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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 Internal Revenue Service has conceded its inability to challenge the transaction based on current law, any solution lies with Congress. This Article proposes an amendment to § 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

If our transfer tax system is to be taken seriously, Congress must address certain cracks in the tax law that have allowed billions of dollars to escape the income tax and transfer tax bases.1 This Article synthesizes three interrelated but distinct estate planning tools used to exploit those cracks: 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 valuable to taxpayers. Part I then shows, through a

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1 Throughout this Article, I 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 value of these tools depends on the applicable estate tax rate and exemption amount, both of which have varied considerably in the recent past. In 2009, the highest transfer tax rate was 45% and the effective exemption was $3.5 million for estate taxes and $1 million for gift taxes. The estate tax was temporarily repealed for individuals dying in 2010. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001) (EGTRRA). Under the recent tax legislation passed in December 2010, the highest transfer tax rate is currently 35%, with an effective estate tax and gift tax exemption of $5 million. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312 (2010 Tax Act). While the 2010 Tax Act reinstated the estate tax for individuals dying in 2010, it also provided that estates of decedents dying in 2010 might make an election to be subject to carryover basis rather than federal estate tax, as enacted in EGTRRA. In 2013, transfer taxes will return to their pre-EGTRRA levels, with a top rate of 55% and an effective exemption of $1 million. Because more individuals will be subject to the estate tax in 2013 and thereafter than in 2004–2012, see I.R.C. § 2010(c), these tools will increase in value in those future years.
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 ISTIDGT transaction is one of the most important, as it provides enormous potential income tax and transfer tax savings.

The ISTIDGT transaction is antithetical to a transfer tax system and 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. However, because the Internal Revenue Service (IRS) has decided over recent years that it has no authority to challenge taxpayer use of IDGTs, it is Congress that must provide the solution through legislation. To that end, Part II outlines several reform proposals and recommends one specific amendment through which Congress might address the statutory loophole by eliminating IDGTs as a tax-planning tool.

I. THE ISTIDGT 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 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, I analyze each first as an independent, isolated strategy. I 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.

3 See, e.g., T. Randolph Harris, IDGT’s—When Defective Is Effective 16 (May 12, 2006) (unpublished manuscript, on file with author) (“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.”).

4 In advocating reform, I am neither intentionally endorsing, nor denouncing, a system that taxes wealth transfers. Rather, I believe that because a transfer tax system repeatedly 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.
A. Intentionally Defective Grantor Trusts

This Section first outlines the statutory landscape that allows taxpayers to create IDGTs. It then discusses the benefits achieved by taxpayers who exploit the mismatch between the estate tax’s and the income tax’s definition of a complete transfer.

1. Defining the IDGT Loophole

Congress originally enacted I.R.C. §§ 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 to the trust or its beneficiaries the underlying economic control or benefit. 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 §§ 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 trust that “flunks” the grantor trust rules 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,” or IDGT.

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 clients’ favor. The key to the IDGT tax-planning strategy is the misalignment between the grantor trust rules’ and the estate tax’s treatment of transfers to trusts. 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 §§ 2036–2038. An IDGT, therefore, is an irrevocable trust which is structured to be a grantor trust

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5 Unless otherwise indicated, all references to a “section” or “sections” are to the Internal Revenue Code.
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 First, the income tax rate structure has become much more compressed than it was when the grantor trust rules were enacted. (The top marginal rate is now 35%, whereas it was previously as high as 91%.) See I.R.C. § 1(a), (i). Second, nearly all trust income is taxed at the highest marginal rate applicable to individuals. I.R.C. § 1(e). Third, parents no longer can 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. I.R.C. § 1(g).
for income tax purposes, a transfer to which, however, is deemed a complete transfer for estate and gift tax purposes. ⁸

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: §§ 675(4)(C) and 675(2). 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 unilaterally will 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

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⁸ Joint Committee on Taxation, Description of Revenue Provisions Contained in the President’s Fiscal Year 2010 Budget Proposal: Part One—Individual Income Tax and Estate and Gift Tax Provisions, JCS-2-09, at 147 (Sept. 2009) (“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.’”). Under 26 C.F.R. § 25.2511-2(b) (2010), a gift is complete when the donor has given up “dominion and control” over the property.

⁹ Estate planners typically use multiple powers to create an IDGT, since the IRS does not want to encourage IDGTs and therefore tends not to bless the effectiveness of specific 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 Jordahl v. Commissioner, 65 T.C. 92 (1975), the Tax Court stated that retention of a § 675(4)(C) power will not cause estate tax inclusion. But in PLR 200603040 (Oct. 24, 2005), the IRS interpreted the Jordahl protection as limited to powers exercisable only in a fiduciary capacity. This created a problem for practitioners, because the statute is explicit that this particular power must be exercisable in a nonfiduciary capacity in
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.\(^{16}\)

Other retained powers, though less common, may also be used to create a defective grantor trust.\(^{17}\)

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 income must be paid by the grantor. Because those taxes are not paid out of the trust corpus, payment of the trust’s income tax by the grantor is effectively a tax-free gift to the trust (and ultimately to the trust’s beneficiaries).\(^{18}\)

order to get the grantor trust status. However, 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 C.B. 796; see also PLR 2009-44-002 (July 15, 2009) (holding that when a grantor trust is prohibited from reimbursing the grantor for income taxes paid, Rev. Rul. 2008-22 C.B. 796 will apply and that there will be no estate tax inclusion (despite Rev. Rul. 2004-64 C.B. 7, which many had interpreted to indicate otherwise)).

\(^{14}\) I.R.C. § 675(2).

\(^{15}\) See Harris, supra note 3, 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, ALL-ABA COURSE OF STUDY MATERIALS (July 2001). Limiting the power to borrow without adequate security (and not allowing the grantor to borrow without adequate interest) should also raise fewer eyebrows at the IRS. Aucutt, supra note 15.

\(^{17}\) E.g., I.R.C. § 674(a) (power of disposition held by grantor or nonadverse party); I.R.C. § 674(b)(5) (power to add beneficiaries); I.R.C. § 677(a) (power of nonadverse party to distribute income to grantor’s spouse); I.R.C. § 673(a) (grantor holds reversionary interest in either corpus or income, worth at least 5% of entire corpus value).

\(^{18}\) Rev. Rul. 04-64, 2004-2 C.B. 7 (“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
Another fundamental benefit of an IDGT—a benefit that exists for any complete transfer of property and thus is not unique to IDGTs\(^{19}\)—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 transferred property’s future appreciation is not subject to estate or gift tax. Furthermore, any gift tax paid on the initial gift will reduce further the grantor’s taxable estate.

These two benefits, combined with other minor benefits,\(^{20}\) 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.

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 not treated as making a gift of the amount of the tax to the trust beneficiaries.

\(^{19}\) 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 are essentially worthless.

\(^{20}\) One additional benefit is potential income tax savings for the grantor. Individuals reach the highest marginal tax rate for any income over $125,000 ($250,000 for married individuals filing joint returns), while trusts are taxed at an equivalent rate for any income over $7,500. I.R.C. §§ 1(a), (d), (e). Thus, for grantors with IDGT income in excess of $7,500 but with overall personal income less than $125,000, the trust income will be taxed at a lower rate than it would have been within a trust separate from the grantor.

Another benefit is an IDGT’s reversibility. Although the trust must be irrevocable—were the grantor to retain a right to revoke the trust, it would be includible in her estate under § 2038—its grantor trust status can be turned off in some cases. If the trust generates more income than the grantor can afford to pay income tax on, the grantor may renounce whatever power or powers produced grantor trust status. For example, the grantor may simply give up her right to substitute equivalent property in an IDGT based solely on § 675(4)(C). In such a case, the grantor will no longer be liable for the trust’s income tax liability. Although the trust is no longer an IDGT, and related benefits will cease, the transition triggers no transfer tax liability, since the trust remains outside the grantor’s estate.
Installment sales are respected by the IRS as arm’s-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). 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 rate higher than the AFR.

In a typical installment sale done for estate planning purposes, a parent will sell directly to her child assets with appreciation potential. The child then becomes the obligor on a balloon note under which AFR-based interest must be paid to the parent annually and principal must be repaid 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 (parent’s) taxable income and taxed at ordinary income rates. Typically in the estate planning context, the buyer (child) 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. 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 sale—in practice the installment method has several limitations that are particularly salient in the context of estate planning.

21 As long as the seller in an installment sale charges interest equal to the appropriate AFR, the sale will not be treated under § 7872 as a below-market loan. Pursuant to § 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. In comparison, had the child received the assets upon the parent’s death, the gain would have gone completely unrecognized. I.R.C. § 1014.

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. I.R.C. § 453(e). If the taxpayer realizes a gain on any transferred depreciable assets, this gain will trigger immediate taxation under the recapture rules under §§ 1245 and 1250. I.R.C. § 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. I.R.C. § 453A(b).
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. This means that the installment sale triggers no gain recognition 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 removal of the transferred property from the grantor’s gross estate. Although the principal is returned to the grantor’s gross estate upon the note’s maturation, 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 income tax on the capital gain.


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

28 Of course, the grantor still must pay tax on any income or capital gains generated by the trust.

29 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, 97 J. TAX’N 149 (Sept. 2002); Louis A. Mezzullo, Freezing Techniques: Installment Sales to Grantor Trusts, 2000 ABA Prob. & Prop. Mag. available at http://www.abanet.org/rppt/publications/magazine/2000/jf00mezzullo.html; see also Harris, supra note 3, at 15 (arguing that any remaining principal payments after death would have no income tax consequences as a result of Rev. Rul. 85-13, 1985-1 C.B. 184).

30 Rev. Rul. 85-13. Once again, the transaction is a nonevent. Such a reacquisition can be particularly useful 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 § 675(4)(C) power to substitute property of equal value, then the grantor can substitute cash for appreciated trust assets even without trustee permission, unless state law dictates otherwise.
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 property to be transferred in the installment sale. This initial funding ensures that the trust is economically legitimate and respected for estate tax purposes. The grantor then enters into an installment sale with the IDGT. The grantor sells assets with appreciation potential in exchange for a balloon note. The IDGT pays annual interest on the note equal to the AFR and then repays the principal when the note matures (often after 9 years). Because the note has an interest rate 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 IDGT 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 substantial transfers out of the grantor’s estate with only a small initial taxable gift.

31 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 the IRS may be able to argue that the grantor has retained an income interest in the trust and may try to use § 2036(a)(1) to include the entire trust in the grantor’s estate. Therefore, many practitioners argue that before an installment sale, an IDGT should contain assets worth at least 10% of the amount of the installment note. E.g., Baird, supra note 16; see, e.g., PLR 9535026 (May 31, 1995). Furthermore, the entire trust—not just the assets subject to the installment note—should be liable to pay the installment note, and the payment of interest and the repayment of principal on the note should have no direct ties to the amount of income generated by the assets sold to the trust under the installment method. Cf. Fidelity-Philadelphia Trust Co. v. Smith, 356 U.S. 274 (1958).

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

33 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 typically higher than the midterm AFR. Instruments often have a term of 9 years to get the benefit of the lower rate for as long as possible.

34 It may be unnecessary to wait until one installment sale has terminated before engaging in another. One practitioner writes that a new installment sale can be entered each year, using all excess cash within the trust as the 10% seed money necessary for the sale. Steven J. Oshins, Sales to Grantor Trusts: Exponential Leverage Using Multiple Installment Sales, PROB. & PROP., Jan.-Feb. 1999, at 48-50.
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. This same assumption drives other estate planning devices, including the grantor retained annuity trust. However, if the AFR reflects a risk-free market rate of interest, then it is essentially 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 transaction 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 often 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 increase the chances 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 to her son an asset worth $1 million. Assuming that the mother has already exhausted her annual exclusion with respect to her

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35 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.

36 A grantor retained annuity trust (GRAT) is a trust which pays the grantor a specific annuity amount for the fixed term of the trust and which distributes any assets remaining in the trust at the end of the term to the trust’s beneficiaries (often the grantor’s children). The amount of the reportable gift is the actuarial value of the remainder interest passing to the beneficiaries, which is equivalent to the total initial GRAT corpus less the present value of the scheduled annuity payments to the grantor. Thus, if the grantor reserves an annuity stream that, based on the § 7520 rate (which is 120% of the AFR), is projected to exhaust the GRAT’s assets by the end of the term, the beneficiaries’ interest will be valued at zero and the GRAT will generate no taxable gift. However, if the assets held by this “zeroed-out” GRAT outperform the § 7520 rate, then all the annuity payments will be satisfied and the beneficiaries will receive the assets remaining in the GRAT even when the GRAT generated no taxable gift. In 2000, the Tax Court blessed taxpayers’ ability to create a zeroed-out GRAT. See Walton v. Comm’r, 115 T.C. 589 (2000). Unlike ISTIDGT transactions, zeroed-out GRATs are already on Congress’s radar. In the previous Congress, the House passed a bill that would have prevented taxpayers from creating zeroed-out GRATs. See H.R. 4849, 111th Cong. (passed Mar. 24, 2010).
son\textsuperscript{37} and that she has made previous lifetime gifts such that any additional gift will be taxed at the highest marginal gift tax rate,\textsuperscript{38} this gift would generate a gift tax liability in 2011 of $350,000. 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 she can reduce her gift tax liability to only $210,000.

The two most important valuation discounts are the lack-of-control discount and the lack-of-marketability discount.\textsuperscript{39}

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 also trigger the lack-of-marketability discount. 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.\textsuperscript{40} In many cases, such as the legitimate, closely held business described above, 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

\textsuperscript{37} I.R.C. § 2503(b) (allowing a grantor to give up to $13,000 each year to a given donee without any gift tax consequences).

\textsuperscript{38} Pursuant to § 2505, the first $5,000,000 in taxable gifts during a taxpayer’s lifetime will generate no tax liability. And under the current rate tables, all gifts beyond the lifetime exclusion are taxed at a marginal gift tax rate of 35\%. See I.R.C. §§ 2001, 2502.

\textsuperscript{39} 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.

\textsuperscript{40} See Laura E. Cunningham, \textit{Remember the Alamo: The IRS Needs Ammunition in its Fight Against the FLP}, 86 TAX NOTES 1461 (2000); \textit{Cut Your Estate Taxes in Half}, FORBES, Oct. 19, 1998. Typical discounts accepted by the IRS are in the range of 25–40\%. 
an active business but holds solely marketable securities. Thus, by taking
the simple step of placing securities in an FLP rather than giving the
securities to his children outright, the father can reduce drastically his
gift tax liability on the transfer of the same underlying assets, essentially
making his wealth disappear to the federal government.

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 mar-
ketability. 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 nine-year 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 produces a slightly negative overall
investment return over the term of the note, the IDGT in the children’s
hands will still hold assets worth more than $2 million after the interest
and principal have been paid to the grantor on the installment sale.

2 (2009).
42 See, e.g., Cunningham, supra note 40.
43 “[T]he perfect asset for [an IDGT] is an asset that produces cash flow and either
can be transferred currently at a discount or will appreciate significantly.” Kuno S. Bell,
Use Defective Grantor Trusts for an Effective Triple Play, 75 Tax Strategies 12–19
(July 2005).
44 In order to avoid the possibility of paying future gift tax upon the IRS’s revalua-
tion of transferred assets, one commentator recommends using a value definition clause
such as “% of LP interest equal in value to $X.” Baird, supra note 16. If the interest has
been undervalued and the IRS fails to challenge the valuation, then the trust will have
received an even greater transfer tax savings. If the IRS does challenge the undervalua-
tion, then under the formula, the excess partnership interests could revert to the grantor
who will have no gift tax liability as a result. Alternatively, the installment sale contract
could include a formula whereby any such excess interests, that would otherwise trigger
gift tax, would be transferred to charity. In such a case, an IRS revaluation might even
result in a higher gift tax deduction on the income tax return for the year of the original
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, 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, a gift that 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.

Several years earlier, the grantor had established an FLP and funded it with marketable securities now worth $100,000,000. In October 2009, the grantor makes an installment sale to the IDGT of a 15% interest in the FLP, 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).

Over the course of the nine-year note, the assets in the trust (initially worth $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. 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...

45 For ease of illustration, this example assumes that 2009 law has been extended indefinitely into the future, and it ignores the changes to estate and gift tax law in 2010 by EGTRRA, in 2011-12 by the 2010 Tax Act, and in 2013 by the sunset of EGTRRA and the 2010 Tax Act. See supra note 2.
46 See supra note 31. The $1,000,000 cash in the trust ensures 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 § 2036(a)(1). See Oshins, supra note 34, at 48.
47 See supra note 38. I have omitted discussion of the generation-skipping transfer (GST) tax consequences because I assume that there will be no GST liability. I assume that the grantor will 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. See I.R.C. §§ 2010, 2601, 2611, 2631, 2632, 2642.
49 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%.
trust’s earnings, for a total of $1,900,000 over nine years. 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 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.

<table>
<thead>
<tr>
<th>Growth Rate</th>
<th>Income Tax Paid</th>
<th>Value Passing Through Trust</th>
<th>Total Decrease in Gross Estate</th>
<th>Estate Tax Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>$2.06</td>
<td>$10.89</td>
<td>$12.95</td>
<td>$5.83</td>
</tr>
<tr>
<td>8%</td>
<td>$1.90</td>
<td>$17.66</td>
<td>$19.56</td>
<td>$8.80</td>
</tr>
<tr>
<td>10%</td>
<td>$6.34</td>
<td>$23.12</td>
<td>$29.46</td>
<td>$13.25</td>
</tr>
<tr>
<td>15%</td>
<td>$12.54</td>
<td>$40.82</td>
<td>$53.36</td>
<td>$24.01</td>
</tr>
<tr>
<td>20%</td>
<td>$21.36</td>
<td>$66.02</td>
<td>$87.38</td>
<td>$39.32</td>
</tr>
</tbody>
</table>

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 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 § 675(4)(C) right to reacquire the limited partnership assets, and her children would then have $20,000,000 in gross estate with no estate or gift tax consequences.

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50 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. Alternatively, if all the income were taxed at a 35% rate, the income tax liability over nine years would be $4,430,000. In either case, the entire amount would be equivalent to a tax-free gift from the grantor, who pays the tax, to her grandchildren.
have received those assets with a step-up in basis at her death in 2019. 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 on the IDGT income further reduce the grantor’s gross estate, but a reduction in the size of the grantor’s gross estate also may lead to a reduction in state death taxes.51

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 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 $187,000,000.52 With this use of multiple ISTIDGT transactions, 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 challenge it (aside from contesting the value of the assets sold).53 Part II proposes a legislative solution to the tax dodging engaged in by America’s super wealthy.

II. ELIMINATING THE ISTIDGT TRANSACTION

The most obvious solution to the tax planning described in Part I is simply the elimination of all IDGTs. In Part II.A, I propose that instead of full harmonization of the transfer tax and income tax laws, and instead of reform of the grantor trust rules, Congress should merely

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51 Many states have an estate tax that is tied to the schedules for the federal credit for state death taxes that existed under prior law. In these “coupled” states, the state will collect revenue in an amount equal to the credit allowable on the federal estate tax return under § 2011(a). Because Congress repealed the state death tax credit in 2001, these coupled states currently collect no death tax revenue under their pick-up tax.

Decoupled states are those which base their estate tax on something other than the federal credit, such as the grantor’s gross estate. Even though there is no current federal state death tax credit, these states nonetheless collect estate taxes. Thus, a decedent in a decoupled state will pay greater aggregate estate taxes than a decedent in a coupled state. A reduction in the grantor’s estate therefore would result in a reduction in state estate taxes in decoupled states.

52 See supra notes 31, 46, and accompanying text.

53 See infra note 82 and accompanying text.
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 proposal, 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 would not eliminate IDGTs but would diminish their advantages under current law.

A. Primary Proposal: Eliminate IDGTs Without Fundamental Tax Reform

Any proposal to eliminate 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 uses the following table, which describes the possible tax results for any given transfer to a trust.\footnote{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.}

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Complete Gift; No Inclusion in Gross Estate</th>
<th>Incomplete Gift; Inclusion in Gross Estate</th>
<th>Complete Gift; Inclusion in Gross Estate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grantor Trust</td>
<td>Scenario 1</td>
<td>Scenario 3</td>
<td>Scenario 5</td>
</tr>
<tr>
<td>Non-grantor Trust</td>
<td>Scenario 2</td>
<td>Scenario 4</td>
<td>Scenario 6</td>
</tr>
</tbody>
</table>

Although in a certain sense, any given transfer is either complete or incomplete, the three systems of tax produce six\footnote{Theoretically, the table could list two additional possible scenarios: transfers 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 the six scenarios listed in the table.} separate possible scenarios because the tax systems are not coordinated. “By mere coincidence, they sometimes function in unison; other times, they do not.”\footnote{Jay A. Soled, Reforming the Grantor Trust Rules, 76 Notre Dame L. Rev. 375, 418 (2001).}
Scenario 1 describes transfers to IDGTs—although a transfer is complete for both gift tax and estate tax purposes, it is incomplete for income tax purposes and results in a grantor trust. In order to eliminate Scenario 1 transfers, either the transfer tax or the income tax laws, or both, must be modified. This Section describes various possibilities for IDGT-eliminating reform.

First, I discuss harmonization of the transfer tax and income tax systems. Second, I discuss reform of the grantor trust rules’ definition of completed transfer for income tax purposes. Finally, I conclude that while harmonization or revision of the grantor trust rules 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.

1. **Harmonization?**

A harmonized system would employ one single definition of completed transfer for income tax, gift tax, and estate tax purposes. Such a system has intuitive appeal, since all three tax systems attempt to capture those transfers in which a grantor has not fully given up control over the transferred property. Harmonization could be implemented by replacing the current income tax definition (found in the grantor trust rules) with the transfer tax definition, by replacing the transfer tax definition with the income tax definition, or by replacing both the income tax and transfer tax definitions with an entirely new scheme.

The disjointed systems have caused confusion and tax planning opportunities, leading many commentators to recommend some form of coordination or harmonization. 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.”

In 1942, Professor Erwin Griswold 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 princi-

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57 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. Robert T. Danforth, *A Proposal for Integrating the Income and Transfer Taxation of Trusts*, 18 VA. Tax Rev. 545, 601-15 (1999). Danforth recommends replacing §§ 673 through 677 with one single section, a new § 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 §§ 2501–2524].”

58 Comm’r v. Prouty, 115 F.2d 331, 337 (1st Cir. 1940).
ple 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.59

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

<table>
<thead>
<tr>
<th></th>
<th>Complete Gift; No Inclusion in Gross Estate</th>
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The primary virtue of harmonization, at least for purposes of this Article, is that it eliminates the possibility of a Scenario 1 transfer. But as a solution to the IDGT problem, harmonization is unnecessarily overbroad: In getting rid of Scenario 1, it also sweeps away three harmless scenarios. Scenarios 4-6 are not 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).

Thus, although harmonization may be desirable for other reasons,60 other methods may be better targeted at eradicating IDGTs.

59 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 56, at 418.

60 Harmonization has many merits outside of the narrow question of IDGT formation. Indeed, Professor Griswold was principally concerned about creating an efficient tax system:

[The income tax, estate tax, and gift tax provisions relating to transfers and trusts] have grown up almost independently, with the result that they are worded differently and do not fit together in many important matters of detail.
2. Reform of the Grantor Trust Rules?

Another method of abolishing Scenario 1 transfers is through reform of the grantor trust rules. 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. Some have even called for their repeal. 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 use of grantor trust rule reform as a 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 ex-

Furthermore, the courts have done some remarkable things, particularly under the income tax, and it is far from clear just what effect these income tax decisions will be given in the estate and gift tax field. The law as it now stands is fully beyond the comprehension of any but experts, and the most that they can do in many situations is to express doubts. An enormous amount of intricate litigation has resulted. It would seem clear that certainty to the taxpayer, and efficiency in the administration of the tax laws, would be greatly improved if the statute could be changed so as to minimize the present problems.

Griswold, supra note 59, at 338–39.

Although the grantor trust rules originally were 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. See supra note 7 and accompanying text. For this reason, 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.

Soled, supra note 56, at 377; accord Danforth, supra note 57, at 601. (“The grantor trust rules in their present form are an anachronism.”)

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.” Leo L. Schmolka, *FLPs and GRATs: What To Do?,* 2000 Tax Notes Today 49-105, at ¶ 93.


ample, Congress could easily repeal §§ 675(4)(c)\textsuperscript{64} and 675(2),\textsuperscript{65} 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.”\textsuperscript{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.\textsuperscript{67}

Soled’s proposal would eliminate IDGTs, since any grantor trust created under the new rules would be includible in the grantor’s estate under § 2036(a)(1). However, his proposal would require Congress to put other rules in place to fill any holes left by the repealed grantor trust rules.\textsuperscript{68} Thus, the repeal and partial replacement of the grantor trust rules could occur only after substantial congressional study and debate.

\textsuperscript{64} See supra note 10 (describing the power of the grantor to substitute assets of equal value).

\textsuperscript{65} See supra note 14 (describing the power of the grantor to borrow without adequate interest or security).

\textsuperscript{66} Griswold, supra note 59, at 342; see also Soled, supra note 56, at 414 n.206 (“The encompassing nature of the grantor trust rules . . . remain[s] 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.”).

\textsuperscript{67} Soled, supra note 56, at 415.

\textsuperscript{68} Soled concedes, for example, that Congress would need to enact additional restrictions “to prevent a renewal of income-shifting between grantors and the trusts they establish.” Id. at 416.
3. Proposal: Modification of § 2036

While harmonization and reform of the grantor trust rules may be desirable, they are both unnecessary to root out IDGTs. I propose in this subsection a simple solution that would eliminate taxpayers' ability to form IDGTs but which would also leave intact nearly all of current law.

Under my proposal, Congress should amend § 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.

Congress would also create a new § 2036(c): 69

(c) Grantor trusts. For purposes of subsection (a)(3), the decedent shall be deemed to have retained any ownership, power, or right held by a third party that would cause the decedent to be deemed the owner of any portion of a trust under sections 671–677.

Under this proposed rule, there would be no IDGT (Scenario 1) transfers; all grantor trust–generating transfers would result in ultimate inclusion in the grantor’s gross estate (i.e., Scenarios 3 and 5). 70

69 Current § 2036(c) would become § 2036(d). Sections 671–677 contain various provisions that trigger grantor trust status even when the grantor himself has retained no power or right. The new § 2036(c) would ensure that no grantor trusts, even those triggered by powers held solely by a spouse or other third party, would escape estate tax inclusion.

70 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. Such a transfer, labeled as Scenario 5, generates no gaming opportunities, because, in addition to the gift tax liability upon
Like harmonization, some transfers would be complete for both income and estate tax purposes (i.e., Scenario 2). But unlike harmonization, my proposal would leave untouched those transfers which, under the present rules, are complete for income tax purposes (no grantor trust is created) and incomplete for estate tax purposes (i.e., Scenarios 4 and 6).71 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.72

Some commentators might question my proposal because it fails to achieve the efficiency and predictability of a harmonized system. Others might object because it targets a well-functioning transfer tax system and fails to cure the underlying IDGT-creating pathogen—the grantor trust rules.73 Through the lens of tax policy, both concerns are on the mark. However, 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—and therefore easier to enact and implement—than either harmonization or reform of the grantor trust rules.74

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 extensive congressional debate. After all, both grantor trust rule reform and harmonization have

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71 These transfers, if they actually exist, should cause no immediate congressional concern. See supra text accompanying notes 59–60.

72 Under current law, the estate tax rules already are narrower than the gift tax rules. See supra note 55.

73 Cf. Danforth, supra note 61, 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.”).

74 As Voltaire famously stated, “the perfect is the enemy of the good.” VOLTAIRE, LA BÉGUEULE, CONTE MORAL A3 (1772).
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 more significant reform later eliminates IDGTs in some other way.

B. Alternative Proposals: Eliminate Benefits of ISTIDGT Transaction

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 or to engage in an installment sale with an IDGT. Nonetheless, either of the reforms would eliminate much of the tax-planning benefit from ISTIDGT transactions. Although both of these reforms likely would be more complex and less effective than my proposal in Part II.A, either would be preferable to the status quo.

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

Rev. Rul. 85-13 is the primary authority giving rise to ISTIDGT transactions. 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.\(^{75}\)

The ruling discusses the *Rothstein* decision,\(^{76}\) 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.”\(^{77}\) 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*:

\(^{76}\) Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984).
The 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.78

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.79

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 arm’s-length transactions for purposes of both income tax and gift tax.80 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.81 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.82

78 Id.
79 Id.
80 Section 7872 explicitly states that it applies to the entire Internal Revenue Code—Title 26 of the U.S. Code—and therefore to both the income tax and transfer tax subtitles. I.R.C. § 7872(a)(1) (“For purposes of this title . . . .”). However, under the IRS’s current approach to ISTIDGT transactions, the note’s characterization of income and principal (pursuant to § 1274) is irrelevant for income tax purposes, since the interest income is not taxable. Rev. Rul. 85-13, 1985-1 C.B. 184; PLR 9535026 (May 31, 1995).
81 See I.R.C. §§ 1274(d), 7872(f)(1)–(2).
82 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).
Therefore, I recommend that Congress amend § 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 arm’s 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, § 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. While such a reform would add additional complexity to the already undesirable grantor trust rules, it would remove the primary benefit of ISTIDGT transactions.

2. Installation Notes Are Retained Interests

As long as a trust holds equity equal to at least 10% of the face value of an owed installment note, the IRS is unlikely to challenge the installment note as a retained interest for purposes of estate and gift taxes. If Congress is unwilling to make the entire IDGT includable in the grantor’s estate (as does my proposal in Part II.A), 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. 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.”

83 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.
84 The reform would also add complexity to other parts of the Code. Congress would need to cross-reference the new basis rule in other sections, such as § 1016.
85 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.
86 See PLR 9535026 (May 31, 1995).
87 Unlike the statutory grantor trust rules, the completed transfer rules for estate and gift tax purposes are found mostly in regulations. Therefore, rather than drafting this new rule directly into the Internal Revenue Code, 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.
88 Mitchell M. Gans & Jay A. Soled, Reforming the Gift Tax and Making It Enforceable, 87 B.U. L. REV. 759, 797 n.147 (2007) (“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 install-
CONCLUSION

Transfer taxes are a sensitive topic on Capitol Hill and getting transfer tax legislation through Congress is typically extremely difficult. But even if Congress continues this course of avoiding the most important issues underlying our federal transfer tax system, it need not avoid altogether legislating in the transfer tax area. 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. However, pushing such a reform through Congress may be 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 better 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.

89 The transfer tax provisions enacted as part of the 2010 Tax Act emerged only as part of a final demand in negotiations that became a linchpin to passage of the entire Act.

90 For example, Laura E. Cunningham, FLP Fix Must Be Part of Transfer Tax Reform, 112 TAX NOTES 937, 937 (Sept. 11, 2006).