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## Estate Planning in the Nineties: Friday the Thirteenth, Chapter 14: Jason Goes to Washington - Part II

Martin D. Begleiter

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# ESTATE PLANNING IN THE NINETIES: FRIDAY THE THIRTEENTH, CHAPTER 14: JASON GOES TO WASHINGTON—PART II

*Martin D. Begleiter\**

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## INTRODUCTION

Unlike previous revisions to the estate and gift tax provisions of the Internal Revenue Code,<sup>1</sup> sections 2701-2704 of the Code<sup>2</sup> and the provision which preceded them<sup>3</sup> treat extremely sophisticated estate planning techniques.<sup>4</sup> Chapter 14<sup>5</sup> and its predecessor were clearly aimed

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1. All references to the Internal Revenue Code are to the Code of 1986, as amended and in effect as of the date of this Article, unless otherwise indicated.

2. I.R.C. §§ 2701-2704 (1994).

3. Section 2036(c), the predecessor of sections 2701-2704, was enacted as part of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10402, 101 Stat. 1330, 1330-431 to 1330-432. Section 2036(c) was substantially amended by the Technical and Miscellaneous Revenue Act (TAMRA) of 1988, Pub. L. No. 100-647, § 3031, 102 Stat. 3342, 3634-40. Section 2036(c) was retroactively repealed and replaced by sections 2701-2704 in the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, §§ 11601-02, 104 Stat. 1388, 1388-490 to 1388-501.

4. The two major estate tax reform acts in recent years, the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, and the Economic Recovery Tax Act (ERTA) of 1981, Pub. L. No. 97-34, 95 Stat. 172, focused on the basic elements of estate and gift taxes. While some provisions of the Tax Reform Act of 1976 were quite complex (for example, section 2032A dealing with the valuation of farms for estate tax purposes), the thrust of the legislation was to unify the estate and gift taxes. Most of the major changes made by the Tax Reform Act of 1976 dealt with basic issues such as tax rates and the marital deduction, as well as changing the previous estate and gift tax deductions to a unified credit. See I.R.C. §§ 2001, 2010, 2056, 2502, 2505. The main provisions of ERTA again concerned basic estate tax provisions, such as the unified credit, the marital

at restricting if not eliminating "estate freezing."<sup>6</sup> But Chapter 14 goes much further. In addition to traditional estate freezing techniques, it attempts to limit business buy-sell agreements,<sup>7</sup> lapses of voting rights,<sup>8</sup> and the valuation of retained interests in trusts.<sup>9</sup> These areas, particularly retained interests in trusts, unlike the corporate stock recapitalization and similar techniques which provided the impetus for the enactment of the predecessor to Chapter 14, had never been extensively used for estate freezing purposes and were not widely viewed as abusive.<sup>10</sup>

Section 2036(c), the predecessor to Chapter 14, adopted an estate tax inclusion approach to estate freezing problems.<sup>11</sup> Many commentators and critics argued that this was the wrong method to combat abusive estate freezes.<sup>12</sup> The argument was repeatedly made that the abusive estate freeze was a problem of valuation rather than one of inclusion or exclusion.<sup>13</sup> Chapter 14 responded to these criticisms by taking a valuation approach to the common estate freezing tech-

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deduction, gifts within three years of death, and the gift tax annual exclusion. See I.R.C. §§ 2010, 2056, 2503, 2035.

For a discussion of section 2032A of the Tax Reform Act of 1976, see Martin D. Begleiter, *Section 2032A: Did We Save The Family Farm?*, 29 *DRAKE L. REV.* 15 (1979-80); Martin D. Begleiter, *Special Use Valuation Nine Years Later: A Farewell to Farms*, 63 *TAXES* 659 (1985).

5. Chapter 14 of the Internal Revenue Code encompasses sections 2701-2704.

6. H.R. REP. NO. 100-391, pt. 2, at 1043 (1987), reprinted in 1987 U.S.C.C.A.N. 2313-378, 2313-659; see Richard L. Dees, *Section 2036(c): The Monster That Ate Estate Planning and Installment Sales, Buy-Sells, Options, Employment Contracts and Leases*, 66 *TAXES* 876, 876-78 (1988); see also Martin D. Begleiter, *Estate Planning in the Nineties: Friday the Thirteenth, Chapter 14: Jason Goes to Washington—Part I*, 81 *KY. L.J.* 535 (1992-93) [hereinafter Begleiter, *Jason—Part I*] (exploring the history of section 2036(c) and section 2701 regarding estate freezing).

7. I.R.C. § 2703. A discussion of this section is beyond the scope of this Article.

8. *Id.* § 2704. A discussion of this section is beyond the scope of this Article.

9. *Id.* § 2702.

10. Begleiter, *Jason—Part I*, *supra* note 6, at 536-44.

11. I.R.C. § 2036(c) (1989).

12. "Discussion Draft" *Relating to Estate Valuation Freezes: Hearings Before the House Comm. on Ways and Means*, 101st Cong. 92-109 (1990) [hereinafter *Hearings*] (statement of E. James Gamble, American College of Trust & Estate Counsel); *id.* at 53-66 (statement of John A. Wallace, Director, A.B.A. Probate & Trust Division); *id.* at 67-91 (statement of Jere D. McGaffey, Chair-Elect, A.B.A. Section of Taxation); EXPLANATORY MATERIAL CONCERNING COMMITTEE ON FINANCE 1990 RECONCILIATION SUBMISSION PURSUANT TO HOUSE CONCURRENT RESOLUTION 310, 136 *CONG. REC.* S15629, S15680 (daily ed. Oct. 18, 1990) [hereinafter *SENATE EXPLANATORY MATERIAL*]. Due to the short deadline, the Senate Budget Committee sent the reconciliation bill to the floor without printing a formal report. The reports submitted by the various senate committees, including the Senate Finance Committee, were submitted in lieu of a formal report at the beginning of the debate. *Id.* at S15629 (statement of Sen. Sasser); see S. Stacy Eastland, *The Legacy of I.R.C. Section 2036(c): Saving the Closely Held Business After Congress Made "Enterprise" a Dirty Word*, 24 *REAL PROP. PROB. & TR. J.* 259, 327-28 (1989).

13. See, e.g., *Hearings, supra* note 12, at 92, 94 (statement of E. James Gamble, American College of Trust & Estate Counsel).

niques: preferred stock recapitalizations and partnership freezes.<sup>14</sup> Indeed, probably the most significant difference between former section 2036(c) and Chapter 14 is that section 2036(c) took an estate inclusion approach while the latter involved a valuation approach to the problem.

*Estate Planning in the Nineties: Friday the Thirteenth, Chapter 14: Jason Goes to Washington—Part I (Jason—Part I)* evaluated the effect of Code section 2701 on estate freezes, particularly the preferred stock recapitalization.<sup>15</sup> *Jason—Part I* concluded that while under a Chapter 14 regime estate freezes might be more difficult and less effective than they were prior to 1987,<sup>16</sup> partial freezes were likely still possible and could, in the right situation, be beneficial.<sup>17</sup> More importantly for present purposes, *Jason—Part I* concluded that section 2701 correctly identified the source of the possible abuse inherent in estate freezing as a gift tax valuation problem (as former section 2036(c) did not).<sup>18</sup>

Section 2702, however, deals with a completely different problem than section 2701. Section 2702 deals with transfers by a grantor in trust where the grantor retains an interest.<sup>19</sup> Unlike estate freezes, particularly preferred stock recapitalizations, this was not a well known and widely discussed estate planning technique in 1987 or indeed in 1990.<sup>20</sup> Nor was it certain prior to 1990 whether the techniques against which section 2702 was directed were abusive. Section 2702 was somewhat of a tagalong to the estate freeze legislation, and it is uncertain if the valuation rationale correctly employed to combat estate freezes in section 2701 is effective on the transfers covered by section 2702.

The purpose of this Article is to analyze section 2702 to determine if Congress correctly reasoned that the problem with the transactions it

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14. I.R.C. § 2701(a)(1); Begleiter, *Jason—Part I*, *supra* note 6, at 557-58.

15. Begleiter, *Jason—Part I*, *supra* note 6.

16. *Id.* at 583-84.

17. *Id.* at 584. Recent literature, particularly concerning family limited partnership freezes and limited liability companies, appears to agree with this conclusion. See, e.g., Richard L. Dees, *The Slaying of Frankenstein's Monster: The Repeal and Replacement of Section 2036(c)*, 69 TAXES 151, 156 (1991); Kenneth D. Esch & Pamela L. Spaccarotella, *Limited Liability Companies as an Alternative Choice of Entity for Farming and Ranching Operations in the State of Nebraska*, 28 CREIGHTON L. REV. 19, 47 (1994); John H. Gardner, *Planning with Chapter 14 and GST Interaction*, 21 EST. PLAN. 146, 149-50 (1994); Richard M. Horwood, *Limited Liability Companies Provide New Planning Options*, 21 EST. PLAN. 266, 272 (1994); Brenda S. Sanford, *Family Farms: A Conversion to a Limited Partnership May Protect the Farm from Liquidation*, 11 T.M. COOLEY L. REV. 861, 903-07 (1994); Andrew J. Willms, *Family Limited Partnerships and Limited Liability Companies: New Estate Planning Tools for the 90s*, 76 WIS. LAW. 17, 19 (1994).

18. Begleiter, *Jason—Part I*, *supra* note 6, at 584.

19. I.R.C. § 2702(a).

20. See discussion *infra* Part I.

sought to regulate under section 2702 was a gift tax valuation problem, similar to section 2701.<sup>21</sup> In examining that issue, a number of subsidiary issues become apparent and are discussed.<sup>22</sup> This Article concludes that the inclusion of trust interests in the estate freezing statute was ill-advised. The "problem" Congress saw in retained interests in trusts is different in type from that involved in the typical estate freeze.<sup>23</sup> More importantly, any "abuse" involved in the transactions covered by section 2702 arose from decisions which long predate corporate stock recapitalizations.<sup>24</sup> This abuse stems from an entirely different source than does the "abuse" in preferred stock recapitalizations and similar transactions.<sup>25</sup> The estate tax leverage gained by using the techniques against which section 2702 was directed does not involve valuation problems at all. It involves inclusion/exclusion problems that have existed for more than fifty years and have been around for far longer than estate freezes.<sup>26</sup> Moreover, it is distinctly possible that no abuse (or very limited abuse) exists in the transactions covered by section 2702.<sup>27</sup> In any event, the valuation approach used in section 2702 creates far more complications than are necessary to correct any abuses arising from the techniques against which Congress directed the section. Once the cause of the leverage gained by using these techniques is correctly identified, any abuses can be remedied with minor statutory changes.<sup>28</sup>

Prior to analyzing section 2702, it is necessary to supplement the examination of the history of estate freezes contained in *Jason—Part I* with some discussion of the techniques against which section 2702 is aimed<sup>29</sup> and the extent to which they were viewed as abusive, both prior to 1987 and in 1990.<sup>30</sup> Some discussion of the operation of section 2702 is also necessary.<sup>31</sup> However, like *Jason—Part I*, this Article is intended to be neither a detailed explanation of Code section 2702

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21. See discussion *infra* Part II.D.

22. For example, given the broad scope of section 2702, the question of whether any or all the transactions covered by the section are abusive must be considered. See discussion *infra* Part III. Assuming some of the transactions are abusive, the question of whether the statute applies to more transactions than necessary to prevent the abuse identified becomes significant. In addition, the remedy chosen (a valuation of zero on interests retained by the grantor) deserves examination.

23. See discussion *infra* Part VIII.B.

24. See discussion *infra* Part VIII.B.1.

25. See discussion *infra* Part VIII.B.1.

26. See discussion *infra* Part VIII.B.1.

27. See discussion *infra* Part V.

28. See discussion *infra* Part VIII.

29. See discussion *infra* Part I.

30. See discussion *infra* Part II.

31. See discussion *infra* Part III.

and the regulations thereunder, nor an analysis of every provision of the section, nor a suggestion for technical changes necessary in the statute. The focus is on whether any abuse exists in the techniques section 2702 was enacted to regulate and whether the perceived abuses were really valuation problems.

## I. GRITs AND JOINT PURCHASES: LATECOMERS TO ESTATE FREEZING

It is quite clear that section 2702 was enacted to restrict the use of the grantor retained income trust (GRIT) and the joint purchase.<sup>32</sup> Therefore, an examination of the workings of these devices, the tax savings inherent in each and the treatment of each prior to 1990 is in order.

### A. *The GRIT*

Tax lawyers were well aware of estate freezes and their advantages by the 1970s.<sup>33</sup> In contrast, the GRIT was unknown until the early 1980s. The first major treatment of the GRIT was given by Richard Covey in April of 1984 in the course of discussing a change in the valuation tables from six percent to ten percent.<sup>34</sup> Quite simply, a GRIT is a trust in which the grantor retains the income interest for a term of years which is expected to expire prior to his death.<sup>35</sup> When the trust is created, a gift is made. However, the gift is only the value of the remainder interest.<sup>36</sup> The reason for this is obvious: any inter-

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32. See *supra* note 12 (explaining the absence of a Senate report); see also H.R. CONF. REP. No. 101-964, at 1130-33 (adopting the Senate provisions on this point); Mitchell M. Gans, *GRITs, GRATs and GRUTs, Planning and Policies*, 11 VA. TAX REV. 761, 822 (1992) (stating that Congress' objective in enacting section 2702 was to close down the GRIT as a tax-savings strategy).

33. Begleiter, Jason—*Part I, supra* note 6, at 539-41.

34. PRACTICAL DRAFTING Apr. 1984, at 397-430 (Richard B. Covey ed.). The GRIT (or as it was referred to in the article, "the Grantor Income Trust For Term of Years") was introduced as a "New Planning Opportunity." *Id.* at 403-22. The term "grantor retained income trust" was first used by PRACTICAL DRAFTING in the January 1985 issue. PRACTICAL DRAFTING Jan. 1985, at 586 (Richard B. Covey ed.). The acronym GRIT first appeared in that publication in 1988. PRACTICAL DRAFTING Jan. 1988, at 1338 (Richard B. Covey ed.).

35. PRACTICAL DRAFTING Apr. 1984, at 403 (Richard B. Covey ed.); see also Jonathan G. Blattmachr & Mitchell M. Gans, *An Analysis of the TAMRA Changes to the Valuation Freeze Rules: Part I*, 70 J. TAX'N 14, 18 (1989) ("A GRIT is an estate planning tool which has become popular in recent years: an irrevocable trust under which the grantor retains an income interest for a fixed period after which the remainder passes to or for other persons.").

36. I.R.C. § 2501 (1994); Treas. Reg. § 25.2511-1(e), (h)(7) (as amended in 1994); see also *id.* § 25.2512-5(d)(2) (1994) ("When the donor transfers property in trust or otherwise and retains an interest therein, generally, the value of the gift is the value of the property transferred less the value of the donor's retained interest."). The regulation then refers to section 2702 for the valuation of transfers after October 8, 1990. *Id.*

est retained by the donor in the GRIT (the right to the income for the term of years) is not transferred. A person cannot make a transfer to himself in the gift tax sense.<sup>37</sup> Therefore, the value of the gift is substantially less than the value of the property transferred. For example, assuming a ten percent interest rate, the value of the retained income interest in a ten year GRIT where the GRIT is funded with \$1,000,000 is \$614,457.<sup>38</sup> Therefore, the value of the remainder (and the value of the taxable gift) in such a GRIT is \$385,543. Assuming the grantor survives the term of the GRIT, the grantor transfers \$1,000,000 worth of property (plus any appreciation) to the remaindermen for the cost of the gift tax on \$385,543.<sup>39</sup> In addition, the value of the gift is "frozen" in the sense that the appreciation is never subject to a transfer tax in the grantor's hands.<sup>40</sup> Of course, if the grantor dies during the term of the GRIT, the trust property is included in the grantor's gross estate at its full value on the date of the grantor's death.<sup>41</sup> Therefore, most creators of GRITs included a provision leaving the property to the grantor's estate if the grantor dies during the trust term.<sup>42</sup> To further reduce the value of the gift and the gift tax, some authorities have discussed including a commutation power in the GRIT (that is, a power of the trustee to distribute to the grantor that portion of the trust equal to the value of the grantor's interest in the trust).<sup>43</sup> In summary, GRITs were advantageous because they leveraged the uni-

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37. For transfers made after April 30, 1989, subject to section 2702, a qualified retained interest is valued under section 7520. See Treas. Reg. § 25.2512-5 (1994).

38. Actually, the term-of-years values are not given; they are derived by subtracting the values in Table B from one. Treas. Reg. § 20.2031-7(d)(2)(iii), (6) (1994).

39. If the grantor in this example had made no prior gifts, she would pay no gift tax because the gift tax would be fully covered by the unified credit. I.R.C. § 2505.

40. *In re Mainzer*, 573 N.Y.S.2d 129 (Sur. Ct. 1991); PRACTICAL DRAFTING Apr. 1984, at 403 (Richard B. Covey ed.); Harry F. Lee, *The Economics of a GRIT*, 68 TAXES 555, 556 (1990).

41. I.R.C. § 2036(a)(1); Treas. Reg. § 20.2036-1(a) (as amended by T.D. 6501, 1995-36 I.R.B. 8).

42. *Mainzer*, 573 N.Y.S.2d at 129-30; PRACTICAL DRAFTING Apr. 1984, at 403 (Richard B. Covey ed.).

43. See, e.g., PRACTICAL DRAFTING Apr. 1984, at 401-03 (Richard B. Covey ed.); PRACTICAL DRAFTING July 1984, at 484-85, 487 (Richard B. Covey ed.); PRACTICAL DRAFTING Oct. 1984, at 546-47 (Richard B. Covey ed.); PRACTICAL DRAFTING Jan. 1985, at 583-85 (Richard B. Covey ed.); PRACTICAL DRAFTING July 1985, at 710-12 (Richard B. Covey ed.); PRACTICAL DRAFTING Apr. 1986, at 905-06 (Richard B. Covey ed.); PRACTICAL DRAFTING Jan. 1987, at 1072-73 (Richard B. Covey ed.); PRACTICAL DRAFTING Apr. 1987, at 1113-14 (Richard B. Covey ed.); PRACTICAL DRAFTING Jan. 1988, at 1341 (Richard B. Covey ed.); PRACTICAL DRAFTING July 1988, at 1524 (Richard B. Covey ed.); PRACTICAL DRAFTING Apr. 1989, at 1693-94 (Richard B. Covey ed.); PRACTICAL DRAFTING July 1989, at 1795-96 (Richard B. Covey ed.); PRACTICAL DRAFTING Apr. 1990, at 2096-97 (Richard B. Covey ed.); PRACTICAL DRAFTING July 1991, at 2457-58 (Richard B. Covey ed.); see also Byrle M. Abbin, *Taking the Temperature of Asset Value Freeze Approaches: What's Hot, What's Not*, 66 TAXES 3, 20 (1988) (suggesting the inclusion of a commutation power to counter the effect of discrimination against community property taxpayers).



fied credit by transferring property to the remaindermen at a reduced gift tax cost.<sup>44</sup>

### B. Joint Purchase

The joint purchase is likewise quite simple in concept. An asset is purchased jointly by a member or members of the older generation in a family and by a member or members of the younger generation in the same family or by a trust for their benefit.<sup>45</sup> The older generation purchases and holds a life estate, while the younger generation purchases the remainder.<sup>46</sup> Each purchaser contributes the value of his or her interest, as determined by the Treasury tables.<sup>47</sup> Since each purchaser paid consideration equal to the value of the interest purchased, no gift is made on the purchase.<sup>48</sup> When the older generation purchaser dies, since he or she owns only a life estate, nothing is included in his or her gross estate.<sup>49</sup> Therefore, property is transferred to the members of the younger generation (or trusts for their benefit) at no transfer tax cost and at a value far greater than the purchase price paid.

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44. Perhaps the best and most succinct summary was given by Surrogate Roth in *In re Mainzer*.

A GRIT is a commonly used "estate freeze" technique which permits an older generation of a family to pass along future appreciation of family owned corporations or partnerships to a younger generation at considerable tax savings. Such savings result from splitting the assets used to fund the trust into two parts, one, an income interest which the grantor retains, the other, a remainder interest which is passed on to a younger generation of the grantor's family. The gift tax is assessed on the present value of the remainder interest. If the grantor survives the trust term, the remainder interest (including appreciation) passes to the remaindermen without any further transfer tax. If the grantor dies during the trust period, the trust principal, although still distributed to the remaindermen, is nonetheless included in the grantor's estate for Federal estate tax purposes. Thus, most trust instruments also provide that if the grantor dies during the trust term, the trust corpus reverts to the grantor's estate. Such a contingent reversionary interest has two benefits, *viz.*, it permits the grantor to make a different disposition of the corpus and it entitles the grantor to an additional gift tax discount based on his or her actuarial life expectancy.

*Mainzer*, 573 N.Y.S.2d at 129-30.

45. PRACTICAL DRAFTING Apr. 1986, at 859, 895 (Richard B. Covey ed.).

46. *Id.*

47. *Id.*

48. *Id.* at 861-62; PRACTICAL DRAFTING July 1986, at 971 (Richard B. Covey ed.).

49. See PRACTICAL DRAFTING Apr. 1986, at 864-69 (Richard B. Covey ed.); PRACTICAL DRAFTING Jan. 1988, at 1352-54 (Richard B. Covey ed.). *But see* Gradow v. United States, 897 F.2d 516, 518-19 (9th Cir. 1990); PRACTICAL DRAFTING Apr. 1987, at 1129-32 (Richard B. Covey ed.); PRACTICAL DRAFTING Jan. 1988, at 1345-52 (Richard B. Covey ed.).

## II. LEGISLATIVE PROPOSALS AND ACTION PRIOR TO 1990

A. *The Early Legislative Proposals*

As related in *Jason—Part I*,<sup>50</sup> an article by Professor George Cooper of Columbia Law School<sup>51</sup> extensively analyzed some of the estate freezing techniques existing in the late 1970s and stimulated interest in tax reform. As described in *Jason—Part I*, from 1977 to 1987 there were a number of tax reform efforts.<sup>52</sup> The first was a set of proposals by the Treasury Department in 1984.<sup>53</sup> These proposals mentioned neither GRITs nor joint purchases by name. They did propose, however, that in cases where the grantor retained an interest in the property transferred, no gift or estate tax would be imposed until the grantor's interest terminated.<sup>54</sup> This was part of a larger effort to coordinate the estate and gift taxes and reduce complexity in the Code.<sup>55</sup> Had this proposal been adopted, the advantages of a GRIT would have been eliminated, since no gift would have occurred until the term of years had expired. Joint purchases would not have been affected.

The President's tax proposal contained no provision relating to the topics under discussion.<sup>56</sup> A revision of the Treasury proposals removed the "hard to complete" gift tax rule originally proposed.<sup>57</sup> At the request of the Treasury Department, the Section of Taxation of the American Bar Association appointed a task force to study transfer tax reform. The task force's report<sup>58</sup> was never formally adopted by the Section of Taxation or the American Bar Association,<sup>59</sup> nor did it become the basis of legislation. However, its recommendations, which would have greatly impacted GRITs, will be discussed subsequently.<sup>60</sup> These efforts piqued legislative interest in estate freezing and set the stage for congressional action.

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50. Begleiter, *Jason—Part I*, *supra* note 6, at 539-41.

51. George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 170-81 (1977).

52. Begleiter, *Jason—Part I*, *supra* note 6, at 544-45.

53. See 2 U.S. DEPT. OF THE TREASURY, *TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT* (1984).

54. *Id.* at 378-79.

55. *Id.* at 378; see discussion *infra* Part VIII.B.

56. See RONALD W. REAGAN, *THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY* (1985).

57. PRACTICAL DRAFTING July 1985, at 718-19 (Richard B. Covey ed.).

58. Task Force on Transfer Tax Restructuring, *Report on Transfer Tax Restructuring*, 1987 A.B.A. SEC. OF TAX'N, reprinted in 41 TAX LAW. 395 (1988) [hereinafter *Task Force Report*].

59. *Id.* at 395 n.\*.

60. See discussion *infra* Part VIII.B.

*B. Section 2036(c), 1987 Version: The Estate Inclusion Approach*

By 1987, Congress was ready to control estate freezing. The staffs of the Joint Committee on Taxation and the House Ways and Means Committee prepared a description of revenue raising options.<sup>61</sup> As to estate freezing, the proposals discussed the elimination of minority discounts and the inclusion in the gross estate of the value of common stock transferred in a recapitalization.<sup>62</sup> The House bill included both proposals;<sup>63</sup> the Senate included neither.<sup>64</sup> The Conference Committee approved only the estate freeze proposal, which became Code section 2036(c).<sup>65</sup>

Section 2036(c), as originally enacted, contained nothing specific about GRITs or joint purchases.<sup>66</sup> The legislative history makes it abundantly clear that the focus of the legislation was on corporate recapitalizations.<sup>67</sup> It is unclear whether GRITs and joint purchases were even considered. Nevertheless, uncertainty as to the scope of the provision led at least one commentator to question whether GRITs and joint purchases were subject to the statute, and his tentative conclusion was that neither should be.<sup>68</sup>

These conjectures became irrelevant in a brief time. As noted in *Jason—Part I*,<sup>69</sup> it quickly became apparent that, as originally enacted, section 2036(c) was overbroad and inadequate to deal with the estate freezing problem.<sup>70</sup>

*C. Section 2036(c), 1988 Version*

The uncertainty inherent in the original version of section 2036(c) resulted in major changes in 1988.<sup>71</sup> In the Technical and Miscellane-

61. STAFF OF THE JOINT COMM. ON TAX'N WITH THE STAFF OF THE COMM. ON WAYS AND MEANS, 100TH CONG., DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES PREPARED FOR THE COMM. ON WAYS AND MEANS 265-67 (Comm. Print 1987) [hereinafter *OPTIONS*].

62. *Id.*

63. H.R. 3545, 100th Cong. (1987).

64. See S. 1920, 100th Cong. (1987).

65. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10402, 101 Stat. 1330, 1330-431 to 1330-432.

66. I.R.C. § 2036(c) (1988).

67. H.R. REP. NO. 100-391, pt. 2, at 1063 (1987), reprinted in 1987 U.S.C.C.A.N. 2313-78, 2313-678 to 2313-679; H.R. CONF. REP. NO. 100-495, at 994-96 (1987), reprinted in 1987 U.S.C.C.A.N. 2313-1245, 1740-42; *OPTIONS*, supra note 61, at 265-67.

68. PRACTICAL DRAFTING Apr. 1988, at 1430-32 (Richard B. Covey ed.).

69. Begleiter, *Jason—Part I*, supra note 6, at 547.

70. Dees, supra note 6, at 887; see also Wayne M. Gazur, *Congressional Diversions: Legislative Responses to the Estate Valuation Freeze*, 24 U.S.F. L. REV. 95, 123 (1989) (asserting that the legislation was widely criticized by many as vague and poorly conceived).

71. Technical and Miscellaneous Revenue Act (TAMRA) of 1988, Pub. L. No. 100-647, § 3031, 102 Stat. 3342, 3634-40.

ous Revenue Act (TAMRA), Congress attempted to clarify section 2036(c) and provide safe harbors.<sup>72</sup> For purposes of this Article, however, the significance of the TAMRA amendments is that, for the first time, the GRIT is specifically mentioned.<sup>73</sup>

TAMRA established that section 2036(c) did not apply to a GRIT which met the following requirements:

1. the GRIT lasted 10 years or less;
2. the income interest was retained by the grantor; and
3. the grantor was not the trustee.<sup>74</sup>

The inclusion of the so-called "statutory GRIT" as a safe harbor clearly raised the question of whether a common law GRIT was subject to section 2036(c) by negative inference.<sup>75</sup>

As noted in *Jason—Part I*, even the extensive amendments made by TAMRA were insufficient to solve the problems of the original section 2036(c).<sup>76</sup> Under the broad regulatory authority granted it in the statute, the Internal Revenue Service (Service) attempted to provide guidance to practitioners.<sup>77</sup> In advance of regulations, the Service issued an "administrative pronouncement" in the form of I.R.S. Notice 89-99.<sup>78</sup> The Notice clearly stated the Service's view that section 2036(c) applied to GRITs and joint purchases based on its belief that the safe harbors enacted by TAMRA were illustrative of the types of arrangements that fell within the scope of the statute.<sup>79</sup>

72. For the text of section 2036(c), as amended by TAMRA, and a discussion of its provisions, see Begleiter, *Jason—Part I*, *supra* note 6, at 548-55.

73. Section 2036(c)(6), as amended by TAMRA, provided an exception for a GRIT meeting certain requirements (the so-called "statutory GRIT"). See *infra* notes 74-75 and accompanying text.

74. Section 2036(c)(6), as amended by TAMRA, provided as follows:

(6) Treatment of certain grantor retained income trusts.—

(A) In General.—For purposes of this subsection, any retention of a qualified trust income interest shall be disregarded and the property with respect to which such interest exists shall be treated as held by the transferor while such income interest continues.

(B) Qualified Trust Income Interest.—For purposes of subparagraph (A), the term "qualified trust income interest" means any right to receive amounts determined solely by reference to the income from property held in trust if—

- (i) such right is for a period not exceeding 10 years,
- (ii) the person holding such right transferred the property to the trust, and
- (iii) such person is not the trustee of such trust.

Technical and Miscellaneous Revenue Act (TAMRA) of 1988, Pub. L. No. 100-647, § 3031, 102 Stat. 3342, 3635.

75. PRACTICAL DRAFTING Jan. 1989, at 1661-64 (Richard B. Covey ed.); Dees, *supra* note 6, at 888-93.

76. Begleiter, *Jason—Part I*, *supra* note 6, at 553-55.

77. I.R.C. § 2036(c)(8) (1988).

78. I.R.S. Notice 89-99, 1989-2 C.B. 422, 435.

79. *Id.* at 423 & n.2.

#### D. The Aftermath

Jason—Part I described the problems of section 2036(c), even as “clarified” by I.R.S. Notice 89-99,<sup>80</sup> and the severe criticism of the section by leading practitioners and estate planning organizations.<sup>81</sup> As therein stated, one of the major problems was that the estate tax inclusion approach of section 2036(c) was the wrong approach to the problem.<sup>82</sup> The leaders of the estate planning bar argued that any problems caused by estate freezing were not problems of inclusion or exclusion, but problems of gift tax valuation at the time of the freeze.<sup>83</sup> More significant for purposes of this Article, however, is that many of these commentators argued that trusts (including GRITs) and joint purchases should not be treated the same way as corporate and partnership freezes.<sup>84</sup> Accordingly, a task force composed of members of the three leading estate planning organizations drafted a proposal to revise section 2036(c).<sup>85</sup> The proposal specifically and intentionally did not deal with GRITs or joint purchases.

In the Spring of 1990, Representative Rostenkowski, then Chair of the House Ways and Means Committee, introduced a discussion draft of a new statute that would repeal section 2036(c) and substitute a gift tax valuation approach. A hearing on the discussion draft was held on April 24, 1990.<sup>86</sup> On June 27, 1990, the Senate Finance Committee and two subcommittees held a joint hearing on the discussion draft and on August 1, 1990, Chairman Rostenkowski introduced H.R. 5425, which elaborated on and modified the discussion draft.<sup>87</sup>

The Senate soon followed suit. On September 26, 1990, Senators Bentsen, Boren and Daschle introduced S. 3113, which repealed section 2036(c) and proposed a revised method of regulating estate freezes.<sup>88</sup> On October 13, 1990, S. 3113 was modified to incorporate

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80. Begleiter, *Jason—Part I*, *supra* note 6, at 556-58.

81. *Id.* at 557.

82. *Hearings*, *supra* note 12, at 92-109 (statement of E. James Gamble, American College of Trust and Estate Counsel); *id.* at 53-66 (statement of John A. Wallace, Director, A.B.A. Probate & Trust Division); *id.* at 67-91 (statement of Jere D. McGaffey, Chair-Elect, A.B.A. Section of Taxation); SENATE EXPLANATORY MATERIAL, *supra* note 12, at S15680.

83. *Hearings*, *supra* note 12, at 97-98 (statement of E. James Gamble, American College of Trust & Estate Counsel); *id.* at 64-65 (statement of John A. Wallace, Director, A.B.A. Probate & Trust Division); *id.* at 71 (statement of Jere D. McGaffey, Chair-Elect, A.B.A. Section of Taxation).

84. *See supra* note 83.

85. Memorandum from the Joint Task Force Drafting Committee 1-6 (on file with the *DePaul Law Review*).

86. Begleiter, *Jason—Part I*, *supra* note 6, at 558.

87. *Id.*

88. *Id.*

many of the key provisions of H.R. 5425.<sup>89</sup> The Senate bill became sections 11,601 and 11,602 of the Revenue Reconciliation Act of 1990, which was incorporated into the Omnibus Budget Reconciliation Act (OBRA) of 1990, enacted on November 5, 1990.<sup>90</sup>

### III. SECTION 2702: NIGHTMARE ON PENNSYLVANIA AVENUE

This Part is intended only to provide an overview of section 2702. Many details and qualifications are omitted, as the purpose of this Article is to evaluate whether the valuation approach reflected in section 2702 with regard to GRITs and joint purchases is correct. Any attempt at a detailed summary of the many qualifications and complications of section 2702 would detract rather than enhance this effort. Some of the details are, however, given in the footnotes of this Part. Other details will be given in later Parts as they become relevant to the discussion.<sup>91</sup>

The basic rule of section 2702 is that when a person creates a trust for a member of his or her family<sup>92</sup> and retains an interest in that trust, the value of the retained interest (unless it is a qualified interest) is zero.<sup>93</sup> The statute is applicable only for determining the value of the

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89. *Id.*

90. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, §§ 11601-02, 104 Stat. 1388, 1388-490 to 1388-501.

91. For more detailed explanations of the mechanics of section 2702, see PRACTICAL DRAFTING Jan. 1991, at 2370-78 (Richard B. Covey ed.); PRACTICAL DRAFTING Apr. 1991, at 2433-88 (Richard B. Covey ed.); John M. Beehler, *Trust Estate Freeze Valuation Rules Under the Final Section 2702 Regulations*, 70 TAXES 604 (1992); Dees, *supra* note 6; Gans, *supra* note 32; Louis S. Harrison, *The Real Implications of the New Transfer Tax Valuation Rules—Success or Failure?*, 47 TAX LAW 885 (1994); Don W. Llewellyn, *The Evolution of Sophisticated Tax Planning for Lifetime Gifts—What Planning Techniques Continue to Be Effective?*, 30 REAL PROP. PROB. & TR. J. 213 (1995); Carlyn S. McCaffrey, *GRATs and QPRTs, Split Interest Transfers: An Estate Planner's Panacea?*, 20 AM. C. TR. & EST. COUNS. NOTES 47 (1994); Peter J. Melcher & Lucy M. Arend, *Grappling with GRATs*, 72 TAXES 661 (1994); David W. Olsen, *So . . . What's for Breakfast: GRITs, GRATs or GRUTs?*, 7 J. SUFFOLK ACAD. L. 49 (1990-91); Lloyd Leva Plaine & Pam H. Schneider, *Proposed Valuation Regulations Provide Workable Exceptions for Transfers in Trust*, 75 J. TAX'N 142 (1991).

92. A family member includes the grantor's spouse, the grantor's ancestors and lineal descendants and their spouses, and the grantor's brothers and sisters and their spouses. I.R.C. §§ 2702(c), 2704(c)(2); Treas. Reg. § 25.2702-2(a)(1) (1992); *see also id.* § 25.2702-1(c) (as amended in 1995) (setting forth other exceptions to the rule).

93. I.R.C. § 2702(a)(1), (2) (1994). This rule is not applicable to a number of trusts, the most important of which is the completely revocable trust. *Id.* § 2702(a)(3); Treas. Reg. § 25.2702-1(c)(1) (as amended in 1995). Although the Code states an exception for a transfer "if such transfer is an incomplete gift," I.R.C. § 2702(a)(3)(A)(i), the regulations take the position that only an entirely incomplete gift is excepted. Treas. Reg. § 25.2702-1(c)(1) (as amended in 1995). The position in the regulations appears to be the more logical one and is more consistent with the legislative history. *See* PRACTICAL DRAFTING Apr. 1991, at 2442-44 (Richard B. Covey ed.). Section 2702(a)(3) was changed by the Small Business Job Protection Act of 1996 to substitute

transfer and whether the transfer is a gift.<sup>94</sup> Retained interests which are qualified interests, in contrast, are valued by use of the Treasury tables under section 7520.<sup>95</sup> The only qualified interests are:

1. an annuity interest;<sup>96</sup>
2. a unitrust interest;<sup>97</sup> and
3. a noncontingent remainder if all other interests are annuity interests or unitrust interests.<sup>98</sup>

Transfers of term interests, which include life interests,<sup>99</sup> are treated as transfers in trust.<sup>100</sup> Finally, joint purchases are treated as if the person acquiring the term interest acquired the entire property and transferred the remainder interest to the other purchaser for the consideration furnished by that purchaser.<sup>101</sup>

The application of section 2702 to GRITs and joint purchases is draconian. A grantor creating a common law GRIT would make a taxable gift of the entire value of the property transferred, since the grantor's retained interest would be valued at zero. The same result would befall a grantor creating a trust in which the grantor reserved a life income interest. In each case, a gift tax would be assessed on the full value of the trust property at the time the trust was created. This rule killed the GRIT, except for personal residences.<sup>102</sup> If a parent and a child jointly purchase an asset, with the parent buying a term of years or a life interest and the child buying the remainder, the parent is treated as purchasing the entire property, then transferring the re-

"incomplete gift" for "incomplete transfer." Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1701(f)(11)(B)(i), 110 Stat. 1755, 1872.

Personal residence trusts (PRTs) and qualified personal residence trusts (QPRTs) are also excepted from the Code's application. See I.R.C. § 2702(a)(3)(A)(ii). A discussion of PRTs and QPRTs is beyond the scope of this Article except for their relevance in evaluating the effectiveness of the code. See discussion *infra* Part VI.F. For more information on PRTs, see Treas. Reg. § 25.2702-5 (as amended in 1992); PRACTICAL DRAFTING Apr. 1992, at 2784-92 (Richard B. Covey ed.); PRACTICAL DRAFTING Oct. 1992, at 3012-15 (Richard B. Covey ed.); Gans, *supra* note 32, at 851-78.

94. I.R.C. § 2702(a)(1). The rule is not applicable to future transfers of the retained interest outside the grantor's family, to outright transfers, or to estate and generation-skipping taxes.

95. *Id.* § 2702(a)(2)(B). Portions of the tables are also reprinted in Treasury Regulation section 20.2031-7(d)(6) (1994). See also Treas. Reg. § 25.2512-5(a) (1994) (discussing valuation of annuities, unitrusts' interests, and other remainder or reversionary interests).

96. I.R.C. § 2702(b)(1).

97. *Id.* § 2702(b)(2).

98. *Id.* § 2702(b)(3). This qualified interest will not be further considered in this Article.

99. *Id.* § 2702(c)(3).

100. *Id.* § 2702(c)(1).

101. *Id.* § 2702(c)(2).

102. Dees, *supra* note 17, at 163. Transfers of personal residences, if qualified, are exempt from section 2702. See I.R.C. § 2702(a)(3)(A)(ii).

remainder to the child for the price paid by the child.<sup>103</sup> However, that transfer is a transfer with a retained interest.<sup>104</sup> Therefore, the value of the parent's retained term of years or life interest is zero, and the parent is treated as making a gift of the entire value of the property (less the consideration furnished by the child).<sup>105</sup> This effectively killed the joint purchase.

Outside of personal residences<sup>106</sup> and trusts for non-family members,<sup>107</sup> the only types of vehicles remaining under section 2702 are Grantor Retained Annuity Trusts (GRATs)<sup>108</sup> and Grantor Retained Unitrusts (GRUTs).<sup>109</sup>

#### IV. WHY SECTION 2702 WAS ENACTED

Given the impact of section 2702 on trusts, some analysis of the abuses Congress saw in the GRIT and the reasons for enacting the structure deserve some examination. The question of whether GRITs and joint purchases as they existed prior to 1987 were abusive is postponed until Part V.

An examination of the legislative history<sup>110</sup> and of work by several commentators<sup>111</sup> identifies the following factors as contributing to the advantages of a GRIT and to the concerns that GRITs and joint purchases were abusive:

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103. I.R.C. § 2702(c)(2); see SENATE EXPLANATORY MATERIAL, *supra* note 12, at S15682; Neil E. Cass & Richard A. Campbell, *New Internal Revenue Code Chapter Fourteen Replaces Section 2036(c)*, 79 ILL. B.J. 508, 512 (1991).

104. I.R.C. § 2702(a)(1); Cass & Campbell, *supra* note 103, at 512.

105. SENATE EXPLANATORY MATERIAL, *supra* note 12, at S15682; Cass & Campbell, *supra* note 103, at 512.

106. Personal residence trusts are exempt from section 2702. I.R.C. § 2702(a)(3)(A)(ii).

107. For example, a trust in which the grantor retained the income interest for a term of years, after which the trust was terminated and the property distributed to the grantor's niece, would not be subject to section 2702 because the niece is not a member of the grantor's family. See *id.* §§ 2702(a), (e), 2704(c)(2). While this exception may be extremely beneficial to the grantor in certain situations, it is doubtful that a large number of grantors will alter their dispositive schemes to take advantage of this definition.

108. *Id.* § 2702(b)(1).

109. *Id.* § 2702(b)(2). According to the commentary, the GRAT appears to offer more tax savings opportunity than the GRUT. Gans, *supra* note 32, at 822-51; Harrison, *supra* note 91, at 917-23. This is bolstered by the fact that in the first few years following enactment of section 2702, far more letter rulings have involved GRATs than GRUTs. An examination of the indices of CCH Federal Estate and Gift Tax Reports (as of July 23, 1996) reveals that 14 private letter rulings and technical advice memorandums have involved GRATs and one private letter ruling has involved a GRUT. Cumulative Index for Reports 1-310, 3 Fed. Est. & Gift Tax Rep. (CCH) 15,523-580 (June 6, 1995); Latest Additions to Cumulative Index for Reports 1-310, 3 Fed. Est. & Gift Tax Rep. (CCH) 15,505-520 (July 23, 1996). While not conclusive, of course, this implies that lawyers believe GRATs offer tax advantages over GRUTs in many circumstances.

110. SENATE EXPLANATORY MATERIAL, *supra* note 12.

111. Gans, *supra* note 32; Harrison, *supra* note 91.



1. the use of one interest rate to value a grantor's retained interest, regardless of when the gift was made;
2. the fact that a grantor could retain a contingent remainder interest in, and a testamentary power of appointment over, the trust, which interests were given value for gift tax purposes and which further reduced the value of the gift;
3. the use of the tables to value the retained interest did not accurately value the retained interest in any particular trust, partly because the value given to the retained interest included not only income but also appreciation, and partly because of the investment options available to the trustee;
4. adverse selection; and
5. leverage benefit.

Each of these will be examined in turn.

### A. *The Interest Rate Problem*

GRITs became attractive when interest rates for valuing life estates, terms for years and remainder interests were changed from six percent to ten percent for transfers after November 30, 1983.<sup>112</sup> The reason was that the increase in rates increased the value of a grantor's retained term of years and, since few trust investments generated a ten percent return, the grantor's retained interest was overvalued.<sup>113</sup> Clearly, using one interest rate to value terms of years, income interests, and remainder interests, regardless of changing interest rates available in the market, artificially distorts their value. Congress recognized this problem and addressed it in 1988.<sup>114</sup> Code section 7520 requires that actuarial tables used for valuing partial interests in property be revised monthly to take account of changes in market interest rates.<sup>115</sup> It should be noted that section 7520 was enacted entirely independent of Chapter 14 and its predecessor, Code section 2036(c). Any concern about the tables' currency and reflection of interest rates available in the market, therefore, was fully satisfied by the enactment of section 7520 and should not have been a concern in 1990 when section 2702 was enacted.<sup>116</sup> However, the enactment of section 7520 did not cure the effects of the high rate used for the table.<sup>117</sup>

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112. F. Landson Boyle, *Evaluating Split-Interest Valuation*, 24 GA. L. REV. 1, 21 (1989).

113. PRACTICAL DRAFTING Apr. 1991, at 2434 (Richard B. Covey ed.); Boyle, *supra* note 112, at 21.

114. Technical and Miscellaneous Revenue Act (TAMRA) of 1988, Pub. L. No. 100-647, § 5031, 102 Stat. 3668-69 (codified as amended at I.R.C. § 7520 (1994)). The change is described in Boyle, *supra* note 112, at 21-22.

115. Boyle, *supra* note 112, at 22. Section 7520 also requires the Internal Revenue Service to change the tables at least every 10 years to reflect the most recent mortality tables. *Id.*

116. Gans, *supra* note 32, at 773, 794; Llewellyn, *supra* note 91, at 222.

117. The rate specified under section 7520 is quite high. Gans, *supra* note 32, at 773 n.22.

### B. Retention of Contingent Principal Interests

Another concern was that grantors of GRITs often retained certain interests in the principal of the trusts. The most important of these interests were:

1. the right to have the entire corpus of the estate payable to the grantor's estate if the grantor died during the trust term;<sup>118</sup> and
2. the retention of a testamentary power of appointment during the term of the trust.<sup>119</sup>

Both of these interests could be valued and, if the grantor retained one or both of these interests, the value of the gift was reduced by the value of the retained interests.<sup>120</sup>

### C. Incorrect Valuation of Retained Interests

This argument, which was perhaps the strongest argument supporting the enactment of section 2702, has two parts.

#### 1. Use of the Tables Does Not Accurately Reflect Return on Any Particular Trust

Clearly, Congress was concerned about the undervaluation of gifts by the tables because of the differing investment vehicles available:

In addition, the committee is concerned about the undervaluation of gifts valued pursuant to Treasury tables. Based on average rates of return and life expectancy, those tables are seldom accurate in a particular case, and therefore, may be the subject of adverse selection. Because the taxpayer decides what property to give, when to give it, and often controls the return on the property, use of Treasury tables undervalues the transferred interests in the aggregate, more often than not.<sup>121</sup>

The Treasury Department thought that creators of GRITs were doing exactly what the Senate Finance Committee suspected by contributing assets with great potential for growth but little current income (or by suggesting that trustees invest the GRIT in such assets).<sup>122</sup> The Senate was searching for a way to more closely match the gift tax

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118. SENATE EXPLANATORY MATERIAL, *supra* note 12, at S15680; PRACTICAL DRAFTING Apr. 1991, at 2434 (Richard B. Covey ed.); Harrison, *supra* note 91, at 901-02; Lee, *supra* note 40, at 560-64.

119. PRACTICAL DRAFTING Apr. 1991, at 2434 (Richard B. Covey ed.).

120. *Id.*

121. SENATE EXPLANATORY MATERIAL, *supra* note 12, at S15681.

122. Llewellyn, *supra* note 91, at 222; *see also Hearings, supra* note 12, at 42-44 (statement of Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury); SENATE EXPLANATORY MATERIAL, *supra* note 12, at S15680 ("Use of the Treasury tables is allowed even when they do not accurately predict the actual rate of return from the property.").

value of the retained interest to the actual income from the interest to be paid to the grantor during the continuance of the trust.

## 2. *Income vs. Appreciation*

Although the Senate report does not refer to it, a number of commentators have recognized that the tables contain an underlying assumption which is questionable. The section 7520 tables divide the value of property contributed to a trust by using an interest rate.<sup>123</sup> By doing the valuation this way, the underlying assumption is that the grantor will receive the value of his or her entire interest (as determined by the tables) through distributions of income over the life of the trust.<sup>124</sup> If, however, the investments are chosen so that the income is less than the table rate, some of the value of the grantor's interest (as valued by the tables) is transferred to the remainderman through growth in the corpus.<sup>125</sup> In short, appreciation in corpus benefits the remainderman, whereas valuing the grantor's interest by percentage and mortality tables allocates such appreciation to the grantor. This overstates the value of the grantor's retained interest, understates the value of the gift, and reduces the amount of the taxable gift.

### D. *Adverse Selection*

As pointed out by a number of commentators, one benefit of a GRIT was the "rate benefit," that is, when the table rate exceeded the rate on investments available to the trustee, the taxable gift was undervalued because the grantor's retained interest (based on the tables)

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123. The rate is 120% of the federal mid-term rate for the month in which the valuation falls. I.R.C. § 7520(a)(2) (1994). However, the grantor may use the federal mid-term rate for either of the two months preceding the month in which the trust is created. *Id.* § 7520(a).

124. See Louis S. Harrison, *The Strategic Use of Lifetime Gifting Programs to Reduce Estate Taxes in Light of Recent Congressional and Internal Revenue Service Antipathy Towards Transfer Tax Reduction Devices*, 40 DEPAUL L. REV. 365, 371 n.32 (1991), stating that:

The trustee of a GRIT could decide to invest in high growth, low yield assets, thereby transferring, in effect, more property to the remainderman than was assumed for gift tax valuation purposes, while depriving the grantor of his or her assumed retained income. For example, if the gift tax valuation discount rate was assumed to be 10.80%, then the grantor was assumed to be receiving a 10.80% rate of return each year via his or her income interest. If the trustee invested the GRIT in assets which yielded 6.80% in income and 4% in growth each year, then 6.80% in income was returned to the grantor while 4% in growth was transferred, free of gift tax, to the remainderman. This arguably was abusive since the initial gift tax valuation assumed that the grantor would be receiving income equal to 10.80% of the GRIT each year.

*Id.* at 371 n.32.

125. *Id.*; see also Boyle, *supra* note 112, at 15, 17 (discussing the accuracy of the Treasury tables); Gans, *supra* note 32, at 766 (discussing GRIT-related investment strategies).

was overvalued.<sup>126</sup> These commentators also noted that if the investments of the trust had a higher rate of return than the table rate, the grantor's retained interest would be undervalued to the detriment of the grantor.<sup>127</sup> It has been argued that since the grantor could not predict at the creation of the trust the rate of return the investments would produce,<sup>128</sup> approximately as many GRITs would benefit the Treasury as would benefit the taxpayer.<sup>129</sup> This, in turn, means that GRITs are not abusive.<sup>130</sup> This is particularly true if the trustee has the power to reinvest the trust property.

The Senate Finance Committee<sup>131</sup> and some commentators,<sup>132</sup> however, believed that a grantor would only create a GRIT where it was very likely that the return realized by the GRIT would be less than the table rate.<sup>133</sup> Therefore, adverse selection would turn the rate differential into an abuse.

### E. Leverage Benefit

This benefit, mentioned only by one commentator,<sup>134</sup> is difficult to describe briefly. To simplify, it is the extra appreciation generated by a GRIT over an outright gift. For a GRIT to be comparable in value to an outright gift, more must be transferred to the GRIT to convey the same amount to the remainderman than is required for an outright gift.<sup>135</sup> The reason is that the grantor retains the income from the GRIT for a term of years, whereas in an outright gift, the property is given to the beneficiary immediately. The "leverage" benefit results from the fact that the additional amount contributed to the GRIT is available to be invested and appreciate.<sup>136</sup>

This division of appreciation does not appear to have influenced the Senate Finance Committee in formulating section 2702. In any event,

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126. Gans, *supra* note 32, at 766-68; Harrison, *supra* note 91, at 898-99; *see supra* note 123; *supra* text accompanying notes 122-24.

127. Gans, *supra* note 32, at 767-68; Harrison, *supra* note 91, at 898-99.

128. *See supra* note 127; Lee, *supra* note 40, at 556-57.

129. Gans, *supra* note 32, at 767-68; Harrison, *supra* note 91, at 898-99.

130. *See supra* note 129. Harrison is a particular proponent of this view.

131. SENATE EXPLANATORY MATERIAL, *supra* note 12, at S15680-81.

132. *See, e.g.*, Gans, *supra* note 32, at 768-69, 772-73.

133. *Id.* at 772-73; Lee, *supra* note 40, at 565.

134. Gans, *supra* note 32, at 784-87.

135. *Id.* at 785.

136. *Id.* at 786. Gans compares a \$100 GRIT with the equivalent outright gift (\$90.90 for a one year GRIT at a 10% table rate, assuming a 10% rate was available in the market). The donee of the outright gift would have \$100 at the end of the year. The GRIT would have \$110. Of the \$10 in GRIT appreciation, \$9.09 would have been generated by a comparable outright gift of \$90.90. The remaining \$0.91 of appreciation results from the fact that \$100 of corpus is appreciating, rather than \$90.90. *Id.* at 785-87.

it is minimal as compared to appreciation caused by investment selection and will not be further considered here.

### V. WERE GRITS AND JOINT PURCHASES ABUSIVE?

The discussion of the abuses that were perceived to exist in GRITs and joint purchases in Part IV leads readily to several questions.

1. Why did Congress adopt the solution embodied in section 2702?
2. Does section 2702 work, that is, does it rectify the abuses perceived in GRITs and joint purchases?
3. What are the costs (in complexity, adjustments, and other matters) of the regime imposed by section 2702?
4. Are there other, perhaps less intrusive alternatives available to cure the problems seen by commentators and Congress in GRITs and joint purchases? Alternatively, if Congress characterized the problems incorrectly, is there a different and better structural change to deal with the problem?

The remainder of this Article considers these questions in the order just stated. However, it is worthwhile to pause to consider briefly whether GRITs and joint purchases were abusive at all. In one sense, the enactment of Code section 2702 rendered this question moot. In a broader sense, however, no statute is ever safe from repeal.<sup>137</sup> If, on analysis, it is found that the techniques are not abusive, or that only minor abuses are present in the techniques, narrower solutions can be crafted which do not disrupt the system to the extent section 2702 does.<sup>138</sup>

#### A. The GRIT

It has been argued that several of the concerns identified previously<sup>139</sup> are not abusive.<sup>140</sup> The rate benefit, that is, the taxes saved if the table rate is greater than the average rate of return on investments, is minimal.<sup>141</sup> This is so because only the spread between the table rate and the actual return is saved.<sup>142</sup> In addition, any savings are somewhat offset due to the possibility of transfer tax losses.<sup>143</sup> Similarly, any variance of the value of the grantor's retained interest resulting from the trust investments growing at a greater rate than the

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137. Indeed, section 2036(c), the predecessor of section 2702, was itself repealed. *See supra* note 3.

138. *See* discussion *infra* Part VIII.

139. *See* discussion *supra* Part IV.

140. Harrison, *supra* note 91, at 898-99.

141. *Id.* at 898-900.

142. *Id.*

143. *Id.*

table rate is minimal.<sup>144</sup> And any possible abuse resulting from the fact that the table rate is not adjusted frequently to take account of changing market conditions was cured by the enactment of section 7520.<sup>145</sup> Leverage benefit, as previously noted, is minimal in any event.<sup>146</sup>

There appears to be a disagreement over whether adverse selection exists.<sup>147</sup> Even those arguing that adverse selection exists cite no studies indicating its existence. The author is aware of no study demonstrating adverse selection by grantors in creating GRITs, nor even any studies showing that a large percentage of GRITs underperform the table rate. Therefore, any argument based on adverse selection remains unproven.

But even assuming a few taxpayers gain some advantages from rate benefit, adverse selection and leverage benefits, there is an additional factor involved in evaluating whether such advantages are abusive. That factor is that no table will accurately value the grantor's retained interest in any particular trust. Tables are used as convenient devices to value interests in many trusts with the expectation that the experience in many trusts will average out: some favoring the taxpayer and some favoring the government. To argue, as the Senate report does, that the table rates are inaccurate in most cases,<sup>148</sup> misses the point that no table can correctly value the retained interest in an individual case. A table is created to provide an administratively workable and convenient rule for many cases. This is necessitated by the fact that the gift of the remainder interest is complete when made<sup>149</sup> and the remainder interest must be valued and taxed at that time, prior to any knowledge of the trust's investment experience. In addition, as Judge Friendly has stated, "the United States is in business with enough different taxpayers so that the law of averages has ample opportunity to work."<sup>150</sup> Even assuming adverse selection may exist, it is inequitable for the government to pick and choose cases in which to use the tables. It is certainly questionable tax policy for Congress to outlaw the use of the tables in cases where their use may be advantageous to

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144. *Id.*

145. Gans, *supra* note 32, at 773.

146. See discussion *supra* Part IV.E.

147. Compare Gans, *supra* note 32, at 768-73, and SENATE EXPLANATORY MATERIAL, *supra* note 12, at S15680-81, with Harrison, *supra* note 91, at 898-900.

148. SENATE EXPLANATORY MATERIAL, *supra* note 12, at S15681.

149. Treas. Reg. § 25.2511-1(a) (1958).

150. *Gelb v. Commissioner*, 298 F.2d 544, 552 (2d Cir. 1962).

taxpayers but mandate their use when the tables work to the government's advantage.<sup>151</sup>

Lastly, another possible disadvantage of the GRIT should be noted. The true comparison of the GRIT should be with the outright gift.<sup>152</sup> A grantor making an outright gift has no risk that the appreciation of the property will be subject to transfer tax.<sup>153</sup> However, if the grantor dies during the term of the GRIT, the value of the trust on the date of the grantor's death will be included in the grantor's gross estate and subject to the estate tax.<sup>154</sup> Therefore, there was a risk of increased transfer taxation associated with the creation of a GRIT as contrasted with the making of an outright gift.

The considerations discussed appear to demonstrate that these alleged abuses of the GRIT (rate benefit, leverage benefit and adverse selection) were either minimal or non-abusive. The remaining advantages of a GRIT, however, were clearly abusive. Reducing the value of the gift by valuing a reversionary interest or a power of appointment retained by the grantor, even though no additional property was distributed to the grantor, clearly gave the GRIT advantages over an outright gift.<sup>155</sup> The fact that the tables ignored appreciation clearly overvalued the grantor's retained interest and permitted a transfer of property to the remainderman without being subject to any transfer tax.<sup>156</sup> And the fact that Code section 7520 set the table rate at a higher rate than generally available for trust investments can result in overvaluing the grantor's retained interest.<sup>157</sup>

That some tax savings were available to grantors of GRITs does not indicate that the enactment of Code section 2702 was either a rational response to the problems created by the GRIT or that the theory underlying section 2702 was correct. The answer to these questions depends on a comparison of the benefits of section 2702 with the difficulties caused by its provisions and an examination of whether limited remedies or developing case law, or a combination thereof,

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151. *Hearings*, *supra* note 12, at 64-65 (statement of John A. Wallace, Director, A.B.A. Probate & Trust Division).

152. *See generally* Gans, *supra* note 32 (weighing the risks and benefits of a GRIT versus a comparable outright gift).

153. An outright gift is complete when made. Treas. Reg. § 25.2511-2(b) (as amended in 1983). Only in very rare instances, not relevant to this Article, is the appreciation from the date of gift to the date of the grantor's death taxed by inclusion of the value of the trust in the grantor's gross estate. *See* I.R.C. § 2035 (1994) (discussing gifts made within three years of decedent's death); *id.* § 2041 (providing rules for general powers of appointment).

154. I.R.C. § 2036(a).

155. Gans, *supra* note 32, at 787-91; Harrison, *supra* note 91, at 901-02.

156. Harrison, *supra* note 91, at 900-01.

157. Gans, *supra* note 32, at 792-95.

could have solved these problems. These examinations will be undertaken shortly.<sup>158</sup>

### B. Joint Purchase

If there were areas of abuse involved in the creation of a GRIT, it is difficult to find any such abuse in the joint purchase. In its simplest form, the joint purchase involves the purchase of a life income interest in an asset by an older generation member of a family (for instance, a parent) and the purchase of the remainder interest by a younger generation member of the same family (for instance, a child). There is no gift involved because the parent contributes consideration equal to the value of the life income interest and the child contributes the value of the remainder. The concern appeared to be that the appreciation between the date of purchase and the date of death was not subject to a transfer tax (because a life income interest is not included in the gross estate),<sup>159</sup> although that concern was not very clearly expressed.<sup>160</sup> This treatment, however, merely appears to be a result of the Code's allowance of split ownership of temporal interests in property. No abuse is evident. If the value of either interest in property at the time of purchase exceeds the consideration paid by the purchaser, a taxable gift occurs.<sup>161</sup> Moreover, if the child's consideration comes from money or property previously given to the child by the parent, a gift tax has presumably been paid on the gift.<sup>162</sup> Even if an irrevocable trust for the child purchases the remainder interest, the creation of the trust presumably generated a gift tax.<sup>163</sup> A comparable example would be to say that the creation of a tenancy-in-common is an abuse because the appreciation of the surviving co-tenant's share is not included in the estate of the first co-tenant to die. If the creation of temporal interests in property is allowed, it is hard to see a joint purchase as abusive.<sup>164</sup>

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158. See discussion *infra* Parts VII, VIII.

159. I.R.C. § 2033.

160. SENATE EXPLANATORY MATERIAL, *supra* note 12, at S15680-81.

161. *Id.*

162. I.R.C. § 2501.

163. Treas. Reg. § 25.2511-2(b) (as amended in 1983).

164. See discussion *infra* Part VIII.B (arguing that the problem perceived by Congress in the GRIT and the joint purchase really involves the problem of recognizing the creation of temporal interests in property for tax purposes). That is, these problems are not valuation problems at all, but structural problems which can be corrected only by a structural solution.



## VI. DOES SECTION 2702 WORK? HE'S BACK!

## A. GRITs and Joint Purchases

The purpose of Congress in enacting Code section 2702 was to prevent the type of estate planning techniques exemplified by the GRIT and the joint purchase.<sup>165</sup> It is important to note, however, that the legislative history reveals that Congress was concerned not only with GRITs and joint purchases, but more generally with the use of trusts and term interests to cause tax avoidance.<sup>166</sup> It is quite clear that section 2702 effectively foreclosed the GRIT and the joint purchase as tax avoidance devices.<sup>167</sup> The section eliminated two major transfer tax savings aspects of the GRIT. First, the value of the taxable transfer is no longer reduced by the value of the grantor's retained interest.<sup>168</sup> Therefore, the value of the taxable gift is the full value of the transferred property. Second, the grantor can no longer indirectly transfer property to the remainder beneficiaries by investing solely in high growth assets and keeping income to a minimum.<sup>169</sup> Because the only retained interests given value by section 2702 are annuity and unitrust interests,<sup>170</sup> which are based either on an absolute dollar figure or a percentage of the original or yearly trust assets,<sup>171</sup> if the income is less than the required payout, the remainder must be paid from principal.

As to the joint purchase, section 2702 treats it as a purchase of the entire property by the member of the older generation (the parent) followed by a transfer of the remainder interest to the member of the younger generation (the child).<sup>172</sup> Since the transfer of the remainder interest to the child is a transfer with a retained interest subject to section 2702<sup>173</sup> and the parent's life interest or term of years is not a qualified interest,<sup>174</sup> the parent's retained interest is valued at zero.<sup>175</sup>

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165. See discussion *supra* Parts II, IV.

166. See discussion *supra* Part IV.

167. Gans, *supra* note 32, at 792-93.

168. *Id.*

169. *Id.*

170. See I.R.C. § 2702(a)(2)(B), (b)(1)-(2) (1994).

171. A qualified annuity interest can be either a dollar amount or a fixed percentage of the initial fair market value of the trust. Treas. Reg. § 25.2702-3(b)(1)(ii)(A), (B) (as amended in 1995). A qualified unitrust interest is a fixed percentage of the net fair market value of the trust assets determined annually. *Id.* § 25.2702-3(c)(1) (as amended in 1995).

172. I.R.C. § 2702(c)(2).

173. *Id.* § 2702(a)(1).

174. It is not a qualified interest because it is not an annuity or unitrust interest. *Id.* § 2702(a)(2).

175. *Id.*

The result is a taxable gift of the full value of the property (less any consideration furnished by the child).

### B. *Beating Section 2702: GRATs and High Rates of Return*

However, in order to be effective, section 2702 must not only prevent tax avoidance by eliminating the advantages of the GRIT and joint purchase, it must also prevent other manipulation by grantors which result in tax avoidance. The evidence so far is that section 2702 has been unsuccessful in this part of its task. A number of authors have shown that when the trust's rate of return exceeds the section 7520 table rate used to value the retained term of years, a tax savings is achieved by transferring more property to the remainder beneficiaries than was subject to transfer tax on the date of the gift.<sup>176</sup> This transfer tax savings is achieved by producing more income than the tables predict and allocate to the grantor's retained interest. Since, at least in a Grantor Retained Annuity Trust (GRAT), the amount of payment to the grantor is fixed, the additional income passes to the remainder beneficiaries with no transfer tax (assuming the grantor outlives the GRAT term).<sup>177</sup> Indeed, one author calls the GRAT "a virtually risk-free and an almost gift-tax-free method of shifting future income and appreciation to another"<sup>178</sup> and illustrates this with a detailed and thorough example.<sup>179</sup>

### C. *Beating Section 2702: Changing the Assets*

It has been noted that since the retained interest in a GRAT is either a fixed dollar amount or a fixed percentage of the original trust

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176. Gans, *supra* note 32, at 802; Steven A. Horowitz, *MIGRATS<sup>sm</sup> Are Better Than Your GRATs Despite New Section 7520 Regulations*, 74 TAXES 299, 300 (1996); Llewellyn, *supra* note 91, at 253-54, 285; McCaffrey, *supra* note 91, at 47. A GRAT is preferred over a GRUT for this purpose because in a GRAT, appreciation in the value of the trust assets will not increase the payment to the grantor, enabling a greater amount of property to be transferred tax-free to the remainder beneficiaries. Gans, *supra* note 32, at 802.

177. Gans, *supra* note 32, at 802. Some authorities recommend a "zeroed out GRAT," a GRAT in which the present value of the grantor's retained annuity interest, discounted by the applicable section 7520 interest rate, is equal to or greater than the value of the property transferred to the trust. Horowitz, *supra* note 176, at 300. In such a case, there is no taxable gift and any rate of return produced by the trust in excess of the section 7520 rate used, either in income or appreciation, is transferred totally tax-free to the remainder beneficiaries. *Id.* The author does note some I.R.S. resistance to this technique and some uncertainty as to its effectiveness. *Id.*; see also Gans, *supra* note 32, at 833-34, 911 (stating that the zero-value rule for GRATs gives them a comparable advantage over outright gifts); McCaffrey, *supra* note 91, at 58-62 (discussing several possible approaches to structuring a GRAT).

178. McCaffrey, *supra* note 91, at 59.

179. *Id.* at 60-62.

assets,<sup>180</sup> it is never affected by investment performance. However, a change in the trust assets after the creation of a GRAT, perhaps due to a change in economic conditions, resulting in higher yielding assets, could result in transferring property tax-free to remainder beneficiaries.<sup>181</sup>

#### D. Beating Section 2702: Income Tax Effects

If the income tax on the trust is paid by the grantor under the grantor trust rules or under a provision of the governing trust instrument,<sup>182</sup> the GRAT is advantageous when compared to an outright gift even when the rate of return on the GRAT investments is less than the table rate.<sup>183</sup> The reason is that the trust will not pay the income tax on its income<sup>184</sup> and the payment of income tax by the grantor is not a taxable gift.<sup>185</sup> As a result, property is transferred to the remainder beneficiaries tax-free.<sup>186</sup>

#### E. Estate Tax Inclusion

Based on prior rulings concerning charitable trusts,<sup>187</sup> most commentators believed that only a portion of a GRAT or GRUT would be included in a grantor's gross estate if the grantor died during the trust term.<sup>188</sup> If this position ultimately proves correct, a GRAT will have an advantage over some other techniques in that only a portion of the appreciation in the property between the date of creation of the GRAT and the grantor's date of death will be included in the grantor's gross estate.<sup>189</sup>

180. Treas. Reg. § 25.2702-3(b)(1)(ii)(A), (B) (as amended in 1995).

181. Martha W. Jordan, *Sales of Remainder Interests: Reconciling Gradow v. United States and Section 2702*, 14 VA. TAX REV. 671, 708 (1995).

182. See I.R.C. §§ 671-677 (providing the income tax provisions for trusts). Section 677 will usually be the applicable provision, since it deals with income for the benefit of the grantor.

183. Gans, *supra* note 32, at 828; Llewellyn, *supra* note 91, at 253-54.

184. See *supra* note 183.

185. Gans, *supra* note 32, at 828-29.

186. *Id.* at 829. Of course, in the case of an outright gift, the donee bears the burden of income taxes on the income earned by the gifted property. *Id.*

187. Rev. Rul. 82-105, 1982-1 C.B. 133-34; Rev. Rul. 76-273, 1976-2 C.B. 268-69.

188. PRACTICAL DRAFTING Oct. 1993, at 3377-79 (Richard B. Covey ed.); PRACTICAL DRAFTING July 1994, at 3741 (Richard B. Covey ed.); Gans, *supra* note 32, at 878-911; McCaffrey, *supra* note 91, at 55-56; Olsen, *supra* note 91, at 69-73.

189. It should be noted that there are indications that, at least in the case of a zeroed-out GRAT, the entire trust will be included in the gross estate if the grantor dies during the trust term under section 2039. Priv. Ltr. Rul. 94-51-056 (Sept. 26, 1994). Several authors have criticized the I.R.S.'s reasoning in this ruling. See David R. Hodgman & Debra L. Stetter, *Analyzing GRATs: Does the Emperor Have any Clothes?*, 134 TR. & EST. 41, 47 (1995); Steven A. Horowitz, *Succession Planning for the Family Business Enterprise: Sales, GRATs and Donative Transfers—the Comparative Advantages*, 74 TAXES 428, 436 (1996).

### F. The Personal Residence Exception

Section 2702 contains an exception to its "zero value rule" for retained interests for transfers of personal residences in trust where the grantor holds a term or life interest in the trust.<sup>190</sup> This means that a grantor can continue to create a GRIT with the grantor's personal residence. The regulations have expanded the requirements for a personal residence trust into two types: the Personal Residence Trust (PRT) and the Qualified Personal Residence Trust (QPRT).<sup>191</sup>

Basically, a PRT is an irrevocable trust created with a personal residence of the grantor as the trust property, with the grantor retaining a term of years in the trust.<sup>192</sup> The regulations provide detailed rules regarding what constitutes a personal residence and what other property may be in the trust.<sup>193</sup> Significant restrictions on the PRT exist.<sup>194</sup>

The QPRT is much more flexible and popular than the PRT.<sup>195</sup> It may hold a personal residence, improvements and limited amounts of cash.<sup>196</sup> The grantor's term interest can be transferred by gift.<sup>197</sup> If the trust assets are disposed of, the trust agreement must specify either outright distribution to the term holder, conversion of the trust into a GRAT, or give the trustee power to select one of the two choices.<sup>198</sup> There are a vast number of governing instrument requirements which greatly complicate the trust.<sup>199</sup>

Of course, even with the complications and limits imposed by the mandatory requirements, the availability of the QPRT creates a major flaw in the scheme of section 2702. One commentator has referred to PRTs and QPRTs as providing an "extraordinary opportunity" for tax

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190. I.R.C. § 2702(a)(3)(A)(ii) (1994).

191. Treas. Reg. § 25.2702-5 (1992).

192. Catherine Veihmeyer Hughes, *The Qualified Personal Residence Trust ("QPRT")*, Outline for Presentation at a Meeting of the Estate and Gift Tax Committee, Section of Taxation, A.B.A. (August 4, 1995) (outline on file with the *DePaul Law Review*).

193. Treas. Reg. § 25.2702-5(b)(2)(i), (ii) (1992); see PRACTICAL DRAFTING Oct. 1993, at 3357-61 (Richard B. Covey ed.).

194. PRACTICAL DRAFTING Oct. 1993, at 3361-62 (Richard B. Covey ed.). For example, the residence cannot be sold or transferred by the trust. *Id.* There appear to be a number of provisions which must be included in the trust instrument. *Id.*; see *infra* note 217. Other than the personal residence, only proceeds payable as a result of damages to, or destruction or involuntary conversion of the residence, I.R.C. § 1033; Treas. Reg. § 25.2702-5(b)(3) (1992), and insurance policies on the residence, PRACTICAL DRAFTING Oct. 1993, at 3357-61 (Richard B. Covey ed.), may be held in the PRT.

195. PRACTICAL DRAFTING Oct. 1993, at 3362 (Richard B. Covey ed.).

196. Hughes, *supra* note 192, at 5.

197. *Id.*

198. *Id.* at 7.

199. PRACTICAL DRAFTING Oct. 1993, at 3362-68 (Richard B. Covey ed.); Hughes, *supra* note 192, at 4-9; see *infra* note 217.

savings.<sup>200</sup> The two major tax advantages offered by the availability of the QPRT are: (i) if the grantor survives the term, any future appreciation on the personal residence or residences is removed from the grantor's estate at no transfer tax cost,<sup>201</sup> and (ii) the taxable gift is not the full value of the property, but is reduced by the value of the grantor's retained interest.

Why did Congress create this huge loophole in the attack on valuation abuses? Primarily, it appears that Congress believed that the PRT could not be abusive.<sup>202</sup> A second reason may be linked to the origin of the section 2702 rules. It is quite clear that Congress based section 2702 on the charitable deduction rules enacted in 1969.<sup>203</sup> The charitable deduction rules allow a charitable deduction for transfers of remainder interests in a personal residence or a farm.<sup>204</sup> When this exception to the annuity trust and unitrust requirements for split interest trusts for a charitable deduction was enacted, Congress apparently believed that this situation was not subject to valuation abuse.<sup>205</sup> Congress felt the same way about reserved terms of years in personal residences.<sup>206</sup> It may be that Congress believed that any effect of the exception would be de minimis because a personal residence does not usually comprise a large fraction of a person's wealth, thus limiting any potential for abuse.<sup>207</sup> It should also be noted that the appreciation in personal residences being limited,<sup>208</sup> the possibility of investing in high growth, low income assets not being present,<sup>209</sup> the detrimental loss of the step-up in basis which would occur if the personal residence is owned until death,<sup>210</sup> and the transactional costs of creating and administering QPRTs, support the idea that QPRTs are not abusive.<sup>211</sup> Despite the force of these arguments, the attention paid by

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200. Llewellyn, *supra* note 91, at 216; *see also* Cass & Campbell, *supra* note 103, at 512 (asserting that the GRAT is a useful planning technique, although not as advantageous as a GRIT).

201. Hughes, *supra* note 192, at 1.

202. Gans, *supra* note 32, at 806-10.

203. *Id.*; *see* Cass & Campbell, *supra* note 103, at 511; Horowitz, *supra* note 176, at 305; Llewellyn, *supra* note 91, at 225; Jeffrey N. Pennell, *Section 2036(c) Repealed and Replaced with Chapter 14*, 2 PROB. PRAC. REP. 1, 5 (Dec. 1990); Plaine & Schneider, *supra* note 91, at 147.

204. I.R.C. §§ 2055(e)(2), (3)(I)(i), 2522(c)(2) (1994); Treas. Reg. § 20.2055-2(e)(2)(ii) (as amended in 1994); *Id.* § 25.2522(c)-3(c)(2)(ii) (as amended in 1995).

205. S. REP. NO. 91-552, at 88 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2116-18, *and in* 1969-3 C.B. 479-80; *see* Estate of Blackford v. Commissioner, 77 T.C. 1246, 1250 (1981).

206. Harrison, *supra* note 91, at 923-24.

207. *Id.*; Gans, *supra* note 32, at 806.

208. Gans, *supra* note 32, at 807.

209. Harrison, *supra* note 91, at 923-24.

210. *Id.*

211. *Id.*

commentators to QPRTs<sup>212</sup> and the number of rulings on them appear to refute these contentions.<sup>213</sup> It appears that many tax and estate planning lawyers and their clients believe that QPRTs offer enough substantial tax advantages to employ them.

### G. Summary

Although section 2702 makes GRITs and joint purchases practically useless, the GRAT and to a lesser extent the GRUT, continue to offer tax savings opportunities in many situations. Moreover, the availability of PRTs and QPRTs provide additional opportunities for tax planning. Clearly, if the purpose of section 2702 was to close down the use of term interests in trusts as estate freezes, the section has failed to do so.

## VII. THE PRICE OF SECTION 2702: JASON'S TRIUMPH

The analysis of section 2702 is not complete after determining whether the section accomplished its purposes. From the previous discussion, it is clear that section 2702 accomplished part, though not all, of its purpose. But, to competently evaluate the wisdom of the section, the cost of the accomplishment must also be compared with the importance of the purpose to be achieved.

### A. Complexity

As previously mentioned, the remedy employed by section 2702 was copied from the revision of the charitable deduction in 1969.<sup>214</sup> The revision of the charitable deduction came with enormous complexity.<sup>215</sup> Indeed, the provisions regarding charitable remainder

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212. See *supra* notes 200-01.

213. As of July 23, 1996, QPRTs or PRTs were involved in 17 of 35 rulings listed in the Cumulative Index, and the latest additions thereto, of the CCH Federal Estate and Gift Tax Reporter under section 2702. Cumulative Index for Reports 1-310, 3 Fed. Est. & Gift Tax Rep. (CCH) 15,523-580 (June 6, 1995); Latest Additions to Cumulative Index for Reports 311-369, 3 Fed. Est. & Gift Tax Rep. (CCH) 15,505-520 (July 23, 1996).

214. See *supra* note 203 and accompanying text.

215. The complexity came in the form of mandatory governing instrument requirements imposed primarily by regulations. An extensive discussion of these requirements may be found in the following BNA Tax Management Portfolios: BONNIE S. BRIER & NANCY J. KNAUER, *Charitable Income Trusts*, Tax Mgmt. (BNA) 442-2d (1993); BONNIE S. BRIER & NANCY J. KNAUER, *Charitable Remainder Trusts and Pooled Income Funds*, Tax Mgmt. (BNA) 435-2d (1992).

What follows is a partial list of governing instrument requirements for the various types of charitable split interest trusts. This list is taken primarily from Zoe M. Hicks, *Charitable Giving Strategies*, Outline for Presentation at a Meeting of the Estate and Gift Tax Committee, Section of Taxation, A.B.A. (February 15, 1992) (outline on file with the *DePaul Law Review*).

1. Mandatory Provisions for Charitable Remainder Annuity Trusts (CRAT) and Charitable Remainder Unitrusts (CRUT)

trusts were deemed to be so complex that the Internal Revenue Service published approved forms for these trusts.<sup>216</sup>

Given the history of section 2702, it is not surprising that, as in the charitable deduction area, many complex and mandatory governing instrument requirements were imposed.<sup>217</sup> Of course, this makes cre-

- a. Must provide for payment to a noncharitable beneficiary of a dollar amount or a fixed percentage of at least five percent of the initial fair market value (CRAT) or of a fixed percentage of at least five percent of the net fair market value of the property valued annually (CRUT). I.R.C. § 664(d)(2)(A), (d)(3) (1994).
  - b. Only the annuity or unitrust amount may be paid to the noncharitable beneficiary. *Id.* § 1.664-2(a)(4) (as amended in 1994); *id.* § 1.664-3(a)(4) (1972).
  - c. The recipient must be a named person or persons who are alive when the trust is created. Treas. Reg. § 1.664-2(a)(3)(ii) (as amended in 1994); *id.* § 1.664-3(a)(3)(ii) (1972).
  - d. The term of the annuity or unitrust must be either the life or lives of the noncharitable beneficiary or a term not exceeding 20 years. I.R.C. §§ 664(d)(1)(A), 2(A).
  - e. The payment period begins on the trust's creation. Treas. Reg. § 1.664-2(a)(5)(i) (as amended in 1994); *id.* § 1.664-3(a)(5)(i) (1972).
  - f. At the end of the term, the remainder must be paid to the charity or continued in trust for a charitable use. I.R.C. § 664(d)(1)(C), (2)(C).
  - g. Alternative charitable remaindermen must be named. Treas. Reg. § 1.664-2(a)(6)(iv) (as amended in 1994); *id.* § 1.664-3(a)(6)(iv) (1972).
  - h. The annuity or unitrust amount must be prorated for any year less than 12 months. *Id.* § 1.664-2(a)(1)(iv) (as amended in 1994); *id.* § 1.664-3(a)(1)(v) (1972).
  - i. Additional contributions to an annuity trust must be prohibited. If additional contributions to a unitrust are permitted, a formula must be stated to compute the unitrust amount. *Id.* § 1.664-2(b) (as amended in 1994); *id.* § 1.664-3(b)(1)-(2) (1972).
  - j. Correction must be made for incorrect payments. *Id.* § 1.664-2(a)(1)(iii) (as amended in 1994); *id.* § 1.664-3(a)(1)(iii) (1972).
  - k. The trustee must be permitted to invest to obtain a reasonable amount of income. *Id.* § 1.664-1(a)(3) (as amended in 1994).
  - l. Estate taxes may not be paid from the trust. Rev. Rul. 82-128, 1982-2 C.B. 71.
  - m. In a short taxable year, the valuation of the trust assets must be made on the last date of that year. Rev. Rul. 82-165, 1982-2 C.B. 117.
  - n. Private foundation restrictions should be imposed on the trustee. Rev. Rul. 72-395, 1972-2 C.B. 340.
2. Requirements for Charitable Lead Annuity Trusts (CLAT) and Charitable Lead Unitrusts (CLUT)
    - a. Must provide for a guaranteed annuity interest or guaranteed unitrust interest to charitable organizations. These interests are determined in the same manner as charitable remainder trusts. I.R.C. §§ 2522(c)(2), 2055(e)(2).
    - b. Must be established for a specific term of years or for the life of one or more persons living at the trust's creation or a combination thereof. Treas. Reg. § 1.170A-6(c)(2)(i)(A), (ii)(A) (as amended in 1994); *id.* § 20.2055-2(e)(2)(v)(a), (vi)(a) (as amended in 1994); *id.* § 25.2522(c)-3(c)(2)(v)(a), (vi)(a) (as amended in 1994).
    - c. Must specifically prohibit violation of the private foundation rules. I.R.C. §§ 4947(a)(2), 508(e).

216. Rev. Proc. 90-32, 1990-1 C.B. 546; Rev. Proc. 90-31, 1990-1 C.B. 539; Rev. Proc. 90-30, 1990-1 C.B. 534; Rev. Proc. 89-21, 1989-1 C.B. 842; Rev. Proc. 89-20, 1989-1 C.B. 841.

217. McCaffrey, *supra* note 91, at 49-52; Plaine & Schneider, *supra* note 91, at 149. Some of the governing instrument requirements of the GRAT, GRUT, PRT and QPRT are as follows:

1. GRAT

- a. The annuity interest must be irrevocable. The fixed amount may be a stated dollar amount or a fraction or percentage of the initial fair market value. Treas. Reg. § 25.2702-3(b)(1)(i), (ii)(A)-(B) (as amended in 1995).
  - b. The annuity must be paid at least annually. *Id.* § 25.2702-3(b)(ii)(A), (B) (as amended in 1995).
  - c. If the annuity is stated as a fraction or percentage, the governing instrument must contain provisions meeting the requirements of Treasury Regulation section 1.664-2(a)(1)(iii) (as amended in 1994) on incorrect determination of the fair market value of the trust property. *Id.* § 25.2702-3(b)(2) (as amended in 1995).
  - d. The rules of Treasury Regulation section 1.664-2(a)(1)(iv) (as amended in 1994) relating to computation for short taxable years must be met in the governing instrument. *Id.* § 25.2702-3(b)(B) (as amended in 1995).
  - e. Additional contributions are prohibited. This is a governing instrument requirement. *Id.* § 25.2702-3(b)(4) (as amended in 1995).
  - f. No distributions to anyone other than the holder of the qualified annuity are permitted. This is a governing instrument requirement. *Id.* § 25.2702-3(d)(2) (as amended in 1995).
  - g. The term must be for the life of the term holder, for a term of years, or for the shorter of the two. This is a governing instrument requirement. *Id.* § 25.2702-3(d)(3) (as amended in 1995).
  - h. Commutation of the term holder's interest must be prohibited by the governing instrument. *Id.* § 25.2702-3(d)(4) (as amended in 1995).
2. GRUT
- a. Basically, all the above requirements of the GRAT are applicable to the GRUT, except that the unitrust interest is a fixed fraction or percentage of the net fair market value of the trust determined annually. *Id.* § 25.2702-3(c), (d) (as amended in 1995).
  - b. Additional contributions to a GRUT are not prohibited. *Id.*
3. PRT
- a. A grantor can create only two such trusts. *Id.* § 25.2702-5(a) (as amended in 1992).
  - b. Only personal residence and qualified proceeds can be held in the trust. This is a governing instrument requirement. *Id.* § 25.2702-5(b) (as amended in 1992).
  - c. The primary use of the personal residence must be as a residence of the term holder. *Id.* § 25.2702-5(b)(2)(iii) (as amended in 1992).
  - d. A personal residence must be either the principal residence of the term holder under Code section 1034, one other residence of the term holder under Code section 280A(d)(2) or an undivided fractional interest in either type of residence. Treas. Reg. § 25.2702-5(b)(2)(i) (as amended in 1992).
  - e. The only other property allowed in the trust is proceeds from damage, destruction or involuntary conversion of the trust residence. The proceeds must be reinvested in a personal residence within two years of receipt. The latter is a governing instrument requirement. *Id.* § 25.2702-2(b)(3) (as amended in 1992).
4. QPRT
- a. Requirement d of a PRT, *supra*, must be met. *Id.* § 25.2702-5(c)(2)(i) (as amended in 1992).
  - b. Requirement c of a PRT must be met. *Id.* § 25.2702-5(c)(2)(iii) (as amended in 1992).
  - c. The income from the trust must be distributed to the term holder at least annually and distributions to anyone else during the trust term must be prohibited. These are governing instrument requirements. *Id.* § 25.2702-5(c)(3), (4) (as amended in 1992).
  - d. The trust must be prohibited from holding any property other than one personal residence of the term holder, cash for trust expenses incurred or reasonably expected to be incurred within six months of the addition, for improvements to the residence to be paid within six months of the addition, for the purchase of the initial residence if there is a contract to purchase (within three months of the addition), and to purchase another residence, with the same limit as for initial purchase. *Id.* § 25.2702-5(c)(5) (as amended in 1992).



ating these trusts far more complex for the practitioner than creating a GRIT prior to 1990. As one leading practitioner put it: "Experience with the complex governing instrument requirements for charitable remainder trusts has shown that technical and not-so-technical mistakes are bound to be made in attempting to comply with these requirements. It would therefore be desirable to avoid uncertainty and unnecessary litigation by eliminating any unnecessary requirements."<sup>218</sup>

Clearly, the complexity of GRATs, GRUTs and QPRTs will cause problems for practitioners.

### B. Artificiality of the System

A problem with section 2702 is that it makes this portion of the transfer tax system very artificial. It does so by falsely characterizing what it is doing. The section 2702 zero value rule is supposedly "[s]olely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer)."<sup>219</sup> The rule appears to be solely one of valuation and applies only for the limited purpose stated.

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- e. If cash can be held in the trust, any excess amounts, determined quarterly, must be paid to the term holder. Also, at termination, any unused cash must be paid to the term holder within 30 days of termination. These are governing instrument requirements. *Id.* § 25.2702-5(c)(5)(ii)(B) (as amended in 1992).
  - f. The trust may hold improvements to the residence, sale proceeds (in a separate account), insurance on the residence, and insurance proceeds in a separate account. *Id.* § 25.2702-5(c)(ii)(2)(B)-(D) (as amended in 1992).
  - g. Commutation of the term holder's interest is prohibited. This is a governing instrument requirement. *Id.* § 25.2702-5(c)(6) (as amended in 1992).
  - h. If the personal residence ceases to be so used or is sold (if no proceeds can be held), the trust ceases to be a QPRT. This is a governing instrument requirement. *Id.* § 25.2702-5(c)(7) (as amended in 1992). Additional governing instrument requirements are mandated if the personal residence is sold and the trust is permitted to hold proceeds of sale. *Id.* Similar requirements are imposed for insurance proceeds. *Id.* § 25.2702-5(c)(7)(B) (as amended in 1992).
  - i. On ceasing to be a QPRT, the trust must either distribute the assets, be converted to a GRAT or give the trustee discretion to choose one of the alternatives. This is a governing instrument requirement. *Id.* § 25.2702-5(c)(8) (as amended in 1992). A number of governing instrument requirements, including compliance with all the mandatory provisions of Treasury Regulation section 25.2702-3 (as amended in 1995), is required if conversion to a GRAT is the chosen alternative. *Id.* § 25.2702-5(c)(8)(ii) (as amended in 1992).
  - j. The grantor must be prohibited from purchasing the residence from the trust. This is a governing instrument requirement for QPRTs created after May 16, 1996. Prop. Treas. Reg. PS-4-96, 1996-18 C.B. 874.

218. Pam H. Schneider, *Proposed Regulations Under Sections 2701, 2702 and 2703*, Presentation before the I.R.S. on behalf of the A.B.A. 17 (Sept. 20, 1991) (on file with the *DePaul Law Review*).

219. I.R.C. § 2702(a)(1) (1994).

However, the rule really states that for gift tax purposes, in any transfer in trust for the benefit of the grantor's family where the grantor retains an interest, that retained interest is treated as if it did not exist. In other words, under section 2702, a transfer by the transferor to the transferor is a gift.<sup>220</sup>

Such a rule, of course, flies in the face of both normal understanding and previous tax rules.<sup>221</sup> If the donor retains an interest (such as a life income interest or the income for a term of years) in a trust, the normal understanding is that the gift is only of the portion of the property which is transferred.<sup>222</sup> The gift tax rule had previously conformed to this common understanding.<sup>223</sup> Section 2702, despite its stated limits, effectively reverses this rule for transfers in trust under which the grantor retains an interest and other interests are given to family members. By valuing the grantor's retained interest as zero for gift tax purposes, the Code is effectively ruling that the grantor's retained interest is a gift and is part of the taxable transfer. *By retaining an interest, the grantor has effectively made a taxable gift to himself.*

Of course, such a rule is extremely artificial. And, like most artificial rules, it affects matters beyond the rule's stated limits. For example, any income paid to the grantor during the term of the grantor's retained interest (and not spent during the grantor's lifetime) is included in the grantor's gross estate under section 2033.<sup>224</sup> This income is actually taxed twice, because the present value of the retained income interest is subject to gift tax at the time of the creation of the trust under section 2702.<sup>225</sup>

### C. Adjustments Required for Future Gifts and Estate Tax

Double taxation of the income paid to the grantor is not the only problem resulting from the artificiality of section 2702. For example, what happens if some time after the creation of the trust, the grantor

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220. This is the effect of valuing the transferor's retained interest at zero. The effect, of course, is that the entire value of the transferred property is treated as a taxable gift. Thus, by valuing the grantor's retained interest at zero, the fact that a person cannot give property to himself is ignored.

221. Under previous tax law, a retained interest by the transferor was treated as an incomplete gift. Treas. Reg. § 25.2511-1(e) (1958).

222. Otherwise put, the value of the property less the value of the interest retained by the grantor.

223. Treas. Reg. § 25.2511-1(e) (1958).

224. I.R.C. § 2033.

225. The income interest is one of the components of the property and is a part of its value at the time of the creation of the trust. By valuing this interest at zero, section 2702 requires that gift tax be paid on this portion of the trust property's value. To the extent not spent, section 2033 taxes this value again as part of the decedent's gross estate. Jordan, *supra* note 181, at 707 n.168.

gives away all or part of his retained interest? Since this interest has effectively already been subject to the gift tax at the creation of the trust, taxing it again would be double taxation. A complicated regulation was required to rectify this problem.<sup>226</sup> Similarly, the problem of an increase in the decedent's gross estate resulting from a zero valuation needed to be addressed by regulations.<sup>227</sup> These issues arise only because of the artificial system imposed by section 2702, and the adjustments necessitated by such issues further complicate the transfer tax system.

#### D. *Early Payments of Transfer Taxes: Pay Me Now, Not Later*

Another effect of section 2702 is that it requires the early payment of transfer taxes or a reduction in the grantor's unified credit.<sup>228</sup> Prior to the enactment of section 2702, the amount of the grantor's taxable gift when the grantor retained an interest in a trust created for family members was the value of the property transferred reduced by the value of the grantor's retained interest.<sup>229</sup> The zero value rule of section 2702 increases the value of the taxable gift (because the grantor's retained interest is valued at zero) and consequently increases the value of the gift tax payable (or unified credit used).<sup>230</sup> Whether the early payment of gift tax in these circumstances is good tax policy is debatable.<sup>231</sup> The problem with section 2702 is that the early payment of tax is imposed on only one part of the transfer tax system by a rule which postures as a valuation rule and with no consideration of overall transfer tax policy.<sup>232</sup>

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226. Treas. Reg. § 25.2702-6(a) (1992). The regulation provides for a reduction in taxable gifts in this situation. The amount of the reduction is the lesser of "(i) the increase in the individual's taxable gifts resulting from the interest being valued at the time of the initial transfer under, Treas. Reg. § 25.2702-2(b)(1) or (c), or (ii) [t]he increase in the individual's taxable gifts (or gross estate) resulting from the subsequent transfer of the interest." *Id.* § 25.2702-6(b)(1) (1992).

But the regulation was required to deal with other problems as well. In computing an individual's taxable gifts under the above regulation, to which transfer is the annual exclusion allocated? Can gift splitting be used on the later transfer of the retained interest? *See* Treas. Reg. § 25.2702-6(a)(3), (b)(2) (1992). *But see id.* § 25.2702-6(b)(3) (1992) (reducing any reduction in subsequent taxable gifts (or adjusted taxable gifts) for estate tax purposes if the estate tax computation would reduce the adjusted taxable gifts by the gift tax paid).

227. *See id.* § 25.2702-6(a)(2), (b)(1), (3) (1992).

228. I.R.C. §§ 2010(b), 2505(b).

229. Treas. Reg. § 25.2511-1(e) (1958).

230. Because the gift tax is computed on the amount of current taxable gifts and previous taxable gifts. I.R.C. § 2502.

231. *See* discussion *infra* Part VIII.

232. *See* discussion *infra* Part VIII.

*E. Section 2702 Is Both Overinclusive and Underinclusive*

One test of a statute's quality is whether it includes all cases it is intended to apply to and no others. Section 2702 fails the test on both counts. The most obvious case in which section 2702 is overinclusive is the case where the grantor retains a life income interest. No abuse was possible in this case even prior to the enactment of section 2702, because the entire value of such a trust is included in the grantor's gross estate.<sup>233</sup> Under section 2702, however, the grantor of such a trust must pay gift tax on the full value of the trust at the time of the trust's creation and, in addition, the estate must pay a tax on the appreciation of the trust property. There was no reason to change the gift taxation scheme for this type of trust except in the context of a total change in transfer tax structure, because it was not abusive.<sup>234</sup> No doubt some percentage of grantors are willing to create a trust only if they can receive the income from the trust property for life. Grantors should not be penalized for making such a choice.<sup>235</sup>

As previously noted,<sup>236</sup> the statute is also underinclusive because of its exclusion of the transfer of personal residences in trust for family members where the grantor retains an interest in the trust.<sup>237</sup>

The result of the overinclusion and underinclusion of section 2702 is that certain techniques, such as GRATs, GRUTs and QPRTs and indeed outright gifts<sup>238</sup> are favored, whereas GRITs, joint purchases and retained life estates are disfavored. While abusive techniques can and should be curbed, it is not the function of the tax system to favor certain techniques of estate planning over other techniques when the disfavored techniques are not abusing the system.

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233. I.R.C. § 2036(a). Therefore, all appreciation between the date of the creation of the trust and the date of the grantor's death is subject to transfer tax.

234. See generally Gans, *supra* note 32, at 821 (explaining that section 2702 does not favor life-estate trusts).

235. Gans also argues that "[b]y making [section 2702] 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." *Id.* at 822.

236. See discussion *supra* Part VI.F.

237. I.R.C. § 2702(a)(3)(A)(ii).

238. See, e.g., Melcher & Arend, *supra* note 91, at 666-72. The authors argue, based on a series of computations, that an outright gift is preferable to a GRAT by an appreciation rate on the trust assets of 27%. *Id.* A series of overlapping two year GRATs (referred to by the authors as "LAZY GRATs") are superior to outright gifts at a 20% appreciation rate. *Id.* But see Gans, *supra* note 32, at 822-37 (arguing that, especially for certain assets and when the grantor pays the income tax on trust earnings, a GRAT can be superior to an outright gift when the trust's rate of return exceeds or perhaps is even slightly below the table rate).

## VIII. THE SEARCH FOR SOLUTIONS: THE BANISHING OF THE MONSTER

The foregoing has demonstrated that section 2702 did not accomplish its broader purpose of ending perceived abuses in split-interest transfer tax avoidance techniques, although it did effectively eliminate the GRIT and joint purchase.<sup>239</sup> It has also demonstrated that the price paid for this "success" is quite high in terms of distortion of the transfer tax system, complexity, overinclusion and underinclusion. Is there a better way?

### A. Limited Solutions

#### 1. The GRIT

##### a. Statutory Solutions

If, as Congress appeared to believe,<sup>240</sup> the GRIT as a whole (rather than just certain aspects of it) was abusive, a simple solution would have been to amend current section 2036<sup>241</sup> to provide that the gross estate would include the value (as of the grantor's date of death) of the property of any trust under which the grantor had retained a term of years, even if the term of years had expired prior to the grantor's death. This would have completely solved the GRIT problem with no complications<sup>242</sup> and no adjustments in other Code sections. Indeed, the amendment would be quite simple.<sup>243</sup> Such a solution would avoid the problems of current section 2702 and ensure that all the appreciation of the trust property is subject to transfer tax.

As previously noted,<sup>244</sup> however, section 7520 addressed one of the major concerns about the GRIT and several of the other concerns are *de minimis*. The two remaining concerns were:

239. See discussion *supra* Part VI.

240. See discussion *supra* Part IV.

241. I.R.C. § 2036 (1994).

242. See Gans, *supra* note 32, at 816-17. The only complications would be determining what property was in the trust when it terminated and valuing that property. The greater the length of time between the termination of the trust and the death of the grantor, the more significant this problem becomes.

243. One possibility would be to amend current section 2036 by using the reverse of current section 2702(c)(3). The process would be to renumber current section 2036(c) as section 2036(d), and add a new section 2036(c) to read as follows: "(c) For the purposes of section (a), the term 'for life' shall include an interest in the property for a term of years which expires before the death of the decedent."

Alternatively, some limits on the application of the rule could be used. For example, a "three years before death" rule, similar to current section 2038, might be considered. See I.R.C. § 2038(a). Another alternative might be to include the property in decedent's gross estate but value it on the date the latest term of years reserved by the grantor ended.

244. See discussion *supra* Part V.

1. a grantor could further reduce the taxable gift by retaining a contingent remainder interest and a testamentary power of appointment in the trust in case the grantor died during the trust term; and
2. the tables assume that the entire value of the grantor's retained interest is returned to the grantor by distributions of income (that is, that the entire table rate will be realized by the trust as income) and appreciation of the trust corpus is not taken into account by the tables (the appreciation factor).

The first problem is relatively easy to solve. A short amendment to the gift tax statute disallowing a reduction of a taxable gift for the value of contingent remainder interests, testamentary powers of appointment or similar interests reserved by grantors who also reserve term interests, would solve the problem without causing collateral effects on the rest of the system.

The appreciation problem is somewhat more difficult. The income and appreciation factors of each trust are different. Both are dependent on the original property contributed to the trust and the changes in investments made by the trustee. Nevertheless, a solution is not impossible. One possibility is that the Treasury Department could undertake a study over a period of years to determine the average income and appreciation of trusts. Following that study, the section 7520 rate could be based on the study results and reexamined periodically.<sup>245</sup> Another possibility might be to assume that in the average trust, one-half (or some other portion) of the table rate is income and one-half is appreciation, and amend section 7520 accordingly. One objection might be that lowering the rate in such a manner results in a detriment to the government because, if the same tables are used for both purposes, the grantor of a split-interest charitable trust might obtain an increased charitable deduction. Such an argument is unfair because it reflects a "heads I win, tails you lose" philosophy by the government. It is poor tax policy to insist that tables be used only when they favor the government and never when they favor the taxpayer.<sup>246</sup>

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245. It should be noted that the section 7520 tables are to be revised every 10 years to take into account changes in mortality tables. I.R.C. § 7520(c)(3).

246. *Hearings, supra* note 12, at 64-65 (statement of John A. Wallace, Director, A.B.A. Probate & Trust Division). Mr. Wallace is also a member of the law firm of King & Spalding in Atlanta. He is one of the most highly respected estate planning practitioners in the United States. Mr. Wallace's statement is worth quoting:

This questioning of certain split interest transactions apparently reflects a concern that the Treasury tables do not work well in the context of these two specific cases [GRITs and joint purchases] because the taxpayer may secure an advantage if the current yield of the subject property falls below the assumed rate of return in the tables. On the other hand, use of the tables to determine the transfer tax consequences of gifts of life

Yet the use of actuarial tables for dealing with estate tax problems has been so widespread and of such long standing that we cannot assume Congress would have balked at it here; the United States is in business with enough different taxpayers so that the law of averages has ample opportunity to work.<sup>247</sup>

#### b. Case Law Solutions

One major concern with the GRIT was that in cases where the trust property was unproductive or underproductive, the use of the tables has not been reflective of the actual value to be attributed to the income interest.<sup>248</sup> Even before section 2702 was enacted, the Internal Revenue Service challenged the use of the tables in this situation.<sup>249</sup> In a series of cases involving the annual exclusion,<sup>250</sup> the Service had some success in arguing that the tables should not be used to value the income interest in such cases,<sup>251</sup> at least when the trustee did not have the power to change investments.<sup>252</sup> Invoking *Dickman v. Commissioner*,<sup>253</sup> a series of letter rulings applied this policy to cases where the grantor could require conversion of unproductive property into income producing property, but failed to do so.<sup>254</sup> The Service contended that this failure constituted a taxable gift. In a recent case, the Service extended this contention to a common law GRIT.<sup>255</sup> The GRIT was funded with closely-held stock which produced annual in-

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estates and terms of years, or the transfer tax implications of charitable lead and charitable remainder trusts, will work to the advantage of the Treasury under similar circumstances. We question whether a change that rejects the use of tables where they work against the Treasury, but insists upon their application where the opposite result occurs, represents good tax policy, and fosters likely taxpayer agreement that our transfer tax system is fair, equitable and worthy of their highest standard of voluntary compliance.

*Id.*

247. *Gelb v. Commissioner*, 298 F.2d 544, 551-52 (2d Cir. 1962) (footnote omitted); see *Northeastern Penn. Nat'l Bank & Trust Co. v. United States*, 387 U.S. 213, 224 (1967) (quoting *Gelb*, 298 F.2d at 551-51 with approval).

248. See discussion *supra* Part V.

249. PRACTICAL DRAFTING Oct. 1993, at 3328-29, 3351-53 (Richard B. Covey ed.).

250. I.R.C. § 2503(b).

251. See, e.g., *Maryland Nat'l Bank v. United States*, 609 F.2d 1078, 1081 (4th Cir. 1979); *Berzon v. Commissioner*, 534 F.2d 528, 531-32 (2d Cir. 1976); *Calder v. Commissioner*, 85 T.C. 713, 730 (1985); Rev. Rul. 76-360, 1976-2 C.B. 298.

252. See *Rosen v. Commissioner*, 397 F.2d 245 (4th Cir. 1968) (allowing use of tables to value present interest and allowing annual exclusion where trustees had power to sell non-dividend paying closely held stock). *But see* Rev. Rul. 69-344, 1969-1 C.B. 225, 226 (stating that the I.R.S. will not follow the holding in *Rosen*).

253. 465 U.S. 330 (1984).

254. PRACTICAL DRAFTING Oct. 1993, at 3328 (Richard B. Covey ed.) (citing Priv. Ltr. Rul. 88-01-008 (Oct. 7, 1987) and Priv. Ltr. Rul. 90-52-050 (Oct. 3, 1990)); see also Priv. Ltr. Rul. 87-23-007 (Feb. 18, 1987) (discussing nonpayment of noncumulative preferred stock dividends as a means of bypassing estate and gift taxes).

255. *O'Reilly v. Commissioner*, 973 F.2d 1403, 1406 (8th Cir. 1992), *rev'g* 95 T.C. 646 (1990).

come of .2% of the stock's value.<sup>256</sup> The grantors attempted to value their retained interests by using the tables.<sup>257</sup> The Service argued that the tables should not be used. The Tax Court held the tables could be used, but the Eighth Circuit reversed, holding that the use of the tables in this case would be "unrealistic and unreasonable,"<sup>258</sup> since the use of the tables produced a "wildly unrealistic measurement."<sup>259</sup>

An argument certainly exists that no statutory solution should be attempted. Rather, the resolution of whether the tables should be used to value the grantor's retained interest in a GRIT should be allowed to be resolved through continued development by cases and rulings.

One proposal, which was not adopted, recommended importing some of the case law just discussed into the statute.<sup>260</sup> It was proposed that either the Service or a taxpayer could value the property involved in a transfer without regard to actuarial tables if it was established that the assumptions made by the tables were, or were likely to be, substantially different from the actual experience of the trust.<sup>261</sup> Since the proposal was to amend section 2036(c), the effect of the proposal permitted the use of the actual experience of the trust as evidence of whether the tables should be applied.<sup>262</sup> While this proposal was not adopted in what ultimately became section 2702, it offers some evidence that a proposal based on the developing case law could be an effective way of solving the problem.

## 2. *Joint Purchases*

Assuming there is any abuse involved in a joint purchase and a concomitant need to regulate it,<sup>263</sup> two relatively limited solutions come to mind. First, if a statutory solution was necessary, adding to section 2036 a slightly reworded version of current section 2702(c)(1)-(3) would appear to work.<sup>264</sup> Alternatively, one might await case law developments to determine if a developing estate tax doctrine relating to

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256. *Id.* at 1404.

257. Since the GRIT was created in 1985, the old 10% tables in Treasury Regulation section 25.2512-5(f) (1994) were used. *O'Reilly*, 973 F.2d at 1404.

258. *Id.* at 1408.

259. *Id.* at 1406.

260. *Hearings, supra* note 12, at 206-07 (statement of Donald C. Lubick, Chair, Tax Policy Committee, Section of Taxation, District of Columbia Bar).

261. *Id.* at 207.

262. *Id.*

263. See discussion *supra* Part V.

264. Current section 2702(c) provides:

(1) In general.—The transfer of an interest in property with respect to which there is [one] or more term interests shall be treated as a transfer of an interest in a trust.



the sale of a remainder interest applies to joint purchases. In *Gradow v. United States*,<sup>265</sup> a case arising in a community property jurisdiction, the decedent left a will attempting to dispose of both his and his wife's interest in the community assets. Basically, the decedent's will gave his widow an election.<sup>266</sup> If she rejected the will, she received only her share of the community property.<sup>267</sup> If she agreed with the will, she would transfer her share of the community property into a trust, which would include her husband's share of the community assets.<sup>268</sup> She would receive the income from the trust for life (together with the couple's residence and her husband's personal and household effects and jewelry).<sup>269</sup> On her death, the trust property would go to the Gradow's son.<sup>270</sup> The widow accepted the will and added her share of the community property to the trust.

The Service contended that, since the value of the widow's share of community property was worth more than the value of the life income interest in the trust, the election should be viewed as a transfer of her community property to the trust with a retained life income interest includable in her estate under section 2036(a).<sup>271</sup> The Service contended that the assets the widow gave up were not full and adequate consideration.<sup>272</sup> The court held that "full and adequate consideration" required payment of an amount equal to the value of the interest which would be taxed—the widow's share of community property.<sup>273</sup>

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(2) Joint purchases.—If [two] or more members of the same family acquire interests in any property described in paragraph (1) in the same transaction (or a series of related transactions), the person (or persons) acquiring the term interests in such property shall be treated as having acquired the entire property and then transferred to the other persons the interests acquired by such other persons in the transaction (or series of transactions). Such transfer shall be treated as made in exchange for the consideration (if any) provided by such other persons for the acquisition of their interests in such property.

(3) Term interest.—The term "term interest" means—

(A) a life interest in property, or

(B) an interest in property for a term of years.

I.R.C. § 2702(c)(1)-(3) (1994).

265. 11 Cl. Ct. 808 (1987), *aff'd* 897 F.2d 516 (Fed. Cir. 1990).

266. *Id.* at 808, 809.

267. *Id.*

268. *Id.*

269. *Id.*

270. *Id.*

271. Abbin, *supra* note 43, at 14.

272. *Gradow*, 11 Cl. Ct. at 810.

273. *Id.* at 813. Two recent cases that agree with the *Gradow* decision are *Estate of D'Ambrosio v. Commissioner*, 105 T.C. 252 (1995), *rev'd* 101 F.3d 309, 318 (3rd Cir. 1996) and *Pittman v. United States*, 878 F. Supp. 833 (E.D.N.C. 1994).

There has been a good deal of criticism of *Gradow*.<sup>274</sup> In any event, there has also been some speculation that a joint purchase should be treated similarly to a sale of a remainder interest.<sup>275</sup> If this suggestion is adopted by the courts, legislation might not be needed. Keep in mind, however, that it is dubious whether the joint purchase represents an abusive situation.<sup>276</sup>

## B. The Structural Solution

### 1. The Real Problem

As emphasized in *Jason—Part I*, the driving force behind the enactment of section 2036(c) and later Chapter 14 was estate freezing, particularly corporate recapitalizations used as estate planning devices.<sup>277</sup> Trusts and joint purchases were very much an afterthought.<sup>278</sup> After the disastrous experience with section 2036(c),<sup>279</sup> and the criticism of the practicing bar and commentators that the wrong approach had been taken and that recapitalizations were valuation problems rather than inclusion problems,<sup>280</sup> Congress reversed focus. In developing Chapter 14, Congress treated corporate recapitalizations and similar techniques as valuation problems.<sup>281</sup> Again, trusts went along for the ride. But in trying to solve the problems created by GRITs and joint purchases by using valuation solutions, Congress made as crucial a mistake as it did when, in enacting section 2036(c), it treated corporate recapitalizations as estate inclusion problems. The central problem with section 2702 is that, if any problem exists with the GRIT and the joint purchase, it is not a valuation problem, it is a problem of inclusion and exclusion.

The problem of estate freezing through corporate recapitalization was correctly characterized as a valuation problem.<sup>282</sup> The problem was determining the correct valuation of the senior (preferred) and junior (common or growth) interests. The “bells and whistles” added to the preferred interests often resulted in incorrect valuations for these interests.<sup>283</sup> Since generally only the preferred interests were

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274. See, e.g., Abbin, *supra* note 43, at 17-22.

275. Priv. Ltr. Rul. 94-12-036 (Dec. 23, 1993); PRACTICAL DRAFTING Oct. 1993, at 3427-28 (Richard B. Covey ed.).

276. See discussion *supra* Part V.

277. Begleiter, *Jason—Part I*, *supra* note 6, at 537-45.

278. See discussion *supra* Part VI.A.

279. Begleiter, *Jason—Part I*, *supra* note 6, at 545-56.

280. *Id.* at 545-58.

281. *Id.* at 556-58.

282. *Id.* at 584.

283. *Id.* at 536-37.

retained by the older generation and the common interests given to members of the younger generation, very little gift tax was paid. The question was truly one of correctly valuing the preferred and common interests.

On the other hand, in a GRIT there is no significant question of how to value the retained and transferred interests.<sup>284</sup> The problem is that a retained interest is not a transfer subject to the gift tax.<sup>285</sup> Otherwise stated, interests retained by the grantor are not included in the term "taxable gift," on which the gift tax is computed.<sup>286</sup> More specifically, the transfer tax sections allow a transfer to be divided into temporal interests,<sup>287</sup> and interests which are reserved in the grantor are not taxed.<sup>288</sup> Since a gift tax on the transferred interests is imposed on the date of the transfer, the transferred property must be valued on the date of the transfer and only the value of the transferred interests is taxed.<sup>289</sup> No further gift is made when the grantor's retained term interest expires<sup>290</sup> because all that is transferred at that time is the remainder interest and that has already been taxed.

In short, it is the rule taxing a gift at the time of the transfer and allowing the splitting of the transfer into various temporal segments that allows any transfer tax savings on a GRIT. The tax savings on a joint purchase are also possible because of the splitting of the interests in property between the life estate and remainder, with different persons owning each interest.<sup>291</sup>

The problem of allowing a transfer to be divided into different temporal interests and not taxing those temporal interests retained by the

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284. The only question is whether the tables really value these interests correctly. To say that the tables are inadequate is really an attack on the use of tables in any case, rather than saying that a better valuation method can be developed.

285. Treas. Reg. § 25.2511-1(e) (as amended in 1994).

286. I.R.C. §§ 2502, 2503 (1994).

287. For example, life income interests, terms of years and remainders.

288. More technically, interests reserved to the grantor render the gift partially incomplete. Treas. Reg. § 25.2511-1(e) (1958). As to those parts of the gift which are incomplete, no transfer tax is imposed.

289. Blattmachr & Gans, *supra* note 35, at 18.

290. *Id.*

291. This is possible because the law prior to section 2702 did not view the purchase of temporal interests for the current value of those interests as a transfer of the entire asset, including the appreciation, to the remainderman at the death of the life tenant. There was no gift at the time of creation, since each purchaser paid the value of his or her interest. There was no gift on death, because the life estate simply expired. Nothing was transferred on death. *See also* Treas. Reg. § 25.2511-2(f) (as amended in 1983) (stating that the gift tax does not apply to transfers occurring by reason of the death of the donor, since the statute is confined to transfers by living donors). And the life estate, since it expired on death, is not included in the owner's gross estate. *See, e.g., Helvering v. Rhodes' Estate*, 117 F.2d 509, 510 (8th Cir. 1941); *Frew v. Bowers*, 12 F.2d 625, 627 (2d Cir. 1926).

grantor is a question of inclusion and exclusion, not of valuation. The interests retained by the grantor are not taxable gifts.<sup>292</sup> They are incomplete gifts not subject to the gift tax.<sup>293</sup>

The concept of dividing a transfer into temporal segments has been embedded in the transfer tax law for many years. As early as 1945, the Supreme Court could state: "Accordingly, it has been held that if the income of a trust is required to be distributed periodically, as annually, but distribution of the corpus is deferred, the gift of the income is one of a present interest, that of the corpus, one *in futuro*."<sup>294</sup> The principle continues to be recognized in the current tax law.<sup>295</sup>

Given that section 2702 deals with the inclusion and exclusion of interests, rather than the valuation of these interests, another aspect of the problem of section 2702 becomes apparent. Valuation problems are often confined to particular situations. A narrowly-tailored provision applicable to one situation can be employed to solve such problems without causing a domino effect. The solution to the valuation problem will generally not impact other provisions of the transfer tax system. An example is found in Code section 2701 which involves a valuation problem.<sup>296</sup> While the solution to the corporate freeze was complicated, section 2701 does not impact heavily on other transfer tax sections.<sup>297</sup> Another example is the enactment of section 7520 in 1988.<sup>298</sup> The change greatly affected the valuation of temporal interests in property, but had almost no effect on the structure of the transfer tax system.

A problem involving the inclusion or exclusion of an interest in the transfer tax system, however, is usually not so easy to fix. Any change in the treatment of such an interest usually has effects on other parts of the transfer tax system. These effects must be taken into account in formulating the solution. One example, already mentioned, is that

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292. Treas. Reg. § 25.2511-1(e) (1958).

293. *Id.* This rule is similar to the rule that a gift is not complete until the donor parts with dominion and control, which has been part of the gift tax law since the gift tax was first enacted. *Burnet v. Guggenheim*, 288 U.S. 280, 286 (1933); Treas. Reg. § 25.2511-2(b), (c) (as amended in 1983).

294. *Fondren v. Commissioner*, 324 U.S. 18, 21 (1945) (citing *Sensenbrenner v. Commissioner*, 134 F.2d 883, 886 (7th Cir. 1943) and *Fisher v. Commissioner*, 132 F.2d 383, 386 (9th Cir. 1942)).

295. Treas. Reg. § 25.2511-1(e) (as amended in 1994). In addition, section 2503 allows an annual exclusion only for gifts of present interests. I.R.C. § 2503(b) (1994). The determination of what is a present interest also involves separating a transfer into temporal interests. *See* Treas. Reg. § 25.2503-3 (as amended in 1983).

296. *Belgeiter, Jason—Part I*, *supra* note 6, at 584.

297. The solution chosen did require some adjustments to later gifts and to the estate tax, Treas. Reg. § 25.2701-5 (1992), but that was primarily due to the solution chosen, rather than the nature of the problem.

298. *See* discussion *supra* Part IV.A.

Code section 2702, in attempting to deal with the GRIT, also impacted the reserved life income interest.<sup>299</sup> Prior to the enactment of section 2702, a grantor who created a trust and reserved a life income interest made a gift of the value of the remainder interest,<sup>300</sup> although the entire trust would be included in the grantor's gross estate when the grantor died.<sup>301</sup> Under section 2702, the grantor pays a gift tax on the full value of the property on the creation of the trust.<sup>302</sup> The trust is still included in grantor's gross estate<sup>303</sup> but the trust is not an adjusted taxable gift.<sup>304</sup> The point is that section 2702 impacts the reserved life income interest and other aspects of the transfer tax system. This is because section 2702 ignores the grantor's retained interest only for certain gift tax purposes and only for certain transfers.<sup>305</sup> No changes were made in other transfer tax sections impacted by retained interests, thus causing the unintended effects and complications discussed in this Article.<sup>306</sup> Such an approach can work in a valuation section because in many cases a change in the valuation of an interest has minimal impact on the Code's transfer tax structure. A structural change, however, such as the enactment of section 2702, usually impacts the transfer tax system beyond the immediate provision. Therefore, to solve a structural problem, such as the splitting of an asset into temporal interests, a structural change in the system is required.<sup>307</sup> To confuse a valuation provision, which generally has a limited impact on other provisions, with a structural change, which

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299. See discussion *supra* Part VI.D, E.

300. Treas. Reg. § 25.2511-1(e) (as amended in 1994).

301. I.R.C. § 2036(a) (1994).

302. *Id.* § 2702(a), (c)(3).

303. *Id.* § 2036(a).

304. *Id.* § 2001(b).

305. *Id.* § 2702(a).

306. Gans, *supra* note 32, at 817.

307. It might be noted that the same approach taken in section 2702 was used in limiting the charitable deduction in 1969. See discussion *supra* Parts VI.E, VII. The solution could validly be employed in the charitable area because in the charitable area a deduction question was involved, rather than a question of inclusion and exclusion. Because deductions are a matter of legislative grace, see, for example, *Indopco, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934), Congress has great leeway in limiting or qualifying deductions without affecting the basic structure of the transfer tax. This is why the 1969 changes to the charitable deduction could work without causing the problems which occur with section 2702. The limits on interests which qualify for the charitable deduction and the governing instrument requirements are limited to qualifying for the deduction, and do not affect the basic tax structure. Section 2702 however, because it impacts on the basic inclusion-exclusion issue of whether a gift is complete, ignores the impact that the zero valuation rule has on the transfer tax structure of the Code.

usually has ripple effects well beyond the problem at which it is directed, can have serious and unexpected consequences.<sup>308</sup>

A structural solution to the problem posed by GRITs and joint purchases and other problems caused by recognizing temporal interests in property would involve adopting one rule applicable to all transfer tax aspects of such split interests in trusts. Fortunately, a great deal of work has already been done in this area.<sup>309</sup> Basically, the proposals divide into two positions. One position is the so-called "easy to complete" rule, providing that most transfers are subject to the gift tax and not the estate tax.<sup>310</sup> The other position is the "hard to complete" rule, which provides that gifts are incomplete if any substantial interest is retained, and subjects most transfers with retained interest to the estate tax.<sup>311</sup> Detailed comment and evaluation of

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308. An example of confusing the issues of completion of a gift and valuation was noted by the court in *Estate of DiMarco v. Commissioner*, 87 T.C. 653 (1986). The case involved the question of whether a corporate survivor's benefit plan providing for income to the spouse of an employee was a gift by the employee to his spouse. *Id.* at 654. The Service contended that the employee made a gift when he became employed by the corporation, but because the value of the benefit could not be determined on that date, the gift should be treated as incomplete until the benefit could be valued (on the employee's death). *Id.* at 659-60. The court, in rejecting this contention, noted the following:

In addition, we believe that respondent has confused the issues of completion and valuation in this case . . . We also question, however, whether the fact that the value of transferred property cannot be readily determined at the time of the transfer is relevant in determining whether the transfer is complete for gift tax purposes. We have noted above that transfers of property are complete and subject to the gift tax at the time the donor relinquishes dominion and control over the transferred property. Nothing in the statute or the regulations suggests that, even if a donor relinquishes dominion and control over transferred property, the transfer is or can be considered to be incomplete for gift tax purposes if the value of the property is uncertain . . . Accordingly, we reject any suggestion by respondent either that transfers of property are incomplete for gift tax purposes simply because "no realistic value can be placed" on the property at the time the transfer occurs, or that transfers of property become complete for gift tax purposes only when the value of the transferred property can be easily ascertained.

*Id.* at 660-61.

309. The leading efforts are AMERICAN LAW INST., FEDERAL ESTATE AND GIFT TAXATION (1969) [hereinafter ALI PROJECT]; 2 U.S. TREASURY DEPT., TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH—GENERAL EXPLANATION OF THE TREASURY DEPARTMENT PROPOSALS (Nov. 1984) [hereinafter TREASURY PROPOSALS]; Harry L. Gutman, *A Comment on the ABA Tax Section Task Force Report on Transfer Tax Restructuring*, 41 TAX LAW. 653 (1987-88); and Jerome Kurtz & Stanley S. Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal*, 70 COLUM. L. REV. 1365 (1970); *Task Force Report*, *supra* note 58.

310. Kurtz & Surrey, *supra* note 309, at 1375-76. Section 2702 could be viewed as adopting an "easy to complete" rule for the limited purposes of determining whether a transfer is a gift and the amount of the gift. However, section 2702 is deficient in that it does not make the rule applicable to the estate tax and to other areas (such as the annual exclusion) affected by its rule.

311. The Section of Taxation Task Force advocated such a rule with respect to retained income interests and completely revocable trusts, but an easy to complete rule with respect to other retained powers and retained future interests. *Task Force Report*, *supra* note 58, at 405-10.

these proposals has been done elsewhere and is beyond the scope of this Article.<sup>312</sup> What is important is that a structural problem must be solved by a structural change and a structural change makes the change generally applicable to all areas of the transfer tax system in which the problem occurs. A structural problem cannot be rectified by an isolated change to one part of the system because a problem of inclusion and exclusion permeates the system. A section such as 2702 is doomed to failure because of an inadequate perception of the problem and a solution which cannot possibly work on a structural problem.

### IX. CONCLUSION: JASON LIVES

The addition of Chapter 14 to the Code in 1990 (as well as its predecessor, former section 2036(c)) was the first real statutory attempt to attack sophisticated estate planning techniques. The focus of concern and certainly the leading worry was corporate recapitalizations. This concern dictated the formulation of section 2036(c) and, when that proved unworkable, Chapter 14. That corporate recapitalizations were the primary focus is evidenced by the amount of space devoted to that problem in the legislative history, as discussed in this Article as well as in *Jason—Part I*, which examined section 2701.<sup>313</sup> As discussed, the critics of section 2036(c) were quite correct that the “estate freeze” problem was a question of valuation. In enacting section 2701, Congress attacked the problem from the correct perspective.<sup>314</sup> The

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Gutman agrees as to retained life estates, but questions the rule in other aspects. See Gutman, *supra* note 309, at 675-81. The Treasury studies similarly recommended a hard to complete rule for retained beneficial interests and revocable transfers, but an easy to complete rule for retained powers and reversionary interests (with some qualifications). TREASURY PROPOSALS, *supra* note 309, at 378-80. The American Law Institute recommendation was similar. See ALI PROJECT, *supra* note 309, at 41-47; see also Gans, *supra* note 32, at 815 (discussing both of the proposed alternative approaches); Llewellyn, *supra* note 91, at 223 (explaining the “hard to complete” rule for preventing undervaluation of remainder interests following retained interests).

312. See *supra* note 309. It should be noted, however, that a hard to complete rule for retained interests subjects appreciation to the transfer tax system. An easy to complete rule has the advantage of disposing of all taxation at the time of transfer and leaving nothing remaining for future consideration. It also makes passing of certain difficult to treat assets, such as farms and closely held businesses, to the next generation much more easily accomplished. One commentator has noted that the pre-section 2702 system didn't work because the transfer tax system evaluated all gifts at the time of transfer and had no mechanism to take into account post-transfer appreciation, except for the life income interest. McCaffrey, *supra* note 91, at 47-48. Moreover, the system contained no method of assessing an additional tax if later events showed the assumptions on which the original valuation and tax were based were not accurate. *Id.* at 55.

313. Begleiter, *Jason—Part I*, *supra* note 6.

314. That is not to say that the solution Congress chose was correct. A number of matters in section 2701 could have been clarified, and some aspects incorporated in it are quite debatable. Moreover, technical changes will also be needed. See *id.*

legislation covering trusts was of secondary importance in the debate leading up to both section 2036(c) and Chapter 14. The question of whether the problems of corporate recapitalizations on one hand, and GRITs and joint purchases on the other, were the same, received little or no examination or analysis. In section 2702, Congress took a valuation approach to the perceived problems of trusts. What emerged was a statute which effectively ends the use of GRITs and joint purchases (except as to personal residences) as estate planning tools. The price for this result, however, is very high. The statute does not accomplish its broader goal of making it impossible to beat the tables, it simply substitutes GRATs for GRITs. Section 2702 and the regulations issued under it are extremely complex and have substantial impact on other gift tax and estate tax provisions of the Code. The section 2702 exception for personal residences has fostered a whole new estate planning technique which appears to be gaining popularity. The statute is both overinclusive and underinclusive. The problems created by section 2702 are serious. It is unlikely that they will be corrected in the near future.

If Congress is merely concerned with GRITs and joint purchases, specific legislation could be crafted to deal with the individual problems perceived with these techniques.<sup>315</sup> More specifically, legislation could attack the true abusive aspects of the GRIT which include: (i) retention of and allowance for reductions in the value of taxable gifts for retained contingent remainder interests and powers of appointment; and (ii) failure of the tables to account for appreciation.<sup>316</sup> Such legislation, to be effective, would require a limited gift tax revision together with a change in the section 7520 table rates.<sup>317</sup> Joint purchases and GRITs could also be attacked through a limited estate tax inclusion approach.<sup>318</sup> However, the case for joint purchases being abusive is far less convincing than the case for certain aspects of the GRIT being so. Indeed, the case against joint purchases appears, at bottom, to be that sophisticated taxpayers who adopt this technique save some transfer taxes.<sup>319</sup> This is hardly abusive.<sup>320</sup> A

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315. See discussion *supra* Part VIII.A.

316. See discussion *supra* Part VIII.A.1.

317. See discussion *supra* Part VIII.A.1.

318. See discussion *supra* Part VIII.A.2.

319. See discussion *supra* Part V.B.

320. It has long been the rule that using valid techniques to save taxes is not abusive at all, but perfectly legal.

As to the astuteness of taxpayers in ordering their affairs so as to minimize taxes[,] courts have said that "the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it." *Superior Oil Company v. Mississippi*, 280 U.S. 390, 395-96 [(1930) (J. Holmes)]. This is so because "nobody owes any public



strong argument can be made not only for repeal of section 2702 regarding joint purchases, but also that no new legislation should be enacted regulating joint purchases because they are not abusive.<sup>321</sup>

The major reason for the failure of section 2702 is that it attacked the perceived problem in the wrong way. If the concern of Congress is broader than GRITs and joint purchases and extends to all trusts because of the recognition of different temporal interests in property, then the problem is a tax base (or inclusion-exclusion) problem, not a valuation problem. Tax base problems are structural problems which require structural solutions. Such problems cannot be rectified by insular provisions taking a valuation approach: such provisions are incapable of treating structural problems. Several structural changes which would address such problems have been suggested in recent years. If Congress is serious about legislating with regard to trusts, it should examine these suggestions. In any event, repeal of section 2702 should be seriously considered.

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duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions." Learned Hand, C.J., dissenting in *Commissioner v. Newman*, 159 F.2d 848, 851 [(2d Cir. 1947)].

*Atlantic Coast Line R. Co. v. Phillips*, 332 U.S. 168, 172-73 (1947).

"The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Gregory v. Helvering*, 293 U.S. 465, 469 (1935). In addition "a taxpayer is free to arrange his financial affairs to minimize his tax liability; thus, the presence of tax avoidance motives will not nullify an otherwise bona fide transaction." *Estate of Stranahan v. Commissioner*, 472 F.2d 867, 869 (6th Cir. 1973) (citations omitted); see *Nyhus v. Travel Mgmt. Corp.*, 466 F.2d 440, 449 (D.C. Cir. 1972); *Continental Oil Co. v. Jones*, 113 F.2d 557, 564 (10th Cir. 1940); *Helvering v. Johnson*, 104 F.2d 140, 143 (8th Cir. 1939); *Gaddis v. United States*, 330 F. Supp. 741, 755 (S.D. Miss. 1971).

321. See discussion *supra* Part V.B.