

I DIG IT, BUT CONGRESS SHOULDN'T LET ME: CLOSING THE IDGT LOOPHOLE

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By combining three tools that independently are beneficial to taxpayers, clever estate planners have devised a transaction—the installment sale of discounted assets to an intentionally defective grantor trust—that saves their ultra-wealthy clients millions of dollars in estate and gift taxes. This transaction, which is a foundational part of many estate plans, takes advantage of rules that Congress never intended to be used in this way. Because the IRS has conceded its inability to challenge the transaction based on current law, any solution lies with Congress. This Article proposes an amendment to Section 2036 that would close the hole in the transfer tax base by eliminating taxpayers' ability to form intentionally defective grantor trusts. Because this simple, targeted proposal leaves intact nearly all of current law, it could be adopted quickly as an interim solution in anticipation of fundamental tax reform.

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INTRODUCTION

This Article is about highlighting certain cracks in the tax law that have allowed billions of dollars to escape the income tax and transfer tax bases.¹ If our transfer tax system is to be taken seriously, Congress must address three particular estate planning tools: the intentionally defective grantor trust (or IDGT, pronounced “I dig it”), the installment sale, and asset valuation discounts.²

Part I describes the current benefits of these three tools, which independently are beneficial to taxpayers. It then shows, through a detailed example, how the three tools have been combined in one particularly effective estate planning transaction: an installment sale of discounted assets to an IDGT. Throughout this Article, I refer to this as the “ISTIDGT” (installment sale to intentionally defective grantor trust) transaction. Of the strategies used by estate planners for their wealthy clients, this transaction is one of the most important, as it provides enormous potential income tax and transfer tax savings.³

In Part II, I argue that the ISTIDGT transaction is antithetical to a transfer tax system, and that Congress never intended that the tax law would sanction such a transaction. In fact, many estate planners believe that the unintended tax benefits created by the Internal Revenue Code in favor of society’s wealthiest individuals provide low-hanging fruit for federal revenue generation.⁴ However, because the Internal Revenue Service (IRS) has decided over recent decades that it has no authority to challenge taxpayer use of IDGTs, it is Congress that must provide the solution through legislation.⁵ To that end, Part II reviews several reform proposals and makes one primary recommendation to Congress that would eliminate IDGTs as a tax-planning tool.

I. THE TRANSACTION

To analyze the tax-planning strategy behind the ISTIDGT transaction, the tax treatment of the transaction's three basic components must be viewed in sequence. In this Part, I survey the tax treatment of the transaction's three basic components: IDGTs in Part I.A, installment sales in Part I.B, and valuation discounts in Part I.C. Because each component by itself is a powerful estate planning tool, each will be analyzed first as an independent, isolated strategy. I will then discuss the components together as part of the larger ISTIDGT transaction. Part I.D provides a concrete example to illustrate the potential tax savings generated by the technique.

A. Intentionally Defective Grantor Trusts

Congress originally enacted sections 671–677, the grantor trust rules, to prevent high-income individuals from shifting income by transferring assets to a trust of which lower-income family members are beneficiaries. Specifically, the rules target transfers to trusts where it appears a grantor has not given up the underlying economic control or benefit to the trust and/or its beneficiaries. A grantor trust for income tax purposes results when a grantor transfers assets to a trust but retains one or more of the powers listed in sections 671–677. Such transfers are treated for income tax purposes as a nonevent, since the grantor is required to pay all income taxes on the trust income as if the trust assets belonged to her.⁶ Because grantor trust status was originally something to be avoided, a transfer that “flunks” the grantor trust rules to become a grantor trust is known as a “defective” grantor trust. Thus, when a grantor intentionally retains a power over transferred assets that will trigger grantor trust status, the trust is known as an intentionally defective grantor trust.

For several reasons independent of the grantor trust rules, income shifting is no longer a matter of great concern.⁷ However, because the grantor trust rules remain in place, estate

planners have discovered ways to use the rules in their taxpayer clients' favor. The key to the IDGT tax-planning strategy is understanding why a grantor would wish to trigger the grantor trust rules. Not all retained powers listed in the grantor trust rules will cause trust assets to be included in the grantor's estate at death under sections 2036–2038. An IDGT, therefore, is an irrevocable trust which is structured to be a grantor trust for income tax purposes but which is deemed a complete transfer for estate and gift tax purposes.⁸

1. Commonly Used Grantor Trust Powers

Before discussing the tax benefits of such a trust, this subsection describes two of the most important powers used by estate planners to create IDGTs.⁹ Each of these powers triggers grantor trust status but does not trigger ultimate estate tax inclusion.

Section 675(4)(C) states:

The grantor shall be treated as the owner of any portion of a trust in respect of which . . . [a] power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term “power of administration” means . . . [a] power to reacquire the trust corpus by substituting other property of an equivalent value.¹⁰

Thus, a grantor can form a grantor trust by specifying in trust documentation that she will unilaterally be able to remove trust assets and substitute property of equal value. This grantor trust–creating power does not constitute any right to “the possession or enjoyment of, or the right to the income from, the property, or the right . . . to designate the persons who shall possess or enjoy the property or the income therefrom,”¹¹ nor any right “to alter, amend, revoke, or terminate [the transfer],”¹² nor any other right that would cause inclusion under the estate tax rules. Therefore, because the retained power to substitute property of equal value will not cause estate inclusion but will cause the application of grantor trust rules, such a trust qualifies as an IDGT. Such treatment has been blessed by the Service.¹³

Section 675(2) states:

The grantor shall be treated as the owner of any portion of a trust in respect of which . . . [a] power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security.¹⁴

Although some practitioners worry that this power may be sufficient to cause estate tax inclusion when the grantor or her spouse is named as the trustee,¹⁵ naming some third party as the trustee—someone who is a nonadverse party—should eliminate the possibility of inclusion in the gross estate.¹⁶ And limiting the power to borrowing without adequate security (and not allowing the grantor to borrow without adequate interest) should also raise fewer eyebrows at the IRS.¹⁷

Other retained powers, though less common, may also be used to create a defective grantor trust.¹⁸

2. *The Benefits of Using an IDGT*

The primary benefit of an IDGT is that the income taxes paid on IDGT income escape transfer taxation. By using an IDGT, an individual can transfer the beneficial interest in property to others, removing that property from her gross estate. But because an IDGT is disregarded for income tax purposes, any taxes on the trust's interest income must be paid by the grantor. Effectively, because those taxes are not paid out of the trust corpus, payment of the trust's income tax by the grantor is a tax-free gift to the trust (and ultimately to the trust's beneficiaries).¹⁹

Another important benefit of an IDGT—a benefit that exists for any complete transfer of property and thus is not unique to IDGTs²⁰—is that it freezes the value of the taxpayer's assets for transfer tax purposes. Although a gift tax return must be filed for any gratuitous transfer to an IDGT, the property's future appreciation is not subject to estate or gift tax. Furthermore, any gift tax paid on the initial gift will further reduce the grantor's taxable estate.

These two benefits make an IDGT a powerful estate planning device even when all trust property is transferred subject to gift tax. The next Section discusses how installment sales can drastically reduce gift tax liability while preserving the IDGT benefits.

B. Installment Sales

In this Section, I first view installment sales in isolation, outlining the primary tax benefit of installment sales generally along with a discussion of their primary downsides as an estate planning tool. Second, I show that when combined with an IDGT, an installment sale can be enormously beneficial to taxpayers. An ISTIDGT transaction eliminates the downsides associated with a typical installment sale while preserving the benefit and creating additional benefits.

1. Installment Sales Generally

An installment sale occurs when a seller transfers property to a buyer in exchange for a series of future payments, which may extend over several years. Installment sales are respected by the IRS as arms-length transactions (which generate no gift tax) as long as the buyer pays the fair market value for the property, which includes an interest charge equal to the applicable federal rate (AFR).²¹ Although the benefit of avoiding gift tax can be substantial, the technique is useful as an estate planning device only in situations where the transferred assets appreciate at a higher rate than the AFR.

In a typical installment sale done for estate planning purposes, a parent will sell assets with appreciation potential directly to her child. The child then transfers to the parent a balloon note which pays annual interest based on the AFR and which repays the principal upon the note's expiration. Any appreciation in the transferred assets that exceeds the AFR will be economically equivalent to a tax-free gift to the child.

The beneficial tax treatment of installment sales is mitigated somewhat by two factors. First, the annual interest payments must be reported as the seller's taxable income, and taxed at ordinary income rates.²² Typically in the estate planning context, the buyer has no offsetting interest deduction on the sale. Second, the sale triggers the recognition of gain in the transferred assets—no carryover basis is permitted.²³ Therefore, in the above example, the parent would have been taxed on any pre-transfer appreciation, if any, that previously had gone untaxed. Although in many cases the taxpayer may elect to report the gain under the installment method—ratably over the time period of the installment sale²⁴—in practice the installment method has several limitations that are particularly salient in the context of estate planning.²⁵

2. *Installment Sales to an IDGT*

As a result of a 1985 revenue ruling, the tax treatment of an ISTIDGT transaction is much more beneficial than the treatment of a general installment sale. In Rev. Rul. 85-13, the IRS held that any exchange between a grantor and a grantor trust is not a taxable event, since the grantor trust is not a separate taxpayer.²⁶ This means that the installment sale triggers no gain recognition²⁷ and that interest payments made by the trust to the grantor are not taxable.

Even though the ISTIDGT transaction has no income tax consequences, it is still respected for estate tax purposes, resulting in the transferred property being removed from the grantor's gross estate.²⁸ Although the principal is returned to the grantor's gross estate upon the note's maturation, it has the same value as the assets initially transferred to the IDGT. This treatment of installment sales to IDGTs has the effect of freezing the value of the assets in the grantor's estate; any appreciation above the AFR will pass to the trust's beneficiaries without being subject to any transfer tax. A further benefit of installment sales to IDGTs is that the grantor can reacquire with cash the appreciated assets without triggering tax on the capital gain.²⁹

In order to illustrate the benefit of leverage in ISTIDGT transactions, the installment sale process must be explained. First, the grantor sets up an IDGT and funds it through a taxable gift to the trust of at least 10% of the value of the anticipated installment sale. This initial funding ensures that the trust is economically legitimate and respected for estate tax purposes.³⁰ The grantor then enters into an installment sale with the IDGT. The grantor sells assets with appreciation potential in exchange for a balloon note.³¹ The IDGT pays annual interest on the note equal to the AFR and then repays the principal of the note when it matures (often after 9 years³²). Because the note pays interest equal to the AFR, the transaction is deemed to be for full value and no gift tax must be paid.

The grantor can magnify the tax savings of an IGDT through repeated use of installment sales to the same IDGT, using any remaining cash or assets from one completed sale as the 10% guarantee for a subsequent sale. Assuming that the assets transferred through the installment sale appreciate at a rate greater than the AFR, then installment sales of increasing size can be made over time. These repeated transactions over multiple decades allow huge transfers out of the grantor's estate with only a small initial taxable gift.

The primary assumption that drives the success of an ISTIDGT transaction is that the trust assets will appreciate at a rate greater than the AFR.³³ However, if the AFR reflects a risk-free market rate of interest, then it is impossible for a taxpayer (without illegally trading on inside information) to choose investments that consistently generate an investment return greater than the AFR. It would thus seem that an ISTIDGT would be appropriate only for individuals willing to take some market risk.

The next Section shows that with various valuation discounts, an asset's return on investment will almost always exceed the AFR. As a result, the ISTIDGT transaction can be an attractive estate planning tool even for conservative clients with low risk tolerance.

C. Valuation Discounts

This Section demonstrates the estate planning benefits derived from valuation discounts on certain types of assets. It then shows how picking the right type of asset for an ISTIDGT transaction can almost completely assure that the asset's investment return exceeds the required interest payments on the installment note.

1. Valuation Discounts Generally

Valuation discounts enable individuals to pay lower transfer taxes than they would otherwise. For example, assume a wealthy mother intends to transfer an asset worth \$1 million to her son. Assuming that the mother has already exhausted her annual exclusion with respect to her son³⁴ and that she has made previous lifetime gifts such that any addition gift will be taxed at the highest marginal gift tax rate,³⁵ this gift would generate a gift tax liability in 2009 of \$450,000. However, if she can find some applicable valuation discount that will cause the transferred asset to be valued at \$600,000 for gift tax purposes, then her gift tax liability will be only \$270,000.

The two most important valuation discounts are the lack-of-control discount and the lack-of-marketability discount.³⁶

The lack-of-control, or minority, discount would be triggered, for example, when a parent transfers to her son 30% of the shares of a closely held corporation while the parent retains the remaining 70% of the business that she founded years ago. While the fair market value of the business may be \$10 million, the 30% interest in the hands of the son will be valued at less than \$3 million to account for his lack of influence and control in directing the affairs of the business.

This same example likely would trigger the lack-of-marketability discount as well. Because the closely held business is not traded on a public exchange, the son's 30% interest would be valued at less than \$3 million to account for the lack of a ready market.

Together, the lack-of-control and lack-of-marketability discounts can create an overall discount of up to 50% for some assets.³⁷ In many cases, such as legitimate, closely-held businesses, such discounts are entirely justified, as they reflect the true economic value of the assets. However, taxpayers have exploited the valuation discount regime to create discounts where none should exist. For example, a father may form a family limited partnership (FLP) that holds as assets solely \$10 million in marketable securities. He may then claim lack-of-control and lack-of-marketability discounts when he gives FLP interests to his children. Perhaps surprisingly, the gift tax law on such a transaction is clear: The FLP interests are entitled to substantial discounts. Indeed, the Tax Court has acquiesced almost entirely in allowing steep valuation discounts for FLP assets, even when the FLP is not engaged in an active business but holds solely marketable securities.³⁸ Thus, by taking the simple step of placing securities in an FLP rather than giving the securities to his children outright, the father can drastically reduce his gift tax liability on the transfer of the same underlying assets, essentially making his wealth disappear to the federal government.³⁹

2. Valuation Discounts Used in ISTIDGT Transactions

In order for an ISTIDGT transaction to be respected as generating no gift tax, the IDGT must pay the grantor fair market value for the assets transferred, which includes paying an interest rate at least as high as the AFR. However, a grantor would prefer to receive as little as possible from the IDGT in return for the transferred assets, because anything remaining in the

IDGT after the repayment of the installment note will have passed to the trust's beneficiaries with no transfer tax liability. Valuation discounts enable such a result.

Assume that a parent uses an installment sale to sell FLP interests worth \$10 million to an IDGT, whose beneficiaries are her children. The parent hires an appraiser who values the FLP interests at \$6 million, a 40% discount that reflects the assets' lack of control and lack of marketability. In exchange for the interests, the IDGT will transfer to the parent an installment note worth \$6 million plus interest equal to the AFR. At the end of the installment term, the IDGT will be required to transfer \$6 million to the grantor. Even if the underlying \$10 million in assets held by the FLP declines in value slightly over the term of the note, the IDGT will still hold assets worth between \$3 and \$4 million after the interest and principal have been paid to the grantor on the installment sale.

Because the ISTIDGT transaction will be successful only to the extent the transferred assets produce a return greater than the required interest payments on the installment note, "the perfect asset for a DGT is an asset that produces cash flow and either can be transferred currently at a discount or will appreciate significantly."⁴⁰

D. Example: An ISTIDGT Transaction Using Discounted Assets

In this Section, I provide an example of an ISTIDGT transaction to quantify the benefits that a wealthy taxpayer can achieve at the federal government's expense.

In June 2009,⁴¹ an unmarried grantor establishes a trust with her grandchildren named as beneficiaries, and with a trusted financial advisor as the trustee. The trust qualifies as an IDGT because the grantor retains the right to substitute assets of equivalent value (§ 675(4)(C)) and because the trust can sprinkle income and principal on the beneficiaries in the complete discretion of the trustee (§674(a)). The grantor funds the trust with an initial cash gift of

\$1,000,000,⁴² a gift which she will report on a gift tax return, but for which she will pay no gift tax as this is the first taxable gift made during her lifetime.⁴³ She will also allocate \$1,000,000 of her GST exemption such that the inclusion ratio will be zero and no GST tax liability will ever result from this trust.

Several years earlier, the grantor had established an FLP for her children and funded it with marketable securities now worth \$100,000,000. In October 2009, the grantor makes an installment sale of a 15% interest in the FLP to the IDGT and the interest is appraised at a fair market value of \$10,000,000, due to lack-of-control and lack-of-marketability discounts. In exchange for the partnership interest, the grantor receives from the trust a nine-year note with face value of \$10,000,000 and an annual interest rate of 2.66% (the midterm AFR for Oct. 2009).⁴⁴

Over the course of the nine-year note, the assets in the trust (a total of \$16,000,000, including the \$15,000,000 in underlying FLP assets and the initial \$1,000,000 in cash contributed to the trust) earn 8% annually.⁴⁵ Each year, the note pays interest to the grantor in the amount of \$266,000. Over nine years, a total of \$2,394,000 is paid to the grantor in interest. The grantor also pays annual income tax on the trust's earnings, for a total of \$1,900,000 over nine years.⁴⁶ In October 2018, at the end of nine years, the trust assets are worth \$28,700,000 (\$15,000,000 of which remains in the FLP and \$13,700,000 of which is held in separate marketable securities). The principal amount of the note, \$10,000,000, is paid off, leaving \$18,700,000 in the trust (\$3,700,000 of marketable securities and \$15,000,000 of FLP assets). Then, in 2019, the grantor dies unexpectedly, leaving her entire estate to her children.

By utilizing the installment sale to the IDGT of her limited partnership interest, and by paying income tax on the trust's income, the grantor has decreased her gross estate by

\$19,600,000 (\$18,700,000 remaining in the trust, minus the initial \$1,000,000 gift, plus the \$1,900,000 in income taxes paid) with no gift tax consequences. Assuming an estate tax rate of 45%, this amounts to over \$8,800,000 in saved estate taxes that the grantor's decedents otherwise would not have received. And since no gift tax was ever actually paid on the initial \$1,000,000 gift that funded the IDGT, the grantor has succeeded in passing over \$20,000,000 to her family members without anyone paying a dime in transfer taxes.

The following table shows the estate tax savings (in millions) given various growth rates of the trust's underlying assets.

Growth Rate	Income Tax Paid	Value Passing thru Trust	Total Decrease in Gross Estate	Estate Tax Savings
5%	\$2.06	\$10.89	\$12.95	\$5.83
8%	\$1.90	\$17.66	\$19.56	\$8.80
10%	\$6.34	\$23.12	\$29.46	\$13.25
15%	\$12.54	\$40.82	\$53.36	\$24.01
20%	\$21.36	\$66.02	\$87.38	\$39.32

The tax benefits in this example are, in many cases, understated:

First of all, if the grantor had been married, the initial seed money could have been \$2,000,000 (through gift splitting) without generating any tax liability. Or if our grantor had been a billionaire willing to pay \$4,050,000 in gift taxes, she could have made an initial gift to the trust of \$10,000,000. In either case, the trust could have purchased a larger asset through the installment sale, and the tax savings would thus be multiplied.

Second, the grantor could have exercised her section 675(4)(C) to reacquire the limited partnership assets, and her children would then have received those assets with a step-up in basis. The appreciation on those assets would go untaxed (as it would have been had no trust been used at all), for a further income tax savings of potentially several million dollars.

Third, this example has focused only on federal taxes. Not only may state income taxes further reduce the grantor's gross estate, but a reduction in the size of the grantor's gross estate may lead to a reduction in state death taxes.

Lastly, this example has assumed that the grantor dies shortly after settling the installment note. However, a grantor could leverage the same IDGT for multiple installment sales and further tax savings. Had our grantor not died, then in 2018 she could have used the \$18,700,000 remaining in the IDGT as the seed money for a new installment sale. This time, she would be able to sell assets to the IDGT worth as much as \$187,000,000.⁴⁷ With this use of leverage, the benefits of IDGTs over several years can be enormous.

* * *

This Part has shown that a grantor can, with fairly low risk, drastically reduce the size of her gross estate through the use of installment sales to an IDGT. Although the IRS has never explicitly blessed the technique, it has conceded that it has little power to stop it.⁴⁸ Part II proposes a legislative solution to the tax dodging engaged in by America's super wealthy.

II. PROPOSAL

In Part II.A, I outline my preferred solution to the IDGT techniques utilized by estate planners. I propose that instead of full harmonization of the transfer tax and income tax laws, Congress should merely amend the estate tax law to provide that any transfer that is incomplete for income tax purposes will also be incomplete for estate tax purposes. The primary virtue of my solution, which would eliminate taxpayers' ability to form IDGTs, is that it could be enacted quickly and without extensively reforming estate tax or income tax law. In Part II.B, I briefly suggest two alternative solutions that may also diminish the current advantages of IDGTs.

A. Harmonization of Income, Estate, and Gift Tax Systems?

Any proposal to eliminate the possibility of IDGT formation must focus on three systems of taxation, each of which potentially treats a transfer to a trust in one of two ways, based on whether the transfer is complete. For income tax purposes, a transfer to a trust may or may not establish a grantor trust. For gift tax purposes, a transfer to a trust may or may not be a completed gift. For estate tax purposes, a transfer to a trust may or may not be pulled back into the transferor's gross estate.

In order to analyze the various proposals, this Section will use the following table, which describes the possible tax results for any given transfer to a trust.⁴⁹

	Complete Gift; No Inclusion in Gross Estate	Incomplete Gift; Inclusion in Gross Estate	Complete Gift; Inclusion in Gross Estate
Grantor Trust	Scenario 1	Scenario 3	Scenario 5
Non-grantor Trust	Scenario 2	Scenario 4	Scenario 6

Although in a certain sense, any given transfer is either complete or incomplete, the three systems of tax produce six⁵⁰ separate possible scenarios because the tax systems are not

coordinated. “By mere coincidence, they sometimes function in unison; other times, they do not.”⁵¹

The confusion and tax planning opportunities that have been caused by the disjointed systems have led many commentators to recommend harmonization of the income tax rules for trusts with the transfer tax rules. One judge in 1940 stated that “the interrelation of the income, estate, and gift taxes presents many puzzling problems which deserve the attention of Congress.”⁵² Professor Erwin Griswold long ago made this reform proposal:

The need is for provisions which would coordinate and harmonize the application of the income, estate, and gift taxes to transfers and trusts. . . . [This] is based upon the general principle that a person can escape income and estate tax with respect to any property only by giving it away without qualification and without the reservation of any interest in the property. If he makes such an outright unqualified gift, he incurs a gift tax, but is no longer subject to the income tax on the income from the property, nor to the estate tax on the principal when he dies. If, however, he makes a transfer which is anything short of an outright unqualified gift, he pays no gift tax, but the income from the property remains taxable to him, and the property will be included in his gross estate on his death.⁵³

Under such a harmonization proposal, all transfers to trust would seemingly belong either to Scenario 2 (a complete transfer would be treated as complete under all three tax systems) or Scenario 3 (an incomplete transfer would be treated as incomplete under all three tax systems).

One primary virtue of harmonization, particularly for purposes of this Article, is that it eliminates the possibility of a Scenario 1 transfer. Scenario 1 describes transfers to IDGTs—although a transfer is complete for both gift tax and estate purposes, it is incomplete for income tax purposes.

However, because harmonization also appears to eliminate Scenarios 4-6, we must analyze those scenarios to see whether harmonization truly is the best way to eliminate IDGTs. None of these scenarios seems particularly prone to taxpayer abuse, since all three require ultimate inclusion in a grantor/decedent’s gross estate of any property transferred. The only

differences between Scenarios 4–6 and Scenario 3 (which would survive under harmonization) are whether gift tax must be paid at the time of the transfer (as in Scenarios 5 and 6) and whether the trust will have a separate identity for income tax purposes (Scenarios 4 and 6). Because these scenarios are harmless, tax reform that sweeps them away, like harmonization, may be overbroad.

This Section discusses two broad methods for eliminating IDGTs—reforming grantor trust rules and reforming transfer tax rules—either of which could be achieved with or without harmonization of the income and transfer tax systems. It concludes that while harmonization may achieve the elimination of IDGTs, a simpler solution is to draft rules merely ensuring that the completed-transfer rules for estate tax purposes are narrower than the completed-transfer rules for income tax purposes.⁵⁴ Under such a solution, any transfer that results in a grantor trust would, without further action, also trigger ultimate inclusion in the transferor's gross estate (i.e., Scenarios 3 and 5). At the same time, some transfers that are complete for income tax purposes may still be incomplete for estate tax purposes (i.e., Scenarios 4 and 6). And of course some transfers would be complete for both income and estate tax purposes (i.e., Scenario 2).

1. Reform of the Grantor Trust Rules (§§ 671–677)

“The grantor trust rules in their present form are an anachronism.”⁵⁵ Although the grantor trust rules were originally designed to prevent income shifting, it is now nearly impossible for wealthy individuals to lower their income tax liability by shifting their taxable income to a trust. First, the income tax rate structure has become much more compressed than it was when the grantor trust rules were enacted.⁵⁶ Second, nearly all trust income is taxed at the highest marginal rate applicable to individuals.⁵⁷ Third, parents can no longer take advantage of

their young children's lower tax rates, since the Code taxes most unearned income of children under age fourteen at the highest marginal rate of the parents.⁵⁸

For these reasons, one professor has noted that

[t]he rules regarding grantor trust status have become rules in search of a purpose and, one might think, relegated to a relic of a bygone era. But where classification as a grantor trust was once to be avoided at all costs (hence their common classification by practitioners and commentators alike as “defective trusts”), taxpayers may now deliberately establish grantor trusts as a way to minimize their income and transfer tax burdens. In short, taxpayers use as a shield what was once a sword of the Internal Revenue Service This thwarts congressional intent and leads to significant revenue losses.⁵⁹

Another professor comments that currently the principal effect of the grantor trust rules “is to provide the taxpayer with an awesomely powerful avoidance tool. It is not a matter of the cure being worse than the disease. It is, rather, that the cure has become the disease.”⁶⁰

Because taxpayers have turned grantor trust status into a tool to be used against the IRS, several commentators have advocated revision of the grantor trust rules.⁶¹ Some have even called for their repeal.⁶² Although I agree that for reasons larger than just the IDGT problem, the grantor trust rules should be reformed, I discuss in this subsection the desirability of using grantor trust rule reform as the method for eliminating IDGTs.

One way of addressing the IDGT problem would be to repeal the particular rules most often used by taxpayers to form IDGTs. For example, Congress could easily repeal sections 675(4)(c)⁶³ and 675(2),⁶⁴ which are fairly artificial ways of creating grantor trusts. Such an ad hoc solution would require no coordination or harmonization of the income and transfer tax systems. However, while “[i]t might then appear that further tinkering would be desirable, . . . the process could go on resulting in ever increasing statutory complexity. On the whole it seems fairly clear that the problem can be better handled by undertaking a new approach to the entire field.”⁶⁵ Furthermore, “the encompassing nature of the grantor trust rules would remain out of

sync with the Code's current progressive rate structure and it is highly unlikely that mere tinkering with these rules would result in a coordinated set of rules between the income and transfer tax systems."⁶⁶

A somewhat related solution, suggested above, is to repeal all, or nearly all, of the grantor trust rules. Professor Jay Soled argues that

grantor trust status should only apply in two situations: (1) when the terms of the trust require payments of trust property to the grantor or grantor's spouse or (2) when payments of trust property can be made currently to the grantor or the grantor's spouse under a discretionary, revocation, or amendment power exercisable by the grantor or the grantor's spouse, whether acting alone or in conjunction with any other person. This proposed definition of grantor trust status combines current Code §§ 676 and 677(a)(1), both of which were enacted before the grantor trust rules. Their enactment and retention under the proposal makes sense even today, because when the grantor or the grantor's spouse has direct access or use of trust property, the grantor should be treated as having complete dominion and control over trust property and taxed accordingly.⁶⁷

Under Soled's approach, additional restrictions would be enacted "to prevent a renewal of income-shifting between grantors and the trusts they establish."⁶⁸

Another way to achieve IDGT elimination is through harmonization⁶⁹—reforming the grantor trust rules by adopting the completed-gift rules under either the estate tax or gift tax for purposes of the income tax.⁷⁰ The proposal of Professor Robert Danforth does exactly this—he recommends using the gift tax rules as the measure of a gift's completeness for purpose of the grantor trust rules.⁷¹

2. Reform of Estate and Gift Tax Rules

A different way to stop the creation of IDGTs is to leave the grantor trust rules intact and to amend the transfer tax rules. The estate and gift tax rules could be modified in ways similar to those proposed above for grantor trusts. First, Congress could tinker with the statutory language of the estate and gift tax sections to provide that the powers most commonly used to form IDGTs

would likewise be treated as retained powers for transfer tax purposes; the transferred property would not be subject to the gift tax and would remain part of the grantor's gross estate.

Second, the estate and gift tax rules could be replaced with a simple harmonizing rule providing that any transfer that triggers the grantor trust rules for income tax purposes would be deemed an incomplete transfer for gift tax and estate tax purposes, resulting in no gift tax and continued estate tax inclusion. For all other transfers, the grantor would be deemed to have parted with dominion and control, which would generate gift tax and estate tax exclusion. This harmonization would achieve the same result as Danforth's harmonization rule proposed above—it would eliminate the possibility of IDGTs by treating all transfers as either complete or incomplete for purposes of all three tax systems.

Many commentators would reject these solutions because they target a fairly well-functioning transfer tax system and fail to cure the underlying IDGT-creating pathogen—the grantor trust rules.⁷²

3. Proposal: No Harmonization

While reform of the grantor trust rules may be desirable for other reasons, I believe that grantor trust rule reform is unnecessary to root out IDGTs. I therefore propose in this subsection a simple solution that would eliminate taxpayers' ability to form IDGTs but which would also leave intact nearly all current law.

Under my proposal, Congress should amend section 2036(a) by adding a new paragraph (3) such that 2036(a) would read:

(a) General rule. The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

- (1) the possession or enjoyment of, or the right to the income from, the property, or
- (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom, **or**
- (3) any power or right which would cause the decedent to be deemed the owner of any portion of a trust under sections 671–677.**

Under this rule, there would be no IDGTs; all grantor trust–generating transfers would result in ultimate inclusion in the grantor’s gross estate.

Unlike the harmonization proposals, this proposal would change nothing about the gift tax system’s completed transfer rules. Thus, a transfer may cause grantor status and may at the same time be deemed a completed gift. However, because the transferred asset would always be subject later to the estate tax,⁷³ any post-transfer appreciation in the property would be taxed. Such a transfer, labeled above as Scenario 5, generates no gaming opportunities.

My proposal would also leave untouched those transfers (if any) which are complete for income tax purposes (no grantor trust is created) but incomplete for estate tax purposes. Labeled above as Scenarios 4 and 6, these transfers likewise should cause no immediate congressional concern.

Like harmonization, my proposal would ensure that no transfer that would cause ultimate estate tax exclusion would simultaneously cause grantor trust status. However, unlike harmonization, my proposal would leave untouched any transfer that would cause estate tax inclusion under the present rules. Whereas harmonization would result in one common completed-transfer definition for income, estate, and gift tax systems, my proposal would create a completed-transfer definition for the estate tax system that is narrower than both the income tax and the gift tax. Thus, because my proposal eliminates the gaming opportunities available with IDGTs but retains all other current income and transfer tax laws understood by practitioners, it is

much simpler than harmonization, and therefore presumably could be implemented more quickly than full harmonization.

Harmonization ultimately may be desirable, particularly if achieved through reform of the grantor trust rules. But such reform, if it were ever to occur, would undoubtedly involve substantial congressional debate. After all, harmonization has been unsuccessfully advocated by brilliant scholars and practitioners for decades. Because my proposal is simple, targeted, and has little (if any) downside, it should be enacted now as an interim fix to the particular problem of IDGTs, even if later harmonization chooses to eliminate IDGTs in some other way.

B. Alternative Solutions

Despite decades of proposals by noted academics and practitioners to change fundamentally the grantor trust rules and to align income tax and transfer tax principles, Congress has done nothing to prevent the creation of IDGTs. Thus, this Section suggests two reforms that, unlike my proposal in the previous Section, would *not* eliminate the ability of a grantor to create an IDGT. Nonetheless, either of the reforms *would* eliminate much of the tax-planning benefit from ISTIDGTs. Although both of these reforms likely would be more complex and less effective than my prior proposal, either would be preferable to the status quo and are therefore included in this Article.

1. A Transaction Between a Grantor and a Grantor Trusts Is a Recognition Event

Rev. Rul. 85-13 is the primary authority giving rise to installment sales to IDGTs. The ruling provides that a transaction, such as an installment sale, between a grantor and a grantor trust is not a taxable event. The relevant issue in the ruling was this:

To the extent that a grantor is treated as the owner of a trust, whether the trust will be recognized as a separate taxpayer capable of entering into a sales transaction with the grantor.⁷⁴

The ruling discusses the *Rothstein* decision,⁷⁵ in which the Second Circuit held that “although the grantor must be treated as the owner of the trust, . . . the trust must continue to be viewed as a separate taxpayer.”⁷⁶ The sale that occurred in that case between the grantor and the grantor trust—the grantor’s transfer of an unsecured promissory note in exchange for the trust’s corpus—was deemed to be a recognition event between the separate taxpayers in which the grantor acquired a cost basis in the assets.

The revenue ruling reaches the opposite conclusion on facts nearly identical to those of *Rothstein*:

[T]he transfer of trust assets to [the grantor in exchange for a promissory note] was not a sale for federal income tax purposes and [the grantor] did not acquire a cost basis in those assets.⁷⁷

In deciding not to follow *Rothstein*, the IRS criticizes the Second Circuit’s reasoning:

It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust, . . . the grantor has treated the trust property as though it were the grantor’s property.⁷⁸

However, the IRS’s conclusion in Rev. Rul. 85-13 that a grantor trust is *not* a separate entity capable of engaging in sales transactions with the grantor is at odds with the IRS’s position that a grantor trust *is* a separate entity for gift tax purposes. Section 7872 recharacterizes below-market loans as arms-length transactions for purposes of both income tax and gift tax.⁷⁹ Because there is no gift tax rule equivalent to Rev. Rul. 85-13 holding that there are no gift tax consequences in a transaction between a grantor and a grantor trust, installment notes from grantor trusts bear interest equal to the applicable federal rate in order to avoid having the forgone interest being treated as an imputed gift.⁸⁰ In other words, the IRS treats a grantor and a grantor trust as separate entities for gift tax purposes but not for income tax purposes. Although

the IRS could remedy this mismatch by withdrawing Rev. Rul. 85-13 at any time, the IRS has subsequently affirmed the ruling, deferring to Congress on the issue.⁸¹

Therefore, I recommend that Congress amend section 671 to provide that a sale between a grantor and a grantor trust *is* a recognition event; after all, the sale in nearly all cases is done at arms-length and thus provides sufficient realization of gains. Making the sale a recognition event would ensure that any built-in gain in assets transferred to an IDGT through an installment sale would be taxed. In order to prevent grantors from selectively triggering losses by transferring only those assets with built-in losses, section 671 could also contain a new basis rule providing that the grantor and the grantor trust will take a basis in their newly acquired assets equal to the greater of the fair market value and the carryover basis. In effect, the new provision would cause capital gains to be taxed immediately and capital losses to be deferred until sold to an unrelated third party. While such a reform would add additional complexity to the already undesirable grantor trust rules, it would remove the primary benefit of ISTIDGT transactions.⁸²

2. *Installment Notes Are Retained Interests*

The IRS currently maintains that as long as a trust holds equity equal to at least 10% of the face value of an owed installment note, the installment note is not a retained interest for purposes of estate and gift taxes.⁸³ If Congress is unwilling to include the entire IDGT in the grantor's estate, it should at least pursue inclusion of the installment note by creating a new rule that treats an installment note to a related party (including a grantor trust) as a retained interest by the seller in the assets sold.⁸⁴ This would gut the asset-freeze strategy in ISTIDGT transactions, because under such a rule, "only when the note is completely discharged would the seller be deemed to have made a completed gift equal to the excess of the value of the assets at that time over the amounts previously received on the note."⁸⁵

CONCLUSION

The past year indicates that Congress wishes to avoid the sensitive topic of transfer taxes at all costs. But even if Congress continues this course of avoiding the most important issues underlying our federal transfer tax system, it need not avoid legislating in the transfer tax area altogether. Notwithstanding the pressures of an election year, Congress should indicate its willingness to defend the transfer tax base by making a quick, easy fix to the tax laws that currently allow taxpayers to avoid taxes on large fortunes through IDGTs. Enactment of my proposal would be such a fix.

Certainly there are several reforms beyond the scope of this Article that would also make IDGTs less attractive to taxpayers. For example, Congress could (and should) reform the valuation discount rules that allow wealthy taxpayers to claim significant valuation discounts on liquid assets held in FLPs.⁸⁶ However, pushing such a reform through Congress would be just as difficult as harmonization or reform of the grantor trust rules. Although enactment of my proposal would not fix the fundamental problems that lie in the intersection of income taxes and transfer taxes, it is nonetheless attractive: By focusing on enforcing political decisions that have been made and repeatedly reaffirmed in the past, Congress could feasibly eliminate IDGTs and protect the transfer tax base while avoiding the larger, more sensitive, political issues surrounding transfer taxes generally. Fundamental tax reform will not occur overnight. But in the meantime, Congress should reach for the low-hanging fruit and close the IDGT loophole.

¹ Throughout this Article, I will use the terms “estate and gift tax” interchangeably with the term “transfer tax.” I use both terms to refer to Subtitle B of the Internal Revenue Code, which includes chapters 11–15.

² The estate tax was temporarily repealed for individuals dying in 2010, making these estate planning tools temporarily irrelevant for those dying in the current year. However, these tools are still of value to taxpayers who will die after 2010, as long as the estate tax repeal sunsets as scheduled at the end of 2010. Indeed, because more individuals will be subject to the estate tax in 2011 and thereafter than in 2004–2009, *see* section 2010(c), these tools will even increase in value.

³ Robert Keebler, *Intentionally Defective Grantor Trust (IDGT) Sales* (Dec. 2007), http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2007/CPA/Dec/Sales.jsp. (“Perhaps the most popular strategy for very large estates is the sale to an intentionally defective grantor trust.”).

⁴ *See, e.g.*, T. Randolph Harris, *IDGT's—When Defective Is Effective*, 16 (May 2006) (“The estate planning benefit of almost any trust can be enhanced by structuring it as an IDGT. These techniques are so taxpayer friendly that it is very likely that they will not last forever. However, unless and until Congress takes action to the contrary, the IRS has conceded that it has no basis on which to challenge their use.”).

⁵ In advocating reform, I am not intentionally endorsing (nor denouncing) a system that taxes wealth transfers. Rather, I believe that because throughout U.S. history a transfer tax system has been judged desirable by Congress, the Internal Revenue Code should reflect that judgment. Therefore, Congress should embrace any reform that protects the chosen tax base against transactions that thwart congressional intent.

⁶ I.R.C. § 671. The grantor is also allowed to claim the deductions and credits generated by the grantor trust’s income. *Id.*

⁷ *See infra* Part II.A (listing the reasons that income shifting has declined).

⁸ JCS-02-09 (“A trust that is structured such that the grantor is treated as the owner for income tax purposes, but not for gift or estate tax purposes, is sometimes referred to as an ‘intentionally defective grantor trust.’”).

⁹ Estate planners typically use multiple powers, since the IRS does not want to encourage IDGTs and therefore tends not to bless the effectiveness of given powers in creating grantor trusts. The IRS now simply refuses to issue private letter rulings in many cases.

¹⁰ I.R.C. § 675(4)(C).

¹¹ I.R.C. § 2036(a).

¹² I.R.C. § 2038(a).

¹³ In a recent ruling, the IRS held that the § 675(4)(C) powers, even when exercisable in a nonfiduciary capacity, will not result in causing the trust assets to be includible in the grantor’s gross estate on account of that retained power. Rev. Rul 2008-22; *see also* PLR 200944002.

¹⁴ I.R.C. § 675(2).

¹⁵ *See* Harris, *supra* note 4, at 10; Ronald D. Aucutt, *Installment Sales to Grantor Trusts*, BUSINESS ENTITIES (Mar.-Apr. 2002).

¹⁶ Thomas C. Baird, *A Potpourri of Leveraged Transfers Using Defective Grantor Trusts*, ALI-ABA COURSE OF STUDY MATERIALS (July 2001).

¹⁷ Aucutt, *supra* note 15.

¹⁸ *E.g.*, § 674(a) (power of disposition held by grantor or nonadverse party); § 674(b)(5) (power to add beneficiaries); § 677(a) (power of nonadverse party to distribute income to grantor's spouse); § 673(a) (grantor holds reversionary interest in either corpus or income, worth at least 5% of entire corpus value).

¹⁹ Rev. Rul. 2004-64 (“When the grantor of a trust, who is treated as the owner of the trust under subpart E [the grantor trust rules], pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries.”); *see also supra* note 13.

²⁰ While this benefit may seem unremarkable since nearly all taxable gifts receive the same treatment, this benefit is a prerequisite for the use of IDGTs—without estate tax exclusion of the trust's appreciation, all other benefits become pointless.

²¹ As long as an installment sale charges the appropriate AFR, the sale will not be treated under section 7872 as a below-market loan. Pursuant to section 1274(d), the IRS calculates the various AFRs (short-term, mid-term, and long-term rates) each month and publishes them in a revenue ruling.

²² I.R.C. § 453.

²³ I.R.C. §§ 453, 1001, 1011.

²⁴ I.R.C. § 453.

²⁵ A taxpayer may not use the installment method to report gain on marketable securities—the gain is taxed immediately upon the sale. § 453(e). If the taxpayer receives a gain on any transferred depreciable assets, this gain will trigger immediate taxation under the recapture rules under sections 1245 and 1250. § 453(i)(1). And if the installment obligation exceeds \$150,000, an additional tax must be paid to reflect the deferral of tax allowed by the installment method. § 453A.

²⁶ Rev. Rul. 85-13. *See infra* Part II.B.1 for a discussion of the IRS's legal reasoning in Rev. Rul. 85-13.

²⁷ Because no gain is recognized, section 453's installment method is completely inapplicable to the transaction. Likewise inapplicable are the limitations under that section regarding marketable securities, recapture for depreciable assets, and sales exceeding \$150,000. *See supra* note 25.

²⁸ In the event that the grantor dies before repayment of the principal on the installment note, the principal value of the note will be includable in the grantor's estate. However, the income tax consequences in such a situation—whether the grantor would recognize taxable income in the amount of gain attributable to the unpaid principal on the note—are unclear. Jonathan G. Blattmachr, et al., *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, ESTATES, TRUSTS, & GIFTS (Sept. 2002); *see also* Harris, *supra* note 4, at 15 (arguing that any remaining principal payments after death would have no income tax consequences as a result of Rev. Rul 85-13).

²⁹ Rev. Rul. 85-13. Once again, the transaction is a nonevent. Such a reacquisition can be a particularly useful tool for terminally ill grantors; although the grantor will take a carryover basis in the asset upon reacquisition, the appreciated asset will receive a stepped-up basis in the hands of the grantor's heirs upon her death. I.R.C. § 1014. On the other hand, if the appreciated asset had remained in the trust, the IDGT's beneficiaries would not receive a similar basis step-up. I.R.C. § 1015. Note that if one of the grantor trust-triggering powers is the section 675(4)(C)

power to substitute property of equal value, then the grantor can substitute cash for appreciated trust assets even without trustee permission.

³⁰ This initial funding guards against the risk that the installment sale transaction will be disregarded as a sham transaction. If the IDGT does not have a cash reserve out of which to make future interest payments and relies alone on the income generated by the asset, then IRS may be able to argue that grantor has retained an income interest in the trust and may try to use § 2036(a)(1) to include the trust in the grantor's estate. Therefore, before an installment sale, an IDGT should contain assets worth at least 10% of the amount of the installment note. *E.g.*, PLR 9535026; *see also, e.g.*, Baird, *supra* note 16.

³¹ Sometimes the trust begins to pay back principal before the end of the note term. But I describe the most aggressive case, where interest only is paid during the lifetime of the installment sale note.

³² The midterm AFR is for instruments with a term of between 3 and 9 years. The long-term AFR, for instruments with a term of greater than 9 years, is higher, so instruments often have a term of 9 years.

³³ The tax treatment of an ISTIDGT transaction essentially allows an IDGT to borrow from the grantor the necessary funds to purchase an asset that is projected to grow at a faster rate than the annual interest payments, which are set at the AFR.

³⁴ § 2503(b) (allowing a grantor to give up to \$13,000 each year to a given donee without any gift tax consequences).

³⁵ Pursuant to section 2505, the first \$1,000,000 in taxable gifts during a taxpayer's lifetime will generate no tax liability. And under the rate tables, if the total of prior lifetime gifts exceeds \$1,500,000, the marginal gift tax rate will be 45%.

³⁶ Other commonly used discounts include the blockage discount, the fractional-interest discount, the key-person discount, the built-in capital gains discount, and the restricted-stock discount.

³⁷ Owen G. Fiore, *Valuation Issues Involving Family-Owned Entities*, 77 TAXES, No. 1. Typical discounts accepted by the IRS are in the range of 25–40%.

³⁸ *See, e.g.*, Miller v. Commissioner, T.C. Memo. 2009-119; Pierre v. Commissioner, 133 T.C. No. 2 (2009).

³⁹ *See, e.g.*, Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition in its Fight Against the FLP*, 86 TAX NOTES 1461 (2000).

⁴⁰ Kuno S. Bell, *Use Defective Grantor Trusts for an Effective Triple Play*, PRACTICAL TAX STRATEGIES (WG&L) (July 2005).

⁴¹ For ease of illustration, this example assumes that 2009 law is extended indefinitely into the future, and it ignores the changes to estate and gift tax law in 2010 by EGTTRA and in 2011 by EGTRRA's sunset.

⁴² *See supra* note 30. The \$1,000,000 cash in the trust is to ensure that the trust can make its annual interest payments. If the trust relies solely on income produced by the asset to make interest payments on the note, the IRS may have a better argument for including the annual income stream in the grantor's estate under section 2036(a)(1). *See* Stephen J. Oshins, *Sales to Grantor Trusts: Exponential Leverage Using Multiple Installment Sales*, Probate & Property 48 (Jan./Feb. 1999).

⁴³ If she has given no prior lifetime gifts, this gift will generate no tax liability. *See supra* note 35.

⁴⁴ Rev. Rul. 2009-33.

⁴⁵ The FLP earns 8% annually, which is distributed to the partners, including the IDGT. The liquid assets held by the IDGT likewise earn 8% annually. All of the earnings, less the annual interest payments, are reinvested and earn a return of 8%.

⁴⁶ I assume that over the entire nine-year period, all assets are subject to an income tax rate of 15% for both capital gains and dividends.

⁴⁷ See *supra* notes 30, 42, and accompanying text.

⁴⁸ See *infra* note 81 and accompanying text.

⁴⁹ I recognize that some transfers are “split gifts” where a portion is a complete gift and the other portion is not. However, I ignore such gifts for purposes of this paper, focusing on the basic treatment of various transfers. Ultimately, the analysis of “split gifts” would not change my conclusions regarding the applicable scenarios.

⁵⁰ Theoretically, the table could list two additional possible scenarios: transfers which are treated as incomplete gifts but which are not pulled back into the gross estate and which are made either to (1) a grantor trust or (2) a non-grantor trust. But under current law, these scenarios are nonexistent—any transfer that is complete for estate tax purposes is also complete for gift tax purposes. Because such scenarios do not exist and because no commentator advocates changing this rule (since it leads to no tax avoidance), I confine my analysis to only the six scenarios listed in the table.

⁵¹ Jay A. Soled, *Reforming the Grantor Trust Rules*, 76 NOTRE DAME L. REV. 375, 418 (2001).

⁵² *Comm'r v. Prouty*, 115 F.2d 331, 337 (1st Cir. 1940).

⁵³ Erwin N. Griswold, *A Plan for the Coordination of the Income, Estate, and Gift Tax Provisions with Respect to Trusts and Other Transfers*, 56 HARV. L. REV. 337, 342 (1942).
Accord Soled, *supra* note 51, at 418.

⁵⁴ Already, the estate tax rules are narrower than the gift tax rules. See *supra* note 50.

⁵⁵ Robert T. Danforth, *A Proposal for Integrating the Income and Transfer Taxation of Trusts*, 18 VA. TAX REV. 545 (1999).

⁵⁶ The top marginal rate is now 35%, whereas it was previously as high as 91%.

⁵⁷ I.R.C. § 1(e).

⁵⁸ I.R.C. § 1(g).

⁵⁹ Soled, *supra* note 51, at 377.

⁶⁰ Leo L. Schmolka, *FLPs and GRATs: What To Do?*, 2000 TAX NOTES TODAY 49-105, ¶ 93.

⁶¹ Griswold, *supra* note 53; John L. Peschel, *The Impact of Fiduciary Standards on Federal Taxation of Grantor Trusts: Illusion and Inconsistency*, 1979 DUKE L.J. 709.

⁶² Schmolka, *supra* note 60, at ¶ 93; Joseph M. Dodge, *Simplifying Models for the Income Taxation of Trusts and Estates*, 14 AM. J. TAX POL'Y 127 (1997); Sherwin Kamin, *A Proposal for the Income Taxation of Trusts and Estates, Their Grantors, and Their Beneficiaries*, 13 AM. J. TAX POL'Y 215 (1996).

⁶³ See *supra* note 10 (describing the power of the grantor to substitute assets of equal value).

⁶⁴ See *supra* note 14 (describing the power of the grantor to borrow without adequate interest or security).

⁶⁵ Griswold, *supra* note 53, at 342.

⁶⁶ Soled, *supra* note 51, at 414 n. 206.

⁶⁷ *Id.* at 415.

⁶⁸ *Id.* at 416.

⁶⁹ See text accompanying *supra* notes 51-53.

⁷⁰ The powers listed in the grantor trust rules have almost exactly the same purpose as sections 2036 and 2038: They attempt to capture those transfers in which a grantor has not fully given up dominion and control over the transferred property. Therefore, it seems intuitive that the two systems be coordinated.

⁷¹ Danforth, *supra* note 55, at 601–15. Danforth recommends replacing sections 673 through 677 with one single section, a new section 673, which triggers grantor trust status whenever a grantor makes an incomplete transfer and which states that “for purposes of this section, whether the grantor has made a completed transfer of an interest shall be determined according to the rules applicable to [the federal gift tax rules, found in sections 2501–2524].”

⁷² *Cf.* Danforth, *supra* note 55, at 602 n.247 (“[T]axing the grantor’s income tax payments as gifts would address the transfer tax problem . . . , but it would fail to address an even more fundamental problem: the present grantor trust rules are illogical and do not comport with economic reality.”)

⁷³ This assumes that the grantor trust–creating power remains attached to the property. If the retained power were later given up, a later gift tax would be generated for any portion of the gift not previously taxed.

⁷⁴ Rev. Rul. 85-13.

⁷⁵ Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984)

⁷⁶ Rev. Rul. 85-13.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ Section 7872 explicitly states that it applies to the entire Internal Revenue Code.

⁸⁰ See §§ 1274(d); 7872(f)(1)–(2).

⁸¹ The IRS has subsequently cited Rev. Rul. 85-13 to support its position that transactions between a grantor and a grantor trust have no significance for income tax purposes. See, e.g., PLR 200247006 (Aug. 9, 2002); PLR 200228019 (July 12, 2002); PLR 9535026 (May 31, 1995).

⁸² The new recognition rule would not change the result from Rev. Rul. 85-13 that interest payments made by the trust to the grantor are not taxable to the grantor. However, a rule providing for the recognition of the interest payments would be a wash, as the rule most likely would result in an offsetting interest-paid deduction to the trust.

⁸³ PLR 9535026.

⁸⁴ Because a rule like this one is typically memorialized in regulation than in statute, Congress could pass legislation directing the Treasury Department to implement the new rule by writing appropriate regulations under the relevant Code sections, including 2036, 2512, 2701, and 2702.

⁸⁵ Mitchell M. Gans & Jay A. Soled, *Reforming the Gift Tax and Making It Enforceable*, 87 B.U. L. REV. 759, 797 n.147 (“Consider the case of a taxpayer who sold a \$1 million piece of real estate to her daughter in return for a ten-year, \$100,000 installment note. By year ten, assume the value of the real estate had appreciated to \$2.5 million; were that the case, in year ten, after the note had been satisfied, the taxpayer would be deemed to have made a \$1.5 million gift to her daughter (i.e., the excess of \$2.5 million less the \$1 million she received in payments).”).

⁸⁶ E.g., Laura E. Cunningham, *FLP Fix Must Be Part of Transfer Tax Reform*, 112 TAX NOTES 937 (2006).