THE ROAD TO TRANSFER TAX SIMPLIFICATION IS PAVED WITH INCREMENTAL INTENTIONS, NOW.

By Kelly Moore and David Frederick***

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I. INTRODUCTION

In 1776 Adam Smith laid out his cannons of just taxation. In his seminal work *An Inquiry into the Nature and Causes of the Wealth of Nations*, Smith said that to achieve maximum justice "every tax ought to be levied . . . in the manner in which it is most likely to be convenient for the contributor to pay it."[1] Tax scholars and economists have thoroughly considered Adam Smith's call for taxpayer convenience in the tax code, and from it they have divined another important cannon, the cannon of simplicity. Briefly stated, the cannon of simplicity dictates:

> The tax system should be simple, plain and intelligible to the common taxpayer. The tax should not be complicated. It should be simple to understand as to how it is to be calculated and how much is to be paid. The form/forms to be filled [out] for calculation and payment [of] tax should be simple and intelligible to the tax payer. This cannon is essential in order to avoid corruption and oppression on the part of the tax [collector].[2]

Stated plainly, it is important that a tax code be as simple as possible, lacking in unnecessary complexities and confusions. As it is likely clear to all American taxpayers, the Internal Revenue Code ("IRC" or "the code") of the United States is anything but simple or bereft of unnecessary complexities and confusions. Containing eleven subtitles, one hundred chapters, and nearly ten thousand sections, the national tax code of the United States is more than thirteen thousand pages of pure statute, making it one of the longest statutes in the history of the world.[3] Though length does not necessarily imply complication, in this case the extreme length of the Internal Revenue Code is due in no small part to its labyrinthine complexity. As Henry C. Simons observes, "Simplicity in modern taxation is a problem of basic architectural design. Present legislation is insufferably complicated and nearly unintelligible . . . Present laws are

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1. 2 ADAM SMITH, AN Inquiry INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 826 (R.H. Campbell and A.S. Skinner eds., Clarendon Press 1976) (1776).

2. R.K. SURI, J.K. BUDHIRAJA & NAMITA RAJPUT, A TEXTBOOK OF I.S.C. ECONOMICS, VOLUME II, 378 (Pitambar Publishing Company) (2005).

3. *See* Trygve Lode, *How Long Is It? (The United States Tax Code)*, 2006, http://www.trygve.com/taxcode.html.

marvelously well built. But they are abominable architecturally. They lack structure or a sound foundational plan."[4]

Simplicity is the goal, but complexity is the reality. This disparity has led innumerable politicians, tax scholars, and economists to consider wide ranging reforms to simplify the complexities inherent in the tax code. These proposals have ranged from the modest, such as eliminating certain itemized deductions;[5] to the moderate, such as replacing the progressive rate tables with a flat rate tax;[6] to the extreme, such as replacing the entire existing tax code with a lump sum poll tax.[7] Of course, few successful sweeping simplifications are ever enacted by Congress.

Part of the problem in simplifying the code can be found on a straight forward policy level. While some may be in favor of simplifying the tax code by eliminating the progressive rate structure, others disagree with this measure, arguing that the social justice inherent in the progressive rates is essential to our nation, even if such a system adds some complexity.[8] Such fundamental policy disagreements cripple efforts to affect comprehensive simplifications of the IRC's substance and may account for the code's complexity, as it contains vast and intricate networks of compromises between various policy positions. Such networks of compromises in the Internal Revenue Code make it a delicate creation. Altering the substance of one portion of the code may have negative consequences on other parts. Finally, it is argued that any material change to the substance of the tax code, however positive and appropriate, may come with unforeseeable problems.[9] As Professor Walter Blum says, "In respect to taxation there is, generally speaking, considerable gain in merely preserving ancient rules intact and avoiding change."[10] Dr. Herbert Stein adds to this idea, "Old taxes are good taxes.

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4. HENRY C. SIMONS, FEDERAL TAX REFORM 28 (University of Chicago Press) (1950).

5. *See e.g.* Barack Obama, *Barack Obama's Comprehensive Tax Plan,*OBAMA FOR AMERICA, 2008, http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_ FINAL.pdf.

6. CARL SHOUP, FACING THE TAX PROBLEM: A SURVEY OF TAXATION IN THE UNITED STATES AND A PROGRAM FOR THE FUTURE 429-30 (Twentieth Century Fund, Inc. 1937).

7. *See* Joel Slemrod, *Which Is the Simplest Tax System of Them All?*, *in* ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 355 (Henry J. Aaron and William G. Gale eds., Brookings Institution Press 1996).

8. *See, e.g.,* Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It,* 93 YALE L.J. 259, 274-78 (1983).

9. *See infra* note 20 and accompanying text for an example of the effects of changing the tax code.

10. WALTER J. BLUM, H. COMM. ON WAYS & MEANS, TAX POLICY AND PREFERENTIAL PROVISIONS IN THE INCOME TAX BASE, 8th Cong., 1st Sess., 1 TAX REVISION COMPENDIUM 77, 78 (1959).

The economic system has adjusted to them so as to reduce discriminatory effects they might have had when first imposed."[11] An old tax is a good tax. Simplifying the substance of the code will just create more headaches. If it's not completely broken, do not fix it.

The recent history of the federal transfer tax system displays the difficulties and fierce policy debates attendant to any attempt to drastically change the substance of the tax code. The estate and gift taxes have been the center of a heated policy debate for the past several years.[12] Since the mid-1990s, an increasingly powerful network of grassroots movements, conservative tax policy wonks, and Republicans in Congress has sought to kill the "death tax" and systematically dismantle these taxes.[13] This network won at least a temporary victory in 2001 when the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"), better known simply as the Bush tax cuts, started a phase out of the estate tax that would culminate in permanent repeal in 2010.[14] Of course, the repeal network has been opposed by others who hope to keep the estate tax in place as a mechanism to break up large family fortunes upon the death of the wealth holder.[15] For the proponents of the estate tax, victory comes in 2011 when the death tax comes back in full force, unless Congress passes legislation to make the Bush tax cuts permanent before then.[16]

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11. HERBERT STEIN, H. COMM. ON WAYS & MEANS, WHAT'S WRONG WITH THE FEDERAL TAX SYSTEM? , 86th Cong., 1st Sess., 1 TAX REVISION COMPENDIUM 112 (1959).

12. *See generally* Graetz, *supra* note 8; MICHAEL J. GRAETZ & IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH (Princeton University Press 2005).

13. *See generally* AMERICAN FAMILY BUSINESS INSTITUTE, http://www.nodeathtax.org (last visited Feb. 8, 2010) (this website is just one of many examples of how the coalition working to repeal the estate tax acted as a broad combination of legislators, pressure groups, grassroots organizations, and individuals).

14. *See* Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of 26 U.S.C.) (retaining the gift tax component for 2010 to address income tax avoidance gambits through the artifice of inter vivos transfers of productive property. The gift tax's other policy justification of capturing for transfer tax purposes inter vivos transfers which would avoid the eventual imposition of the estate tax, which was the gift tax's original policy justification, is not relevant in the year of estate tax repeal).

15. *See* GRAETZ & SHAPIRO, *supra* note 12, at 99. Graetz and Shapiro observe that the repeal movement was resisted ideologically by various groups, but that these groups never truly coalesced into an organized opposition movement that could stand up effectively to the repeal coalition. *Id.*

16. EGTRRA § 901. This section provides that all changes EGTRRA makes to the tax code shall be effectively erased on January 1, 2011. *Id.* Such a provision was necessary for the legislation to pass muster with the Byrd Rule, a parliamentary rule in the Senate that prohibits that chamber from passing legislation which would, in effect, significantly increase the federal deficit beyond a ten year period. *See* 2 U.S.C. § 644

While it remains unclear exactly what will happen to the federal transfer tax system, most indicators are signaling that the tax code will return substantially to its pre-2001 form, including the estate tax.[17] Though the repeal minded Republicans held the White House and both houses of Congress until 2006, they never took the necessary steps to make the tax cuts permanent. With the election of 2008, the changing of the guard that started in 2006 came to completion as Democrats, who are more typically in favor of keeping the estate tax in full effect, took impressive majorities in both houses of Congress and President Barack Obama took his seat in the Oval Office. President Obama favors the continuation of the estate tax, as one tax periodical noted, "Obama would preserve the estate tax as in effect in 2009: a 45-percent top tax rate and a $3.5 million exemption."[18] Currently, Congress is not seriously considering any bills to make the estate tax repeal permanent. As the deadline for making EGTRRA permanent creeps closer, it becomes increasingly apparent that this piece of legislation will sunset and the transfer tax will be returned to its pre-2001 state.

As the struggle surrounding EGTRRA demonstrates, trying to simplify the substance of the tax code with broad strokes to its policies may be a difficult, and ultimately failing endeavor. But taking steps to simplify the construction of the tax code may be somewhat easier. In all of its length and complexity, the IRC contains a significant number of provisions that are inconsistent and problematically constructed. These problematic provisions can range from mild disruptions to severe contradictions. Perhaps the most obvious inconsistencies in the code occur when different sections of the tax law treat the same transaction differently. The code often deals with these inconsistencies through special reconciliation measures that resolve conflicts as they arise.[19] Resolving such structural inconsistencies through reconciliation provisions is itself problematic as it adds to the complexity of the already sinuous statute.

(2006); *see also* George K. Yin, *Temporary-Effect Legislation, Political Accountability, and Fiscal Restraint*, 84 N.Y.U.L. REV. 174, 215-16, 218 (2009). For more on EGTRRA's sunset provision, *see* Barry A. Nelson, *Throw Me from the Train*, TRUSTS & ESTATES, Oct. 1, 2008, at 62.

17. *See* Michael A. Fletcher, *Federal Estate Tax's Future Remains in Flux; Levy Is Set to Expire Next Year; Democrats Aim to Reinstate It*, WASH. POST, Dec. 20, 2009, at A13, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/12/18/AR2009121804118.html?nav=emailpage.

18. Mark A. Luscombe, *Tax Proposals of the Presidential Candidates*, TAXES, Oct. 2008, at 4.

19. *See infra* text accompanying notes 28, 31-33.

The better option would be to work to eliminate these structural inconsistencies as they arise in the code. This alternative allows the twofold simplification of effectively resolving construction problems within the code and potentially shortening the overall length of the statute. Moreover, the substantive integrity of the code can be maintained by merely eliminating the inconsistent provisions in such a way that mirrors the effects of the existing reconciliation provisions. Doing so would allow the general simplification of the tax code while avoiding the mires of policy debates that surround substantive revisions and simplifications.

Even with merely changing the construction of the code, caution is still recommended. Wholesale change, whether to the tax code's policies or its construction, can still be nearly impossible to successfully implement. The Internal Revenue Code is simply too big, cumbersome, and complex to be effectively altered in one broad stroke. The tortured approach and ultimate demise of EGTRRA demonstrate the difficulties inherent in effecting wholesale change to the tax code.[20] Even if EGTRRA was only altering the code's construction, the massive swipe this troubled piece of legislation takes at the foundation of the tax code does not serve to simplify the IRC. Rather, EGTRRA only complicates the situation through its various phase-outs and sunsets by making the expected payment of taxes an uncertain prospect for taxpayers.

The lessons learned from EGTRRA about altering the tax code are clear. To be successful, changes to the IRC should not come by way of sweeping legislation, seeking to drastically alter major portions of the Code. Instead, incremental changes are appropriate. Moreover, applying incremental changes to the construction of the Code, rather than getting bogged down in policy debates that surround the Code's substantive policies, is likely to be a more successful way of simplifying the tax laws.

The transfer tax system of the Internal Revenue Code provides ample opportunity to demonstrate the advantages of eliminating inconsistencies through incremental, structural reform. The American transfer tax system, which is composed of the gift and estate taxes,[21] is intended to be a unified tax system that draws a tax from gratuitous transfers of wealth, with the

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20. *See Charting a Course: Estate Planning 2009-2011*, J. ACCT., July 2009; *See generally* Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, 115 Stat 38 (codified as amended in scattered sections of 26 U.S.C.).

21. *See* I.R.C. §§ 2001-2524 (2006).

gift tax collecting from inter vivos transfers[22] and the estate tax collecting from transfers on death.[23] These taxes are bound together through such mutual operations as a unified credit,[24] a consistent rate schedule,[25] and equivalent deductions for gifts to spouses.[26] However, there are several inconsistencies between the two taxes that create complications within the code, such as the taxes' disjointed treatment of transfers of wealth to trust. Depending on the facts and circumstance surrounding the transaction, a gratuitous transfer to a trust may be considered a completed gift for purposes of the gift tax, but not a completed gift for the estate tax. Adding to the confusion, income from the transferred property may still be attributable to the donor under the rules of the income tax—thus indicating no completed gift—even if the transfer tax indicates otherwise.[27] The tax code's various and inconsistent treatments of the same gratuitous transfers to trusts led Judge Jerome Frank of the Second Circuit to ponder that "[p]erhaps to assuage the feelings and aid the understanding of affected taxpayers, Congress might use different symbols to describe the taxable conduct in the several statutes, calling [the transfer to trust] a 'gift' in the gift tax law, a 'gaft' in the income tax law, and a 'geft' in the estate tax law."[28]

The diverging characterizations of the same transaction under each tax add unnecessary complexity to the tax code. In the transfer tax system, there are numerous provisions leading to such problematic anomalies, including I.R.C. sections 2035-2038, commonly known as the "string provisions."[29] Each of these provisions is designed to capture an inter vivos transfer of wealth not sufficiently complete for the estate tax system, but of which the gift tax may or may not have snared some portion as a completed gift. The discussion of this article involves the string provision of § 2036(a)(1), which provides that if a decedent was the income beneficiary of a self-settled trust for a period of time that in some manner is related to the date of his death, the property of the trust shall be included in his gross estate.[30]

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22. I.R.C. §§ 2501-2524 (2006).
23. I.R.C. §§ 2001-2210 (2006).
24. I.R.C. §§ 2010, 2505 (2006).
25. I.R.C. §§ 2001, 2502 (2006).
26. I.R.C. §§ 2056(a), 2523 (2006).
27. I.R.C. §§ 671-677 (2006).
28. Comm'r v. Beck's Estate, 129 F.2d 243, 246 (2d. Cir 1942).
29. *See* Grayson M. P. McCouch, *Rethinking Section 2702*, 2 FLA. TAX REV. 99, 107 (1994) (explaining how the "string provisions" may raise a problem of double taxation).
30. I.R.C. § 2036(a)(1) (2006). *See, e.g.*, Rapelje's Estate v. Comm'r, 73 T.C. 82, 85-86 (1979).

Despite the focus on this particular string provision, the discussion here may suggest an impact on all of the string provisions in the transfer tax system.

Lost in the many fierce debates over the policies and existence of the transfer tax system surrounding EGTRRA is a discussion of a much more modest feature added to the gift tax by this legislation: the incorporation of the income tax's grantor trust concepts into the definition of taxable gift for gift tax purposes.[31] This incorporation suggests an incremental change that can be made to simplify the transfer tax treatment of certain transfers to trust. Specifically, EGTRRA § 511(e)[32] provides:

> [Internal Revenue Code] [s]ection 2511(relating to transfers in general) is amended by adding at the end the following new subsection:"(c) TREATMENT OF CERTAIN TRANSFERS IN TRUST—Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, *unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1*."[33]

The parameters of this incorporation have never been tested,[34] but this article assumes a possible and seemingly straightforward application. In non-technical terms, this provision dictates that for purposes of the gift tax any transfer to trust shall be treated as a taxable gift, unless the income tax provisions in Subchapter J do not treat the transfer as complete for income tax purposes, in which case the transfer to trust will not be treated as a complete, taxable gift.[35] Through this provision the gift tax now incorporates the income tax's definition

31. Economic Growth and Tax Relief Reconciliation Act, Pub. L. No. 107-16, § 511(e), 115 Stat. 38, 71 (2001) (codified at I.R.C. § 2511(c) (2006)).

32. As amended by the Job Creation and Worker Assistance Act of 2002, Public Law 107-147, § 411(g)(1), 116 Stat. 21.

33. *Id.* (emphasis added).

34. The Service recently responded to the uncertainty surrounding new Section 2511c with Notice 2010-19, 2010-7 I.R.B. (discussing new Section 2511c, as amended by Section 411(g) of the Job Creation and Worker Assistance Act of 2002 (Pub. Law 107-147). The Notice indicates that the service believes that the section is being "inaccurately interpreted," and that the Service and treasury intend to clarify in further regulations. I.R.S. Notice 2010-19, 2010-7 I.R.B. This article proceeds under a possible interpretation of the Section which may be disfavored by the Service, but which, if adopted, could reconcile the definition of completed gift between the gift tax and the income tax regarding transfers to trust.

35. I.R.C. § 2511(c) (2006).

of a grantor's transfer to trust for purposes of defining a completed gift. By doing so, the definition of a completed gift, regarding transfers to trust, between the gift tax and the income tax are essentially reconciled.

However, this reconciliation currently takes effect in 2010, the year that the estate tax is currently slated for repeal, though the reconciliation will presumably stay in effect thereafter if the estate repeal becomes permanent.[36] As such, this provision does nothing to reconcile the definition of completed gift between the gift and estate taxes. The fact that the incorporation is effective only after the estate tax is repealed suggests the gift tax's goal of preventing estate tax avoidance through lifetime transfers dictates a different definition of taxable gift while the estate tax is in force. But it is intriguing to consider what effect this provision may have if it were left in effect in a taxation landscape that includes the income, gift, and estate taxes. As an example of an incremental change that may simplify the transfer taxes absent the complete repeal of the estate tax, this article evaluates the possibility of leaving EGTRRA section 511(e) in place should the estate tax be resurrected after the 2010 repeal, concluding that certain complexities will be removed from the estate tax calculation if the incorporation remains in place with the estate tax.

For purposes of this article, the focus will be on the following transaction: a transfer to an irrevocable trust in which the grantor retains a lifetime income interest and the remainder interest is transferred to a party unrelated to the grantor.[37] Under current provisions of the tax code, this transaction will be ignored as a grantor trust for income tax purposes,[38] deemed a completed gift of the remainder for gift tax purposes[39] and taxed

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36. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 511(f)(3), 115 Stat. 38, 71 (2001).

37. The analysis of this article is not dependent on the party who holds the remainder interest in the trust being unrelated to the party holding the lead interest. However, assuming the interest holding parties are unrelated will help keep the analysis simple and straight forward by avoiding potential complications with I.R.C. § 2702, which provides for special evaluation rules in case of transfers of interests in trusts under different circumstances.

38. I.R.C. § 677(a) (2006).

39. Smith v. Shaughnessy, 318 U.S. 176, 181 (1943); *see* I.R.C. § 2501(a) (2006); I.R.C. § 2511(a) (2006). The *Smith* decision is actually the source of much of the confusion surrounding the disparate treatments of remainder interests by the estate and gift taxes. There the Court said, "[T]he gift and estate tax laws are closely related and the gift tax serves to supplement the estate tax. . . . [T]he taxes are not 'always mutually exclusive' . . '[S]ome' of the 'total gifts subject to gift taxes . . . may be included for estate tax purposes and some not.'" *Smith*, 318 U.S. at 179. This decision has been embraced by the Internal Revenue Service through enactment of Treas. Reg. § 25.2503-3 (as amended

in the grantor's estate for estate tax purposes by virtue of the retained income interest.[40] That is, this one transaction will be considered a gift for the purposes of the gift tax, but not a gift under the income and estate taxes.

Section Two of this article discusses the estate tax conclusion related to this transaction. Section Three discusses the gift tax conclusion related to this transaction, including a discussion of how the conclusion would differ if the grantor trust rules were incorporated into the definition of taxable gift. Section Four shows the unnecessary complexity involved in reconciling the differing estate and gift tax treatment of the same transaction and discusses the components of the estate tax calculation relevant to this transaction. Section Five includes a discussion on how this calculation would change if grantor trust concepts were incorporated into the definition of taxable gift and necessary safeguards to avoid manipulation of grantor trusts to avoid estate tax. Section Six discusses the income tax considerations related to this transaction. Section Seven concludes that retaining EGTRRA section 511(e) will reduce some complexity from the estate tax calculation, and offers general reflections on the prospect of reducing the code's complexity through similar incremental steps aimed at simplifying its construction.[41]

II. ESTATE TAX CONSIDERATIONS

From the first enactment of the modern estate tax, Congress evinced a concern that the estate tax base could be depleted, and the tax itself could be avoided, through lifetime transfers.[42] Adding to this concern was a fear that wily testators would use trusts to structure their affairs in such a way that while they have transferred the property to another party during life, the testators would have retained some benefit or enjoyment of the

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in 1983) and the examples that section contains. Though the Court denied it, this decision set up the system of contradictory double taxation that is currently patched up by the operations of I.R.C. § 2001(b) (2006), and which this article argues may be cured by extending EGTRRA § 511(e), Pub. L. No. 107-16, 115 Stat. 38, 26 U.S.C. § 2511 (2006).

40. *See* I.R.C. § 2036(a)(1) (2006). *See generally* Goodnow v. United States, 302 F.2d 516 (1962) (holding that inclusion in gross estate for purposes of § 2036(a) is not determined by technicalities but by the substance and practical effects of retained interests).

41. For a broader discussion of the possible incorporation of grantor trust concepts into the transfer tax code *see* Robert T. Danforth, *A Proposal for Integrating the Income and Transfer Taxation of Trusts*, 18 VA. TAX REV. 545 (1999); *see also* Jay A. Soled, *Reforming the Grantor Trust Rules*, 76 NOTRE DAME L. REV. 375 (2001).

42. McMurtry v. Comm'r, 203 F.2d 659, 660 (1st Cir. 1953).

property.[43] Such schemes would allow the testators to both enjoy the fruits of the property in life, and avoid taxation on the property at death.[44] Retention of lifetime income interests, or reversions and the power to revoke, alter or amend the terms of a gift are examples of powers causing this concern.

Congress dealt with this concern variously during the life of the estate tax, using such tools as the gift tax and amending various sections of the income and estate tax. Some of the provisions Congress enacted over the years to deal with estate tax evasions are currently embodied in sections 2036, 2037 and 2038 of the Internal Revenue Code, the aforementioned "string provisions."[45] The string provisions are designed to capture certain mechanisms that testators commonly use to avoid the effects of the estate tax through life time transfers by drawing those transfers back into the testator's estate for tax reckoning at the grantor's death. The provisions are said to pull the transfers back in as though they were still on strings tied to the estate, hence the name.[46]

While the string provisions are somewhat effective at preventing testators from avoiding tax, these sections add complexity to the estate tax calculation as they frequently require an adjustment to be made to the decedent's total lifetime taxable gifts when calculating the decedent's estate tax liability.[47] The transaction considered for purposes of this article in which the testator retains an income interest in his property for life will be drawn back into the testator's estate for estate tax purposes by virtue of the string in section 2036(a), which provides:

> 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 . . ., 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—

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43. *See* Burnet v. Guggenheim, 288 U.S. 280, 284 (1933).

44. *See generally* BORIS BITTKER ET AL., FEDERAL ESTATE AND GIFT TAXATION 11-12 (7th ed. 1996).

45. *See generally* I.R.C. §§ 2036-38 (2006).

46. *See* Thomas Earl Geu, *Closely-Held Business Symposium: The Uniform Limited Partnership Act*, 37 SUFFOLK U. L. REV. 735, 807 (2004).

47. *See* Richard L. Dees, *Time Traveling to Strangle Strangi (And Kill the Monster Again), Part 2*, TAX NOTES TODAY, Aug. 20, 2007, *available at* 2007 LEXIS TNT 162-29 (discussing at length the complexities and confusions of the string provision).

> (1) the possession or enjoyment of, or the right to the income from, the property. . . [48]

For purposes of the estate tax, the transfers to our model trust are essentially ignored.[49] The trust corpus shall be taxed upon the grantor's death.[50] This string indicates that no transfer was completed and no gift was made.[51]

III. GIFT TAX RAMIFICATIONS

Section 2501 imposes a tax on a transfer of property through gift by an individual, resident or nonresident.[52] Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise.[53] The code does not, however, expressly define the essential term "gift." Instead, regulations proffered by the IRS define this key term in broad strokes, with emphasis on the substance of the transfer over its form.[54] The regulations state, "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax."[55] The Supreme Court has also helped shape the definition of a gift subject to tax, emphasizing that a donor must part with dominion and control over the property to have made a completed gift.[56] Specifically the Court has said, "When the gift tax was enacted Congress was aware that the essence of a transfer is the passage of control over the economic benefits of property rather than any technical changes in its title. . . [A] transfer of property upon trust, with power reserved to the donor either to revoke it and recapture the trust property or to modify its terms so as to designate new beneficiaries other than himself is incomplete . . ."[57] Simply stated, these broad definitions indicate that a gift is complete and subject to gift tax considerations to the extent the donor has gratuitously parted with dominion and control over property, leaving the donor no power to change the

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48. I.R.C. § 2036(a)(1) (2006).

49. *See generally* Henry J. Lischer, Jr., *Incomplete Lifetime Transfers: Retained Beneficial Interests Under Sections 2036(a)(1) and 2037*, 52-1st Tax Mgmt. Portfolio (BNA) 11-D (2009)

50. *See id.*

51. *See id.*

52. I.R.C. § 2501(a)(1) (2006).

53. I.R.C. § 2511(a) (2006).

54. *See, e.g.*, Treas. Reg. § 25.2511-1 (as amended in 1997).

55. Treas. Reg. § 25.2511-1(c)(1).

56. *See* Sanford's Estate v. Comm'r, 308 U.S. 39, 43-44 (1939).

57. *Id.* at 42-44.

disposition for the benefit of the donor or any other person.

In evaluating whether sufficient dominion and control has been relinquished over a trust to warrant the conclusion that a gift has been made by a grantor to an inter vivos trust requires an examination of trust terms and applicable state law.[58] For instance, if a grantor transfers property to a trust in which the grantor retains the right to revoke, a gift has not been made as dominion and control have not been relinquished.[59] Similarly, if state law provides the grantor with the power to revoke a trust, a gift has not been made.[60] Moreover, even if the grantor has retained no power to revoke, the gift may not be complete where the trust is subject to the grantor's creditors.[61]

Even when a trust is irrevocable and is not subject to the grantor's creditors, the retention of the ability to change the beneficial interests of the trust without limitations may render the transfer to the trust an incomplete gift.[62] However, retaining the power to control the beneficial interests of a trust shall make the transfer an incomplete gift only if the retained power leaves the donor reasonably unfettered control over the trust.[63] If, on the other hand, the grantor retained a power that is governed by an enforceable external standard, such as an enforceable directive written into the trust agreement, the gift shall be considered complete, notwithstanding the retained power.[64] Similarly, a gift will not be considered "incomplete" merely because of a retained power to affect the manner or time of enjoyment of the gift or a retained power that may only be exercised with the consent of an adverse party.[65] That is, the

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58. *E.g.*, Comm'r v. Allen, 108 F.2d 961, 962 (3d Cir. 1939) (citing New Jersey law to determine whether a gift had been made).

59. Burnet v. Guggenheim, 288 U.S. 280, 283-84 (1933).

60. *See, e.g.*, *Allen*, 108 F.2d at 965-66. (holding that a gift by a minor child was not completed until the donor attained the age of twenty-one because, under state law, minors have power to revoke all transfers).

61. Outwin v. Comm'r, 76 T.C. 153, 162-63 (1981). The general rule effective in the United States is that there can be no self-settled spendthrift trusts, and where a grantor attempts to make a gift to a trust and yet retain beneficial interests in the property gifted, the grantor's creditors retain the power to reach the trust property. *See* RESTATEMENT (THIRD) OF TRUSTS § 58 cmt. b (2001).

62. Sanford's Estate v. Comm'r, 308 U.S. 39, 43-44 (1939).

63. *See* Treas. Reg. § 25.2511-2(c) (as amended in 1999).

64. *See* Treas. Reg. § 25.2511-2(d).

65. Most notably, the retained power to alter the beneficial interests of others will not prevent the transfer from being complete for gift tax purposes if the power is one of the following: (1) a power that affects only the "manner or time" of the benefit or enjoyment, (2) a power to amend the trust exercisable only with consent of a party having a "substantial adverse interest," or (3) a power of a fiduciary nature that "is limited by a fixed or ascertainable standard" enforceable by the beneficiaries. Treas. Reg. § 25.2511-2(d), (e), (g) (as amended in 1999).

inquiry into whether a completed gift has been made requires an analysis, which, though guided by Treasury regulations, is highly contingent on the facts surrounding the transfer.

The trust involved in our transaction is an irrevocable trust in which the grantor retained only an income interest.[66] For purposes of the gift tax, it is irrelevant that the grantor did not transfer his entire interest in the property. The Internal Revenue Code allows for the taxation of partial interests that are gratuitously transferred. The regulations state, "If a donor transfers by gift less than his entire interest in property, the gift tax is applicable to the interest transferred."[67] Therefore, barring some unforeseen circumstance such as the minority or insolvency of the grantor, the transfer to the model trust used in this article creates a complete gift of the remainder of the trust. This gift will be taxable to the grantor as an inter vivos transfer under the gift tax.[68]

IV. ESTATE TAX CALCULATIONS

It is a simple matter to see the contradictory treatment of the same transaction. As Section Two indicated, the transfers to trust will be considered part of the grantor's estate at death, as though no gift had taken place.[69] Section Three described that the same transaction will be considered a taxable gift by the gift tax at the time the trust is funded.[70] In essence, one tax says that there has been no completed gift while the other says there has. In order to prevent double taxation of the same transaction the contradiction between these two provisions must be reconciled. Such reconciliation is currently achieved by a complicated calculation of the estate tax at the time of the grantor's death.[71]

Under the current unified transfer tax system, the value of the decedent's gross estate and the value of the decedent's adjusted taxable gifts are combined to form the starting point for the calculation of the decedent's estate tax liability.[72] The estate tax rate table is applied to the combination of these values,

66. *See supra* note 37 and accompanying text.

67. Treas. Reg. § 25.2511-1(e) (as amended in 1997).

68. The grantor's retained income interest is not the subject of the gift and the value of this interest is not subject to the gift tax. As the remainder is given to an unrelated party, the value of the gift is the value of the remainder in the trust, valued using actuarial tables. *See* I.R.C. § 2702 (2006).

69. *See supra* notes 47-50 and accompanying text.

70. *See supra* notes 52, 59-60 and accompanying text.

71. *See* I.R.C. § 2001(b) (2006).

72. *See* I.R.C. § 2001(b)(1)(A)-(B) (2006).

generally, less allowed recipient-based and expenditure/loss-based deductions.[73] The resulting tentative tax liability is then reduced by applicable credits against the estate tax.[74] As discussed above, the string provisions may include in the decedent's gross estate property that the decedent transferred away in the form of a taxable gift.[75] To avoid double taxation, the value of the lifetime gift is purged from the calculation and the estate tax liability is reduced to the extent that the prior transfer triggered the payment of any gift tax.[76] The purging of the value of the prior taxable gift and the allowance of a credit for any gift tax paid maintains the integrity of the unified estate and gift tax system and prevents double taxation; however, it also adds complexity to an already intricate process.

The alternative to these adjustments is to treat the transfer to trust consistently between the two taxes and avoid the threat of double taxation altogether. Currently the gift tax considers the model trust of this article as a completed gift while the estate tax does not. Either both taxes should consider this a completed gift or both should consider as a non-completed gift. Such consistency would be the effect that EGTRRA section 511(e) would have on the transfer taxes if it were left in the code when the estate tax is reinstated in 2011.

EGTRRA section 511(e) provides that the trust is deemed wholly owned by the grantor by virtue of the grantor trust provisions of the income tax.[77] Accordingly, the trust will not be deemed a taxable gift when it is established. The result is that if the trust is brought into the grantor's gross estate by virtue of a string provision when the grantor dies, no purging or crediting will be necessary. Instead, the property in the trust will be subjected to the transfer tax system for the first time through the estate tax. Thus, this provision commands a one time, straight forward tax reckoning for our model trust, which will greatly simplify its tax calculation. Though this simplification does not work to undo all of the complication inherent in the calculation of

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73. *See, e.g.,* I.R.C. § 2053(a) (2006) (payment of certain expenses and claims against the estate); I.R.C. § 2054 (2006) (casualty losses); I.R.C. § 2055(a) (2006) (bequests for charitable uses); I.R.C. § 2056(a) (2006) (bequests to surviving spouses).

74. *See, e.g.*, I.R.C. § 2010 (2006) (the estate portion of the unified credit); I.R.C. § 2011 (2006) (credit for state death taxes paid); I.R.C. § 2012 (2006) (credit for gift taxes paid); I.R.C. § 2013 (2006) (credit for prior transfers); I.R.C. § 2014 (2006) (credit for foreign death taxes paid).

75. *See supra* text accompanying note 46.

76. *See* I.R.C. § 2001(b)(2) (2006).

77. *See* Pub. L. No. 107-16, § 511(e), 115 Stat. 71 (2001); *see infra* text accompanying note 78.

the federal transfer tax, it does provide an incremental step towards effectively remedying the tax's structure.

V. INCOME TAX CONSIDERATIONS

The term "grantor's trust," used liberally throughout this article, is a term of art used by estate planners with major tax implications, but it is never explicitly defined by the Internal Revenue Code. A grantor's trust is any trust that the income tax will consider as containing property that is still substantially controlled by the trust's grantor. Consequently, the income generated by the corpus of such a trust is rightly taxable to the grantor. The income tax rules pertaining to the operations of a grantor's trust are contained in Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code, commonly referred to as simply Subchapter J.[78]

Recall that EGTRRA section 511(e) provides in part, "a transfer in trust shall be treated as a taxable gift under section 2503 [gift tax], *unless the trust is treated as wholly owned by the donor or the donor's spouse under . . . subchapter J.*"[79] As mentioned above, this provision effectively reconciles the status of a transfer to trust between the gift and income taxes. When this reconciliation is extended to the estate tax, as this article contemplates, a substantial contradiction in the code is resolved and the operation of the federal tax system is simplified. However, because of this shared definition and other overlaps among the taxes, the income tax treatment of the grantor's trust is conspicuously intertwined with the gift and, perhaps eventually, the estate taxes' treatment of these devices. This may be an unavoidable feature of incremental simplification: relying on some existing concept of one tax to smooth the wrinkles of another.

A truly thorough analysis of the income tax treatment of a grantor trust by Subchapter J will necessarily be frustrated by the length and complexity of the subchapter's provisions. Subchapter J is a dizzying network of cross references, general rules with multitudes of exceptions, and thick regulations. As one analysis observes, "the statutory provisions relating to the income taxation of trusts and estates are sometimes so complicated and obscure, and at other times so poorly thought through, that they discourage reasonable efforts at mastery . . .

78. I.R.C. §§ 641-692 (2006).

79. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38, 71 (2001) (emphasis added).

even when the statutory language itself is sufficiently clear, one too often remains in a quandary over the correct answer to a particular question. While one can say the same about many areas of federal income taxation, it is particularly true in the case of taxation of fiduciary income."[80] An in depth analysis of all the twists and turns of this labyrinth of specific tax rules is beyond the scope of this article. Still, a general statement of subchapter J's operations will be helpful.

Distilled to its essence, subchapter J provides a hybrid taxation system for the income of trusts. Elsewhere in its provisions, the tax code describes two different income tax treatments of legal entities, such as corporations and partnerships. The first is a double tax regime, whereby an entity, such as corporation, is taxed once at the aggregate level, and then its disbursements are taxed again at the level of the individual stockholders who receive them.[81] The second is a conduit tax regime, whereby an entity, such as a partnership or limited liability company, is considered to have all of its income passed through to its individual member, where it is taxed to them individually.[82] "A trust is not considered a legal entity."[83] As such, it does not fall neatly into either category.[84] Rather, the precepts of Subchapter J dictate that, depending on how the trust is classified, the income of the trust is either taxed in the aggregate, like a corporation, or passed through to the beneficiaries, most notably its grantor, like a partnership.[85]

Sections 671-677 delineate a grantor's trust as one in which the grantor of the trust retained one or more statutorily enumerated rights over the trust property.[86] These enumerated rights, which include the right to effect a reversion,[87] control who holds the beneficial enjoyment of trust property,[88] exercise various administrative powers,[89] revoke a transfer to the trust,[90]

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80. M. CARR FERGUSON, et. al., FEDERAL INCOME TAXATION OF ESTATES, TRUSTS, & BENEFICIARIES xi (2009 supplement).

81. *See* I.R.C. §§ 11(a), 61(a)(7) (2006).

82. I.R.C. § 701 (2006); *Single Member Limited Liability Companies*, IRS.GOV, Aug. 27, 2009, http://www.irs.gov/businesses/ small/article/0,,id=158625,00.html.

83. Stevens Family Trust v. Huthsing, 81 S.W.3d 664, 665 n.2 (Mo. Ct. App. 2002) (quoting Farris v. Boyke, 936 S.W.2d 197, 200 (Mo. Ct. App. 1996)).

84. *See* Alan S. Acker, *Income Taxation of Trusts and Estates*, TAX MGMT. PORTFOLIO (BNA) No. 852-3rd § II.B (2007).

85. *See id.* at § II.C.-D.

86. *See id.* at § II.D, n.13.

87. I.R.C. § 673 (2006).

88. I.R.C. § 674 (2006).

89. *See* I.R.C. § 675 (2006).

90. I.R.C. § 676(a) (2006).

or receive distributions of trust income, [91]are considered evidence that the grantor has not sufficiently divested himself of dominion or control of the trust property and should still rightly be taxed for the property's income. Consequently, the tax code states that the income of a grantor's trust will be taxed through the conduit method, and the income tax liability for the trust's income shall pass directly to the grantor.[92] The trust used as the model throughout this article will be considered a grantor trust under the subchapter due to the grantor's retained interest in one hundred percent of the trust's income for life.[93] Accordingly, the grantor will be responsible for the income tax of the trust's property for life. Thus, for income tax considerations, there has been no parting with control over the trust property; no gift was made.

Due to its tortuous complexity, the future of Subchapter J is a source of some contention.[94] Academic commentators and tax pressure groups have routinely proposed ways to alter its substance, reduce its complexity, and in some cases, eliminate it altogether.[95] Such frequent reconsideration of this provision may be problematic for the gift and estate taxes, as the operations of the transfer tax system seem to be closely linked in function, as well as estate planning practice, to the income tax treatment of trusts described in Subchapter J.[96]

Should grantor trusts in Subchapter J be altered or repealed, the provision currently contained in EGTRRA section 511(e) would lose its intended operating definition of grantor's trust. As such, the provision would have to be redrafted and passed through the legislative process again, relying on a different definition of a grantor's trust or otherwise working to reconcile the gift taxes and estate taxes for these types of trusts. Such a contingency is, again, a constant concern when incremental change is made to the code.

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91. I.R.C. § 677(a)(1) (2006).

92. I.R.C. § 677(b) (2006); *e.g.* Statler Trust v. C.I.R., 361 F.2d 128,131 (2nd Cir. 1966), quoting H.R.Rep. No. 1337, 83d Cong., 2d Sess., 1954 U.S.Code Cong. & Ad.News 4017, 4087.

93. *See supra* note 37 and accompanying text.

94. *See* 1 BYRLE M. ABBIN, INCOME TAXATION OF FIDUCIARIES AND BENEFICIARIES, at xix-xxii (2008).

95. *See, e.g.*, Barry J. London, *Complex Trust Taxation: A Proposed Reform*, 119 U. PA. L. REV. 1035, 1036 (1971); NEAL BOORTZ & JOHN LINDER, THE FAIRTAX BOOK: SAYING GOODBYE TO THE INCOME TAX AND THE IRS 1-6 (1st ed. 2005).

96. *See* I.R.C. §§ 641-692 (2006).

VI. CONCLUSION

It is well agreed upon that the tax code needs to be simplified. But efforts to overhaul the code with striking and sweeping policy changes have been regularly frustrated. The problem seems to be that the code, though complex and daunting, has functioned effectively and has provided revenue for the government for nearly a century. It is generally unappealing to the government, and even to the citizens who must suffer through the complexities of the code, to sweep away a law that, though confusing at times, demonstrably works, and replace it entirely with another law, which may not. Even efforts to substantially alter major policies and operations of the code, though frequently suggested and debated, are rarely carried out.[97] This is not to say that the code is perfect or that it would not benefit from considerable improvements.

Rather than trying to overhaul the system all at once, Congress often resorts to changing the code incrementally, rooting out the complexities and difficulties one at a time. Should Congress focus on removing structural flaws, such as inconsistent definitions and contradictions, their efforts may be met with worthwhile success. Incremental, structural changes such as this, can pass muster with Congress relatively easily, be pleasing (or unnoticed) by voters and taxpayers, and can create minor, but real, improvements to the tax code.

EGTRRA section 511(e) seems to reduce the contradiction between the gift and estate taxes created by the string provisions, and thus the section works to effectively reduce one of the complexities inherent in the tangle of the tax code. However, this incremental change is not a panacea and it certainly does not solve all problems within this area of the code. One issue left unanswered by the current version of EGTRRA section 511(e) is the appropriate tax treatment of transfers to a grantor's trust, like the one in our example, where the trust terminates prior to

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97. It might seem that EGTRRA itself is an obvious exception to the rule that wholesale, substantial changes to the code are rarely carried out. After all, EGTRRA contains a full repeal of the estate tax. But closer consideration may show otherwise. The sunset provision of EGTRRA means that ten years after its enactment the elimination of the estate tax will cease to be effective and the tax will resume in full force at its 2001 levels unless Congress passes legislation to make the repeal permanent. So far, Congress has not taken the necessary actions and it is looking less and less likely that they will. This means that EGTRRA will sunset and the code will go right back to business as usual. The phase out and repeal of the estate tax and all the other policy changes contained within EGTRRA will be nothing more than a ten-year hiccup in the federal tax code. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150 (2001).

the death of the grantor.[98] In such a situation, the transfers to the trust will avoid imposition of the gift tax by virtue of EGTRRA section 511(e) protecting the transfer as not a gift, but will also avoid imposition of the estate tax as the grantor will not have any enforceable interest in the trust at the time of his death. Currently, estate planners design trusts in this manner hoping to reduce the value of the remainder interest actuarially. By defining transfers to wholly owned grantor trusts as beyond the gift tax system, a trust designed and which in fact terminates before the death of the grantor may avoid imposition of the transfer tax altogether. As with any incremental change, this situation will require refinement of the change.

Though it is clear that questions surrounding the appropriate tax treatment of a grantor's trust remain, the reconciliation provision of the grantor's trust rules expressed in EGTRRA is an example of a provision that can have a positive incremental impact to the construction of the IRC. This provision works to correct all but one inconsistency in the code. Given the near certainty of EGTRRA's failure to effect wholesale change, incremental changes such as this one appear to be the better route for simplifying the tax code.

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98. *See supra* note 37 and accompanying text.