantor being viewed (because the 11% entitlement is treated as if it were a 10% entitlement) as entitled to receive a return of contributed principal of $10 in the first year and $9 in the second year. The amount deemed to be placed in the remainderman's pot at inception is therefore equal to $81.

It would be helpful to view the unitrust pot as consisting of two sub-pots at inception, pot one containing the contributed principal required to be returned to the grantor in year one and pot two containing the contributed principal required to be returned to the grantor in year two. During the first year, only pot two would be entitled to participate fully in the earnings of the trust. Pot one would be required to grow, irrespective of the trust's rate of return,

[157] See Treas. Reg. § 1.664-4(b)(2); I.R.S. Notice 89-60, 1989-1 C.B. 700.

from the sum of $10, deemed placed it in at inception, to the sum of $11, the amount payable to the grantor at the end of the first year. Any deficiency or surplus that accrues in pot one would inure to the benefit or detriment of the remainderman's pot. During the second year, pot one would no longer exist, the funds in it having been paid to the grantor at the end of the first year; and pot two would no longer be entitled to participate in trust earnings inasmuch as the payment due to the grantor at the end of the second year would have become fixed on the first day of the second year.

Given the trust's after-tax return of 20%, the amount in pot one at the end of the first year would be equal to $12 ($10 plus a return of 20%). After the payment to the grantor of the unitrust amount of $11 (11% of $100, the value of the corpus at the point of inception), the surplus of $1 would spill into the remainderman's pot. Pot two, at the end of the first year, would contain $10.80 ($9 plus a return of 20%) and would not be entitled to participate in the earnings of the trust during year two. Instead, the $10.80 sum contained in pot two would be required to grow, irrespective of trust earnings, to $11.88 (growth of 10%, the table rate, being required) by the end of year two, with any surplus or deficiency that may occur impacting on the remainderman's pot. With a return of 20% during year two, a surplus of $1.08 (10% of $10.80) would pass into the remainderman's pot.

Contrast the magnitude of the surplus in this example with the magnitude of the surplus that would result in the case of a GRAT earning a 20% return with a 10% table rate. As suggested, the amount deemed to be placed in the GRAT's annuity pot at inception would be equal to the present value of all future payments required to be made to the grantor. Unlike the interval GRUT in the example under consideration, no portion of the GRAT's annuity pot would participate in the trust's earnings. Thus, while a 20% return with a 10% table rate results in a surplus of 10% with respect to the entire amount in the GRAT's annuity pot, only a portion of the amount in the GRUT's unitrust pot can produce a surplus; the balance of the amount in the unitrust pot is entitled to participate in trust earnings.

Consider the second advantage enjoyed by the GRAT over the interval GRUT under examination. The grantor's unitrust payment at the end of year two, which becomes fixed at the beginning of the year, would be equal to $11.99 (11% of $109, the value of

the corpus at the beginning of year two, which represents the sum of the amount in pot two, $10.80, the amount in the remainderman's pot, $97.20, and the surplus of $1 that passes into the remainderman's pot). Yet the amount in pot two at the end of year two would only be equal to $11.88, inclusive of the fixed table rate of 10% for year two ($10.80, the amount in pot two at the beginning of year two, plus 10% equals $11.88). The difference of $.11 is attributable to the surplus of $1 generated in pot one during year one. In other words, the remainderman is, in effect, required to give back to the grantor in year two a portion of year one's surplus, the give-back being equal to the portion of the surplus that corresponds to the unitrust percentage (11% of $1 = a give-back of $.11). In contrast, the remainderman of a GRAT is entitled to retain the entire surplus accruing in the annuity pot. Thus, while the grantor of an interval GRUT would be subject to estate or gift tax upon a subsequent transfer of the give-back, the grantor of a GRAT, not having received any give-back, would not be exposed to such a tax.

The differences between a GRAT and an interval GRUT that result in the GRAT being more attractive where a surplus occurs make an interval GRUT more attractive in the context of a deficiency. Where the rate of return produced by the trust is less than the table rate so that a deficiency results, the GRAT remainderman is required to bear the burden of a greater deficiency than that required to be borne by the remainderman of an interval GRUT. While all of the funds held in the GRAT's annuity pot are in effect entitled to a fixed (or guaranteed) rate of return equal to the table rate, only a portion of the funds in an interval GRUT's unitrust pot is entitled to such a fixed (or guaranteed) return. Thus, the fixed rate, or guarantee, creates less downside exposure for the remainderman of an interval GRUT than it does for the remainderman of a GRAT.

In addition, just as the give-back makes a GRAT more attractive than an interval GRUT where a surplus occurs, it makes the interval GRUT more attractive in the context of a deficiency. For, in the case of an interval GRUT, a deficiency occurring in one year diminishes the amount in the remainderman's pot and, as a consequence, the amount of payments that the grantor is entitled to receive in future years. In the case of a GRAT, on the other hand, the amount that the grantor is entitled to receive is fixed and is

therefore not diminished as a result of any deficiency. In short, where a deficiency occurs, a GRAT will leave more wealth in the hands of the grantor than will a comparable interval GRUT, thus making the interval GRUT a more effective wealth-transfer device in this context.

Although the potential for a surplus to occur in an interval GRUT might make it more attractive than a non-interval GRUT, a non-interval GRUT could,if utilized in conjunction with a loan from the grantor to the trust, be more effective than an interval GRUT. A grantor could create a non-interval GRUT, loaning back to the trust the amount received as a unitrust payment; the loan could have a term coinciding with the interval that would have been selected had the grantor created an interval GRUT. It would, of course, be necessary for the interest rate charged on the loan to satisfy section 7872. Inasmuch as the interest rate required by section 7872 is lower than that utilized in the GRUT valuation table, the combination of a non-interval GRUT with the loan technique described would place more wealth in the hands of the remainderman than would a comparable interval GRUT. The remainderman of an interval GRUT would be required to bear the burden of the table rate during the period of the interval, whereas the remainderman of a non-interval GRUT would only be required to bear the burden of the lower section 7872 rate on the unitrust payments borrowed back from the grantor.

In economic substance, an interval GRUT could be viewed as the equivalent of a non-interval GRUT combined with a loan of the kind suggested. Yet the Code differentiates between these two methods of transfer, requiring the application of a different interest (or discount) rate in each case. As a consequence, the interval GRUT not only fails to offer an advantage over a non-interval GRUT but in fact suffers a comparative disadvantage. From a policy viewpoint, it would seem that the interest or discount rate should be the same, whether applied in the context of a loan subject to section 7872 or in the context of valuing an interval GRUT under the GRUT valuation table. There is no apparent rationale for requiring a higher rate in the case of an interval GRUT than in the case of a loan. Indeed, any well-advised taxpayer would be able to avoid the higher rate applicable to an interval GRUT simply by combining a non-interval GRUT with the loan technique suggested, thus making the more onerous GRUT rate applicable only

to those taxpayers who are not adequately advised.

In sum, non-interval GRUT's produce neither an advantage nor a disadvantage relative to a comparable outright gift, given that the unitrust pot is incapable of generating either a surplus or a deficiency. In contrast, a gift-loan combination and a GRUT are not in parity: The borrowing in the case of the gift-loan combination could produce a profit or loss for the donee, whereas the remainderman of a GRUT would not have the opportunity to enjoy a comparable profit or be required to bear the risk of suffering a comparable loss. Where income properly attributable to the remainderman's pot is includible in the grantor's gross income, the GRUT enjoys an advantage over a comparable outright gift. Since the donee of an outright gift must include all income attributable to the gifted sum in her gross income, the opportunity inherent in the GRUT to shift to the grantor the burden of the income tax on income belonging to the remainderman creates a comparative advantage for the GRUT. Unlike the non-interval GRUT, the interval GRUT does offer the potential for a surplus, as well as the risk of a deficiency — functioning to some extent in a manner similar to a GRAT. It would not, however, be prudent from a tax-planning viewpoint to create an interval GRUT on the hope that a surplus might arise; for, because the rate under section 7872 is lower than the table rate, a non-interval GRUT combined with a loan offers the opportunity for a greater surplus and a lesser risk of deficiency than an interval GRUT.

VII. Personal-Residence Strategies: GRIT, GRAT or Outright Gift?

A donor who wishes to transfer his personal residence must decide whether to effect the transfer by outright gift or by employing a GRIT or a GRAT. This Part of the article focuses on the considerations taxpayers are required to take into account in determining the most effective strategy for transferring a personal residence. The GRUT, as suggested in the preceding Part, functions much like an outright gift and will therefore not be examined as an alternative strategy.[158]

[158] There is potentially one critical difference between an outright gift and a GRUT. Where a donor makes an outright gift of her residence and then leases it back from the donee, the donee is required to include the rent payments in gross income. In contrast,

While Congress sought, in enacting section 2702, to eliminate the GRIT as a tax-planning strategy, it did create a special exception for personal residences.[159] Given Congress' decision to continue the viability of the GRIT in this context only, one might conclude that the personal-residence exception makes the GRIT the vehicle of choice in all cases involving the transfer of a personal residence. A careful examination, however, reveals that such a conclusion would be erroneous. Depending on the circumstances, it might be more effective to place the residence in a GRAT or to gift it outright. In examining the relative effectiveness of the GRIT, the GRAT, and the outright gift, it will be helpful to first consider how a GRIT or a GRAT holding the grantor's residence might be structured. Certain issues implicated by the structure under examination will be considered as well.

A. *Structuring a Personal-Residence GRIT*

With respect to the GRIT, two alternative methods for structuring the trust are feasible. The trust instrument could direct the trustee to permit the grantor to use the residence during the term

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where a grantor transfers her residence to a GRUT and then leases it back, it would seem that all, or some portion, of the rental income received by the trust may well ultimately be taxable to the grantor under I.R.C. § 677 (or perhaps not taxable at all if the grantor is deemed to be the owner of the entire trust), thus making the GRUT more attractive than the outright gift in terms of the amount of wealth produced for the transferee. For a further discussion of the transfer-tax advantages inherent in the shift of the income-tax burden brought about by the application of § 677, see supra notes 135 and 151 and accompanying text.

It is interesting to note in this context that the grantor of a GRIT who retains the right to use a residence owned by the trust is apparently not required to include the fair-rental value of the residence in gross income. See Plant v. Commissioner, 30 B.T.A. 133 (1934), acq. 1976-1 C.B. 1, aff'd, 76 F.2d 8 (2nd Cir. 1935); Priv. Ltr. Rul. 8341005 (June 24, 1983); N. Lane & H. Zaritsky, Federal Income Taxation of Estates and Trusts ¶ 4.08[1] (1988). Although none of the cited authorities address the question whether the trust should be viewed as having received rental income from the beneficiary who is permitted to use the residence, it would seem incongruous to treat the trust as having received rental income while the beneficiary is treated, under the cited authorities, as not having received a distribution from the trust. Under section 7872, an interest-free loan is viewed as consisting in substance of two elements: 1) a payment of interest made by the borrower to the lender; and 2) a payment made by the lender to the borrower that is characterized to reflect the economic reality of the transaction. In other words, the premise underlying I.R.C. § 7872 is that, in substance, there are two components, or transfers, in a transaction where one person is permitted to use the property of another on a charge-free basis.

[159] I.R.C. § 2702(a)(3)(A)(ii).

of the trust on a rent-free basis. Alternatively, the grantor and trustee could enter into a lease requiring the grantor to pay a market-value rent during the term of the trust. The rental payments, after reductions for trust expenses chargeable to income,[160] would be returned to the grantor as a distribution of income.

Under either approach, assuming the trust constitutes a personal-residence trust, section 2702's zero-value rule would be inapplicable.[161] Thus, the value of the interest retained by the grantor would be subtracted from the value of the property contributed to the trust in determining the amount of the taxable gift deemed to occur at inception. The value of the retained interest, whether it is the right to use the residence on a rent-free basis or the right to receive trust income, would be the same, it being determined under the Service's valuation tables.

Although the two approaches are in substance identical, they may be treated differently for income-tax purposes. Where the trust instrument authorizes the grantor to use the residence on a rent-free basis, neither the grantor nor the trust would appear to be required to include in gross income any amount on account of the grantor's use of the residence.[162] In contrast, where the grantor is to pay rent for the use of the residence, it would seem that the rental payments might constitute gross income to the trust,[163]

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[160] See, e.g., Revised Uniform Principal and Income Act § 3, 7B U.L.A. 155 (1962).

[161] I.R.C. § 2702(a)(3)(A)(ii); Treas. Reg. § 25.2702-5(a).

[162] See Plant v. Commissioner, 30 B.T.A. 133 (1934), acq. 1976-1 C.B. 1, aff'd, 76 F.2d 8 (2nd Cir. 1935); Priv. Ltr. Rul. 8341005 (June 24, 1983); N. Lane & H. Zaritsky, supra note 158, ¶14.08[1].

[163] Cf. Richards v. Commissioner, 111 F.2d 376 (5th Cir. 1940) and Hillman v. Commissioner, 71 F.2d 688 (3rd Cir. 1934), where the courts implied that the use of corporate-owned property as a residence by a shareholder did not trigger gross income for the shareholder in part because there was no agreement to pay rent. Compare Chandler v. Commissioner, 119 F.2d 623 (3rd Cir. 1941), where although the court indicated that it would no longer follow its decision in *Hillman*, it did not appear to disagree with the implication in *Hillman* that an agreement to pay rent would trigger gross income.

It should be noted that these authorities address the question whether the person using the property is required to include the rental value of the property in gross income, while it is suggested in text that the payment of rent would produce gross income for the trust. Nevertheless, the authorities imply that if an agreement to pay rent had been made, it would have been appropriate to respect the agreement, taxing the parties as if they had been at arms-length. Cf. Peacock v. Commissioner, 256 F.2d 160 (5th Cir. 1958), where the court, following its prior decision in *Richards*, implied that rental payments in fact received by a corporation from its shareholder for the use of corporate property as a residence were appropriately includible in the corporation's gross income, although the issue of the corpora-

which would ultimately be taxable to the grantor under section 677.[164] Given the potential difference in income-tax treatment applicable with respect to each of the approaches, most grantors would presumably opt for the less risky rent-free approach. As a matter of policy, however, it would be inappropriate to make the income-tax treatment turn upon whether the rent is paid by the grantor and then returned to him as a distribution of income or simply not paid in the first instance; the substance of the transaction, rather than its form, should govern.[165]

In order to avoid a forfeiture of the benefits inherent in the personal-residence GRIT, it would be necessary to provide that any right retained by the grantor with respect to the trust terminate upon the expiration of a period of years designated in the trust instrument.[166] As a practical matter, however, it is likely that many grantors will be reluctant to relinquish the right to use their residence on some fixed date in the future. Perhaps it would be possible for a grantor concerned about relinquishing possession of her residence to enter into a lease with the trustee at the time the trust

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tion's gross income was not before the court. Finally, if the trust is required to include any rental payments in fact made in gross income, it would seem that the trust ought to be entitled to depreciation deductions with respect to the property.

[164] I.R.C. § 677. If, however, the grantor is deemed to be the owner of the entire trust under the grantor-trust rules, it is likely that the trust would be disregarded for income-tax purposes — resulting in neither the grantor nor the trust being required to take rental payments into account in computing gross income. See Rev. Rul. 85-13, 1985-1 C.B. 184. Compare Rothstein v. United States, 735 F.2d 704 (2nd Cir. 1984) (refusing to disregard for income-tax purposes a trust deemed under the grantor-trust rules to be owned by the grantor).

[165] The substance-over-form issue could perhaps be better understood by considering the source of the problem, Helvering v. Independent Life Insurance Co., 292 U.S. 371 (1934), where the court held that the owner of property is not required to include its rental value in gross income. Given this inveterate principle, the reluctance of the courts to find gross income where the grantor of a trust retains the right to use the property contributed to the trust is understandable. Where, however, the grantor does not retain the right to use the property but rather the right to receive trust income, the argument in support of applying the principle is not as strong. Moreover, the courts have traditionally been unsympathetic to taxpayers who seek to have the form of the transaction that they chose disregarded in favor of what they claim at the time of litigation is the substance. See, e.g., Don E. Williams Co. v. Commissioner, 429 U.S. 569, 579-80 (1977); Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 148-49 (1974).

[166] If the grantor retained the right to use the residence or to receive trust income for life, rather than for a fixed period of years, the entire value of the trust corpus would be includible in the grantor's gross estate under I.R.C. § 2036 resulting in a failure to realize the benefits offered by the GRIT.

is created. The lease could provide that, in exchange for a market-value rent, the grantor would be entitled to continue to use the residence after the expiration of the designated period of years. While it would seem that such a market-value lease should not undermine the effectiveness of the GRIT,[167] the Service might argue that the retention of a lease interest (even if the lease required the payment of a market-value rent) does result in a forfeiture of the advantages otherwise obtainable with a personal-residence GRIT.[168]

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[167] See Estate of Barlow v. Commissioner, 55 T.C. 666 (1971), where the court held that a lease giving the decedent the right to occupy the property and receive benefits from its use as tenant, while requiring the payment of market-value rent to the transferees was not a sufficient interest to trigger I.R.C. § 2036.

[168] See Tech. Adv. Mem. 9146002 (July 31, 1991) (where the Service refused to apply *Estate of Barlow* in the context of residential property where less than 100% of the property interest was transferred). Another alternative that might be considered by a grantor concerned about relinquishing possession of her residence at the expiration of the retained term would be to provide in the trust instrument for a life estate in the grantor's spouse following the termination of the grantor's term interest. Under this alternative, the grantor would presumably continue to use the property as her residence as long as the grantor's spouse permitted it. Although it would seem that such an arrangement would result in the residence being included in the grantor's gross estate under § 2036 if she continued to occupy the residence during her spouse's life estate (on the ground that an implied understanding had been reached between the grantor and her spouse at the creation of the trust that would allow the grantor to continue using the residence after the termination of the grantor's retained term), it is arguable that § 2036 would not apply in this context. See Gutchess v. Commissioner, 46 T.C. 554 (1966), acq. 1967-1 C.B. 2; Rev. Rul. 70-155, 1970-1 C.B. 189 (where it is concluded that co-occupancy of the residence where donor and donee are husband and wife does not in itself constitute proof of an implied understanding sufficient to trigger I.R.C. § 2036).

It would seem, however, that a prudent grantor might not be willing to rely on these cited authorities. First, in both of the cited authorities, one spouse gave the other spouse outright ownership of the residence. Perhaps the Service could successfully argue that a different result should obtain where the grantor confers upon her spouse a life estate that follows upon the termination of the grantor's retained interest. Second, the authorities merely stand for the proposition that co-occupancy in itself is not sufficient to trigger an inference of an implied understanding. What additional facts might be sufficient to trigger such an inference in any given case is not clear. Third, it is possible that these authorities will be given a more limited reading in the future, See Estate of Hendry v. Commissioner, 62 T.C. 861 (1974) (refusing to extend *Gutchess* beyond its facts); Estate of Linderme v. Commissioner, 52 T.C. 305 (1969) (distinguishing *Gutchess*), given the movement that has been made in the direction of treating two spouses as one unit for tax purposes. See, e.g., I.R.C. § 2056. Finally, to suggest, as the authorities do, that a husband and wife do not have an implied understanding that they will both continue to use their residence is contrary to the reality of the marital relationship.

Another approach that might be utilized to take care of the grantor's concerns about relinquishing possession of the residence upon termination of the trust would involve a

The reversionary-interest technique utilized prior to the enactment of section 2702 would appear to remain viable in the context of a personal-residence GRIT. As a consequence, it would be advisable for the grantor of a personal-residence GRIT to retain a reversionary interest that is designed to become possessory in the event the grantor were to die during the retained term of years. The advantages offered by a reversionary interest of this nature are the same as those offered by such an interest prior to the enactment of section of 2702.[169]

First, since section 2702 is entirely inapplicable in connection with the creation of a personal-residence trust,[170] the retention of a reversionary interest in a personal-residence GRIT apparently does not trigger the zero-value rule. By retaining a reversionary interest, a grantor of a personal-residence GRIT reduces the amount of the taxable gift deemed to occur upon the creation of the trust, enhancing the attractiveness of the GRIT relative to an outright gift or a GRAT. Second, the grantor of a personal-residence GRIT can, by using a reversionary interest, insure that the marital deduction will not be underutilized.

B. *Structuring a Personal-Residence GRAT*

The structure of a GRAT containing the grantor's residence would necessarily differ from a GRIT.[171] Unlike the GRIT, the grantor would not retain the right to use the residence on a rent-free basis or the right to receive trust income. Instead, the grantor, upon transferring his residence to the GRAT, would presumably retain the right to periodically receive a fixed sum — i.e., an annuity amount. At the time of the creation of the trust, the grantor would enter into a lease with the trustee obligating the grantor to

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purchase by the grantor of the residence from the trust. For a discussion of the income tax issues in connection with such a purchase, see infra note 197.

[169] See supra notes 53-62 and accompanying text.

[170] I.R.C. § 2702(a)(3)(A)(ii); Treas. Reg. § 25.2702-5(a).

[171] Although the term "GRAT" is used in text to describe a trust containing a personal residence that provides for the payment of a fixed sum to the grantor, it would seem that it is possible for such a trust to constitute a personal residence trust or a qualified personal residence trust within the meaning of Treas. Reg. § 25.2702-5. Regardless of whether the trust is within the scope of the regulation, the amount of the taxable gift would be the same, i.e., the taxable gift would be equal to the amount contributed to the trust less the present value of the retained annuity payments.

pay a market-value rent.[172] The lease term would, in all probability, coincide with the annuity term — although, as in the case of the GRIT, a grantor concerned about relinquishing possession of her residence might consider entering into a market-value lease with the trustee for a period extending beyond the annuity term.[173]

Because the grantor pays rent to the trustee, the GRAT might create an income-tax cost that could be avoided with a GRIT. In the case of the GRAT, the grantor's payment of rent to the trustee might produce gross income for the trust[174] that might ultimately be taxable to the grantor under section 677.[175] In contrast, neither the grantor nor the trust would appear to be required to recognize gross income in the case of a GRIT where the rent-free approach is utilized.[176] Thus, the rent-free GRIT may enjoy an income-tax ad-

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[172] The grantor might pay more than a fair-market-value rental to the trust, hoping that any amount paid to the trust as rent would ultimately inure to the benefit of the remainderman on a transfer-tax-free basis. Where, however, the rent agreed to by the grantor and the trustee is inflated beyond what the property would rent for in the marketplace, the Service would presumably take the position that each rental payment constituted an additional taxable gift — or that a taxable gift should be deemed to occur upon entering into the lease equal to the difference between the aggregate amount of rent to be paid by the grantor for the entire lease term and the aggregate amount of rent that the property would produce in the market for such a term. See, e.g., Mitchell M. Gans, Gift Tax: Valuation Difficulties and Gift Completion, 58 Notre Dame L. Rev. 493 (1983). In addition, the Service might argue that where it is contemplated at the outset that rental payments will be inflated, Treas. Reg. § 25.2702-3(b)(4) is violated. The regulation requires the trust instrument in the case of a GRAT to prohibit any additional contributions to the trust; and a violation of this regulation would result in subjecting the annuity interest retained by the grantor to the zero-value rule.

[173] As suggested in the discussion of this issue in the GRIT context, the retention of such a lease interest could result in an adverse estate-tax consequence. If the grantor were to die prior to the expiration of the lease interest, the Service might argue for estate-tax inclusion with respect to the residence under I.R.C. § 2036. While it would seem that such an argument ought not to be available to the Service in the context of a market-value lease, see Barlow v. Commissioner, 55 T.C. 666 (1971), the Service has taken the position that § 2036 should apply in the case of a market-value lease where the asset in question is of a nonbusiness nature and where less than 100% of the asset is transferred. See Tech. Adv. Mem. 9146002 (July 31, 1991). See supra note 168 for a discussion about the possibility of including in the trust instrument a provision that would confer a life estate upon the grantor's spouse that would follow upon the termination of the grantor's retained interest.

[174] See supra note 163.

[175] I.R.C. § 677. If, however, the grantor is deemed to be the owner of the entire trust under the grantor-trust rules, it is possible that neither the grantor nor the trust would be required to include the rental payments in gross income. See supra note 164.

[176] See supra note 162.

vantage over the GRAT.

In determining the amount of the taxable gift deemed to occur upon the creation of the GRAT, the retained market-value lease interest should be ignored. A grantor who retains a right with respect to property he transfers on the condition that he pay full value in connection with any exercise of the right is treated, for transfer-tax purposes, as if he gifted the entire property.[177] Treating a grantor in this fashion is consistent with conventional transfer-tax theory. For example, in applying section 2036,[178] the courts have taken the view that a grantor of a trust who retains a lease interest under which he is obligated to pay a fair-market-value rent is not deemed to have retained an interest within the meaning of the section.[179] In addition, the regulations under section 2702 imply that the retention of a leasehold interest for a fair-market-value rent is not to be viewed as a retained interest.[180] Thus, in the case of a market-value lease retained by the grantor in connection with a contribution of property to a GRAT, the taxable gift would be equal to the value of the property conveyed to the trustee, reduced only by the present value of the retained annuity payments.

If the lease interest is retained for a below-market rent (or for no rent), the gift-tax analysis is somewhat different.[181] As a threshold

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[177] Cf. *Estate of Barlow*, 55 T.C. 666 (1971), where the court held that the decedent's retention of a lease giving him the right to occupy the property and receive benefits from its use as tenant, while requiring payment of market-value rent to transferees was not a sufficient interest to trigger I.R.C. § 2036. It would seem reasonable to infer from the court's decision that it would have held the entire value of the property transferred subject to gift tax had the question arisen in the gift-tax context. But cf. Tech. Adv. Mem. 9146002 (July 31, 1991) (where the Service suggested that the court's reasoning in *Estate of Barlow* should be limited to situations where the trust holds business property, not residential property, and where less than 100% of the property was transferred).

[178] I.R.C. § 2036.

[179] See *Estate of Barlow*, 55 T.C. 666 (1971). But see Tech. Adv. Mem. 9146002 (July 31, 1991).

[180] See Treas. Reg. § 25.2702-4(b). This regulation provides, in part, that "a leasehold interest in property is not a term interest to the extent the lease is for full and adequate consideration (without regard to section 2702)." Id. The effect of this provision is to preclude the general rule concerning joint purchases from applying in the context of a market-rental lease. In other words, the zero-value rule does not apply to a leasehold interest in this context, presumably on the rationale that a market-value lease interest is not a retained interest. And, as Treas. Reg. § 25.2702-1(b), provides, the zero-value rule only applies to non-qualified retained interests.

[181] The retention of a below-market lease interest might affect the estate-tax analysis as well. If the grantor died during the term of such a lease, the amount includible in the grantor's gross estate under I.R.C. § 2036 could be greater than the amount that would be in-

matter, it would be necessary to determine whether the GRAT constitutes a personal residence trust (or a qualified personal residence trust[182]), given that section 2702 and its zero-value rule are entirely inapplicable in the case of such a trust.[183]

While Congress perhaps anticipated that only a GRIT could qualify as a personal residence trust (or a qualified personal residence trust), it would seem that a GRAT might qualify as well. Under the regulations, if the trust instrument prohibits the trustee from acquiring any asset other than the residence of a person holding a term interest in the trust, the trust qualifies as a personal residence trust.[184] Thus, the critical question is whether the grantor of a GRAT containing a residence to be used by the grantor for a below-market rental can be viewed as holding a term interest.

In defining the phrase "term interest" as "(A) a life interest in property, or (B) an interest in property for a term of years,"[185] section 2702 fails to clarify whether it is appropriate to view the grantor of a GRAT as holding a term interest. In other words, section 2702, and the related regulations, do not specify whether the right to receive an annuity sum for a fixed period of years constitutes a term interest or whether the retention of a below-market lease interest would make it appropriate to view the grantor as holding a term interest. It is thus not clear whether the creation of a GRAT containing a residence to be used by the grantor for a below-market rental triggers the zero-value rule.[186]

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cludible on account of the retention of a right to receive an annuity sum each year. The right to use trust property in exchange for a below-market rental would presumably trigger a conventional § 2036 analysis, whereas the retention of an annuity interest might result in a lesser inclusion under § 2036. See infra notes 198-252 and accompanying text for a discussion of the application of § 2036 in the context of a retained annuity. For example, if the grantor retained the right to use the trust property on a rent-free basis, the entire value of the trust corpus would be includible under § 2036, even though the amount that would be includible on the basis of a grantor retained annuity would be less.

[182] In essence, a qualified personal residence trust is a trust that would qualify as a personal residence trust but for the fact that it is permitted to hold limited amounts of cash for certain trust-related or residence-related expenses. Treas. Reg. § 25.2702-5(c)(ii)(A).

[183] Treas. Reg. § 25.2702-5(a).

[184] Treas. Reg. § 25.2702-5(b).

[185] I.R.C. § 2702(c)(3).

[186] In addition to the question raised in text — whether the grantor of a GRAT is to be viewed as holding a term interest in the trust — other issues must be considered in this context. Treas. Reg. § 25.2702-3(d)(2) requires the trust instrument to prohibit the distribution of trust assets to any person other than the holder of the annuity interest during the annuity term. If the trust instrument fails to contain this prohibition, the annuity interest

If a GRAT containing a residence to be used by the grantor qualifies as a personal residence trust (or a qualified personal residence trust), the zero-value rule is inapplicable. As a consequence, the grantor's retention of a below-market lease interest would result in the same gift-tax consequence as would have obtained prior to the enactment of section 2702. The below-market lease would be viewed as an interest in the trust retained by the grantor. The value of this interest, together with the present value of the retained right to receive annuity payments, would reduce the amount of the taxable gift deemed to occur at the creation of the trust.

If a GRAT containing a residence to be used by the grantor does not qualify as a personal residence trust (or a qualified personal residence trust), section 2702 is applicable. The retention of a below-market lease interest would, therefore, trigger the zero-value rule, since a below-market lease interest does not constitute a qualified interest.[187] Consequently, the amount of the taxable gift deemed to occur at the creation of the trust would be equal to the entire value of the property contributed to the trust less the present value of the retained right to receive annuity payments, without any reduction for the value of the below-market lease interest retained by the grantor.

Whether the GRAT constitutes a personal residence trust (or a qualified personal residence trust) is relevant not only in connec-

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retained by the grantor does not constitute a qualified interest — thus triggering the zero-value rule. In the case of a GRAT containing the grantor's personal residence, it would not be unusual for persons other than the grantor to occupy the residence (for example, the grantor's spouse or children). It is not clear whether the occupancy of the residence by members of the grantor's family would cause a violation of the prohibition contained in the regulation. Compare Treas. Reg. § 25.2702-5(c)(4), which requires the trust instrument in the case of a qualified personal residence trust to prohibit the distribution of corpus to any person other than the grantor during the term interest; while this prohibition could certainly be included in a GRAT without triggering the zero-value rule, it does make clear the broadness of the prohibition contained in Treas. Reg. § 25.2702-3(d)(2) in that it is not limited to distributions of corpus. Finally, Treas. Reg. § 25.2702-5(c)(3) requires that the governing instrument of a qualified personal residence trust include a direction that all trust income be distributed not less often than annually to the term holder. The inclusion of such a direction in a GRAT would not cause the zero-value rule to be applicable to the retained annuity interest. See Treas. Reg. § 25.2702-3(b)(1)(iii), which provides that an annuity interest does not fail to constitute a qualified interest merely because the holder of the annuity interest is entitled to receive trust income if it exceeds the annuity amount.

[187] Treas. Reg. §§ 25.2702-1(b), 25.2702-3.

tion with the retention of a below-market lease interest but also in connection with the retention of a reversionary interest. If the GRAT qualifies as a personal residence trust, section 2702's zero-value rule is inapplicable. The retention of a contingent reversionary interest reduces the amount of the taxable gift deemed to occur upon the creation of the trust, just as the retention of a contingent reversionary interest in a GRIT reduced the taxable gift prior to the enactment of section 2702.[188] If, on the other hand, the GRAT does not qualify as a personal residence trust (or a qualified personal residence trust), section 2702 and its zero-value rule are applicable. Thus, the retention of a contingent reversionary interest, which is not a qualified interest,[189] would not effect a reduction in the amount of the taxable gift triggered at the creation of the trust.

In any event, whether or not the GRAT constitutes a personal residence trust (or a qualified personal residence trust), retaining a reversionary interest would prevent an underutilization of the marital deduction. In other words, the reversionary-interest technique utilized in connection with GRIT's prior to the enactment of section 2702 would appear to remain a viable strategy for assuring optimal use of the marital deduction in the context of a GRAT — even if the GRAT does not constitute a personal residence trust (or a qualified personal residence trust).[190] Thus, although the reversionary-interest technique would only work a reduction in the amount of the taxable gift triggered at the creation of a GRAT if it qualified as a personal residence trust (or a qualified personal residence trust), it would nevertheless be beneficial in terms of marital-deduction planning regardless of whether or not the trust is so qualified.

Finally, in structuring a GRAT, it is necessary to consider including a direction in the trust instrument requiring the distribution to the grantor of trust income if it exceeds the annuity amount. For, in the absence of such a direction, the trust will not qualify as a personal residence trust or a qualified personal resi-

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[188] See supra notes 53-62 and accompanying text for a discussion of the contingent reversionary interest.

[189] Treas. Reg. § 25.2702-3(f)(1)(iii).

[190] See supra notes 53-62 and accompanying text for a discussion of the reversionary interest as a planning tool used to assure that the marital deduction is not underutilized.

dence trust.[191] As a consequence, a grantor who does not retain the right to receive excess income forfeits the advantages of qualifying the trust as a personal residence trust or a qualified personal residence trust: Any reversionary interest or below-market lease interest retained by the grantor would be subject to the zero-value rule. Presumably, in most cases, the advantages of qualifying the trust as a personal residence trust would outweigh any possible disadvantage.[192] Thus, a taxpayer who uses a GRAT as the method by which to effect a transfer of her residence would in most instances be well advised to include a direction in the trust instrument requiring the distribution of excess income.

C. *Personal-Residence GRIT, Personal-Residence GRAT or Outright Gift: A Method of Comparison*

Given that the use of a GRAT in connection with a personal residence appears to be feasible, what method of analysis should be used in deciding whether to select the GRAT, the GRIT or an outright gift as the vehicle for transferring a personal residence? Under the approach suggested in the discussion that follows, the GRIT and the GRAT will be first compared. Then, the more effective of these two alternatives, in terms of wealth produced for the transferee, will be compared with the outright gift.

The critical element in comparing the GRIT and the GRAT is the rate of return in the form of rental income generated by the residence. Where the rate of return attributable to rent is greater than the table rate, the GRAT would be more effective than the GRIT as a wealth-transfer device. Conversely, where the rate of return attributable to rent is less than the table rate, the GRIT would be more effective. And where the rate of return attributable to rent is equal to the table rate, the GRIT and the GRAT would be equally effective.[193]

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[191] In order to qualify as a qualified personal residence trust, it is necessary for the trust instrument to require that all income be distributed not less often than annually to the holder of the term interest. Treas. Reg. § 25.2702-5(c)(3). And since, in the case of a personal residence trust, the trust instrument must prohibit the trust from holding any asset other than the residence, Treas. Reg. § 25.2702-5(b), it would obviously not be permissible to retain excess income within the trust.

[192] For a discussion of the disadvantage inherent in the retention of the right to excess income, see supra note 84.

[193] If the table rate is set at a rate that is inappropriately high in relation to the rate of

These conclusions are driven by a fundamental difference between the GRIT and the GRAT. Whereas the income produced by a GRIT passes to the grantor and therefore does not affect the amount of wealth ultimately reaching the remainderman, the amount of income produced by a GRAT can result in either a benefit or a detriment to the remainderman. If the GRAT fails to produce sufficient income, the remainderman will suffer in the sense that the resulting deficiency must be taken out of the principal of the trust that would otherwise pass to the remainderman. If, on the other hand, the GRAT produces a surplus, the remainderman enjoys the benefit of the surplus.

While the GRAT and the GRIT are, as suggested, critically different with respect to the question of income, they function identically insofar as appreciation is concerned; all appreciation inures to the benefit of the remainderman. As a consequence, appreciation need not be considered in comparing the GRAT and the GRIT.

For example, assume that a donor is interested in transferring her residence, which has a fair market value of $1, at a time when the table rate is at 10%. Assume further that the residence would produce a rental income in the market of 10% and no appreciation. If the donor were to create a one-year GRIT, the amount of the taxable gift deemed to occur at the creation of the trust would be approximately $.909 ($ 1 / 1.10). If the donor were instead to create a one-year GRAT retaining the right to receive the sum of $.10 at the end of the year and agreeing to pay a fair-market rental of $.10 for the use of the residence during the year, the amount of the taxable gift deemed to occur at the creation of the trust would also be approximately $.909.[194] With the taxable gift for the GRAT having been held equal to the taxable gift for the GRIT by selecting an annuity payment of $ .10 with respect to the GRAT, a determination of the relative effectiveness of the two approaches is made simply by comparing the amount of wealth each would place

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return available in the form of rent in the market, the relative attractiveness of the GRIT is enhanced. Conversely, if the table rate is set at a rate that is inappropriately low in relation to the rate of return in the form of rent available in the market, the relative attractiveness of the GRAT is enhanced.

[194] The present value of the right to receive $ .10 in one year is approximately $ .0909 ($ .10 / 1.1 = approximately $ .0909). Subtracting this amount from the $ 1 contributed to the trust results in a present value for the remainder, i.e., the taxable gift, of approximately $.909. See Treas. Reg. § 25.2512-5.

in the hands of the remainderman at the end of the one-year term.

At the end of the one-year term, the remainderman of both the GRIT and the GRAT would be entitled to receive the residence with a value of $ 1. Thus, where the table rate is equal to the rate of return attributable to rent, the GRIT and the GRAT are equally effective, in terms of the wealth they produce for the remainderman on the basis of a constant gift-tax cost. This would hold true at any level of appreciation enjoyed by the trust corpus.

If, in this example, the rental value were equal to 12%, the GRAT would be the more attractive of the two approaches. For, at the end of the one-year term, the remainderman of the GRAT would be entitled to the residence with a value of $1 and $.02 in cash, the cash being equal to the $.12 in rent received from the grantor less the $.10 annuity payment. In contrast, the remainderman of the GRIT would only be entitled to the residence. Thus, with the rate of return attributable to rent greater than the table rate, the GRAT would be the more effective vehicle.

Assuming the rate of return attributable to rent were only 8% in this example, the GRIT would be more attractive than the GRAT. At the end of the one-year term, the remainderman of the GRIT would be entitled to the residence with a value of $1. The remainderman of the GRAT, on the other hand, would have been required to bear the burden of the $.10 annuity payment, while having received only $.08 in rent from the grantor (assuming once again that the grantor paid market rent). Thus, if the GRAT were utilized, the remainderman would be entitled to receive the residence, but would take it subject to a $.02 obligation. And, so, the GRIT would be superior in this example.

Once the comparison between the GRIT and the GRAT is complete, the more effective of the two must then be compared with an outright gift. To illustrate, consider the case where the fair-rental rate is 8%. As suggested, the GRIT in this context would generate $ 1 in wealth for the remainderman, which would exceed the wealth generated by the GRAT. If a comparable outright gift of $ .909 were made instead, the donee would have $ .98172 (.909 x 1.08) at the end of one year. Thus, of the three alternative approaches, the GRIT would be the most effective where the rental value is at 8%, in terms of wealth produced for the transferee on the basis of a constant gift-tax cost. In the case where the rental value is at 12%, the GRAT, as suggested, is more effective than

the GRIT, producing $1.02 in wealth for the remainderman (the trustee receiving $.12 in rent and paying to the grantor an annuity amount of $.10) at the end of the one-year term. Contrast this outcome with the results that would occur if a comparable outright gift of $.909 were made instead. At the end of one year, the donee of the outright gift would have $1.01808 in wealth (.909 x 1.12), assuming the gifted sum were invested in a residence generating a rental of 12% or in an investment vehicle of a similar nature. Thus, in this case, the GRAT would be more effective than either the GRIT or the outright gift.

Where the rental rate of return is equal to the table rate, the GRIT and the GRAT are equally attractive. Both produce $1 in wealth for the remainderman at the end of the one-year term (assuming no appreciation). And, in this context, the outright gift is also in parity, producing $1 in wealth for a donee at the end of a one-year period: If $.909 were invested for one year in a vehicle generating 10%, the amount available at the end of the year would be $1.

It would seem, therefore, that where the rental rate of return is less than or greater than the table rate, the outright gift is not the most effective alternative. On the other hand, where the rental rate of return is equal to the table rate, the outright gift, the GRIT and the GRAT all produce, on the basis of a constant gift-tax cost, the same amount of wealth for the transferee — thus rendering all of the alternatives equally attractive.

Each example thus far has assumed that the residence neither appreciated nor depreciated during the one-year period under examination. If it had been assumed that the residence appreciated, the conclusion as to the optimal transfer method would not have changed. For, as previously suggested, appreciation does not have an impact on the comparison between the GRIT and the GRAT, given that the effect of appreciation in both cases is identical — it inures to the benefit of the remainderman. And, in the context of comparing the more effective of the GRIT or the GRAT with the outright gift, the presence of appreciation would never make the outright gift more attractive. Indeed, appreciation would make the GRIT or the GRAT more attractive than an outright gift, since the amount generating appreciation for the transferee is greater in the

case of a GRIT[195] or a GRAT[196] than in the case of an outright gift.[197]

To illustrate, consider a contribution of a residence with a value of $1 to a GRIT or a GRAT. Any appreciation generated for the remainderman by the residence would accrue with respect to the entire value of the residence ($1), whereas the lesser sum of $.909 (assuming a table rate of 10%, this would be the amount of a comparable outright gift) would be available to generate appreciation for the donee in the case of a comparable outright gift.

On the other hand, if depreciation in the value of the residence had been assumed to occur in any of these examples, the ultimate

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[195] For a discussion of leverage benefit in the context of a GRIT, see supra notes 48-52 and accompanying text. While the cited portion of the article focuses on the effect of leverage in the context of a GRIT created prior to the enactment of I.R.C. § 2702, the effect of leverage should be the same in the case of a personal-residence GRIT created after the enactment of I.R.C. § 2702.

[196] In the case of a GRAT, assuming the trust is enjoying a rate of return in excess of the table rate, any additional return in the form of appreciation generated in either the annuity pot or the remainderman's pot would inure to the benefit of the remainderman. In contrast, in the case of a comparable outright gift, the amount generating appreciation for the donee would be less — i.e., less than the sum of the amounts in the annuity and remainderman's pot, which is the amount that would be generating appreciation in effect for the benefit of the remainderman of a GRAT.

[197] Both the GRIT and the GRAT may also enjoy an income tax advantage over the outright gift where the residence appreciates in value. In the case of an outright gift, the donee's basis in the residence is, as a general matter, equal to the basis that the donor had in the residence prior to making the gift. I.R.C. § 1015. Thus, any appreciation accruing during the donor's and donee's ownership of the residence would ultimately be subject to the income tax upon a sale by the donee.

In the case of a GRIT or a GRAT, however, it may be possible to avoid the payment of income tax on all such appreciation. If the entire GRIT or GRAT is treated as a grantor trust, the trust may well be permitted to sell the residence to the grantor before it terminates without being required to recognize any gain on the sale. See Rev. Rul. 85-13, 1985-1 C.B. 184. Compare Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984) (where the court refused to disregard for income tax purposes a trust deemed under the grantor-trust rules to be owned by the grantor). Upon consummation of the sale, the corpus of the trust no longer consists of appreciated property. Instead, the corpus consists of cash equal in amount to the value of the residence at the time of sale. When the trust is terminated, the cash is distributed to the remainderman; the appreciation in the value of the residence accruing during the grantor's and trust's ownership becomes taxable to the grantor if the grantor sells it. But if the grantor should retain the residence until death, none of the appreciation is ever subject to tax. See I.R.C. § 1014. In effect, this technique permits the grantor to exclude from her estate for transfer-tax purposes the appreciation accruing during the trust's ownership of the residence without being required to suffer the basis disadvantage typically associated with the making of an inter vivos gift. As a matter of policy, it would seem inappropriate to permit taxpayers to enjoy all of the advantages inherent in the making of an inter vivos gift without forcing them to suffer some offsetting disadvantage. See supra note 115.

conclusion might have been different. Where depreciation occurs, the outright gift might well prove to be more attractive than either a GRIT or a GRAT. For more wealth ultimately passing to the transferee is at risk — just as more wealth would be available to produce appreciation — in the case of a GRIT or a GRAT than in the case of an outright gift.

For example, if a contribution of a residence with a value of $1 were made to a one-year GRIT, a 50% decline in the value of the residence would leave the remainderman at the end of the year with $.50 in wealth. In contrast, the donee of a comparable outright gift of $.909 (assuming again a table rate of 10%) who suffered a 50% decline in value of the residence but nevertheless received rental income in the amount of $.0909 (in order to isolate the effect of the decline in value, it is assumed that the residence would generate a rate of return in the form of rent of 10%, the table rate, thus eliminating the possibility of rate benefit or loss[198]) would be left at the end of one year with $.5454. When depreciation occurs, therefore, the outright gift might produce a more tax-effective outcome than either the GRIT or the GRAT.

In sum, in deciding whether to effect a transfer of a personal residence by a GRIT, a GRAT, or an outright gift, a critical determinant is the rental rate of return. Where the rental rate of return exceeds the table rate, the GRAT is more effective than the GRIT; and where it is less than the table rate, the GRIT is more effective than the GRAT. In the case where the rental rate of return is equal to the table rate, the outright gift, the GRIT and the GRAT are in parity. While appreciation in the value of the residence makes the GRIT or the GRAT more attractive than the outright gift, a decline in the value of the residence would tend to enhance the relative attractiveness of the outright gift. For the wealth created for the transferee on account of appreciation is greater in the context of a GRAT or a GRIT than in the case of an outright gift. In contrast, a decline in the value of the residence might render the outright gift preferable to either the GRIT or the GRAT.

While, on the basis of this analysis, it appears that an outright gift of a personal residence would never be more effective than a GRIT or a GRAT (except in the case where a decline in value occurs), it is conceivable that a donor might nevertheless choose

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[198] See supra notes 16-27 and accompanying text.

(even where depreciation is not considered likely to occur) to effect a transfer of her residence by outright gift. Where, for example, there is a concern about the donor's health, a GRIT or a GRAT might not be indicated. For if the donor were to die within the income-retention or annuity-retention period, the GRIT and perhaps the GRAT as well would, because of the application of section 2036, be taxed more harshly than a comparable outright gift.[199]

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[199] In the event the grantor of a GRIT were to die within the income-retention period, appreciation accruing during the term of the trust would be included in the grantor's estate under § 2036 of the Code. In effect, an income component would also be included under § 2036, and would, like appreciation, escape taxation in the grantor's estate were an outright gift to be made instead.

In the case of an outright gift, all income and appreciation accruing after the gift is made is excluded from the donor's transfer-tax base. On the other hand, where the grantor of a GRIT dies within the income-retention period, she is treated as if she had retained until the date of her death absolute ownership of the property conveyed to the trust. As a consequence, all income, as well as appreciation, accruing during the term of the trust (i.e., until the date of the grantor's death) must be included in the grantor's gross estate under § 2036.

To illustrate, assume a grantor created a one-year GRIT with a contribution of $1 in property at a time when the table rate was at 10%, thus producing a taxable gift of $.909 at the point of creation. If the grantor died a theoretical moment prior to the end of the one-year term and the value of the corpus did not change during the course of the year, the value of the corpus on the date of the grantor's death ($1) would be included in her estate. In addition, income in the amount of $.10 that the trustee presumably paid the grantor during the course of the year (assuming the trust generated a return in the form of income of 10%) would be included under § 2033. The total amount subject to tax in this case would therefore be $1.10.

If the grantor made a comparable outright gift of $.909 instead and retained the balance of $.091 (i.e., the difference between the $1 that might have been contributed to a GRIT and the amount of the outright gift, $.909), the amount subject to tax — assuming that the grantor died approximately one year after having made the gift and that the grantor earned 10% on the retained amount during the course of the year — would be $1.0091. This amount has been determined by adding the adjusted taxable gift of $.909 to the amount includible under § 2033, which consists of the retained amount of $.091 together with interest earned during the year (at 10%) on the retained amount of $.0091.

In contrast, as suggested, the amount subject to tax where the grantor of the GRIT died just prior to the expiration of the income-retention period would be $1.10. Thus, the GRIT generates a greater tax burden than a comparable outright gift where the grantor dies within the income-retention period. The increased burden results from the exclusion of post-gift income available in the case of the outright gift, an exclusion for which there is not a counterpart in the context of a GRIT where the grantor dies prior to the expiration of the income interest. And if appreciation accrued during the term of the trust, this disparity in tax burden would be even greater — given that appreciation is excluded in the case of an outright gift but made subject to tax where § 2036 is triggered.

In the case of a GRAT as well, it would seem that it is potentially possible for appreciation and what is, in effect, income accruing during the term of the trust to be included in the grantor's estate under § 2036 if the grantor dies within the annuity-retention period. See Rev. Rul. 82-105, 1982-1 C.B. 133. Under the ruling, however, unlike the GRIT, appreciation

Consequently, where the donor has health problems, an outright gift would be the more attractive alternative. It would at least assure the donor that all post-gift appreciation and income would be excluded from her transfer-tax base, thus avoiding the risk of incurring the harsher tax treatment potentially applicable in the case of a GRIT or GRAT where the grantor dies within the retention period.[200]

Where the donor is concerned about relinquishing control of her assets, the GRIT or the GRAT might be the appropriate vehicle despite the donor's health problems. Given that a donor with control concerns would probably be unwilling to make an outright gift of her house, the GRIT or the GRAT, enabling the donor to continue to enjoy the use of the residence during the retention period, might be attractive despite any concerns about the donor's life expectancy. Although, in the event of the donor's death within the retention period, some or all of the benefits that the donor hoped to derive from the GRAT or the GRIT might be forfeited, it is possible that no loss beyond this forfeiture would be suffered.[201]

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accruing after the creation of a GRAT would not always be includible under § 2036. Nor would the ruling require in all cases the inclusion of an income component where the grantor of a GRAT dies prior to the expiration of the annuity interest. For a further discussion of this issue, see infra notes 214-269 and accompanying text.

[200] Id.

[201] In the case of a GRIT where the grantor dies within the income-retention period, I.R.C. § 2036 requires, in essence, that the grantor be treated as if she did not create the trust. Thus, all of the income and appreciation accruing after the creation of the trust must be included in the grantor's gross estate. If the grantor did not create the GRIT but instead retained ownership of the property in question, all of the appreciation and income accruing with respect to the property until the death of the grantor would, of course, be includible in her estate under I.R.C. § 2033. It would appear therefore that a grantor who creates a GRIT and then dies within the retention period is in no worse position than she would be in if she instead retained absolute ownership of the property - thus, assuring that no loss, beyond the failure to realize the benefits of the GRIT, is sustained on account of the grantor's death within the retention period.

This does not, however, hold true in all cases. Where the grantor has previously utilized her unified credit, the grantor of a GRIT does incur a cost that would not be suffered if she did not create the trust. Upon creating a GRIT, the grantor must pay a gift tax on the value of the remainder (and on the value of the income interest as well if I.R.C. § 2702 is applicable — i.e., if the GRIT does not constitute a personal residence trust or a qualified personal residence trust within the meaning of Treas. Reg. § 25.2702-5); and if the GRIT were not created, no such gift tax would be payable. And so a grantor who creates a GRIT loses the opportunity to earn income on the gift-tax money paid to the IRS upon its creation; and if she should die within the retention period, she suffers this loss unnecessarily, for none of the GRIT advantages are secured.

If, on the other hand, the creation of the GRIT would not generate a gift-tax obligation

Thus, a donor disinclined to relinquish immediate control of her assets might be willing to create a GRIT or a GRAT, hoping to live beyond the retention period in order to enjoy the benefits these vehicles offer while knowing that a death within the retention period could result in nothing more than a failure to realize these benefits.[202]

A donor with a portfolio of diversified investments would be required to decide whether it would be preferable to select an investment or her residence in structuring a wealth-transfer strategy. In making the decision, non-tax factors, such as control concerns, might have importance.[203] Indeed, a donor might find such non-tax

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because of the availability of the unified credit — and assuming there was no inclination to make other gifts and therefore no need to conserve the gift-tax unified credit — then, of course, no cost would be incurred in connection with the use of the GRIT. Indeed, in this context (i.e., where the credit is available), it would seem that a taxpayer willing to create a GRIT but unwilling, because of control concerns, to make an outright gift would be well advised to go forward with the GRIT — even if there is substantial doubt about the taxpayer surviving the retention period. After all, if the taxpayer creates a GRIT and survives, the benefits of the GRIT are secured; and if she does not survive, she merely fails to enjoy the benefits she had hoped to achieve and suffers no cost for having made the attempt to secure these benefits.

In the case of the GRAT, the amount that must be included under § 2036 on account of the grantor's death occurring within the annuity-retention period is not clear. It does appear, however, likely that some or all of the benefits that the grantor hoped to enjoy at the time of creating the GRAT might be forfeited where the grantor dies within the annuity-retention period. For a discussion of this issue, see infra notes 214-269 and accompanying text. As in the case of the GRIT, whether or not any additional cost, beyond the forfeiture of the GRAT benefits, would be sustained depends upon the availability of the unified credit. If the credit is available so that the creation of the GRAT would not trigger an obligation to pay a gift tax — and because there is no inclination to make outright gifts, there is no need to conserve the credit — then no cost is incurred in connection with the utilization of the GRAT. If the grantor dies within the annuity-retention period, the GRAT benefits are not realized, but no cost, beyond the failure to realize these benefits, is sustained.

Where, on the other hand, the credit has been previously applied, the creation of a GRAT produces an obligation to pay a gift tax. And if the grantor dies within the annuity-retention period, a failure to realize some, or perhaps all, of the GRAT benefits results; in addition, the income that the grantor could have earned on the gift-tax money paid to the IRS is lost, thus imposing an affirmative cost on the use of the GRAT.

[202] But see supra note 201 for a discussion of the cost associated with the obligation to pay a gift tax at the time the trust is created.

[203] A donor concerned about relinquishing control of her assets might be more inclined, for example, to transfer a marketable security than her residence or her interest in the family business. On the other hand, it is conceivable that another donor, equally concerned about control issues, might be more willing to transfer her residence or a marketable security than her business interest. And, of course, control issues could affect the selection of method of transfer as well. A donor having difficulty relinquishing control of her assets

concerns to be determinative, even though a different decision would be reached were it to be made solely on the basis of a tax-effectiveness analysis. Assume that the donor is indifferent in terms of non-tax concerns and is therefore only interested in choosing an asset to transfer and a method by which to transfer it that will produce the most tax-effective outcome. In order to select the appropriate combination of method and asset for a donor so inclined, a comparative inquiry must be made: Which combination will maximize the wealth produced for the transferee on the basis of a constant gift-tax cost?

When such an inquiry is made, certain conclusions become apparent. These conclusions are somewhat similar to those reached in the context of selecting the most effective method of transfer for a donor owning a residence and no other asset. And, for the moment, they are set forth on the assumption that the assets under inquiry will neither appreciate nor depreciate during the period at issue. Where the rates of return generated by the various investments held by the donor, including the rate of return her residence would generate were it rented, equal the table rate in effect at the time of transfer, the GRIT, the GRAT and the outright gift are in parity. That is to say, they would make equally attractive methods of transfer.

Where these rates of return are all less than the table rate in effect at the time of transfer, the GRIT is the most effective method of transfer. Since, with the enactment of section 2702, the only type of asset that, as a practical matter, a GRIT can accommodate is a personal residence, a contribution of the donor's residence to a GRIT would be the approach of choice.[204]

Where these rates of return are all in excess of the table rate at

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might be more inclined to employ a GRIT or a GRAT than make an outright gift, since a GRIT or a GRAT would at least enable the donor to enjoy continued access to the transferred asset.

[204] Although I.R.C. § 2702 does not preclude a grantor from creating a trust while retaining an income interest for a fixed period of time, it discourages grantors from doing so. The section provides that the creation of such a trust is to be treated for gift-tax purposes in the same fashion as an outright gift would be treated: The entire amount transferred (or contributed to the trust) is subject to gift tax. While, however, the outright gift enables the donor to exclude from her transfer-tax base all post-gift income and appreciation, the use of the trust would result in the inclusion in the grantor's transfer-tax base of post-transfer income and possibly (if the grantor were to die within the income-retention period) appreciation as well.

the time of transfer, the GRAT would be the most effective method of transfer. Selecting the asset to contribute to the GRAT would be a function of rate of return. The asset yielding the highest rate of return would maximize the amount of wealth in the hands of the remainderman. If all of the donor's assets are yielding a rate of return that is equal and in excess of the table rate, a contribution of any one of the assets to a GRAT would produce the same amount of wealth for the transferee. Thus, in these circumstances, all of the donor's assets would make equally attractive candidates for a contribution to a GRAT, thereby enabling the donor to make the selection solely on the basis of non-tax considerations.

A more complicated situation is presented where the donor holds assets that yield different rates of return, some above and some below the table rate. Given that, in this context, assets are available for transfer that yield a rate of return in excess of the table rate, the GRAT would be the transfer vehicle of choice. As in the case where all of the donor's assets yield a rate of return in excess of the table rate, the asset selected for contribution to the GRAT should be the one yielding the highest rate.

Consider the case where all of the donor's assets are yielding a rate of return that is equal to the table rate. Assume, for example, that, at a time when the table rate is at 10%, the donor owns stock yielding 10% and a personal residence that, if rented, would yield 10%. If the residence, with a value of $1, is contributed to a one-year GRIT, the donor is deemed to have made a taxable gift of $.909 (1 / 1.10) and the remainderman will have at the end of the year wealth in the amount of $1. To compare these results with those obtainable with a GRAT, it is necessary to hypothesize a GRAT that will produce the same taxable gift and that will enable the donor to use the residence during the one-year term for a rental that is equal to the annuity amount payable to the donor. Assume that the donor contributes the residence, with a value of $1, subject to a lease obligating the donor to pay a fair-rental value (10%), to a one-year GRAT entitling the donor to receive an annuity amount of $.10 at the end of the year. In these circumstances, the GRAT remainderman would have wealth in her hands in the amount of $1 at the end of the year, the same amount of wealth that the GRIT remainderman would have. A comparable outright gift of the residence (value of $.909) would leave the donee with $1

at the end of the year (assuming the residence generated a rental return of 10% for the donee).

If, in the alternative, the donor were to transfer the stock by GRAT or outright gift — the GRIT being unavailable, as a practical matter, with respect to an asset other than the donor's personal residence[205] — the same results would obtain. That is to say, the transferee would have wealth in the amount of $1 at the end of the year in the case of both the GRAT and the outright gift.

With respect to the GRAT, the trustee would receive $.10 in dividend and would be required to pay the donor the annuity amount of $.10 (this annuity amount is again selected in order hold the gift-tax constant) at the end of the year, thus leaving the remainderman with the stock having a value of $1. With respect to an outright gift of the stock with a value of $.909 (which again holds the gift-tax cost constant), the donee would receive a dividend of 10% and would therefore have $1 in wealth at the end of the year.

Thus, where the assets held by the donor generate a rate of return equal to the table rate, the GRIT, the GRAT and the outright gift are equally effective methods of transfer. So, in these circumstances, the donor remains free to select an asset for transfer and a method by which to transfer it on the basis of non-tax motivations.

To illustrate the case where all of the donor's assets are yielding a rate of return less than the table rate, assume that, at a time when the table rate is at 10%, the donor owns stock yielding 8% and a personal residence that, if rented, would yield 8%. In this context, the opportunity for rate benefit[206] renders the GRIT preferable to an outright gift. Assuming the contribution of the donor's residence,[207] with a value of $1, to a one-year GRIT, the remainderman would have in her hands property with a value of $1 at the expiration of the one-year term. On the other hand, a comparable outright gift of $.909 (comparable in the sense that the taxable gift deemed to occur upon the creation the GRIT would be $.909) would leave the donee with only $.98172 at the end of one year (if the donee invested the gifted sum in an investment yielding 8%,

[205] See supra notes 72-105 and accompanying text.

[206] For a discussion of rate benefit, see supra notes 16-27 and accompanying text.

[207] Of course, a contribution of the grantor's stock to a GRIT would not be tax effective, inasmuch as the zero-value rule of I.R.C. § 2702 would apply — making the entire value of the stock contributed to the trust subject to gift tax. On the other hand, a personal residence could be contributed to a GRIT without triggering the zero-value rule.

which is the rate of return generated by the donor's assets). Thus, because of rate benefit, the GRIT would produce more wealth for the remainderman than the outright gift would generate for the donee, making the GRIT more effective than an outright gift.

The GRIT would also be more effective than a GRAT in these circumstances. In order to hold the gift-tax cost constant (i.e., trigger a taxable gift of $.909), it would be necessary to hypothesize that the donor, having contributed an asset with a value of $1 to a one-year GRAT, retained the right to receive an annuity amount of $.10 at the end of the one-year term.[208] At the end of the year, the remainderman would only have $.98 in wealth ($.08 of return would be generated during the year if the trustee invested the corpus in an asset yielding 8%, but since the trustee would be required to pay the annuity amount of $.10 to the donor, only $.98 would be available for the remainderman). Thus the GRIT containing the donor's residence would also be more effective than the GRAT.

To illustrate the case where all of the donor's investments are yielding a rate of return in excess of the table rate, assume that, at a time when the table rate is at 10%, the donor owns stock yielding 12%, a personal residence that, if rented, would yield 14%, and stock yielding 15%. A contribution of any of these assets to a GRAT would provide the remainderman with more wealth than would a contribution of the donor's residence to a GRIT. The contribution of the donor's residence with a value of $1 to a one-year GRIT would place wealth in the amount of $1 in the hands of the remainderman at the end of the year. In contrast, a contribution of any of the donor's assets to a one-year GRAT requiring — in order to hold the gift-tax cost constant — an annuity payment to the donor at the end of the year of $.10 would produce more than $1 in wealth for the remainderman.

More specifically, a contribution to such a GRAT of the stock yielding 15% would make available to the remainderman at the end of the year wealth in the amount of $1.05 (although the trust would generate $.15 in earnings, the trustee would be required to pay the annuity amount of $.10 to the donor). A contribution of the stock yielding 12% instead would make available to the remainderman at the end of the year wealth in the amount of $1.02

[208] Treas. Reg. § 20.2031-7(f).

($.12 in earnings being generated by the trust corpus with $.10 in annuity payment being made to the donor). A contribution of the donor's residence to such a GRAT with the donor leasing it back at a fair rental (14%) would produce wealth for the remainderman at the end of the one-year term in the amount of $1.04 (the trustee, having received $.14 in rent from the donor, would be required to return to her $.10 of annuity payment). Thus, in these circumstances, a contribution of the stock yielding 15% to a GRAT having the terms hypothesized would place more wealth in the hands of the remainderman than would a contribution of any other asset owned by the donor to a GRAT or a contribution of the donor's residence to a GRIT.

The contribution of the 15% stock to the GRAT described would also be more effective than an outright gift of any asset owned by the donor. A comparable outright gift of the 15% stock with a value of $.909 would produce $1.04535 for the donee at the end of one year (.909 x 1.15) — whereas, as noted above, the GRAT containing the 15% stock would produce $1.05 for the remainderman. Of course, a comparable outright gift ($.909 in value) of either of the donor's lower-yielding assets would produce even less wealth for a donee. Thus, the contribution of the 15% stock to the GRAT would be more effective than an outright gift of any of the donor's assets.

The last and most complicated case to illustrate is where some of the assets held by the donor yield a rate of return in excess of the table rate and some yield a rate of return that is less than the table rate. Consider, for example, a donor who holds stock yielding 12%, stock yielding 8%, and a personal residence that, if rented, would yield 11%, at a time when the table rate is at 10%. In these circumstances, a contribution of the residence with a value of $1 to a one-year GRIT, triggering a taxable gift of $.909, would place in the hands of the remainderman wealth in the amount of $1 at the end of the year. Contrast this with a contribution of the residence (with the grantor retaining a fair-rental-value lease) to a one-year GRAT requiring an annuity payment of $.10 at the end of the year. Such a contribution would trigger the same taxable gift as in the case of the GRIT. Yet, it would produce wealth for the remainderman at the end of the year in the amount of $1.01. The remainderman would receive the residence with a value of $1 and $.01 in cash, representing the excess of the rental income of $.11 received

by the trustee over the annuity payment of $.10 paid by the trustee to the donor.

A contribution of the stock yielding 8% to a one-year GRAT entitling the donor to receive $.10 at the end of the year would leave the remainderman with wealth in the amount of $.98 at the end of the year (the entire earnings of $.08 generated by the trust and $.02 of trust principal would be used to make the annuity payment of $.10 to the donor). On the other hand, a contribution of the stock yielding 12% to a GRAT requiring the same annuity payment would produce for the remainderman at the end of one year wealth in the amount of $1.02. Thus, of all of the GRIT and GRAT alternatives considered in this context, the one that would maximize the remainderman's wealth is the GRAT funded with the 12% stock.

The final alternative to consider is the outright gift. To determine whether such a gift would be more effective than a GRAT funded with the 12% stock, it is necessary to ascertain the amount of wealth that each of the donor's assets, if gifted in an amount designed to hold the gift-tax constant (i.e., $.909), would produce for the donee. Reflected below is the amount of wealth that the donee would have at the end of a year if given the indicated asset with a value on the date of the gift of $.909 (assuming the donee retained the asset and that it continued to produce the same yield it generated in the hands of the donor):

12% Stock	$1.01808	(.909 x 1.12)
Personal Residence	$1.00899	(.909 x 1.11)
8% Stock	$ .98172	(.909 x 1.08)

It is apparent that an outright gift of the 12% stock would produce more wealth for the donee than would such a gift of either the 8% stock or the residence. However, as mentioned above, the GRAT funded with the 12% stock would produce even more wealth for the remainderman ($1.02). Thus, in these circumstances, the GRAT funded with the 12% stock would create the optimal outcome from the viewpoint of tax effectiveness.

In each of the hypotheticals used to illustrate the most effective approach in the context of a diversified portfolio, it was assumed, as indicated at the outset of this discussion, that the asset gifted or conveyed to the trustee would neither appreciate nor depreciate. As in the case of the non-diversified portfolio — where the donor

owned a residence and no other asset — the conclusions reached would not have been any different had appreciation been hypothesized.[209] For, as suggested,[210] in the case of both the GRIT and the GRAT, appreciation has the same effect: it inures to the benefit of the remainderman. Thus, in comparing the GRIT and the GRAT, whether or not appreciation is assumed to occur would not alter the GRIT-GRAT choice. In comparing the more effective of the GRIT or the GRAT with an outright gift, the effect of appreciation would always be to make the GRIT or the GRAT more attractive than the outright gift. Given that, in all of the cases considered, it was concluded that either the GRIT or the GRAT would be more effective than — or at least as effective as — an outright gift,[211] hypothesizing the occurrence of appreciation would simply make the GRIT or the GRAT more attractive and would, therefore, not have any impact in the final analysis.

Depreciation, on the other hand, tends to enhance the attractiveness of an outright gift as compared to a GRIT or a GRAT, which is the case in the context of a non-diversified portfolio as well.[212] As a consequence, it is possible that one might appropriately decide, where it is anticipated that the asset to be transferred might decline in value, to make an outright gift even though a rate-of-return analysis would suggest the use of a GRIT or a GRAT.

In sum, in choosing among the GRIT, the GRAT and the outright gift, the most critical determinant is the relationship between the rate of return generated by the donor's assets and the table rate in effect at the time of transfer. In most cases, the GRIT or the GRAT are more effective than the outright gift. Where, however, the donor's assets yield a rate of return equal to the table rate, the three methods of transfer are in parity. Nevertheless, despite *ex-ante* parity, post-transfer appreciation would make the

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[209] See supra notes 195-196 and accompanying text.

[210] See supra notes 195-196 and accompanying text.

[211] As suggested, the outright gift is in parity with the GRIT and the GRAT where all of the donor's assets are yielding a rate of return equal to the table rate. Thus, in this context, the outright gift is no less attractive than either the GRIT or the GRAT. If appreciation or depreciation were to occur, however, the outright gift might become more or less attractive than the other alternatives — despite the fact that all of the donor's investments yield a rate of return equal to the table rate.

[212] See supra note 196 and accompanying text.

GRIT or the GRAT more effective than the outright gift; conversely, post-transfer depreciation might make the outright gift more effective than the GRIT or the GRAT.[213]

VIII. GRAT's and the Estate Tax

With the enactment of section 2702 and its zero-value rule,[214] grantors contemplating the retention of an interest in the trusts they create will be disinclined to retain income interests, either for a term of years or for life. Instead, they will be more likely to retain either an annuity or a unitrust interest, thereby avoiding the zero-value rule. Where a grantor creates a trust and retains an annuity or unitrust interest and then dies within the retention period, it will be necessary to determine the estate-tax consequence under section 2036.[215] This Part of the article focuses on the application of section 2036 to a retained annuity.

A. *The Service's Approach*

The Service's approach with respect to a retained annuity interest for section 2036 purposes is set forth in Rev. Rul. 82-105.[216] The ruling concludes that the amount to be included in the gross estate under section 2036 where the grantor dies within the retention period is determined by capitalizing the annuity amount on the basis of the table rate in effect at the time of death.[217]

So, for example, assume a grantor were to contribute $100 to a GRAT while retaining an annuity of $10 for a term of years and then to die within the term at a time when the table rate is at 10%. The portion of the trust required to be included in the gross estate, according to the ruling, is ascertained by capitalizing the $10 annuity amount using the table rate of 10%. In other words, the amount to be included in the gross estate is equal to the amount that would produce a return of $10 on the assumption that

[213] It is conceivable that post-transfer depreciation, while enhancing the relative attractiveness of the outright gift, might not be sufficient to outweigh the other advantages (e.g., rate benefit) offered by the GRIT or the GRAT.

[214] I.R.C. § 2702.

[215] I.R.C. § 2036.

[216] 1982-1 C.B. 133.

[217] It is not clear how the Service would apply the ruling in the case of a GRAT where the annuity amount does not remain constant.

investments yield 10%. Thus, in this example, the section 2036 inclusion is equal to $100; for that is the amount that would generate a return of $10 if invested in a vehicle yielding 10%.

Interestingly, the amount to be included would not be any different even if the corpus of the trust appreciated during its term. So if, in this example, the value of the corpus of the trust on the date of death were, say, $1,000,000, the amount to be included under section 2036 would nevertheless be $100 — i.e., the amount that would produce a return of $10 if invested at 10%.[218]

If, on the other hand, the value of the corpus decreased during the term of the trust, the ruling would permit the decrease to be taken into account. The amount of the inclusion under section 2036 is, according to the ruling, equal to the lesser of the capitalized amount or the value of the corpus on the date of death. So, in the example just discussed, the inclusion would have been less than the capitalized amount of $100 had the value of the corpus decreased during the term of the trust; thus, assuming the value of the corpus decreased to $50 by the time of the grantor's death, the amount of the inclusion would be $50.

While one might conclude on the basis of this analysis that, under the ruling, appreciation does not have an impact on the amount of the section 2036 inclusion — unlike a decrease in value, which may have an impact — such a conclusion would not hold true in all cases. Where the capitalized amount necessary to produce the annuity, determined at the time of death, exceeds the amount initially contributed to the trust, some or all of the appreciation that may have accrued during the term of the trust will be includible under section 2036.

Consider, for example, a contribution of $100 to a GRAT with a retained annuity amount of $10 where the grantor dies within the retention period. Assuming a table rate of 5% at the time of the grantor's death, the capitalized amount necessary to produce the annuity of $10 would be equal to $200 (10 / .05). If the corpus of the trust appreciated to a value of $200 by the time of the grantor's death, the entire corpus would be includible under section 2036, thus making all of the appreciation subject to estate tax. And

[218] For an example where the application of the ruling would result in excluding appreciation from the grantor's gross estate even though at the creation of the GRAT no taxable gift is deemed to occur, see supra note 140.

if the value of the corpus on the date of death were less than the capitalized amount ($200), the section 2036 inclusion would be equal to that lesser sum. Indeed, if the value of the corpus did not appreciate at all, remaining instead at its initial value of $100, the includible amount would be $100.

Pre-death appreciation, if any, is taxable in this example because the capitalized amount (determined at death) is greater than the amount initially contributed to the trust. The portion of such appreciation that is subject to tax is not, however, without limit: The total section 2036 inclusion cannot exceed the capitalized amount (in this example, $200), which places a ceiling on the amount of includible appreciation. Thus, the lower the table rate at the time of death, the greater the capitalized amount will be. As the capitalized amount increases, the portion of any pre-death appreciation that is exposed to the estate tax also increases.

Where the capitalized amount necessary to produce the annuity is less than the value of the corpus on the date of death, the ruling requires only the lesser amount to be included under section 2036, even though the corpus has not decreased in value during the term of the trust. To illustrate, assume a grantor makes a contribution of $100 to a GRAT retaining the right to receive an annuity payment of $10. If the grantor died within the retention period at a time when the table rate were 20%, the capitalized amount would be equal to $50 (10 / .20). Even assuming the value of the corpus of the trust were still at $100 at the time of the grantor's death, the amount includible under section 2036 would be equal to the capitalized amount of $50.

Although the corpus of the trust did not suffer a decrease in value in this example, the amount includible under section 2036 is nevertheless less than both the value of the property initially contributed to the trust and the value of the corpus on the date of death. Thus, the higher the table rate in effect at the time of death, the lower the capitalized amount necessary to produce the annuity will be, thereby shrinking the amount of the section 2036 inclusion.

In sum, the ruling does not include appreciation in the gross estate in all cases where the grantor dies within the retention period. Where, however, the capitalized amount determined at the time of death is greater than the amount initially contributed to the trust, some or all of the appreciation is taxable. Unlike the approach

taken with respect to appreciation, the ruling permits a decline in the value of the corpus to be taken into account without regard to the capitalized amount necessary to produce the annuity. Finally, even in the absence of a decline in the value of the corpus, the inclusion amount could be less than the amount initially contributed to the trust where the table rate in effect at the time of death is high enough to produce a capitalized amount that is less than the value of the property contributed at inception.[219]

By requiring that the capitalized amount be determined on the basis of the table rate in effect at the time of death, the ruling makes the table rate in effect at the time of the creation of the GRAT irrelevant. The failure to consider the table rate in effect at the time of creation could be particularly problematic where the retained annuity amount is less than the annuity amount that

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[219] From the discussion in text, it would appear that the ruling has a bias in favor of recognizing for I.R.C. § 2036 purposes a decline in value as opposed to appreciation in value. In other words, while a decline in value is taken into account without regard to the interest rate, appreciation is made subject to inclusion only if the interest rate is low enough at the time of death to produce a capitalized amount that is greater than the amount initially contributed to the trust. In the abstract, one might ordinarily assume that if the Service were to have a bias, it would be in favor of making appreciation subject to tax and making a decline in value irrelevant to the analysis of the § 2036 inclusion. The Service's bias in the ruling is, perhaps, more easily understood when the marital and charitable deductions are considered.

In the ruling, the grantor had created a charitable remainder annuity trust. As a consequence, the entire amount of the § 2036 inclusion was deductible as a charitable contribution under I.R.C. § 2055. Therefore, the only context in which the § 2036 inclusion and the offsetting § 2055 deduction could have an impact would be in calculating the marital deduction. Prior to the enactment of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403, 95 Stat. 172, 403, the marital deduction was equal to the greater of 50% of the adjusted gross estate or $250,000. And so, in years prior to 1982, the amount of the gross estate affected the computation of the marital deduction: Once the adjusted gross estate exceeded $500,000, every additional dollar of inclusion would generate an additional $.50 of marital deduction even if the inclusion were offset by a deduction such as the charitable deduction. Given the interaction of the § 2036 inclusion, the § 2055 charitable deduction and the computation of the marital deduction, it is not surprising that the ruling adopts a bias in favor of taking decreases in value into account.

Under current law, however, the marital deduction being unlimited, it is no longer dependent on the computation of the gross estate. Consequently, there is no longer a need, from the Service's viewpoint, to maintain the bias. Indeed, with respect to a GRAT, more tax would be generated if the bias were reversed. In other words, in the GRAT context, no charitable deduction is available for the remainder interest — unlike the charitable remainder annuity trust in the ruling — which makes the amount of the § 2036 inclusion critical. If the inclusion rule required appreciation to be taken into account in all cases, which would be different from the position taken in the ruling, more tax revenue would be generated.

would be retained if set to equal the return that the table (in effect at the time the trust is created) assumes will be produced.

To illustrate, assume that a grantor contributes $100 to a one-year GRAT at a time when the table rate is at 10% and retains the right to receive an annuity payment of $1 — which is obviously less than the $10 return the table assumes will be produced — at the end of the year. If the grantor were to die within the one-year term and the table rate were still 10% at the time of death, the amount includible under section 2036 according to the ruling would be $10 (the capitalized amount necessary to produce an annuity of $1 assuming an interest rate of 10%). Yet the remainderman is entitled to receive the entire corpus of the trust of $100 (assuming neither appreciation nor depreciation in the corpus during the term of the trust). On this analysis, it appears that a taxable transfer of $10 (the amount includible under section 2036) places $100 of wealth into the hands of the remainderman.

If this computation of the section 2036 inclusion is correct, a tax-free transfer of wealth has occurred[220] unless an adjusted taxable gift is deemed to have been made in connection with the creation of the trust.[221] The ruling does not address whether an adjusted taxable gift is deemed to occur in this context — or, put differently, whether, and to what extent, the inclusion of the gift in the gross estate would preclude it from being treated as an adjusted taxable gift.[222] It is not surprising, however, that the Service chose to ignore the adjusted-taxable-gift issue in the ruling; for the creation of the charitable remainder annuity trust at issue in the ruling[223] did not produce a taxable gift[224] and, therefore, could not be the predicate for an adjusted taxable gift.[225]

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[220] In subjecting only $10 to transfer tax in this context, the ruling holds to its bias. That is, the amount that it exposes to tax is certainly less than what might be includible under other interpretations of I.R.C. § 2036. See infra notes 228-246 and accompanying text.

[221] See I.R.C. § 2001(b)(2). This section defines the term "adjusted taxable gift" and requires that they be included in the computation of the estate tax. Id.

[222] See I.R.C. § 2001(b). This section provides that, if a gift is includible in the gross estate, it does not constitute an adjusted taxable gift. Id.

[223] It should be pointed out that the Service did not analyze in the ruling the gift-tax consequences associated with the creation of the trust.

[224] Since the annuity interest was retained by the grantor, it could not have been the predicate for a taxable gift. Treas. Reg. § 25.2511-1. And, of course, the creation of the remainder interest, which passed to charity, did not produce a taxable gift. I.R.C. § 2522.

[225] See I.R.C. § 2001(b). Section 2001(b) defines the term "adjusted taxable gift" as a taxable gift that is made after December 31, 1976. Consequently, if the creation of the trust

With the enactment of section 2702, the GRAT may well become a popular wealth-transfer technique. Because the remainderman of a GRAT is not a charity, it will be necessary for the Service to consider the adjusted-taxable-gift issue that it was able to avoid in the ruling. Presumably, in the context of the example just discussed, the Service would take the position that since only 10% of the corpus of the trust is includible in the grantor's gross estate under section 2036 (inclusion of $10 / corpus on the date of death of $100), only 10% of the taxable gift deemed to occur at the creation of the trust should be eliminated as an adjusted taxable gift on account of its inclusion in the gross estate.

If the Service adopts this reasoning, the amount subject to transfer tax in the example under consideration (assuming again the death of the grantor within the one-year term of the trust) would be approximately $99.181819. This amount represents the sum of the section 2036 inclusion of $10 and the adjusted taxable gift of $89.181819 deemed to occur in connection with the creation of the trust.

The computation of the adjusted taxable gift has been made by determining, in the first instance, the amount of the taxable gift triggered upon the creation of the trust. Where a grantor, at a time when the table rate is at 10%, contributes $100 to a one-year GRAT while retaining the right to receive an annuity payment of $1 at the end of the year, the amount of the taxable gift is equal to $99.09091[226] (determined by subtracting from the sum of $100 placed in the trust the present value of the annuity payment, which is approximately $.0909).[227] And since, in effect, 10% of the taxable gift is includible in the gross estate under section 2036, that portion — i.e., 10% — of the taxable gift ought not to constitute an adjusted taxable gift. Thus, in this case, the amount of the adjusted taxable gift should be equal to $89.181819, which represents 90% of the taxable gift.

It is interesting to compare the difference in transfer-tax out-

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did not trigger a taxable gift, an adjusted taxable gift could not be deemed to occur in connection with the creation of the trust either.

[226] This conclusion, that a taxable gift has occurred, is reached on the premise that the remainderman is not a charity, and that, therefore, the trust is not a charitable remainder annuity trust that would qualify for non-taxable treatment under I.R.C. § 2522.

[227] The present value of the right to receive the sum of $1 in one year when the discount rate is at 10% is determined as follows: 1 / 1.1 = approximately $.0909.

come depending on whether the grantor dies within the one-year term of the trust or after its termination. As suggested, the amount subject to transfer tax in the event of a death within the trust term would be $99.181819. On the other hand, the amount subject to tax in connection with the trust, if the grantor dies after its termination, would be $99.09091 — which is simply the amount of the taxable gift deemed to occur at the creation of the trust. Thus, the death of the grantor within the term would result in an increase in the grantor's transfer-tax base of $.0909 (the difference between $99.181819 and $99.09091).

The increase of $.0909 is attributable to the application of section 2036, which treats the grantor as if the trust were not created. Put differently, the portion of the trust that becomes subject to tax under section 2036 because of a death within the term (10%) is valued as of the date of death, thus resulting in an inclusion of $10 (10% of $100, the value of the corpus on the date of death). In contrast, if the grantor survives the term, the 10% portion under consideration would remain an adjusted taxable gift — given that it would not be includible in the gross estate — and would, therefore, have a value for transfer-tax purposes of $9.909091 (10% of the taxable gift, which is $99.09091). The difference between the amount that would be includible under section 2036 ($10) and the amount of the adjusted taxable gift with respect to the 10% portion in the event the grantor were to survive the term of the trust ($9.909091) is $.0909 (10 - 9.909091) — thus confirming that the difference in transfer-tax base attributable to a death within or without the term simply results from the application of section 2036 and its date-of-death valuation approach.

B. *An Alternative to the Service's Approach: Income Equivalence*

The method adopted by the Service in the ruling for applying section 2036 in the case where a grantor retains the right to receive an annuity is certainly not the only one it could have selected. At least two other alternative approaches could have been utilized. Under the first of these alternatives, a retained annuity would not be viewed as an interest of sufficient magnitude to warrant application of section 2036. Under the second alternative, a grantor retaining the right to an annuity would be treated as if she had retained an equivalent income interest in the trust, triggering

inclusion under section 2036 of a corresponding portion of the trust.

Consider first the latter alternative. Although the statute does not contemplate that a grantor might create a trust with a retained income interest extending to only a portion of it, the regulations under section 2036[228] set forth a method for applying the section in this context. The regulations provide that in such a case the includible amount is equal to a percentage of the entire value, as determined on the date of death, of the trust corpus; the percentage corresponds to the portion of the trust over which the grantor retained an income interest.[229] So, for example, if a grantor created a trust and retained the right to receive one-half of the income it generated, one-half of the date-of-death value of the corpus would be includible.

The regulations do not indicate whether a retained annuity is to be treated in the same manner, or, indeed, whether section 2036 has any application at all. Nevertheless, in this context, the courts have, in invoking section 2036 with respect to a retained annuity, applied the regulation.[230] In doing so, however, the courts have not adopted a uniform approach for computing the amount of the inclusion.[231]

The question that has not been fully resolved is how, when applying the regulation in the context of an annuity, to determine the portion of the trust that corresponds to the annuity amount. More specifically, is the actual income of the trust or the table rate to be used in determining the corresponding portion of the trust? And if the table rate is used, is it the rate in effect at the time of death, the rate in effect at the time of creation of the trust or some blended rate that takes into account the variations in the table rate during the entire term of the trust?

While, on some occasions, the courts have considered the actual income of the trust in determining the percentage of trust income

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[228] See Treas. Reg. § 20.2036-1(a).

[229] Id.

[230] See Industrial Trust Co. v. Commissioner, 165 F.2d 142, 147 (1st Cir. 1947); Estate of Pardee v. Commissioner, 49 T.C. 140 (1967), acq. 1973-2 C.B. 3; Estate of Becklenberg v. Commissioner, 31 T.C. 402 (1958), rev'd on other grounds, 273 F.2d 297 (7th Cir. 1959).

[231] Compare with United States Nat'l Bank of Portland v. United States, 188 F. Supp. 332, 339-340 (D. Ore. 1960); *Industrial Trust Co.*; *Estate of Pardee*; Estate of Tomec v. Commissioner, 40 T.C. 134 (1963); *Estate of Becklenberg*.

that the annuity represents,[232] the courts have, on other occasions, made the analysis, as the Service would, on the basis of the table rate.[233] And where the courts have used the table rate, they have not clarified the time frame for determining the rate. Unlike the courts, the Service, as previously suggested, has made its position clear in the ruling: The table rate in effect at the time of the grantor's death should be used to compute the includible portion of the trust.

The approach to be considered here, though not the one taken by the Service or uniformly by the courts, would determine the section 2036 inclusion on the basis of a fiction: that the grantor retained the right to receive a percentage of trust income, instead of a fixed annuity.[234] To ascertain the percentage of trust income deemed to be retained by the grantor, a comparison would be made between the annuity amounts received by the grantor prior to death and the trust income for that period. In other words, this approach would determine the includible portion of the trust by converting the annuity into an income interest of an equivalent nature.

To illustrate, assume a grantor contributes $100 to a GRAT, that the table rate (and the actual rate of return enjoyed by the trust as well[235]) is 10% throughout the term of the trust, and that the grantor retains the right to receive an annuity payment of $5 at the end of each year. If the grantor died within the term of the GRAT, the inclusion amount under this approach — accepting for the moment the applicability of section 2036 in the context of a retained annuity[236] — would be equal to one-half of the value of the corpus on the date of death. For, under an income-equivalence analysis, a

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[232] See *Industrial Trust Co.*; *Estate of Becklenberg*.

[233] See *United States Nat'l Bank of Portland*; *Estate of Pardee*; *Estate of Tomec*.

[234] See Task Force on Transfer Tax Restructuring, Report on Transfer Tax Restructuring, American Bar Association Section of Taxation, supra note 114, at 408 (suggesting that the creation of a trust under which an annuity interest is retained should be viewed as triggering a taxable gift with respect to a portion of the trust, the portion to be determined by converting the annuity into its equivalent income interest).

[235] See infra notes 240-246 and accompanying text for a discussion of the possible relevance of the actual earnings enjoyed by the trust in the context of applying the principle contained in the regulations to a retained annuity.

[236] See infra notes 247-254 and accompanying text for a suggestion that the applicability of I.R.C. § 2036, a section designed to trigger an estate-tax inclusion in the case of a retained income interest, is somewhat questionable in the context of a retained annuity.

grantor who receives annuity payments equal to one-half of trust income is in the same position, and should therefore be treated in the same fashion, as a grantor who is entitled to receive one-half of the trust's income.[237] And so, assuming the value of the corpus were $500 on the date of the grantor's death, the inclusion amount under this approach would be $250 (50% of $500), making taxable 50% of the appreciation.[238]

Contrast the result suggested here with the conclusion that the Service would reach with respect to this example under the ruling. The Service would, according to the ruling, include the capitalized amount necessary to produce a return of $5 using as a discount rate the table rate in effect at the time of death. With a table rate of 10% at the time of the grantor's death, the application of the ruling would result in an inclusion of only $50 ($5 / .10) — with none of the appreciation accruing during the term of the trust entering into the grantor's transfer-tax base. Thus, whereas the suggested approach would result in subjecting a portion of the appreciation to tax, no portion of the appreciation would be taxable under the ruling. Indeed, though not always the case, the approach taken in the ruling will usually result in subjecting a lesser portion of appreciation to tax.[239]

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[237] See Estate of Becklenberg v. Commissioner, 31 T.C. 402 (1958). In *Estate of Becklenberg* the Tax Court, in sustaining the valuation approach taken by the Service in that case, held that the includible amount was to be determined by capitalizing the annuity amount by the actual rate of return enjoyed by the trust during the grantor's lifetime. The court calculated the actual rate of return by comparing the average annual income of the trust with the value of the trust portfolio on the date of the grantor's death. Id. at 411. If the method used by the court were applied to the example in text, the result would be the same as that suggested in text: in the example, the average annual rate of return, based on the value of the portfolio at the time of death, is 2% (annual income of $10 / value of the portfolio on the date of death of $500); and the capitalized amount necessary to produce an annuity of $5, if determined on the basis of a discount rate of 2%, is equal to $250 (5 / .02). It should be noted that while the Court of Appeals reversed the decision of the Tax Court, it did so with respect to the issue of includibility and therefore did not pass on the method adopted by the Tax Court for computing the inclusion amount.

[238] If the corpus of the trust did not appreciate at all, one-half of the date-of-death value of the corpus ($50) would be includible. And with $400 in appreciation, the amount includible, as suggested in text, is $250. Thus, the additional amount that must be included on account of the appreciation is $200, which represents 50% of the appreciation.

[239] In some circumstances, however, application of the approach in the ruling could result in subjecting a greater portion of appreciation to tax. Consider, for example, the contribution of $100 to a GRAT where the grantor retains the right to receive an annuity at the end of each year of $5. Assume that at the time of the grantor's death, which occurs within the term of the trust, the value of the corpus is $200 and that the table rate at that time is

In suggesting that it might be appropriate to treat the grantor, in this example, as if she retained an income interest with respect to 50% of the trust, a critical assumption was made: that with a table rate, and actual rate of return as well, of 10% at all relevant times, the retention of the right to receive a $5 annuity is equivalent to the retention of an income interest in one-half of the trust. Given the reality of the investment marketplace, however, a retained annuity interest is not so readily translated into an equivalent income interest.

As a practical matter, the income generated by a trust will vary over time and, therefore, the relationship between the amount of the annuity and trust income will typically not remain constant. Even assuming that income equivalence were to be determined by examining the relationship between the annuity amount and the amount of trust income that would be generated if the trust earned the table rate (instead of actual income), the relationship would still not hold constant in most cases. While the table rate in the example is hypothesized to remain level, in reality the table rate is adjusted each month to reflect the change in interest rates available in the market,[240] rendering the percentage of the table rate that the annuity amount represents susceptible to constant change. In addition, the value of a trust portfolio might fluctuate significantly during the term of the trust. And, thus, even assuming a fixed table rate (rather than, as under current law, a table rate that is periodically adjusted to reflect changes in the market rate[241]), the relationship between the annuity amount and trust income would nevertheless be likely to vary during the term of the trust.

The complexity encountered in determining the income interest that is the equivalent of the annuity amount — because of potential changes in the rate of return and fluctuations in the value of the trust portfolio — could be avoided by making the income-

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2.5%. Under the ruling, the amount includible would be equal to $200 ($5 / .025), the effect of which is to subject to tax all of the appreciation. On the other hand, if the principle in the regulation is applied as suggested in text, less than all of the appreciation would be subject to tax as long as the trust actually earned before the grantor's death an aggregate income in excess of the aggregate amount of annuity payments made to the grantor. For in such a case, the grantor would be treated as retaining an income interest in less than all of the trust.

[240] See I.R.C. § 7520. Section 7520 ties the table rate to the rate available in the market on Treasury obligations. Id.

[241] Id.

equivalence analysis on the basis of the actual income earned by the trust during the grantor's lifetime. While the tables are designed to permit a valuation judgment to be made where future facts, such as the level of income that a trust might generate over a period of years, are critical but of course unknown, the courts typically apply the tables even where the actual facts are known and have proven to be contrary to the assumptions underlying the tables.[242] Despite the reluctance of the courts to deviate from the tables in general, a strong case can be made for doing so in this context.

What makes the use of actual facts — i.e., the actual income earned by the trust during the grantor's lifetime — a particularly appealing method for applying section 2036 in the context of a retained annuity is that all of the relevant facts would always have occurred by the death of the grantor, which is when the section imposes tax. Indeed, it is perhaps difficult to justify the application of the tables, which are merely predictive, to a retained annuity for section 2036 purposes, given that the actual facts are known by the time the tax is to be imposed.[243]

For example, assume a grantor contributes $100 to a five-year GRAT entitling her to receive a $10 annuity payment at the end of

[242] See, e.g., O'Reilly v. Commissioner, 95 T.C. 646 (1990); Estate of Tomec v. Commissioner, 40 T.C. 134 (1963); Estate of Green v. Commissioner, 22 T.C. 728 (1954).

[243] See Industrial Trust Co. v. Commissioner, 165 F.2d 142, 147 (1947) stating, "There is no necessity for assuming an artificial rate when the actual income over past years can be ascertained." But see *Estate of Tomec*, 40 T.C. at 141. In *Estate of Tomec* the court refused to adopt this principle — pointing out that the trust lasted for too brief a period to warrant relying on the trust's actual experience and implying that it might have implemented the principle had the trust been in existence for a longer period of time. Perhaps, the *Tomec* court was concerned about the possibility that, when examined for a short-term period, income might be somewhat aberrational and therefore inappropriate to use in determining the income-interest equivalence of an annuity.

To take a drastic example of a context in which it might be appropriate to reject the *Industrial Trust* approach, assume a grantor creates a GRAT by contributing $100 to it and retaining the right to receive an annuity payment of $1 at the end of each year during its term. Assume further that the grantor dies one year after the creation of the trust. If the trust earned only $1 in the first year of its existence — because perhaps the obligor on the bond purchased by the trustee defaulted on its interest payment — it would seem unfair to apply the Industrial Trust approach and thereby require the inclusion of the entire corpus in the grantor's estate under I.R.C. § 2036. After all, the grantor obviously contemplated, at the time of creating the trust, that substantially more than $1 of income would be earned by the trust each year. It would seem therefore more appropriate in this example to ignore the reality of trust income in favor of the table rate, which presumably would result in a § 2036 inclusion of substantially less than the entire corpus.

each year. Assume further that the grantor dies just prior to the expiration of the five-year term at a time when the corpus of the trust has a value of $500, having received an annuity payment of $10 at the end of each of the first four years. To determine the equivalent income interest on the basis of actual income, it would be necessary to calculate the amount of trust income earned during the first four years of the trust, the time during which the grantor received an annuity payment. And so if the trust earned aggregate income of, say, $100 during these years, it would be appropriate under this analysis to treat the grantor as if she retained an income interest with respect to 40% of the trust ($40 of aggregate annuity payments / $100 of aggregate trust income), requiring the inclusion under section 2036 of 40% of the trust corpus.[244] Thus, in this example, the section 2036 inclusion amount would equal $200; in addition, as a result of this inclusion, 40% of the taxable gift deemed to occur at the creation of the trust would be disregarded (or eliminated) in computing adjusted taxable gifts.

It would be possible to use, as an alternative to actual trust income, the table rate in conjunction with the actual value of the trust portfolio. If the table rate were used, the includible portion of the trust would be determined by comparing the annuity payments received by the grantor with the amount of income that the table rate, as applied to the value of the portfolio, would have produced.

To apply this approach in the example under consideration requires making some assumptions about the value of the trust port-

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[244] The amount of income that the trust actually earned during each of the four years could affect the ultimate conclusion, even if the aggregate amount of actual income ($100) were to remain the same. With the time-value of money making the earlier receipt of funds more valuable, it would be difficult to determine income equivalence without taking into account the percentage of trust income received by the grantor during each year prior to her death. Consider, for example, a trust earning $20 in each of the two years prior to the death of the grantor. If the grantor were entitled to receive an annuity of $10, the analysis suggested in text would lead to the conclusion that 50% of the trust should be includible under I.R.C. § 2036. Would the conclusion change if, assuming the grantor still received an annuity of $10 for each of the two years, the trust earned zero in year one and $40 in year two? In this case, the grantor has enjoyed an interest in the trust that is more valuable than an interest that would entitle the grantor to receive one-half of trust income. Quite obviously, such an income interest would entitle the grantor to receive zero in year one and $20 in year two. Since the grantor receives, in fact, $10 in each year and since the receipt of $10 in each of the two years is more valuable than the receipt of $20 in year two, it would not be unreasonable to conclude that the grantor should be treated as having retained an income interest of greater than 50% in the trust.

folio during each of the four years. Assume that the value of the portfolio is $100 at the end of year one, that it increases to $500 on the first day of year two and that it remains at a value of $500 until termination of the trust. If the table rate (say 10%) is applied to the portfolio value during each of the four years in order to arrive at trust income for purposes of the income-equivalence analysis, the aggregate income of the trust would be $160.[245] With the grantor having received aggregate annuity payments of $40 during the four years, the grantor would be treated on this analysis as if she retained an income interest with respect to 25% of the trust. As a consequence, $125, 25% of the date-of-death value of the corpus, would be includible under section 2036, permitting an exclusion from adjusted taxable gifts of 25% of the taxable gift deemed to occur at the outset.

The use of the table rate in this fashion results in treating the grantor as if she retained an income interest with respect to 25% of the trust. Yet, as a matter of reality, the grantor received 40% of all trust income during her lifetime. The application of the table rate in this context constitutes, in effect, a rejection of a known reality in favor of a valuation method designed to predict a reality that is not yet known. It would, therefore, seem preferable to determine income equivalence on the basis of actual income, rather than on the basis of the income that would hypothetically be earned were trust investments to yield the table rate.[246]

To avoid confusion, it would be helpful to note that the applica-

[245] The calculation is as follows:

year one —	$100 x 10%	=	$10
year two —	$500 x 10%	=	$50
year three —	$500 x 10%	=	$50
year four —	$500 x 10%	=	$50
			$160

[246] But see *Estate of Tomec*, 40 T.C. at 141-42. In *Estate of Tomec*, the court indicated that actual income should not be utilized, at least where the trust had not been in existence for a sufficient period of time. It should be emphasized that, in using the table rate, the court did not adopt the approach discussed in text. Instead, the court used the table rate to capitalize the annuity payment in a fashion somewhat similar to the approach used by the Service in Rev. Rul. 82-105, 1982-1 C.B. 133. Although the court's approach is similar to the Service's, it should be pointed out that the issue before the court was not identical to the issue posited in the ruling. While the ruling involved a trust where the grantor retained an annuity interest, *Tomec* involved a trust where the grantor could control all income except for an annuity amount.

tion of the table rate to the actual value of the portfolio in order to produce a hypothetical income — which, as suggested appears to be a less defensible method for determining income equivalence than one that would take actual income into account — is significantly different from the Service's use of the table rate in the ruling. In the ruling, the table rate was used to determine the capitalized amount necessary to generate a return equal to the annuity amount. If the table rate were used in this manner in the example under consideration, the includible amount would be $100 (annuity amount of $10 / table rate of .10). On the other hand, as suggested, the use of the table rate in the income-equivalence analysis would trigger an inclusion of $125, thus exposing to tax $25 of appreciation that would not be subject to tax under the Service's application of the table rate.

In sum, the courts have not clearly set forth the appropriate method for determining the includible portion of a trust where the grantor dies within the annuity-retention period. The Service, on the other hand, has taken an unequivocal position: The annuity amount is to be capitalized on the basis of the table rate in effect at the time of the grantor's death. As suggested, if section 2036 is to apply in the context of a retained annuity, it would be preferable to determine the includible portion of the trust by comparing the annuity amounts received by the grantor prior to death with the actual income earned by the trust for that period. The rejection of the table rate in this context is, it has been suggested, appropriate. For it is difficult to justify the use of the table rate, which is merely a predictive tool, where the amount of the trust's actual income is necessarily known by the time of the grantor's death.

C. *Another Alternative: Reject Section 2036*

At the outset of this discussion, it was suggested that there are two alternatives to the approach adopted by the Service in the ruling: 1) to apply section 2036 in a manner that would result in an inclusion of the portion of the trust corresponding to the retained annuity amount, with the corresponding portion determined on the basis of an income-equivalence analysis or 2) to reject the application of section 2036 on the ground that a retained annuity is not sufficiently similar to an income interest to warrant treating it as such. With the discussion of income equivalence completed, the

question whether the section should have any application in the context of a retained annuity is now the focus of discussion.

The statute itself does not make any reference to the retention of an annuity. By its terms, it applies to the retention of the right to an income interest or the possession or enjoyment of the property transferred. Although the regulations are also silent on the question of a retained annuity, they do provide that the retention of a portion of an interest in the property transferred triggers an inclusion of a corresponding portion of the trust corpus.[247] Whether this provision in the regulations is intended to make the section applicable in the case of a retained annuity on the rationale that an annuity sum is in essence a portion of an income interest is not disclosed.

While the Supreme Court has never decided whether such a rationale brings a retained annuity interest within the scope of the section, it has strongly implied that the section is applicable where a grantor transfers property to a trust subject to the right to receive an annuity.[248] And, in general, the lower courts have unhesitatingly applied the section in this context.[249] Presumably, the

[247] See Treas. Reg. § 20.2036-1.

[248] See Fidelity-Philadelphia Trust v. Smith, 356 U.S. 274 (1958), where the court held that an annuity-life-insurance combination was not includible under the predecessor of current I.R.C. § 2036. In reaching its holding, the court emphasized that the annuity and life-insurance policy purchased by the decedent from the insurance company were independent, id. at 280-81, thus implying that § 2036 might have been applicable by virtue of the retained annuity had the life policy and the annuity been connected. In addition, the court indicated its approval in a lower-court case that held the section inapplicable where a person transferred property in exchange for the promise of an annuity in a non-trust context, implying that the retention of an annuity in the context of a trust would appropriately trigger the section. Id. at n. 8.

[249] See United States Nat'l Bank of Portland v. United States, 188 F. Supp. 332 (D. Ore. 1960); Estate of Pardee v. Commissioner, 49 T.C. 140 (1967), acq. 1973-2 C.B. 3; Estate of Becklenberg v. Commissioner, 31 T.C. 402 (1958), rev'd, 273 F.2d 297 (7th Cir. 1959). See also Estate of Uhl v. Commissioner, 241 F.2d 867 (7th Cir. 1957).

In contrast, the court's analysis in Ray v. United States, 762 F.2d 1361 (9th Cir. 1985), suggests that it would be prepared to reject § 2036 in the context of an annuity retained by the grantor of a trust where it could be established that the transaction constituted a sale of property in exchange for the annuity. See also Stern v. Commissioner, 747 F.2d 555 (9th Cir. 1984); La Fargue v. Commissioner, 689 F.2d 845 (9th Cir. 1982); Estate of Fabric v. Commissioner, 83 T.C. 932 (1984) (applying the Ninth Circuit precedents cited in this note in accordance with Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971), cert. denied, 404 U.S. 940 (1971) — refusing to apply § 2036 on the basis of its conclusion that a sale in exchange for an annuity had been effected). But see Joseph M. Dodge, Redoing the Estate and Gift Tax Along Easy-to Value Lines, 43 Tax L. Rev. 241, 298 (1988)

willingness of the courts to apply the section where the grantor of a trust retains the right to receive an annuity is predicated on the rationale that in substance, though not in form, a grantor receiving annuity dollars is in the same position as a grantor who is receiving income dollars. For example, a grantor who retains the right to receive an annuity of $10 would be entitled to receive the same amount of money each year as would a grantor who retained an income interest, assuming trust investments generated an annual income of $10.[250]

Nevertheless, an annuity and an income interest are not identical. An annuity is fixed, whereas an income interest generates fluctuating amounts for the grantor depending upon the earnings of the trust. The right to receive income is such an important attribute of property ownership that the application of the section is explicitly conditioned on its retention. Thus, it is certainly arguable that the retention of the right to receive a fixed annuity sum, conferring upon the grantor a quality of ownership that is less substantial relative to an income interest, ought not to be viewed as within the scope of the section.[251]

That this difference in the quality of ownership has significance is made clear by a comparison of two different types of outright transfer: 1) an outright gift of property where the donee personally promises to pay the donor the income it generates each year until the death of the donor; and 2) an outright transfer of property in exchange for a personal promise by the transferee to pay the transferor a fixed annuity sum each year until the death of the transferor. While, in the former case, section 2036 would clearly apply,[252] it would apparently have no application in the latter case.[253]

(suggesting that the Ninth Circuit approach should be overruled). In addition, the Seventh Circuit refused to apply the section in the case of an annuity payable to the grantor of the trust where the grantor was entitled to receive payments even if the property contributed to the trust by the grantor had been exhausted. See Estate of Becklenberg v. Commissioner, 273 F.2d 297 (7th Cir. 1959).

[250] Cf. Northeastern Pennsylvania National Bank and Trust Co. v. United States, 387 U.S. 213 (1967) (where the court held that an annuity interest could be viewed as the equivalent of an income interest in the marital deduction context).

[251] See Tax Fairness and Economic Growth Act of 1992, H.R. 4210, which, if signed by the president, would have overruled Northeastern Pennsylvania National Bank and Trust Co. v. United States, 387 U.S. 213 (1967).

[252] See, e.g., Greene v. United States, 237 F.2d 848 (7th Cir. 1956); Estate of McNichol v. Commissioner, 29 T.C. 1179 (1958).

[253] See *Fidelity-Philadelphia Trust Co.*, 356 U.S. at 280 n.8.

The only possible rationale for the difference in outcome in these two cases is that the quality of ownership enjoyed by the transferor in the transferred property is of a greater or more substantial magnitude in the case where the transferor retains the right to income.

Given the disparity in the quality of ownership enjoyed by the grantor in the case of an income interest on the one hand and an annuity interest on the other, it is surprising that the courts have not given more serious consideration to the possibility of rejecting section 2036 in the context of a trust where the grantor has retained the right to receive an annuity. Indeed, this disparity apparently being so critical where the transfer is of an outright nature, why should it be ignored simply because the transfer is made in trust instead?

The argument for treating an annuity as outside the scope of section 2036 has added force where the right to the annuity is retained for a period of years, rather than for the life of the grantor. Whatever merit there may be in terms of applying section 2036 where the annuity is retained for life, it is certainly more difficult to justify the use of the section where the annuity is to be paid to the grantor for only a period of years — just as the justification for applying the section in the case of an income interest is weaker where the grantor retains a term of years than it would be if the grantor retained a life estate.[254] Consider, for example, a contribution of $100 to a one-year GRAT which entitles the grantor to receive an annuity sum of $10 at the end of the year. Once the trust has been created, the grantor is entitled to receive one $10 payment irrespective of the amount of income or appreciation enjoyed by the trust during the year. It would seem that the grantor's quality of ownership in the trust corpus, where the annuity is to be paid for a period of years, is of a limited nature and therefore might not warrant, were the grantor to die within the retention period, the application of section 2036's valuation method.

[254] See Estate of Hendry v. Commissioner, 62 T.C. 861 (1974); Estate of Nicol v. Commissioner, 56 T.C. 179 (1971). In these cases, the respective courts address the question of the appropriateness of applying the section where the grantor happens to die during a retained term of years without any contemplation at the time of the trust's creation that the grantor would in fact die during the term.

D. *Neutrality Considerations*

From the viewpoint of neutrality, however, the application of section 2036 where the grantor dies during the annuity-retention period is desirable. For the section operates in this context as a penalty, offsetting the benefits of the GRAT and thereby making the transfer-tax rules applicable to it less distortionary.[255]

As previously suggested, the GRAT produces a surplus in the annuity pot where the actual return proves to be greater than the table rate, making the GRAT more effective than a comparable outright gift in terms of wealth produced for the transferee. On the other hand, where the actual return proves to be less than the table rate, the GRAT produces a deficiency in the annuity pot, making the GRAT less effective than a comparable outright gift in these terms. Since taxpayers are typically able to make some reasonable prediction about the rate of return their assets will produce, they will be attracted to the GRAT by the opportunity it offers for a surplus where they anticipate that the asset contributed to it will produce a return in excess of the table rate.

It is, however, always possible that the contributed asset will produce an actual return less than the table rate in effect at the time of contribution. Given the risk that the actual rate of return might be less than the table rate, the transfer-tax rules applicable to a GRAT appear, at least superficially, to be neutral: A taxpayer inclined to make a wealth transfer, being unable to predict whether the actual rate of return would be above or below the table rate in effect at inception, could not determine whether the GRAT would be more or less effective than a comparable outright gift and would therefore decide between these two methods on the basis of other concerns.

This view of the rules as neutral is predicated on the tacit assumption that, in some rough sense, the upside — which occurs if

[255] If a penalty is not imposed in order to offset the benefits of the GRAT, a question of equity is also implicated. Consider a taxpayer who, motivated by family or other non-tax concerns, utilizes an outright gift as a method of transfer, thus choosing to forgo the benefits made available by a GRAT. Such a taxpayer would incur a greater transfer-tax cost than would be incurred by a taxpayer willing to utilize a GRAT, even assuming both taxpayers had an equal amount of wealth to transfer. To impose different amounts of transfer tax on these two taxpayers simply because one is willing to use a GRAT and the other is not would appear to be inequitable, as well as distortionary. See Halbach, supra note 108, at 218 (suggesting that equity and neutrality are interrelated).

the actual rate proves to be greater than the table rate — is balanced or offset by the downside — which occurs if the actual rate proves to be less than the table rate. This assumption, however, is not reflective of reality. For taxpayers will take probabilities into account, deciding to utilize the GRAT only where they are convinced that the probability associated with the upside is greater than the probability associated with the downside. Thus, it would seem that the risk that a deficiency might materialize in the annuity pot does not balance or offset the possibility that a surplus in the annuity pot might be enjoyed.

Nevertheless, the failure of the downside risk to offset the upside potential does not in itself render the transfer-tax rules distortionary. As previously suggested, an outright gift, when combined with a loan from the donor to the donee, can also create a surplus effect.[256] Indeed, the gift-loan technique will produce a greater surplus than will a GRAT.[257] Thus, the potential for a surplus that the GRAT offers does not put it at a comparative advantage, but at a disadvantage, given the potential for an even greater surplus inherent in the gift-loan technique.

This is not to suggest that the GRAT is less effective than an outright gift as a wealth-transfer strategy. Where the burden of the income tax on the GRAT's earnings is borne by the grantor, the GRAT enjoys a substantial advantage over an outright gift.[258] It is this advantage, not the opportunity to enjoy a surplus, that makes the GRAT more attractive than the outright gift, rendering the applicable transfer-tax rules applicable to GRAT's distortionary.

If the Code provided that the burden of the income tax on all GRAT earnings inuring to the benefit of the remainderman had to be borne by the remainderman, the GRAT would not enjoy a comparative advantage. Without such a provision, it is necessary to consider how the Code might be applied in order to "neutralize" the GRAT's comparative advantage.

If a taxpayer were informed that she would be subject, in effect, to a penalty in the event she were to die within the annuity-retention period, she might decide to reject the GRAT and make the transfer by outright gift instead. The greater the penalty in the

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[256] See supra notes 145-148 and accompanying text.
[257] See supra notes 145-148 and accompanying text.
[258] See supra notes 135-136 and accompanying text.

event of a death within the annuity-retention period, the less attractive the GRAT becomes as compared to an outright gift. Indeed, the magnitude of the penalty, together with the probability that it will be incurred, may increase to the point where taxpayers will no longer find the GRAT attractive.[259] At this point, they will decide between the GRAT and the outright gift on the basis of their personal predilections, rather than on the basis of some advantage inherent in the tax rules. An appropriate penalty could therefore "neutralize" the advantage that the GRAT enjoys over the outright gift.[260]

While determining the level of penalty that would achieve neutrality is difficult, one can consider some of the relevant issues. Given that the benefits offered by the GRAT become more substantial as the length of the annuity-retention period expands,[261] one might be inclined to opt for an approach that would impose a penalty that would tend to increase as the length of the retention period increased. This approach, however, fails to account for the increase in the probability that the penalty will be triggered where

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[259] Taxpayers are, of course, free to determine the annuity-retention period. As a consequence, they control the mechanism that determines the probability of incurring the penalty. Taxpayers might be inclined to set a very short retention period in order to minimize the probability that the penalty would be triggered. This strategy, however, would not be prudent. For the benefit that the GRAT offers increases as the length of the annuity-retention period increases. Thus, a taxpayer contemplating a GRAT must, in choosing an annuity-retention period, confront a conflict. On the one hand, a longer period would be desirable in order to maximize the advantage of the GRAT; on the other hand, as the length of the period increases, the probability that the penalty will be incurred increases as well.

[260] Where, of course, actual earnings turn out to be less than the table rate, the GRAT suffers a disadvantage as compared to an outright gift. One might argue that the possibility that such a disadvantage might materialize is in itself a sufficient penalty to "neutralize" the advantage that the GRAT enjoys where actual earnings prove to be greater than the table rate. Such an argument, however, fails to take into account the reality that taxpayers will only employ the GRAT in the case of an asset that has a high probability of generating a return in excess of the table rate and a very low probability of yielding a return that falls below the table rate. Given the absolute control that taxpayers have in deciding which of their assets to transfer to a GRAT, it would seem necessary to impose some penalty — other than the comparative disadvantage suffered by the GRAT where actual earnings turn out to be less than the table rate — in order to achieve neutrality.

[261] It should be noted that as the retention period is lengthened, it, of course, becomes more difficult to predict whether the return generated by the corpus during the term of the trust will be greater than or less than the table rate, thus complicating the process of determining if the use of GRAT will produce an advantage or a disadvantage as compared to an outright gift.

the annuity-retention period is lengthened.[262] The increase in probability could be sufficient to offset the enhanced benefits attributable to a longer retention period, maintaining neutrality without the need for a penalty that increased in magnitude as the length of the retention period expanded.

Another issue that should be considered in establishing an appropriate level of penalty concerns appreciation: Is it necessary to subject to estate tax some portion of the appreciation accruing to the corpus during the term of the trust? As will be recalled, under the approach taken by the Service in the ruling,[263] appreciation accruing during the term of the trust does not ordinarily translate into an increased inclusion amount under section 2036. In contrast, under the income-equivalence method, it is more likely that appreciation in trust corpus will be brought into the gross estate.

When section 2036 is applied in the context for which it was designed — where the grantor retains an income interest — it is clear that all of the appreciation accruing during the term of the trust is subject to tax. The underlying theory is that the grantor who retains an income interest enjoys such a substantial quality of ownership in the property transferred to the trust that it is appropriate, for transfer-tax purposes, to disregard the existence of the trust. Since all of the appreciation accruing with respect to the property transferred to the trust would have been includible in the grantor's estate had the transfer not been made, it follows that all of the appreciation must be subject to tax.

Unlike the theory of ownership that drives section 2036 in the context of a retained income interest, the rationale for applying the section where an annuity interest is retained should be based on a concern about maintaining neutrality. And so the question is whether it is necessary, in order to achieve neutrality, to require the inclusion of appreciation in the case of a retained annuity.

It may be possible that neutrality can be maintained without subjecting the appreciation that accrues during the term of the trust to tax. When section 2036 is applied to a retained income interest, it alters the method of valuation so that the transfer to the remainderman is treated as having been made on the date of

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[262] It, of course, becomes more likely that the grantor will die within the annuity-retention period as the period is lengthened.

[263] Rev. Rul. 82 - 105, 1982 - 1 C.B. 133.

death, rather than on the date of the creation of the trust. As a consequence, in addition to making appreciation taxable, the section eliminates from the transfer-tax calculus the discount that was taken into account in determining the value of the remainder interest for gift-tax purposes. In applying section 2036 in the context of a retained annuity, the elimination of the discount from the transfer-tax calculus might be a sufficient penalty to accomplish neutrality, thus making it unnecessary to require the inclusion of appreciation as an additional sanction.[264]

To illustrate, assume a grantor, at a time when the table rate is at 10%, contributes $100 to a one-year GRAT and retains the right to receive an annuity of $10 at the end of the year. Upon creating the GRAT, the grantor is deemed to have made a taxable gift of approximately $90.90, the discounted value of the remainder inter-

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[264] The elimination of the discount from the transfer-tax calculus places the grantor of a GRAT who dies within the annuity-retention period at a disadvantage as compared to the donor of an outright gift. To illustrate, assume a grantor contributed, at a time when the table rate was at 10%, $100 to a one-year GRAT and retained the right to receive an annuity amount of $10 at the end of the year. The grantor would be deemed to have made a taxable gift of approximately $90.90. If the grantor received income of $5 during the first six months of trust operations (the trust having earned an annual return in the form of income of 10%) and then died, the amount subject to tax, assuming that the discount used to determine the taxable gift were excluded from consideration and that appreciation, if any, were not taxable, would be $105: $5 of income, which would be taxable under I.R.C. § 2033, and $100, which would be the inclusion amount under I.R.C. § 2036 if the section were applied in the suggested manner.

In contrast, an outright gift of $90.90 would produce a lesser inclusion. Assuming the donor invested the $9.10 that she retained so that it would earn an annual return of 10% and died six months after having made the gift, the donor would have $9.55 on the date of her death. This amount, $9.55, would be includible in the donor's estate under § 2033; in addition, the adjusted taxable gift of $90.90 would be subject to tax. And so the total amount subject to tax would be equal to $100.45.

In effect, the grantor of the GRAT is, under the approach considered here, required to include in her transfer-tax base the amount initially contributed to the trust, $100, plus the income of $5 received prior to death — for a total of $105. The donor of the outright gift, on the other hand, must only include $100.45 in her transfer-tax base. The difference in outcomes could be viewed as attributable to the exclusion of post-transfer income, which is available in the case of an outright gift but which, because of the elimination of the discount and the inclusion under § 2033 of income earned during the existence of the trust, is essentially unavailable where the grantor of a GRAT dies within the retention period.

Put simply, the approach considered here would deter a person contemplating a GRAT from creating it if he knew that he would not survive the retention period. Instead, if he were well advised, he would choose make an outright gift. For, assuming death in fact occurs within the retention period, the outright gift would generate a lesser transfer-tax cost than the GRAT.

est. If the grantor survives the one-year term, the amount subject to tax would be $90.90. If, on the other hand, the grantor dies within the one-year term at a time when the corpus of the trust has a value of, say, $120, section 2036 would require the inclusion of the entire $120 in the grantor's gross estate, assuming the section were applied in the same manner as it would be had the grantor retained an income interest. Given the inclusion in the gross estate, the adjusted taxable gift deemed to have been made with respect to the trust would be zero.[265]

What is being suggested is that it may not be necessary, in order to achieve neutrality, to apply section 2036 in the case of a retained annuity in this fashion. Perhaps a penalty sufficient to maintain neutrality would be imposed if — as in the context of a retained income interest — section 2036 did not permit the use of a discount for purposes of valuing the interest subject to tax, but — unlike the way in which the section is applied to a retained income interest — it did permit the exclusion of appreciation.

If this reasoning were adopted in the example under consideration, the amount includible in the grantor's gross estate would be $100,[266] rather than the $120 inclusion that a conventional application of section 2036 would require. This results from valuing the remainder interest for transfer-tax purposes without the use of a discount and excluding from the gross estate all of the appreciation accruing during the term of the trust. Put differently, the amount includible would be equal to the value of the corpus on the date of death (in this case, $120) less the amount of appreciation that had accrued since the creation of the trust ($20).

The inclusion amount of $100, together with the income received by the grantor from the trust that must be included in the gross estate,[267] is greater than the amount that would be subject to tax if the grantor made a comparable outright gift.[268] This difference in the amount subject to tax may constitute a sufficient penalty so

[265] Since the gift would be includible in the gross estate under I.R.C. § 2036, it would not enter into the computation of adjusted taxable gifts. See I.R.C. § 2001(b).

[266] See I.R.C. § 2001(b). With such an inclusion in the gross estate, the adjusted taxable gift deemed to have been made in connection with the creation of the trust would be zero.

[267] See I.R.C. § 2033.

[268] See supra note 264, where it is suggested that the transfer-tax cost associated with an outright gift is less than the transfer-tax cost incurred in connection with a GRAT where the grantor dies within the retention period.

that the GRAT is rendered neutral, even without making taxable appreciation that accrues during its term.[269]

It may be that the advantages offered by the GRAT over an outright gift are, in a rough sense, offset or "neutralized" by the suggested penalty. The penalty, if triggered, results in the imposition of a greater transfer-tax cost than would be imposed were an outright gift made instead. While it is debatable whether the penalty suggested is sufficient to neutralize the comparative advantages of the GRAT, it is important to recognize that neutrality may not require, as section 2036 does in the context of a retained income interest, that appreciation be included in the transfer-tax base. The suggested penalty may create a sufficient deterrent so that taxpayers would choose between the GRAT and the outright gift on the basis of motivations that are not tax driven.

In sum, it would seem that it is not entirely clear whether, and if so, how, section 2036 should be applied where the grantor who retains the right to receive an annuity dies during the retention period. The advantage enjoyed by the GRAT over an outright gift makes it likely that taxpayers will employ the GRAT, even though they would choose to make their transfers by outright gift if the tax rules treated both methods of transfer identically. In order to neutralize the advantage offered by the GRAT, it may be necessary to impose a penalty that would make taxpayers considering a GRAT more inclined to choose a method of transfer without regard to the tax rules. It has been suggested that the application of section 2036 where the grantor dies within the retention period might create a sufficient penalty, although it may not be necessary in order to achieve neutrality to require that the section be applied to a GRAT in the same way that it would be applied in the context of a retained income interest.

IX. GRUT's and the Estate Tax

Neither section 2036 nor the regulations under the section clearly indicate whether the retention of a unitrust interest triggers

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[269] See Rev. Rul. 82-105, 1982-1 C.B. 133. It is conceivable that the position adopted by the Service in the ruling was influenced by the kind of neutrality analysis made in text. For, under the ruling, appreciation is, in most cases, not made taxable; and the remainderman's interest is deemed to pass to her on the date of the grantor's death, thus precluding the use of a discount.

application of the section. The Service's position that the section does apply to GRUT'S is predicated on a substance-over-form analysis. While there is force to the Service's argument that a grantor receiving unitrust amounts is in substance receiving trust income and that therefore section 2036 should apply, it is arguable that a GRUT is not sufficiently similar to an income-interest trust to warrant invoking the section in the case of the GRUT. The discussion that follows will first examine the Service's approach and the difficulties inherent in its application, then focus on similarities and dissimilarities between an income interest and a unitrust interest, concluding with the suggestion that it may be necessary to apply section 2036 to GRUT's in order to maintain neutrality.

A. *The Service's Approach*

The Service's estate-tax approach in the case of a GRUT is set forth in Rev. Rul. 76-273.[270] In the ruling, the grantor created a non-interval charitable remainder unitrust, having retained the right for life to receive each year 6% of the value of the corpus of the trust.[271] The Service concluded that the entire value of the corpus, determined on the date of the decedent's death, would be includible in the grantor's gross estate under section 2036. In reaching this conclusion, the Service reasoned that since the table rate in effect at the time of the grantor's death was equal to 6%, the grantor had in substance retained for life the right to receive all of the trust's income, making it appropriate to require inclusion of the entire corpus under section 2036.[272]

The ruling adopts an income-equivalence approach, implicitly rejecting the section 2036 methodology the Service utilizes in the case of GRAT's.[273] Applying an income-equivalence analysis, the

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[270] 1976-2 C.B. 268.

[271] It is not clear how the Service would apply the ruling in the case of a GRUT where the unitrust percentage does not remain constant.

[272] In the case of an interval GRUT, the Service would still require inclusion of the entire corpus where the unitrust percentage is equal to the table rate in effect at the time of death. So, for example, all of the corpus of a 6% GRUT would be required to be included in the grantor's gross estate where the table rate is 6% at the time of death, even though the unitrust amount is fixed at the beginning of the year and the payment is deferred until the end of the year.

[273] See Rev. Rul. 82-105, 1982-1 C.B. 133; see also supra notes 214-246 and accompanying text for a further discussion of the ruling.

Service treated the 6% unitrust interest retained by the grantor as the equivalent of a right to receive the entire income of the trust on the rationale that the unitrust percentage was equal to the table rate. As a consequence, all of the appreciation in trust corpus, accruing prior to the grantor's death would be taken into account, as well as any decline in value, in determining the section 2036 inclusion — just as it would be taken into account where a grantor retained the right to receive all of the trust's income for life. Where the retained unitrust percentage is less than the table rate, the ruling would treat the grantor as having retained that proportion of trust income corresponding to the relationship that the unitrust percentage bears to the table rate.[274]

Contrast the income-equivalence analysis adopted by the Service in the ruling with the approach it applies in the case of a GRAT. The GRAT ruling, as suggested, requires the inclusion of appreciation accruing during the trust term only if the capitalized amount necessary to produce the annuity payable to the grantor (using as a discount rate, in determining the capitalized amount, the table rate in effect at the time of death) is greater than the value of the property initially contributed to the trust. Thus, even if the corpus of a GRAT were to appreciate substantially during its term, none of the appreciation would be includible unless the capitalized amount exceeded the value of the corpus at inception. With a GRUT, on the other hand, the Service would always include some portion of the appreciation accruing during its term, the portion being equal to the income percentage that is equivalent to the unitrust interest.

Where the value of the GRAT corpus declines during its term, the Service's approach accounts for the decline only if it reduces the amount below that necessary to produce the annuity payment. If the corpus declines to a value less than the capitalized amount, the inclusion amount would equal the value of the corpus. Where the decline does not reduce the value below the capitalized amount, the Service would not permit any portion of the decline to

[274] If the grantor in the ruling had retained the right to receive only 3% of the value of the corpus each year, the unitrust interest would be treated as the equivalent of an income interest with respect to one-half of the trust, and one-half of the value of the trust corpus, determined on the date of death, would be includible under section 2036. This causes the inclusion to take into account one-half of all pre-death appreciation or depreciation.

be taken into account in computing the inclusion. The Service's approach in the case of a decline in the value of the corpus of a GRUT, in contrast, is similar to the treatment it requires with respect to appreciation; a portion of the decline is always taken into the account in computing the inclusion, the portion being equal to the income-equivalent percentage.

The GRUT ruling, like the GRAT ruling, requires the use of the table rate in effect at the time of death in determining the inclusion amount. As previously suggested in the GRAT context, there are alternatives to the approach adopted by the Service. It would be possible to compute the section 2036 inclusion on the basis of the table rate in effect at the time the trust is created, a blended rate that takes into account the variations in the table rate during the entire term of the trust, or the actual income of the trust.

The use of the table rate that happens to be in effect at the time of death can create odd results. Consider a GRUT where the grantor is entitled to receive 8% of the value of the corpus of the trust each year and dies during the term of the trust. If the table rate is 10% at the time the trust is created and remains at 10% until the grantor's death, the Service would require 80% of the value, as measured on the date of death, of the corpus of the trust to be included — with 80% of all appreciation or depreciation accruing during the term of the trust being taken into account. If the table rate decreased to 8% the day before the grantor's death, the Service would require the entire value of the corpus to be included, causing all of the appreciation or depreciation to enter into the computation of the gross estate. Even though the grantor received a unitrust percentage that represented only 80% of the table rate during the entire term of the trust, the decrease in the table rate to 8% on the day before the grantor's death makes it appropriate, in the Service's view, to treat the grantor as if she had retained a unitrust percentage equal to the table rate throughout the trust's term.

If the table rate in effect at the time of trust creation were used instead, only 80% of the trust (and 80% of the appreciation or depreciation) would be includible in the gross estate. Although an 80% inclusion would be more appropriate than the 100% inclusion required by the Service, the use of the table rate in effect at the time the trust is created can also produce odd results. Consider the case where the table rate increased substantially immediately after

the creation of the trust and then remained constant for the balance of the trust term. As before, the relationship between the unitrust percentage and the table rate employed would not be reflective of the relationship existing throughout the term.

While it might appear that the use of the table rate in effect at inception is no less objectionable than the use of the table rate in effect at the time of death, this arguably is not true. The focus of section 2036 is on the retention of an interest in the trust created by the grantor. The statute emphasizes the nature of the grantor's interest in the trust immediately after its creation.[275] And so, given the focus of the statute, it would seem more appropriate to determine the relationship between the unitrust percentage and the table rate at inception rather than at the time of death. In addition, the use of the rate in effect at inception offers assurance to a grantor that the portion of the trust to be included in her gross estate under section 2036 is fixed once the trust is created — thus eliminating any concern that a decrease in the table rate could cause a greater portion of the trust than anticipated to be included.

A blended rate, i.e., one that takes into account the table rate in effect on each day during the existence of the trust, would avoid the unusual results potentially possible with the use of the table rate in effect either at inception or at death. The use of a blended rate would ensure that the portion of the trust to be included is determined by a rate that is reflective of the variations occurring in the table rate throughout the trust term. To illustrate, consider the use of a blended rate in the example just discussed. The portion of the trust required to be included would be slightly in excess of 80%. But for the decrease in the table rate to 8% on the day before the grantor's death, the table rate in effect throughout the term would have been 10%, thus resulting in an inclusion of 80%. The decrease in the table rate to 8% just prior to the grantor's

[275] If, for example, the grantor of a trust retains the right to receive for life one-half of the trust's income and then in an independent transaction subsequently acquires the other half of the income interest in the trust, only one-half of the corpus of the trust is brought into the grantor's gross estate under I.R.C. § 2036. This result flows from the fact that the grantor only retained an interest in one-half of the trust's income, the one-half interest acquired subsequently not being sufficient to trigger § 2036. See Estate of Skifter v. Commissioner, 468 F.2d 699, 704 (2d Cir. 1972). This is not to suggest, however, that the statute makes the nature of the interest at the point of the grantor's death entirely meaningless. Indeed, a grantor who retains an interest at inception and then subsequently transfers it more than three years before death is not subject to the section. See I.R.C. § 2035(a),(d).

death produces a blended table rate that is infinitesimally less than 10%, which would generate an inclusion of slightly more than 80%.

Alternatively, the inclusion amount could be determined on the basis of the actual income of the trust, rather than the table rate. So if, the grantor received aggregate unitrust payments during the term of the trust of $100 and the actual amount of aggregate income earned by the trust during its term were $200, one-half of the trust corpus and one-half of any appreciation (or depreciation) would be includible in the grantor's gross estate.

As suggested in the context of the GRAT discussion, it would seem more appropriate to base the computation of the section 2036 inclusion on the trust's actual income rather than on the table rate. After all, the table rate is in effect nothing more than a prediction about the rate of return to be earned in the future, which makes it possible to determine at the point of taxation a value that is a function of future earnings. In all cases, the aggregate amount of income actually earned by the trust prior to the death of the grantor is necessarily known on the date of the grantor's death. Given this, why is there a preference for the table rate? If in fact the unitrust amounts received by the grantor constitute, say, 70% of the trust's actual income, she should be treated in the same fashion as a grantor who retained the right to receive 70% of the trust's income — irrespective of the relationship that the unitrust amounts received by the grantor bear to the table rate. In sum, it is difficult to justify the use of the table rate, which is merely predictive, where the actual rate of return is necessarily known in all cases by the point at which the tax is imposed.

B. Evaluating the Case for Applying Section 2036

In explicitly focusing on retained income interests, neither section 2036 nor the related regulations disclose whether they apply to retained unitrust interests. The Service's application of section 2036 with respect to GRUT's is predicated on a substance-over-form analysis, similar to that of the GRAT ruling. The Service reasons that a grantor retaining the right to receive a unitrust percentage is in substance in a position equivalent to that enjoyed by a grantor who retains an income interest.

It would seem that, as between a unitrust interest and an annuity interest, the unitrust interest is more closely analogous to an

income interest.[276] Like an income interest, a unitrust interest provides the grantor with amounts that are dependent upon the rate of return generated by trust investments. Where the unitrust percentage designated in the trust instrument approximates the income return that is actually generated by trust investments, the amounts received by the grantor under an income interest or a unitrust interest would not over time be significantly different. In contrast, an annuity interest entitles the grantor to a fixed sum that is entirely unrelated to the actual rate of return enjoyed by the trust, making an annuity interest more likely to produce amounts at variance with those produced under an income interest. The Service, taking the view that section 2036 is applicable to both unitrust and annuity interests, does not make the observation in either the GRAT or the GRUT ruling that the analogy to an income interest is stronger in the case of a unitrust interest.

Nevertheless, when the GRUT is viewed as constituting two pots, a unitrust pot and a remainderman's pot, which are joined as partners with each entitled to participate appropriately in the earnings of the trust, the case for applying section 2036 weakens. As she is entitled to receive nothing more than the amount deemed to be placed in the unitrust pot at inception together with the earnings it generates, the grantor has no interest in the remainderman's pot. Viewed in this fashion, the GRUT is similar to a partnership consisting of the grantor and the remainderman and should be treated accordingly for transfer-tax purposes. Just as one partner's estate does not include any portion of the value of her co-partner's interest in the partnership, so too, in the case of a GRUT, the grantor's estate ought not to include any amount deemed held in the remainderman's pot.

In contrast, an income interest, to which section 2036 is made explicitly applicable, confers an entitlement upon the grantor that is not as compartmentalized as a unitrust interest. Whereas grantors who retain the right to income are entitled to receive all of the income generated by the trust that is in the form of income, grantors retaining a unitrust interest are only entitled to participate in the return accruing in the unitrust pot. While it may be reasonable

[276] It is perhaps for this reason that the Service is more aggressive in requiring the inclusion of appreciation in the gross estate under I.R.C. § 2036 in the case of a GRUT than in the case of a GRAT. See supra notes 214-227 and accompanying text.

to treat a grantor who retains an income interest as if she retained absolute ownership on the rationale that a substantial connection is maintained between the grantor and the entire corpus, no connection is maintained between the grantor and the amount deemed to be contained in the remainderman's pot in the case of a GRUT. In short, a GRUT is more similar to a partnership than to a retained income interest in a trust, thus making the applicability of section 2036 in the context of a GRUT somewhat questionable.

The partnership analogy is stronger where the unitrust interest expires at the end of a designated term rather than upon the death of the grantor. In the case of a non-life term, the amount of contributed principal to be returned to the grantor is fixed at the outset, with the only variable that could affect the amount payable to the grantor being the rate of return generated on trust investments. Similarly, in the case of a partnership, the amount of contributed capital returnable to each partner is fixed at the time the partnership is formed. And, as in the case of the GRUT, the critical variable impacting upon the amount distributable to each partner is the rate of return enjoyed by the partnership.

The life-term GRUT, on the other hand, entitles the grantor to an undetermined return of contributed principal: For each year that the grantor lives, she receives another slice of contributed principal, making the amount of contributed principal ultimately returnable to her dependent upon how long she lives. Variability of this nature is typically not present in the partnership context. The similarity between a GRUT and a partnership is thus greater in the case of the fixed-term GRUT than in the case of the life-term GRUT. As a consequence, the force of the partnership-analogy argument for rejecting section 2036 in the GRUT context is diminished where the GRUT is of the life-term variety.[277]

C. *Neutrality Considerations*

From the viewpoint of neutrality, it may be desirable to adopt an expansive interpretation of the income-interest concept that is at the core of section 2036 in order to bring a unitrust interest

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[277] As suggested in the discussion of GRAT's, the rationale supporting application of I.R.C. § 2036 is similarly more persuasive in the case of an income interest for life than in the case of an income interest for a term of years. See Estate of Nicol v. Commissioner, 56 T.C. 179, 183 (1971).

within its scope. As suggested in the GRAT context, the section can be viewed as imposing a penalty that assists in maintaining neutrality. Likewise, in the GRUT context, the application of the section can be viewed as creating a penalty that would "neutralize" any comparative advantage enjoyed by the GRUT over an outright gift. The GRUT's comparative advantage arises from the method in which the Code allocates the burden for the payment of income tax on GRIT earnings. To the extent that income accruing in the remainderman's pot is taxable to the grantor, the GRUT results in producing more wealth for the remainderman than a comparable outright gift would produce for a donee. For the donee of an outright gift must bear the burden of the income tax attributable to all of the income that the gifted sum generates in the hands of the donee.[278]

This comparative advantage enjoyed by the GRUT could be eliminated by amending the Code to require that the burden of taxation on all income accruing in the remainderman's pot be borne by the remainderman. Alternatively, the advantage could be eliminated by incorporating a rule in the Code that would treat the payment of any income tax by the grantor on income accruing in the remainderman's pot as a taxable gift.

With neither of the suggested alternatives presently contained in the Code, it is perhaps appropriate in order to maintain neutrality to apply section 2036 to GRUT's. In other words, the penalty effect created by section 2036 may "neutralize" the comparative advantage enjoyed by the GRUT.[279] Amending the Code to incorporate either of the two suggested alternatives would be preferable in that the advantage presently enjoyed would be directly eliminated. Assuming, however, that this approach is not taken, section 2036 ought to be applied in the GRUT context.

In sum, the Service considers unitrust and income interests as substantive equivalents. While unitrust interests more closely resemble income interests than annuity interests do, it is arguable

[278] See supra note 148 and accompanying text.

[279] If I.R.C. § 2036 is to be applied to a GRUT in order to "neutralize" its comparative advantage, some of the considerations discussed in the GRAT context will be relevant in the GRUT context as well: namely, whether appreciation accruing during the term of the trust should be includible and whether it is necessary to apply § 2036 of the Code so that the magnitude of the penalty increases as the retention period expands. For a discussion of these issues in the GRAT context, see supra notes 260-269 and accompanying text.

that a GRUT's similarity to a partnership makes it inappropriate to apply section 2036 in the GRUT context. Finally, as a matter of policy, the Code should be amended to eliminate the advantage that the GRUT enjoys over an outright gift. In the absence of such an amendment, section 2036 should be applied to GRUT's to achieve neutrality.

X. Conclusion

With the enactment of section 2702's zero-value rule, the opportunities previously enjoyed by taxpayers to achieve transfer-tax savings through the creation of a GRIT were largely eliminated. Although the personal-residence GRIT is not subject to the section and therefore remains viable, it does not offer the same opportunities for transfer-tax savings previously made available by the GRIT. Indeed, the limited potential for taxpayer abuse inherent in the personal-residence GRIT presumably motivated Congress to create the personal-residence exception. Nevertheless, the exception is inequitable, given that its benefits inure disproportionately to the very wealthy.

The zero-value solution adopted by Congress transcends the GRIT. Where the grantor of a trust retains a life estate, the zero-value rule is triggered, forcing the grantor to pay a gift tax on the entire value of the property contributed to the trust. Despite the payment of the gift tax, the full value of the trust corpus, as determined on the date of the grantor's death, must be included in the grantor's gross estate under section 2036. As a consequence, grantors motivated by non-tax reasons to create a trust under which a life estate is retained will be deterred from doing so. In permitting the zero-value rule to operate in this context, Congress has made the rules applicable in the case of the life-estate trust even less neutral than they had been.

Section 2702 contains an exception to the zero-value rule for GRAT's and GRUT's. The exception is driven by the reality that neither of these trusts permits taxpayers to achieve the same magnitude of transfer-tax savings that the GRIT had made possible. Both the GRAT and the GRUT are, however, capable of producing tax savings, making them attractive relative to the outright gift. If neutrality is to be maintained, the comparative advantage inherent in the GRAT and the GRUT should be eliminated.

While the treatment of a GRIT under section 2036 had been

straightforward, there is ambiguity concerning whether and how the section ought to be applied in the context of a GRAT or a GRUT. Assuming the comparative advantage enjoyed by the GRAT and the GRUT is not directly eliminated, the section should be applied in this context in order to create the effect of a penalty. For, with a properly structured penalty, the comparative advantage would be neutralized.

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