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Retained Interest Transfers Under the Estate and Gift Tax

By Joseph M. Dodge

Joseph M. Dodge

Joseph M. Dodge is the Stearns Weaver Miller Weissler Alhadeff & Sitterson Professor at Florida State University College of Law.

Dodge offers a proposal to simplify the law on transfers with retained interests and powers under the estate and gift tax that are potentially within sections 2036 through 2038. Under the proposal, transfers with retained current-enjoyment interests would be deemed incomplete until the earlier of the termination of the interest or the grantor's death, at which point they would be taxed in full. A transfer in return for a debt obligation contingent on the transferor's death would be treated as a transfer with a retained current-enjoyment interest. Those rules should effectively eliminate the use of grantor retained annuity trusts, grantor retained unitrusts, private annuities, and self-canceling installment notes in estate planning — transactions that have arisen only because of exploitable estate and gift tax rules. Also, the sale of a remainder interest would not help to avoid those rules. The concept of a revocation power would be expanded to include a possibility of receiving distributions. Retained powers to alter, amend, or terminate would cease to be significant. Section 2702 would be repealed.

The proposal is offered as a part of the Shelf Project, a collaboration of tax professionals to develop proposals to raise revenue without a VAT or a rate increase. Shelf Project proposals would improve the fairness, efficiency, and rationality of the tax system.

Shelf Project proposals follow the format of a congressional taxwriting committee report in explaining current law, what is wrong with it, and how to fix it.

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Current Law

The essential characteristic of a transfer with a retained interest or power[1] is that the transferor has not parted with all incidents of ownership over the property. It follows that the basic issue regarding transfers with retained interests and powers under the federal estate and gift taxes has been when (and to what extent) the transfer is to be taxed. Should the transfer be taxed in whole or in part under the gift tax when launched, or instead at the later time the retained interest or power terminates, which can occur no later than the transferor's death?[2] The taxing date (date of gift or date of death) is the date that fixes the value of the amount to be taxed. Valuation determines whether the transfer in question (together with previous gratuitous transfers) falls within the unified estate and gift tax exemption

[1]An interest or power in property is retained by a transferor if she still has the interest or power following the transfer. Thus, the creator of a revocable trust retains the power to revoke. *See* reg. section 25.2702-2(a)(3). An interest or power is not retained if it is given to the transferor in a wholly independent transaction.

[2]A power is personal and does not survive the power holder's death. Hence, it cannot be the subject of a gift, nor can it descend. An interest in property (such as a life estate or its trust equivalent, an express reversion, or a remainder interest) may or may not terminate at the interest owner's death. However, it is unnecessary here to become embroiled in the law of future interests, because the only retained interests that matter in this article are retained current-enjoyment interests (life estates; terms for years; possessory rights; income, unitrust, and annuity interests in trusts; powers to revoke; and, the possibility of receiving distributions from a trust).

amount, which is $5 million per transferor in 2011.[3] It is generally to the taxpayer's advantage to have a transfer taxed at the earliest possible date if the property is expected to appreciate (perhaps by an internal accumulation of income) or if the value of a transferred interest (if able to be determined by using actuarial tables) is lower at the date of transfer than when it comes into possession at a future date.

A remainder interest is a prime example of an interest that increases in value over time, even if the underlying property does not. If the underlying property does appreciate, the appreciation of the remainder interest is compounded. Thus, suppose Jane (age 32) owns Blackacre worth $1 million and makes a gift of a remainder interest to Bill, retaining an income interest for life. The amount of the gift using 4 percent discount rate actuarial tables is only about $200,000. The higher the discount rate, the lower the value of the remainder interest. If the discount rate is 8 percent, the same gift is worth only about $61,000. Jane continues to possess or enjoy the property until death, at which time the property is worth $2 million. If the property is not included in Jane's gross estate, she will have succeeded in removing $2 million from her estate at a gift tax valuation of only $200,000 (or $61,000), while continuing to enjoy the property (and its income yield) for life.

From the beginning of the estate tax in 1916, transfers with some retained interests and powers that expired at the transferor's death were viewed by Congress as being "testamentary." The 1916 statutory language was diluted by a hostile Supreme Court,[4] and Congress responded in 1924, 1931, 1932, 1936, 1949, 1951, 1954, and 1978 to create what are now sections 2036, 2037, and 2038, which are the main focus of discussion here.[5] Those provisions, often reacting to prior cases, have generated a vast quantity of doctrine that is often arcane and ill-matched to the language of the statute.

Most of that body of law applies to transfers in trusts, but a significant application is to transfers of real estate with retained occupancy by the transferor.[6] To summarize current estate tax doctrine with some simplification, an *inter vivos* transfer is included in the gross estate (and thereby taxed at its value at death of the transferor) if the transferor retains (1) possession or enjoyment of the property or an income right therein,[7] (2) a reversion that at the moment just before the transferor's death is worth more than 5 percent of the value of the property,[8] or (3) a power to alter the beneficial enjoyment of income or to revoke, alter, or amend the transfer.[9] However, some retained interests and powers cause inclusion of only a portion of the transferred property.[10] More to the point, sections 2036 through 2038 constitute an imperfect defense against real and perceived tax avoidance. The transfer or release of a retained interest or power more than three years before the decedent's death avoids estate inclusion,[11] as do lapses or expirations of interests and powers at any time before death,[12] although gift tax may be triggered in some of those cases. Retained powers over investments and trust accounting,[13] as well as powers limited by ascertainable standards,[14] are considered under court decisions to be outside the scope of sections 2036 through 2038. Other cracks in the facade of sections 2036 through 2038 have been found in connection with the "transfer by the decedent," "retention,"

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[3]The estate and gift tax is currently (2011) imposed at a flat rate of 35 percent on the sum of (a) the transferor's lifetime cumulative taxable gifts and (b) the transferor's taxable estate, reduced by a fixed dollar amount (currently $5 million) called formally the "exemption equivalent of the unified transfer tax credit" and informally the "exemption amount." Thus, no tax is owed until the cumulative gift and estate transfers of a transferor exceed $5 million. *See* section 2001(b) and (c).

[4]*See May v. Heiner*, 281 U.S. 238 (1930) (holding that a trust transfer with a retained income interest for life was not included in the gross estate under the original "transfer intended to take effect in possession or enjoyment at or after [the transferor's] death" language of the 1916 estate tax).

[5]Section 2036(b) was added in 1978 but is peripheral to the themes of the proposal made herein. Section 2039, dealing with employee survivor benefits and employer annuities, is modeled on section 2036(a)(1), but it is not discussed herein on the ground that those contractual arrangements do not really involve a retained-interest (or retained-power) property transfer.

[6]*See, e.g., Estate of Linderme v. Commissioner*, 52 T.C. 305 (1969).

[7]*See* section 2036(a)(1).

[8]*See* section 2037(a).

[9]*See* sections 2036(a)(2) and 2038(a)(1). In rare cases a contingent power can trigger inclusion by reason of section 2037(b)(2).

[10]Under section 2036(a), an interest in (or power over) only a portion of the income causes the corresponding portion of the property to be included. *See* reg. section 20.2036-1(c)(1)(i) (noting also another situation in which another person has a current-enjoyment interest before that of the grantor). Under section 2037, the amount included is the estate tax value of any interests in the property that are contingent on surviving the decedent (excluding the value, if any, of the retained reversion). *See* reg. section 20.2037-1(e), Example 3. Under section 2038, the amount included is only the interest subject to the power to alter, amend, or terminate. *See* reg. section 20.2038-1(a) (last sentence).

[11]*See* section 2035(a).

[12]Under section 2036(a) the interest or power causes estate inclusion if it is retained for life, for a period not ascertainable without reference to the transferor's death, or for a period that does not in fact end before death. Sections 2037 and 2038 require that the reversion or power exist at the moment just before death.

[13]*See, e.g., United States v. Byrum*, 408 U.S. 125 (1972).

[14]*See, e.g., Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947).

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and ''retained in the transferred property'' requirements and in the statutory exception for transfers for full and adequate consideration in money or money's worth.[15] Those will be discussed when implicated by the changes offered by this proposal.

The federal gift tax traditionally reached only the value, determined under actuarial tables, of the completed gift of an interest in property. Return to the above example of Jane's gift of a remainder interest to Bill. In the 1970s and 1980s, a tax avoidance device known as the grantor retained income trust (GRIT) was developed. It basically followed the format of the gift of a remainder interest by Jane to Bill, except that grantor Jane's income interest was retained for a period expected to end before her death.[16] The actuarial tables used for valuing the gift of remainder interests systematically undervalue remainder interests, first by assuming that no appreciation whatsoever will occur,[17] and second by using a discount rate that is probably too high.[18] Section 2036(a) brings the whole underlying property into the estate if the property is retained for life, for a period not ascertainable without reference to the transferor's death, or for a period that does *not* in fact end before death. If in fact the retained interest *did* lapse before her death, the transferred property avoided estate inclusion under section 2036(a) (or any other provision). Also, because a lapse of an interest is not a transfer, the lapse of the income interest was not treated as a gift thereof, nor did it trigger section 2036(a) by way of section 2035(a).[19] A retained-income trust can be operated so that the economic return on the trust assets can take the form of appreciation, which increases the amount passing to the remainder without tax beyond any initial gift tax.

The eventual response to the GRIT was the 1990 enactment of section 2702. When section 2702 applies, the retained interest[20] is deemed to be worth zero for gift tax purposes, resulting in a deemed gift of the retained interest (as well as of nonretained interests).[21] Thus, in the earlier Jane/Bill example (modified to be in the form of a GRIT), the gift by Jane would be deemed to be of $1 million, despite the retained interest. The later appreciation to Jane's death or the lapse of her interest would escape further estate or gift tax.

There are many exceptions to the application of section 2702. The most noteworthy are for some retained annuity and unitrust interests and for a personal residence trust.[22] Also, section 2702 applies only if the gift of the nonretained interest is to a family member, meaning an ancestor, descendant, sibling, and any spouse of the foregoing or of the grantor.[23]

The enactment of section 2702 has had only the minor effect of causing the grantor to avoid a GRIT when other interests are transferred to family members. GRITS are still allowed for non-family members, and a GRIT equivalent (the personal residence trust) is allowed even for family members. Although a grantor retained unitrust (GRUT) is allowed, the most popular form of retained-interest transfer appears to be the grantor retained annuity trust (GRAT), especially a GRAT with a high payout rate expected to exhaust the trust in a short period, referred to as a short-term GRAT. The short-term GRAT minimizes the risk that section 2036 will apply. It provides for a high annuity payment funded with property that is expected (or hoped) to generate a high rate of return. Suppose Gramps creates a GRAT with $1 million generating a 10 percent rate of return, retaining an annuity of $520,000 each year for two years, with remainder to Junior. After year 1, the trust will have $580,000 ((1.1 x $1 million) - $520,000). At the end of year 2, the trust will have $118,000 ((1.1 x $580,000) - $520,000). Junior will end up with the $118,000 after two years,

[15]For a general discussion of the estate and gift tax doctrine pertaining to transfers with retained interests and powers, see Joseph M. Dodge et al., *Federal Taxes on Gratuitous Transfers: Law and Planning* 114-117, 199-201, 369-454, 469-472, 488-500 (2011).

[16]*See* discussion, *supra* note 12. If the retained interest lapsed before the grantor's death, the interest was not retained for the grantor's life for a period not ascertainable without reference to the grantor's death or for a period that did not in fact end before the grantor's death.

[17]The true value of a remainder interest is the present value of the amount expected to be in the trust at the date the remainder comes into possession. However, the actuarial tables apply the discount rate against the amount presently transferred. That assumes (contrary to the mandates of trust law and of portfolio theory) that none of the future economic return will inure to the corpus (the remainder interest).

[18]Section 7520 requires that the discount rate used in actuarial tables be 120 percent of the applicable federal rate. The higher the discount rate, the lower the present value of a future amount (a remainder interest).

[19]Section 2035(a) provides that a transfer of a retained interest (or release of a retained power) within three years of the transferor's death is not effective to avoid sections 2036 through 2038.

[20]A nonretained interest subject to a retained power to alter, amend, or revoke is treated as a retained interest. *See* reg. section 25.2702-2(a)(4).

[21]Section 2702(a)(2)(A).

[22]*See* section 2702(a)(3)(A)(ii) and (b). The rationale of allowing retained annuity and unitrust interests is to avoid the shifting of economic return from trust accounting income to appreciation. There appears to be no principled rationale for the exception for a personal residence trust.

[23]*See* sections 2702(e) and 2704(c)(2).

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but Gramps will be charged with a gift of only $19,228, using a 4 percent discount rate.[24] Gramps can recycle all the money he gets back in the form of annuity distributions into new GRATs.

There are other exploitable loopholes in the area of retained-interest transfers. One involves the transfer of appreciating property to an object of the decedent's bounty in return for an unsecured promise to make installment payments of principal (with or without stated interest) that terminate on the transferor's death. The payments are set so that (using the annuity factor in the applicable actuarial table for the transferor's age) the present value of the payment stream equals the fair market value of the property transferred. That transaction does not result in a gift because the (actuarial) value of the consideration equals the amount transferred,[25] and it is not a retained-interest transfer for estate tax purposes because a money claim against an individual is not treated as a retained interest in the transferred property.[26] As described so far, that type of transaction (called either a private annuity or a self-canceling installment note (SCIN)) appears to be of the ''estate freeze'' variety, removing only future appreciation from the transferor's gross estate. However, if the transferor dies prematurely, her interest (right to payments) will also terminate prematurely, and (with the benefit of hindsight) the consideration received will turn out to have been grossly undervalued. Thus, if Delilah (age 60) transfers Blackacre worth $1 million to Elizabeth in return for a promise to pay Delilah $92,354 a year for Delilah's life, the value of the promise will equal $1 million (using the 6 percent tables). But if Delilah dies one year later, the value of the consideration that replenished Delilah's estate will have turned out to have been worth only $87,126 (meaning that with hindsight, the gift amount should have been $912,874). Not surprisingly, that device appears to be used exclusively by persons who are expected to underperform their actuarial life expectancy.[27]

Another retained-interest-transfer technique for avoiding both estate and gift tax is one involving a sale of a remainder interest. Suppose John (age 75) owns Blackacre worth $1 million and sells a remainder interest therein (retaining a life estate) to Karen for its then value of $565,910 (using the 6 percent tables). Since that is a sale of a property interest for full and adequate consideration, there is no gift under conventional gift tax purposes, but there is a gift of $434,090 under section 2702 unless Karen is not a family member or some other exception applies (such as for personal residence trusts).[28] If John dies prematurely, the consideration will have been (in hindsight) undervalued. Several appeals courts have held that that type of transaction avoids section 2036(a) by reason of having been a sale for full and adequate consideration in money or money's worth.[29]

To complete the picture, section 2037 covers transfers with retained reversions. Those transfers lack abuse potential because the transferor is not moving the property away from herself but instead drawing the property back when the reversion comes into play. The vesting or coming into possession of the reversion will cause estate inclusion under section 2033. Indeed, the value of a reversion normally increases over time, eliminating the problem of undervaluation of gifts.[30] The absence of abuse potential is also evidenced by the rareness of litigated cases involving section 2037, plus the fact

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[24]A GRAT can be designed to result in a zero or miniscule gift amount. Such a GRAT was upheld in *Estate of Walton v. Commissioner*, 115 T.C. 589 (2000), *Doc 2001-173*, *2000 TNT 248-74*; *acq*. Notice 2003-72, 2003-2 C.B. 964, *Doc 2003-22481*, *2003 TNT 200-26*.

[25]*See* reg. section 25.2512-8.

[26]*See Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958).

[27]*See Fabric v. Commissioner*, 83 T.C. 932 (1984). The actuarial tables are required by section 7520 to be used in all cases except when the person is so ill with an incurable disease or other condition that there is at least a 50 percent chance of dying within one year of the transfer. *See* reg. section 25.7520-3(b)(3).

[28]*See* reg. section 25.2702-4(d), Example 2.

[29]*Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309 (3d Cir. 1996), *Doc 96-31236*, *96 TNT 234-10*; *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997), *Doc 97-18223*, *97 TNT 120-53*; *Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999), *Doc 1999-23835*, *1999 TNT 134-9*. *Contra Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990). Those transactions often involve the transaction known as the ''spousal election will,'' in which H and W, each owning half of the couple's community property, enter into an arrangement by which H (the first decedent) bequeaths his estate to a testamentary trust, income to W for life, remainder to their children, and W agrees to make an *inter vivos* transfer of her community property into the same trust. The courts have treated that arrangement as involving a section 2036 type of transfer by W with consideration received in the form of an income interest in H's trust (that is, as a sale by W of a remainder interest in her own property). For what it's worth, my opinion is that that transaction should not be viewed as a sale by W of her remainder interest. The transaction is not binding until after H's death, because W can elect not to go along. When W does elect to go along, H (who is dead) cannot be said to have purchased anything, nor can H's estate be said to have purchased anything since it hasn't given up anything. (It is the function of an estate to disgorge its assets sooner or later.) The arrangement is just one of parallel gratuitous transfers.

[30]Suppose S creates an irrevocable trust, income to B for life, then reversion to A if living, if not, remainder to C. That transfer can be abusive only if A's reversion (which is subtracted from the gift amount if section 2702 does not apply) is overvalued relative to the other interests. But A's reversion can only increase in value (by B's premature death or the passage of time).

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that the doctrine under section 2037 is esoteric, virtually incomprehensible, and requires valuations of reversions by actuarial specialists. Retained-reversion transfers are subject to section 2702.[31]

Sections 2036(a)(2) and 2038 include in the gross estate revocable transfers and transfers with retained powers to alter or affect the enjoyment of income or corpus. A transfer with a retained power to revoke, alter, or amend is not a completed gift for gift tax purposes.[32]

The estate and gift tax rules are not wholly in sync with each other. Transfers can be subject to both taxes,[33] although in most cases double taxation is mitigated by retroactively eliminating the gift amount from the cumulative tax base if the interest subject to gift tax was also subject to estate tax,[34] but that mitigation doesn't apply to income interests subject to gift tax under section 2702.[35] The possibility of avoiding both estate and gift taxes exists for some retained-power transfers or discretionary trusts for the grantor's benefit. The estate and gift tax rules are out of sync with the income tax grantor trust rules.[36]

Reasons for Change

Current law in this area can be vastly simplified and at the same time immunized from illegitimate tax avoidance. Estate and gift tax planning is illegitimate when a gratuitous transfer is not taxed.

A transfer with a retained current-enjoyment interest takes place economically in three stages, which can be illustrated by the example of the gift of a remainder interest from Jane to Bill discussed at the beginning of this article. First, a gift occurs immediately of the interests in the property that follow the retained current-enjoyment interest (the nonretained interests are collectively referred to herein as the remainder interest). Second, gratuitous transfers occur over time from the retained current-enjoyment interest to the remainder interest. This transfer occurs with the reduction in the value of the current-enjoyment interest as that interest grows shorter in length and with the increase of the value of the remainder interest as the retained interest shrinks. The measure of that annual transfer is the annual reduction in the ''life estate'' or ''term certain'' actuarial factor multiplied by the value of the property (either at the inception of the transfer or at a designated point each year). The third stage occurs on the termination of the retained current-enjoyment interest at or before the transferor's death, when the value of the retained interest wholly vanishes and that of the remainder interest is increased to 100 percent of the then value of the property.

That economic view of what is being gratuitously transferred (and when) should replace the traditional notions of whether a transfer is testamentary, which has informed estate and gift tax law from the beginning. The only transfers that matter under the estate and gift taxes are transfers of objective economic value. But how to translate the concept of economic transfer into tax rules is another matter, which is saved for the ''Proposed Changes in Law'' section, below.

The economic transfer concept is not entirely new. In the income tax it is found in all the provisions providing for accrual of original issue discount. OID is an imputed transfer of value (in the form of interest) from the borrower to the lender over time. The economic transfer concept has found its way into the gift tax by way of section 7872. Suppose Laura lends $100,000 to daughter Barbara at zero interest for a 60-month term. Because the present value (at 5 percent per annum) of the repayment right is $78,350, Laura is deemed to have made an immediate gift to Barbara of $21,650. (Here, Laura has retained the equivalent of a reversion in a sum of money.) Over time, Barbara is deemed to pay interest to Laura at the rate of 5 percent compounded annually on the true loan amount of $78,350.

The tax law does not have to tax disguised value transfers everywhere they exist. The example above involving interest-free loans demonstrates that a retained-reversion transfer is relatively harmless in the context of the transfer taxes because economic value actually flows back to the transferor over time. Nevertheless, disguised value transfers need to be taxed when failure to do so undermines the system by allowing a gratuitous transfer without tax. For a transfer with a retained current-enjoyment interest, all economic transfers occur ''away from'' the transferor, and they occur by reason of the donor's transfer of a remainder interest while retaining a current-enjoyment interest. No third-party transferor is in the picture, and the donee/beneficiaries are not themselves taking the

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[31]*See* section 2702(a), referring to retained interests generally.

[32]*See* reg. section 25.2511-2(b), (c), and (d).

[33]The estate tax rules are found in the detailed (if often opaque) provisions of sections 2036 through 2039, whereas the gift tax rules (apart from section 2702) are located in reg. section 25.2511-1(e), 25.2511-1(h)(7), and 25.2511-2, which in turn are derived from court decisions, such as *Burnet v. Guggenheim*, 288 U.S. 280 (1933); *Estate of Sanford v. Commissioner*, 308 U.S. 39 (1939); and *Camp v. Commissioner*, 195 F.2d 999 (1st Cir. 1952).

[34]*See* section 2001(b) (flush language stating that ''adjusted taxable gifts'' excludes gifts included in the gross estate) and section 2001(b)(2) (credit for gift tax paid on any post-1976 taxable gift).

[35]The income interest itself (having expired at death) is not included in the gross estate under section 2036(a) or any other provision.

[36]Sections 671 through 677.

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property by force, theft, or government regulation, or under the exercise of a general power of appointment conferred upon them by a third party. The transferor is in full control of how the arrangement is structured. The estate and gift tax needs to capture the gratuitous transfer to its full extent. As will be seen below, that can be accomplished without resorting to estimates, guesses, annual valuations, or involved calculations.

GRATs would not exist except for the estate and gift tax. The whole point of an annuity is to provide a stream of payments until death. The function of an annuity in nontax personal finance is for the transferor to insure against his own longevity. The idea of a short-term annuity is contrary to practical reason. The GRAT exists only because the gift and estate tax fail to tax the full value of the transfer (except in the unlikely case that the transferor dies before the retained annuity interest expires). Nobody heard of a GRIT, GRAT, or GRUT before those transactions were concocted by estate planners.

A stream of level payments (mimicking an annuity) is a legitimate form of installment purchase of property. However, an installment obligation incurred by a relative that runs until the death of the transferor entails a gamble that would never be undertaken unless it was virtually certain that the transferor would underperform her life expectancy. Return to the earlier private annuity example in which Delilah (age 60) transfers Blackacre worth $1 million to Elizabeth (a family member) in return for a promise to pay Delilah $92,354 a year for Delilah's life. No reasonable economic actor in Elizabeth's position would undertake that obligation if she expected Delilah to live to a normal life expectancy of age 80 or longer. That example gives the lie to the old canard that actuarial tables will even out in the long run in the game between the commissioner and taxpayers.[37] Estate planners, knowing the rules that play off actuarial tables, will make winning bets, not random ones. Actuarial tables should not be used unless absolutely necessary.[38]

Economic transfer analysis demonstrates that the sale of a remainder interest for its actuarial value cannot be a transfer for full and adequate consideration, because the initial value of the remainder interest involves only the first step of what is ultimately a three-step transfer of economic value.[39]

A retained-reversion transfer has no discernable tax avoidance potential because (as noted earlier) value flows back to the transferor. Retained reversions should simply be ignored under sections 2036 through 2038, as they are ignored under section 2702 when interests are transferred to family members. Retained reversions that descend from the transferor at death would continue to be included in the transferor's gross estate under section 2033.

A transfer with a retained power to revoke is not a meaningful transfer of ownership. Treating that transfer as not a gift (by reason of being an incomplete transfer) is actually helpful to transferors by preventing the same property from being taxed twice, once on transfer and again if the transfer has been revoked (and the property has been made the subject of a later gift or is included in the probate estate).

What is critical in this regard is that the property *might* come back to the donor. Whether the cause of the property's possible return to the transferor is the agency of the transferor or of a third party (such as a trustee) is irrelevant. Until that possibility is terminated by a distribution to a person or persons other than the transferor, the transfer is held to be in suspense and in no way can be said to be complete.

It follows that a transfer should be treated as incomplete to the extent that income or corpus can be distributed to the donor under a distribution power, whether or not that power is limited by such standards as ''support'' or ''comfort'' or whether the donor's creditors can reach the property under state law. Here the models are sections 676 and 677(a) of the income tax grantor trust rules. However, the exception for powers held by an adverse party should be dropped because that concept is based on the fiction that the power holder will act out of self-interest and is not subject to the control of the living donor.[40] Any distribution to a third party would be a complete transfer because it would be freed of the possibility of returning to the transferor.

[37]This canard was given the imprimatur of the Supreme Court in *Ithaca Trust Co. v. United States*, 279 U.S. 151, 155 (1929).

[38]*Ithaca Trust* involved the estate tax valuation of a charitable remainder interest. Current law provides no opportunity to consider post-death facts. However, Congress could enact rules imposing recapture taxes (supplemental estate taxes) when values dependent on estimates of post-death facts turn out to be wrong. *Cf*. section 2032A(c) (recapture tax on account of failure to maintain qualified use).

[39]That point was made in a concise fashion in the dissenting opinion of Judge Richard E. Cowen in *Estate of D'Ambrosio*, 101 F.3d at 318.

[40]The adverse-party principle was followed in *Commissioner v. Prouty*, 115 F.2d 331, 335-336 (1st Cir. 1940), despite the court's admission that ''at the time of the creation of the trust there might be extraneous considerations, whether of a pecuniary or sentimental nature, which would give the donor every confidence that such designated beneficiary would acquiesce in any future desire of the donor to withdraw the gift, in whole or in part.'' The federal tax law is not required to elevate form over substance, and Congress should legislate according to substance.

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Other retained-power transfers should be deemed to be complete when made. Under an estate tax, what matters is parting completely with the property, not its receipt by particular donees.[41] (An accessions tax on gratuitous transferees may be preferable to an estate tax on this account,[42] but that issue is beyond the scope of this article.) Under current law, the retained-power rules are toothless because of court decisions.[43] The retention of a power does not cause value to pass from the transferor to the collective objects of her bounty over time, and the transferor's death affects only how the donee/beneficiaries will divide the property. The subjective value to the transferor of being able to affect beneficial enjoyment is not something possessing objective economic value that can be quantified. The objective economic value has already passed to the donee/beneficiaries as a group. Although property is often viewed as a bundle of rights, control of beneficial enjoyment has no independent market value apart from the underlying assets. In fact, the person having that power (a trustee) is entitled to be compensated for having and exercising it; the trustee does not pay the beneficiaries for that power.[44]

Explanation of Proposal

The unified operative rule for the proposal here would be that a transfer with a retained current-enjoyment interest would be treated as incomplete, under new section 2705, until the earlier to occur of (1) the termination or transfer (by gift) of that interest regarding any property or (2) the transferor's death. At that time (the taxing date), the full value of the property subject to the right would be taxed. Any distributions to third parties before that taxing date would also be taxed.[45] The operative rule ensures that the entire net transfer is subject to tax on an ex post basis, but without having to calculate annual passage-of-time gifts. In the two-year Gramps/Junior GRAT described earlier, Gramps would be treated as making a gift of $118,000 to Junior on the termination of the GRAT. Section 2035(a), treating gifts of retained interests within three years of death as being ineffective to defeat section 2036, would become redundant and would be repealed.

A transferor would be deemed to hold a retained current-enjoyment interest if she *could* receive distributions of income or corpus under the trust in any year.[46] Distributive standards would be disregarded, as would any adverse-party status of the party effecting distributions and any nontax rules pertaining to creditor rights. Tax principles, not trust law doctrine, should control.

A retained interest would be sufficient to trigger the operative rule in full unless it was subject to a vested and fixed interest in another party at the time the transfer becomes complete. Thus, if D created a trust in which 50 percent of the income is payable to A and 50 percent to B, with remainder to C on the death of the survivor, and A predeceases B, only half of the property would be included in A's gross estate under section 2705 on the theory that A had made a completed gift of half the property when the trust was created.[47] Possession or use of transferred tangible property would trigger the operative rule in full. The fact that other parties (such as the transferor's spouse) also held possession or use rights or privileges would be disregarded unless they were fixed and operated to reduce *pro tanto* the enjoyment of the transferor.[48] If the transferor received back sufficient amounts that the trust was being depleted, the amount subject to tax under new section 2705 would be reduced accordingly and appropriately, as distributed amounts have been shifted to the transferor's potential probate (section 2033) gross estate.

A debt obligation received in return for the transferred property that is contingent on (that is, terminates at or with reference to) the transferor's death would be treated as a retained current-enjoyment interest in the transferred property, regardless of the actuarial value of the obligation. Thus, private annuities and SCINs would be subject

[41]*See* reg. section 25.2511-2(a).

[42]*See* Joseph M. Dodge, "Replace the Estate Tax With a Realization Accessions Tax," *Tax Notes*, Mar. 2, 2009, p. 1151, *Doc 2009-636*, or *2009 TNT 39-22*.

[43]*See* cases cited in *supra* notes 13 and 14.

[44]A power is not an interest for gift and estate tax purposes and cannot be the subject of a taxable gift or estate transfer. The sole exception is for general powers of appointment, which are considered the equivalent of fee ownership. *See* sections 2041(a)(2) and 2514(a).

[45]A distribution to a third party from incompletely transferred property is a completed gift because it is no longer subject to the retained power (or, in this case, the retained interest). *See* reg. section 25.2511-2(f).

[46]That rule would effectively mean that the transferor's retained interest is not dependent on any legal right to compel trust distributions.

[47]A right to a percentage of the income currently results in a corresponding percentage of the corpus to be included under section 2036(a)(1). *See* reg. section 20.2036-1(c)(1). However, that rule should not apply when no other person has a fixed right to income. If the grantor has only a right to 50 percent of the income, the other 50 percent is accumulated and is thereby committed to future distribution to a third party. The accumulated income is as much a gratuitous transfer by the grantor as are passage-of-time transfers to the remainders.

[48]That rule would overturn the result of *Estate of Gutchess v. Commissioner*, 46 T.C. 554 (1966) (reviewed), *acq*. Rev. Rul. 70-155, 1970-1 C.B. 189.

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to the operative rule. The amount includable would be reduced by any principal received by the grantor before the taxing date,[49] with principal being computed under section 483 if the obligation bore below-market interest.[50]

Consideration received for the transfer from a transferee would simply be a subtraction from the amount subject to tax under section 2705. It could not negate the operative rule as a matter of law. An issue is whether the consideration, if given as a lump sum at the date of transfer, should be augmented by imputed interest to the taxing date or should be viewed as a purchase of a fraction of the property. However, a purchase of a fractional interest in a fee is not what is happening. The purchase is of a remainder interest that increases over time or through failure to distribute income or principal to the transferor. That is not a market investment but a device to disguise a gratuitous transfer. Any augmentation of the consideration offset to account for earnings thereon is also not warranted, because that augmentation represents earnings and gains of the transferor by investment of the consideration, not amounts given by the transferee.[51] Good investments are what expose a person to the federal transfer taxes.

Sections 2035(a) and 2036(a)(1) would continue to apply to completed retained-enjoyment transfers made before the effective date. New section 2705 would apply to pre-effective-date transfers not subject to sections 2035(a) and 2036(a)(1), but only for economic transfers after the effective date. That is, there would be a subtraction from the amount included under section 2705 for amounts subject to gift tax plus an amount equal to the diminution of the retained interest before the effective date attributable to the decrease in the relevant actuarial factor.

Retained-reversion transfers would be taxed as if the reversion did not exist. Section 2037 would be repealed, but the reversion would not be subtracted in computing the gift. A retained reversion that descends would be includable under section 2033 as an interest owned by the transferor/decedent at death.[52] If the reversion is so included, the gift tax value of the same can be removed from the adjusted taxable gifts amount that is includable in the cumulative tax base.[53]

Section 2038 would also be revoked because the possibility of receiving income or corpus (regardless of the mechanism)[54] would constitute a retained current-enjoyment interest under new section 2705. A retained power to alter, amend, or terminate would be without federal transfer tax significance.[55]

Section 2705 would control for both gift and estate tax purposes. Section 2702 would be repealed.

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[49] *Cf. Greene v. United States*, 237 F.2d 848 (7th Cir. 1956) (excess of annuity value over value of income interest treated as consideration in money's worth). That consideration counts because it is given by the donee and would not otherwise reduce the amount included (the value of the transferred property). Compare the GRAT scenario discussed in the next text paragraph.

[50] Principal payments received would be viewed as the equivalent of distributions of corpus back to the transferor. Applying section 483 precludes overstatement of principal if the obligation bears a below-market interest rate.

[51] The existing regulations concerning the amount includable when a GRAT is included in the gross estate are wrongly conceived, as is the critique of them expressed by Michael D. Whitty in "GRAT Expectations: Questioning, Challenging, and Litigating the Service Position on Estate Tax Inclusion of Grantor Retained Annuity Trusts," 36 *ACTEC J.* 87 (2010).

[52] Although annuities and employee survivor benefits are beyond the scope of this proposal, section 2039 (which was modeled to a large extent on section 2036(a)(1)) should be amended to eliminate the "retained right to payments" requirement. The survivor benefit is here not economically dependent on the lead annuity or retirement benefit, as is the case with a split-interest transfer of property, because the rights are contractually independent. Nevertheless, the survivor benefit is always a gratuitous transfer from the annuitant or employee, and it should be included in the gross estate regardless of any retained right to payments, and even if the primary annuitant or employee has not retained any power over or interest in the arrangement.

[53] *See* discussion, *supra* notes 3 and 34.

[54] That rule would overturn the result of such cases as *Commissioner v. Irving Trust Co.*, 147 F.2d 946 (2d Cir. 1945), holding that an interest or power is not retained when a trustee had discretion to pay corpus to the trust grantor.

[55] That expanded concept of "revoke" would bring the estate tax more in line with the corresponding income tax provisions, sections 676 and 677. Whether all or a portion of the grantor trust rules of sections 671 through 678 should be changed (or even abolished) is beyond the scope of this article. In the income tax, retention of a meaningful reversion has long been a primary indicator of tax ownership. *See* section 673; *Helvering v. Clifford*, 309 U.S. 1 (1940); *Helvering v. Horst*, 311 U.S. 112 (1940); *Hort v. Commissioner*, 313 U.S. 28 (1941). Perhaps no necessity exists to conform the transfer tax rules to the income tax rules, except possibly for a one-way rule that any trust transfer that is effective to shift income away from the grantor should be deemed to be a completed gift. *See* section 2511(c) (effective only for gifts made in 2010).

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