The University of Akron
IdeaExchange@UAkron

Akron Law Review | Akron Law Journals

September 2015

Untangling the Strings: Transfer Taxation of Retained Interests and Powers

Matthew A. Reiber

Please take a moment to share how this work helps you through this survey. Your feedback will be important as we plan further development of our repository.
Follow this and additional works at: http://ideaexchange.uakron.edu/akronlawreview

Part of the Taxation-Federal Estate and Gift Commons, and the Tax Law Commons

Recommended Citation
Reiber, Matthew A. (2015) "Untangling the Strings: Transfer Taxation of Retained Interests and Powers," *Akron Law Review*: Vol. 48 : Iss. 3 , Article 1.
Available at: http://ideaexchange.uakron.edu/akronlawreview/vol48/iss3/1

This Article is brought to you for free and open access by Akron Law Journals at IdeaExchange@UAkron, the institutional repository of The University of Akron in Akron, Ohio, USA. It has been accepted for inclusion in Akron Law Review by an authorized administrator of IdeaExchange@UAkron. For more information, please contact mjon@uakron.edu, uapress@uakron.edu.

UNTANGLING THE STRINGS: TRANSFER TAXATION OF RETAINED INTERESTS AND POWERS

Matthew A. Reiber∗

∗ Associate Professor of Law, Florida Coastal School of Law.

I. INTRODUCTION

The estate tax[1] applies to property[2] transferred[3] at death[4] and to property transferred during life, typically to a trust, under circumstances in which the transferor[5] retains an interest or power.[6] These interests and powers typically allow her to continue using or enjoying the property,

---

1. 26 U.S.C. §§ 2001-2210 (2012). The estate tax is an excise tax levied on the privilege of transferring property at death. *See* CHARLES L. B. LOWNDES, ROBERT KRAMER & JOHN H. MCCORD, FEDERAL ESTATE AND GIFT TAXES § 1.1, at 1 (3d ed. 1974) ("The accepted legal convention in the case of a death tax is that the tax is the price of the privilege of transmitting property at death. Although the tax is measured by the property transferred at death, the formal subject of the tax is the transfer of the property, rather than the property itself."); *see also* Hunter v. United States, 474 F. Supp. 763, 765 (W.D. Mo. 1979) ("The federal estate tax is a tax imposed upon the privilege of transferring property at one's death."). Although the estate tax is typically justified on the ground that it lessens the accumulation of dynastic wealth, it can also be justified as a source of revenue for distributive purposes or the provision of publicly-provided goods and services. *See, e.g.*, Kelly A. Moore, *Proposal for Estate Tax Exclusion Provisions*, 35 OHIO N.U. L. REV. 37, 40-41 (2009) ("Although current estate tax proponents rely primarily on the rationale of breaking up large concentrations of wealth to justify the estate tax, the estate tax was used initially by a federal government determined to raise revenue. . . . Despite the revenue-raising rationale that gave rise to the estate tax, the stronger historic and long-stated primary purpose . . . has been to break up large concentrations of wealth."). The extent to which the estate tax accomplishes either of these goals is debatable and frequently debated. *See, e.g.*, Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241, 242-43 (1988) ("As currently imposed, federal taxes on the transmission of wealth produce little revenue and do not meaningfully redistribute wealth.").

2. The term "property" is construed broadly for estate tax purposes and includes "all property, whether real or personal, tangible or intangible, and wherever situated, beneficially owned by the decedent at the time of his death." Treas. Reg. § 20.2033-1(a) (as amended in 1963).

3. The term "transfer" is defined for gift tax purposes as "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed . . . ." Treas. Reg. 25.2511-1(c)(1) (as amended in 1997). Given the close connection between the gift and estate tax systems, two leading commentators conclude that "the same breadth of construction is appropriate in applying the estate tax," as well. 5 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 126.3.2, at 126-11, 126-12 (2d ed. 1993); *see also* Church v. United States, No. SA-97-CA-0774-OG, 2000 WL 206374, at *8, (W.D. Tex. Jan. 18, 2000) (stating the term "transfer" is given the same meaning in the two transfer tax regimes).

4. *See* 26 U.S.C. § 2033 ("The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."). Section 2033 is typically understood as requiring inclusion of property that would be included in the decedent's probate estate under state law. *See* Treas. Reg. § 20.2031-1(a)(1) (as amended in 1965) ("Sections 2033 and 2034 are concerned mainly with interests in property passing through the decedent's probate estate. Section 2033 includes in the decedent's gross estate any interest that the decedent has in property at the time of his death.").

5. This article focuses on lifetime transfers of property that have deathtime consequences. In the context of these lifetime transfers, the person transferring property to a trust is characterized as a "transferor" or "grantor." Each such transferor or grantor is ultimately a decedent whose estate is subject to estate taxation on some or all of the property previously transferred during life.

6. These retained interests and powers are colloquially referred to as "strings" because the transfer "comes with strings attached."

including receipt of any income generated by it; determine who, from among a universe of potential beneficiaries, will use or enjoy the property, including receipt of any income generated by it, at what times and in what amounts; or reclaim the property depending upon how future events unfold.[7] The presence of these strings – or, more accurately, the ability to pull them – draws some or all of the encumbered property back into the transferor's gross estate[8] at death for estate tax purposes.[9]

To the surprise of some (and the dismay of others), these lifetime transfers are often deemed sufficiently *complete* to require gift taxation when made but sufficiently *incomplete* to justify additional estate taxation at death – meaning that the same transfer can be viewed quite differently by the two transfer tax systems[10] and subject to taxation under both.[11] The methodology for calculating the estate tax eliminates

---

7. *See* 26 U.S.C. §§ 2036-2038.

8. The gross estate is defined for this purpose as "all property, real or personal, tangible or intangible, wherever situated." 26 U.S.C. § 2031(a).

9. *See* Estate of Farrel v. United States, 553 F.2d 637, 640 (Ct. Cl. 1977) (identifying "Congress' over-all purpose to gather into the estate tax all transfers which remain significantly incomplete – on which the transferor still holds a string – during his lifetime.").

10. A lifetime transfer is deemed "incomplete" for gift tax purposes when the transferor retains dominion and control over the property such that she can change the disposition for her own benefit or for the benefit of others. *See* Treas. Reg. § 25.2511-2(b)-(c) (as amended in 1999). A lifetime transfer is deemed "incomplete" for estate tax purposes when the transferor retains dominion and control over the property such that she can change the disposition for her own benefit or for the benefit of others; when the transferor retains the right to use the property (including the right to vote corporate stock) or to receive the income generated by it; and when the transferor retains a reversionary interest of a particular value and, by virtue of the presence of this reversionary interest, suspends another's enjoyment of the property until her death. *See* 26 U.S.C. §§ 2036-2038. *Cf.* Estate of Sulovich v. Comm'r, 587 F.2d 845, 849 (6th Cir. 1978) ("A literal reading of §§ 2036 and 2038 of the Internal Revenue Code mandates that any property transferred by a decedent be included in his gross estate where the decedent retains any power of control. This principle applies even though the transfer takes the form of an ostensibly completed gift.").

11. The gift tax is an excise tax on the privilege of transferring property during life. *See* Treas. Reg. § 25.2511-2(a) (as amended in 1999). The gift tax is frequently characterized as a backstop for the estate tax and income tax. *See* David D. Joulfaian, *The Federal Gift Tax: History, Law and Economics*, 1 (Office of Tax Analysis, U.S. Dep't of Treasury, Working Paper No. 100, 2007), *available at* http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/ota100.pdf ("It is noteworthy that the gift tax was not enacted for its direct revenue yield. Rather, it was introduced as a protective measure to minimize estate and income tax avoidance."). The gift tax results in "an exaction on lifetime transfers that take property which might otherwise be subject to tax at death, out of the estate." RICHARD B. STEPHENS ET AL., FEDERAL ESTATE & GIFT TAXATION ¶ 9.01, at 9-2 (6th ed. 1991). A determination that a transfer satisfies the requirements of a gift, and is therefore subject to gift taxation, does not insulate the transfer from subsequent estate taxation. *Id.*; *see also* JAMES B. LEWIS, THE ESTATE TAX § 1.6, at 12 (4th ed. 1979) ("Because the two taxes are not uniform in their concepts of what is a completed transfer, a transfer of property during life may be subject to gift tax when made and to estate tax upon the transferor's subsequent death.").

the possibility of "double" taxation, but this begs the question whether there is a simpler way to tax some (or all) of these transfers. Moreover, the portions of the estate tax that draw these lifetime transfers into the gross estate – Sections 2036, 2037 and 2038 of the Internal Revenue Code[12] – do not comprise a coherent scheme for deathtime taxation of earlier transfers that came with strings attached. Instead, they are hastily-drawn, *ad hoc* responses to the perceived shortcomings of judicial decisions construing other portions of the estate tax. As a result, they occasionally apply to the same interest, at the same time, but yield widely disparate tax consequences.[13] Against this backdrop, calls for reform are not surprising (although they rarely agree on the appropriate corrective).[14]

This Article takes a more sanguine approach: it acknowledges the utility of certain portions of these provisions to a functioning transfer tax system, but ultimately concludes that the current statutory scheme is overbroad in reach, clumsy in application, and therefore should be replaced with a single, stand-alone provision. Such a provision would require inclusion of property irrevocably transferred during life in which (a) the transferor retains an economic interest in the property, such as the right to use the property or to receive the income generated by the property, (b) the transferor pays gift tax at the time of transfer on less than the full fair market value of the property and (c) the retained interest does not constitute a "qualified interest," or involve the use of a "personal residence," as those terms are used in Section 2702 of the

12. 26 U.S.C. §§ 2036-2038.

13. *See, e.g.*, Treas. Reg. § 20.2031-1(a)(2) (as amended in 1965) ("It should be noted that there is a considerable overlap in the application of sections 2036 through 2038 with respect to reserved powers, so that transferred property may be includible in the decedent's gross estate in varying degrees under more than one of those sections."). In the event of overlap, the provision that results in the largest inclusion in the gross estate prevails. *See* STEPHENS ET AL., *supra* note 11, ¶ 1.02[2][b], at 1-8.

14. *See generally* ABA Task Force on Federal Wealth Transfer Taxes, *Report on Reform of Federal Wealth Transfer Taxes*, 58 TAX LAW. 93 (2004) (arguing that transferors should be given a choice whether to be taxed under the gift tax system or the estate tax system or, alternatively, treating all such transfers as completed gifts when made and thus subject to gift taxation alone); K. Jay Holdsworth et al., *Report on Transfer Tax Restructuring*, 41 TAX LAW. 395 (1988) (ABA task force recommending repeal of the gift tax as applied to transfers with retained interests, thus delaying taxation until death, on the ground that the standard for determining the "completeness" of a transfer should be the same for gift and estate tax purposes); Dodge, *supra* note 1, at 242-44 (arguing that taxation should be delayed until death so that the value of the transferred property can be accurately measured). *See also* Joseph Isenbergh, *Simplifying Retained Life Interests, Revocable Transfers, and the Marital Deduction*, 51 U. CHI. L. REV. 1 (1984) (arguing that Sections 2036, 2037 and 2038 "are now little more than sources of unnecessary complexity and could therefore be repealed without creating substantial new possibilities of tax avoidance.").

Internal Revenue Code.[15] Put simply, this Article advocates limiting inclusion to lifetime transfers to which Section 2036(a)(1) currently applies *but only* when the transferor values her retained interest at an amount other than zero for purposes of calculating the applicable gift tax *except when* the retained interest can be accurately measured on an actuarial basis.[16]

In addition, this Article advocates, by extension, that lifetime transfers in which the transferor retains control of the beneficial interests of others (such as the ability to designate additional or different beneficiaries or to determine the amounts that each might receive) *but relinquishes all financial advantage for herself* should be treated as completed gifts when made and thus subject only to gift taxation on the fair market value of the property at the time of transfer.[17]

Finally, the Article advocates retention of Section 2037(a), albeit in truncated form and without any threshold requirement regarding the value of the reversionary interest as a condition on inclusion, because the presence of a reversionary interest – however contingent it may be and however *de minimis* its value may seem – prevents the transferor from washing her hands of the property from an economic perspective. In short, this Article advocates retention of Sections 2036(a)(1) and 2037(a), with certain modifications, and repeal of the remainder of

15. Section 2702(a)(1) provides that "[s]olely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor . . . shall be determined as provided in paragraph (2)." 26 U.S.C. §2702(a)(1). Section 2702(a)(2) provides, in turn, that the "value of any retained interest which is not a qualified interest shall be treated as being zero." *Id.* § 2702(a)(2)(A). Section 2702(b) then defines these "qualified interests" as including, among other things, "any interest which consists of the right to receive fixed amounts payable not less frequently than annually" and also "any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust . . . ." *Id.* § 2702(b)(1)-(2). The Treasury Regulations define "personal residence trusts" and "qualified personal residence trusts" as those trusts holding one asset, a residence, that will be used as a personal residence of the individual possessing a term interest; in many circumstances, the transferor herself. *See* Treas. Reg. § 25.2702-5(b)(1), (c)(1) (as amended in 1997).

16. 26 U.S.C. § 2702. These accurately valued interests include, for example, the right to receive, not less frequently than annually, a stated dollar amount or a fixed fraction or percentage of the initial fair market value of the property. *See* Treas. Reg. § 25.2702-3(b)(1)(ii) (as amended in 2003).

17. This latter point is not novel. The Treasury Department recommended treating the retention of the ability to control others' beneficial interests as completed gifts subject to gift taxation, but not estate taxation, thirty years ago. *See* 2 U. S. DEP'T OF TREASURY, REPORT TO THE PRESIDENT: TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 375, 379 (1984), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/tres84v2C19.pdf.

Sections 2036 and 2037 and the entirety of Section 2038.[18]

This approach to transfer taxation is preferable for three primary reasons. First, it promotes simplicity by eliminating three complex, largely-overlapping provisions and replaces them with a stand-alone provision that clearly differentiates between those lifetime transfers subject to estate taxation and those not subject to such taxation. Second, it eliminates estate taxation when it is least justifiable – namely, when the transferor relinquishes direct economic benefit from the property and merely retains a non-beneficial interest to determine who gets what. Third, it creates an incentive for transferors who retain economic interests in property to value the retained interests at zero and pay gift tax on the full fair market value of the entire property. This avoids residual concern about potential additional deathtime taxation; however, in so doing, paying transfer tax much sooner than might otherwise be the case – in essence, obtaining the "quid" of protection against potential additional estate taxation in exchange for the "quo" of greater gift taxation.

This approach departs fundamentally from existing law by treating irrevocable transfers with retained non-beneficial interests as completed gifts when made. This approach reflects a preference for immediate gift taxation because the transfer is irrevocable and the donor can calculate precisely the value of the property. Once Lear irrevocably relinquishes his interest in property – by irrevocably transferring land in trust for the benefit of Cordelia or Goneril or Regan in such amounts as he might later determine but, in all events, to one or more of them at some point – a rule that imposes a wait-and-see approach for transfer tax purposes until Lear actually chooses who gets what seems counterintuitive when the existence and amount of the gift are both known. Current law greatly exaggerates the subjective value of one's ability to control another's beneficial interest in property and then compounds the problem by imposing, at least in some circumstances, estate taxation on the full date of death value of the property to which this power attached.[19]

18. The suggested change would also require a conforming amendment to Section 2035(a) to eliminate the references to these three sections to the extent they are no longer applicable. For an overview of Section 2035 and inclusion within the gross estate of gifts made within three years of death, see Peter S Cremer, *The 1981 Act and Section 2035: Problems and Possibilities*, 35 TAX LAW. 389 (1982), and Jeffrey G. Sherman, *Hairsplitting under I.R.C. Section 2035(D): The Cause and the Cure*, 16 VA. TAX REV. 111 (1996).

19. Early taxation should not impose any undue hardship on taxpayers because individuals, confronted with the impediment of immediate gift taxation, can always structure their giving differently by making periodic gifts directly to beneficiaries rather than lump-sum transfers in trust. Early taxation should not shortchange the public fiscally either. The government will receive tax

This Article consists of two main parts. Part II reviews the history and scope of Sections 2036, 2037 and 2038 of the Internal Revenue Code. This part shows that these provisions are not an integrated whole but rather seriatim responses to judicial decisions about estate taxation with which Congress disagreed. This part contends that Congress' hurried efforts to respond to perceived judicial mistakes resulted in statutory provisions that are difficult to understand and even more difficult to apply. Part III proposes an alternative approach to transfer taxation of retained interests and powers of the type covered by Sections 2036, 2037 and 2038. This part advocates repeal of these provisions and replacement with a stand-alone provision that preserves estate taxation when the transferor retains a financial interest in the property, but values her interest at an amount other than zero for gift tax purposes, except when her interest involves payment of specific amounts, at specific times, or the use of a personal residence. In addition, this part includes suggested text for such a statutory provision, provides commentary regarding various aspects of the suggested provision and explains why this approach is preferable to current law. Lastly, Part IV summarizes these arguments and briefly concludes.

II. SECTIONS 2036, 2037 AND 2038 OF THE INTERNAL REVENUE CODE

A. *Overview of Section 2036*

Section 2036(a) of the Internal Revenue Code[20] traces its origin to the Revenue Act of 1916,[21] which imposed estate taxation on, among other things, lifetime transfers "in contemplation of or intended to take effect in possession or enjoyment at or after [the transferor's] death."[22]

revenue earlier than might otherwise be the case and thereby obtain a present value advantage that does not currently exist and an opportunity to invest the increased revenue in ventures of its own choosing.

20. Section 2036(a) provides: "[t]he value of the gross estate shall include the value of all property to the extent of an 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 – (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." 26 U.S.C. § 2036(a).

21. Revenue Act of 1916, Pub. L. No. 64-271, 39 Stat. 756. The entire estate tax comprised four pages of the statutes at large thus reflecting a simpler (or perhaps more naïve) time. *See id.* at 777-80. For a general overview of the events leading to the original estate tax, as well as the history of estate taxation in America, see LEWIS, *supra* note 11, § 25, at 655-704.

22. Revenue Act of 1916, § 202, 39 Stat. at 777-78. The estate tax expressly applied to transfers in contemplation of death until 1976, at which time Congress replaced a subjective

Facially, this statutory language drew within the decedent's gross estate lifetime transfers in which the transferor retained the right to use the transferred property, to receive any income generated by it, or to control who might obtain these benefits, but in all events passing to someone else upon the transferor's death.[23] The Supreme Court held otherwise in *May v. Heiner*,[24] concluding that deathtime taxation was inappropriate because the transferor's secondary income interest, which had not yet attached, expired at death – meaning that there was no interest that passed at death and thus nothing to tax.[25]

Eleven months later, Congress responded with unusual alacrity, expressing by joint resolution that the phrase "intended to take effect in possession or enjoyment at or after" the transferor's death included "a transfer under which the transferor has retained for his life or for any period not ending before his death (1) the possession or enjoyment of, or the income from, the property or (2) the right to designate the persons who shall possess or enjoy the property or the income therefrom . . ."[26] Congress modified this language several years later, dropping the "in

standard based on the decedent's motive with an objective standard that focused on the time between transfer and death – with the gross estate including transfers occurring within three years of death. *See* STEPHENS ET AL., *supra* note 11, ¶ 1.02[2][b], at 1-4. Congress revised this standard in 1981 by making it applicable only to property that would have been included within the gross estate under Sections 2036, 2037, 2038, or 2042 in the absence of a transfer within three years of death. *See* 26 U.S.C. § 2035(a).

23. This provision was critical to the success of the initial estate tax because, at the time, there was not any gift tax and individuals could avoid deathtime taxation altogether by making lifetime gifts. *See, e.g.*, United States v. Wells, 283 U.S. 102, 116-17 (1931) ("The dominant purpose [of the provision] is to reach substitutes for testamentary disposition and thus to prevent the evasion of the estate tax."). Congress did not establish a gift tax until 1924 (approximately eight years after establishing the estate tax) and then promptly repealed it in 1926 in favor of an additional provision in the estate tax that conclusively presumed transfers made within two years of death were made in contemplation of death and thus subject to estate taxation. In 1932, the Supreme Court held conclusive presumptions unconstitutional as applied in this context, and Congress responded by enacting a gift tax later that year. *See* Heiner v. Donnan, 285 U.S. 312 (1932); Revenue Act of 1932, Pub. L. 72-154, tit. 3, 47 Stat. 169, 245-59.

24. May v. Heiner, 281 U.S. 238 (1930) (trust instrument provided for payment of income to transferor's husband for transferor's life and, should he predecease her, then to her, but in all events, upon her death to her children). "At the death of Mrs. May no interest in the property held under the trust deed passed from her to the living . . . . The interest therein which she possessed immediately prior to her death was obliterated by that event." *Id.* at 243.

25. *Id.* The Supreme Court reasoned that the primary income interest (in favor of the transferor's husband) continued in effect even after the transferor's death and that upon his death the remainder interest (in favor of the transferor's children) would pass to them. As such, there was not any "transfer" of property at the transferor-decedent's death because all such "transfers" either occurred previously or would not occur until later. *Id.* at 243-45.

26. Joint Resolution to Amend Section 302 of the Revenue Act of 1926, H.R.J. Res.529, 71st Cong., 46 Stat. 1516, 1516-17 (1931).

contemplation of death" requirement and fashioning the language into its present form.[27]

Section 2036(a)(1), as presently written, draws into the gross estate property transferred during life in which the transferor retained a beneficial interest in the property – specifically, the right to use or enjoy the property or the right to receive the income generated by it.[28] Section 2036(a)(2), in turn, extends inclusion to those transfers in which the transferor retained control over others' interests in the property – namely, the power to decide, from time to time, who will have the right to use or possess the property or the income from it.[29] Significantly, Section 2036(a)(2) requires inclusion even when the transferor did not retain any direct beneficial interest in the property, meaning that she did not benefit financially following the transfer but merely controlled who would.[30] Section 2036(b), which Congress added many years later in response to another Supreme Court decision,[31] explains that retaining the right to vote the stock of a controlled corporation falls within the statutory definition of the term "retention or enjoyment of transferred property."[32] The ostensible rationale for this later addition is that voting

27. Revenue Act of 1932, § 803(a), 47 Stat. at 279.

28. A frequently used example regarding the scope and application of Section 2036(a)(1) involves an irrevocable transfer of property in trust with income to the transferor for life and the remainder passing to her best friend upon death. The initial transfer is subject to gift tax on the present value of the remainder interest because the decedent relinquished dominion and control as to this interest. Section 2036(a)(1) separately and additionally requires inclusion of the same property in the decedent's gross estate for estate tax purposes, and additional tax will be imposed as may be appropriate. 26 U.S.C. § 2036(a)(1) (2012).

29. *Id.* § 2036(a)(2) ("[t]he value of the gross estate shall include the value of all property to the extent of an 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 . . . (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.").

30. A frequently used example regarding the scope and application of Section 2036(a)(2) involves an irrevocable transfer of property in trust with income payable to a golf or tennis instructor for ten years, as the transferor may choose in her absolute discretion, with the remainder payable at the end of the term to her best friend. The methodology for calculating the amount of the gift for gift tax purposes is simpler, because the present values of the gifts will equal the fair market value of the property. Section 2036(a) requires inclusion of this same property in the decedent's estate for estate tax purposes, and an additional estate tax will be imposed to the extent that the property appreciated in value between the date of the transfer in trust and the date of death. *Id.*

31. *See generally* United States v. Byrum, 408 U.S. 125 (1972) (irrevocable transfer of stock of controlled corporation to trust was not includable in the decedent's gross estate even though he reserved right to vote stock and veto sale or other disposition).

32. Section 2036(b)(1) provides that "the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property." 26 U.S.C. § 2036(b)(1). Section 2036(b)(2) provides, in turn, that "a

rights are "so significant with respect to corporate stock that the retention of voting rights by a donor should be treated as the retention of the enjoyment of the stock for estate tax purposes. Congress believed that this treatment is necessary to prevent avoidance of estate taxes."[33]

Section 2036(a) can have a dramatic impact on the value of the gross estate in those situations to which it applies. In particular, Section 2036(a) pulls into the gross estate the value of the entire property to which the interest attaches (and not simply the value of the interest itself).[34] For example, a seventy-year-old who transfers $1 million of IBM stock to a trust, retaining the right to receive dividend income for life and providing that the remainder will pass to her best friend upon death, will have the entire $1 million of stock included in her estate (assuming market values have not changed during the interim). The same result occurs when the seventy-year-old makes the same transfer, to the same trust, providing for the same remainder interest to her best friend but instead provides that dividend income is payable to the seventy-year-old's neighbor in such amounts as the transferor sees fit to allocate to the neighbor. Section 2036(a) does not differentiate between beneficial and non-beneficial interests and thus draws into the gross estate the value of the property to which either type of interest attaches.[35] Moreover, and perhaps more importantly, the property is valued for estate tax purposes at its date of death value rather than its value at the time of initial transfer in trust.[36] A transferor who transfers IBM stock valued at $1 million to a trust on January 1, 1980, retaining the right to receive dividend income for life but providing that the stock pass to her

corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of Section 318), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock." *Id.* § 2036(b)(2). The reference to Section 318 of the Internal Revenue Code brings within the reach of stock ownership of a corporation, for purposes of Section 2036, any stock owned in the same corporation by certain family members, partnerships, and other controlled corporations. 26 U.S.C. § 318(a).

33. STAFF OF J. COMM. ON TAXATION, 94TH CONG., REP. ON TAX REFORM ACT OF 1976 589 (Comm. Print 1976). The amendment reflects a response to (and rejection of) the *Byrum* decision. *See id.* at 588-89.

34. *See* Estate of D'Ambrosio v. Comm'r, 101 F.3d 309, 312 (3d Cir. 1996) ("Section 2036(a) effectively discourages manipulative transfers of remainder interests which are really testamentary in character by 'pulling back' the full, fee simple value of the transferred property into the gross estate . . . .").

35. *See* 26 U.S.C. § 2036(a).

36. *Id.* § 2031(a) (emphasis added) ("The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value *at the time of his death* of all property, real or personal, tangible or intangible, wherever situated.").

best friend at death, will have stock valued at $11.6 million included in her gross estate were she to die on January 1, 2014, due to the stock's appreciation in value during the interim.[37] (The outcome is different, however, when the interest attaches to only a portion of the property, in which event only that portion of the transferred property is included in the estate.[38] Thus, a retained interest in one-half of the dividend income from the IBM stock would halve the resulting inclusion at death.)

Section 2036(a) is typically justified on the ground that transfers subject to retained interests or powers possess the "look and feel" of testamentary dispositions (indeed, they are frequently characterized as "quasi-testamentary" transfers) because the transferor's relationship to the property is not materially different the day after the transfer than it was the day before.[39] Two leading commentators explain: because "persons of substantial wealth often live on their income and have little need to invade capital, a reserved life estate may preserve the most important aspect of ownership, and a gift of the remainder interest may merely anticipate a disposition that would otherwise have occurred at the decedent's death."[40] They continue, however, explaining that the same

37. The stock prices identified in this example are split adjusted prices at January 1, 1980, and at January 1, 2014. IBM stock prices are available at *Historical Stock Price Lookup*, IBM, http://www.ibm.com/investor/financials/historical-stock-price-lookup.wss (last visited Mar. 29, 2015). Of course, markets do not always rise and sometimes fall precipitously, in which event the lower date of death valuation would be used for purposes of inclusion under Section 2036.

38. *See* Treas. Reg. § 20.2036-1(c)(1)(i) (as amended in 2011) ("If the decedent retained or reserved an interest or right with respect to a part only of the property transferred by him, the amount to be included in his gross estate under section 2036 is only a corresponding proportion of the amount described in the preceding sentence [i.e., the value of the entire property].").

39. *See* Estate of Stewart v. Comm'r, 617 F.3d 148, 152 (2d Cir. 2010) ("Absent § 2036 a decedent could transfer to her heir the remainder in a property while retaining a life estate, and the economic result would be substantially identical to what would have occurred if the decedent had left the property to the heir in her will under an irrevocable contract so to do."); Estate of Abraham v. Comm'r, 408 F.3d 26, 37 (1st Cir. 2005) (quoting United States v. Estate of Grace, 395 U.S. 316, 320 (1969)) ("Section 2036 is designed to capture in the decedent's gross estate 'transfers that are essentially testamentary – i.e., transfers which leave the transferor a significant interest in or control over the property transferred during his lifetime.'"); Estate of Thompson v. Comm'r, 382 F.3d 367, 375 (4th Cir. 2004) ("Section 2036 addresses the concern that inter vivos transfers often function as will substitutes, with the transferor continuing to enjoy the benefits of his property during life, and the beneficiary receiving the property only upon the transferor's death."); Mahoney v. United States, 831 F.2d 641, 647 (6th Cir. 1987) (quoting Helvering v. Hallock, 309 U.S. 106, 112 (1940)) ("[T]he statute operates to tax transfers of property 'that are too much akin to testamentary dispositions not to be subjected to the same excise.'"); Wheeler v. United States, No. SA-94-CA-964, 1996 WL 266420, at *3 (W.D. Tex. Jan. 26 1996), *rev'd*, 116 F.3d 749 (5th Cir. 1997) ("Transfers which leave the transferor a significant interest in or control over the property during his lifetime are essentially testamentary in nature, requiring inclusion of the transferred property in the estate.").

40. BITTKER & LOKKEN, *supra* note 3, ¶ 126.6, at 126-71.

justification extends to retained powers as well:

> In arguing that these transfers perpetuate the substance of ownership for the donor and give the donee only the promise of future enjoyment, tax theorists have usually focused on transfers under which the donor is entitled to get the income personally, but the same rationale can be extended to non-beneficial powers, such as a right to spray the income among persons to be designated by the donor. Even though the donor cannot derive direct economic benefit from a power of this type, the very fact that the transfer was made suggests that the donor has no personal need for the income, and that the power to decide, from time to time, which of the beneficiaries shall get the superfluous income is one of the most pleasurable aspects of "ownership."[41]

These commentators thus emphasize the transferor's continued status in relation to the property, rather than her technical legal status, for purposes of justifying later taxation at death: The transferor may transfer legal title to a trustee, and she may divest herself of "ownership" of the property from the perspective of state law, but (from the outside looking in) her relationship to the property has not meaningfully changed – she continues to receive income from the property, or live on the property, or direct its distribution to others.

Other commentators question the propriety of this rationale when applied to non-beneficial interests (such as the right to determine "who gets what"). They contend that this explanation represents an antiquated vestige of an earlier time when lifetime transfers with retained interests were challenged in probate court on the ground that they were, in fact, testamentary in nature and, as such, lacked the formal requirements under state law for valid deathtime transfers. These commentators explain:

> The explanation that the transfers are testamentary in nature is a reflection of a time when disappointed heirs challenged the validity of certain lifetime transfers on the basis that they ought to be subject to the formalities required for a valid will. [Section 2036 seems] to echo that general sense – that the estate tax should apply to assets that the decedent had retained enjoyment of or control over during life. State law has come a long way toward assuring the validity of lifetime transfers, regardless of their testamentary appearance. This widespread recognition under state laws would seem to weaken the criterion of testamen-

41. *Id.* at 126-72; *see also* Dodge, *supra* note 1, at 314 ("It will also be objected that a retained power to alter beneficial interests is not as 'valuable' as a retained interest. The answer to that, to a person of great wealth who is materially well off, a retained power is likely to be as valuable as a retained interest. If the power were not important, it would not have been retained.").

tary in nature as a rationale for [it].[42]

The justifications for estate taxation of lifetime transfers with retained interests and powers may (or may not) have continuing validity, but they become moot when changes in other areas of transfer taxation provide tools that can be deployed to clear a path toward tax simplicity.[43] Moreover, and perhaps just as importantly, transfer taxation based on the assumed (and presumed) subjective value of the ability to decide "who gets what" lacks intellectual probity in the absence of some objective measure of the actual value to individual transferors.[44]

B. *Overview of Section 2037*

Section 2037 of the Internal Revenue Code[45] traces its origins to the Technical Changes Act of 1949.[46] This statutory provision reflects Congress' response to the Supreme Court's decision in *Spiegel's Estate v. Commissioner*, which again construed the phrase "intended to take effect . . . at death" differently from the way Congress would have preferred.[47] In contrast to the unduly *narrow* construction given this phrase in *May v. Heiner*,[48] the Supreme Court switched gears and – at

42. ABA Task Force on Federal Wealth Transfer Taxes, *supra* note 14, at 227.

43. The principles behind Section 2702 – enacted in 1990 to combat certain estate freeze techniques – can be applied broadly to all forms of retained interests and powers for purposes of creating "rough justice" transfer taxation that taxes irrevocable lifetime transfers once (but only once) under the gift tax (but not the estate tax). *See* 26 U.S.C. § 2702 (2012). This approach concedes additional deathtime taxation on any appreciation in value between transfer and death in exchange for increased, immediate life-time taxation – a concession that may (or may not) be all that great given that the government necessarily benefits on a present value basis due to immediate taxation and the opportunity to invest greater tax revenues in ventures of its own choosing, while the transferor potentially benefits only when the transferred asset appreciates in real terms. *See infra* text accompanying notes 77-83.

44. In fact, aggregate transfer tax increases, assuming a single transfer rather than multiple transfers, insofar as a transferor who makes a lump sum transfer rather than multiple smaller transfers, may limit her ability to claim the annual gift tax exclusion, which is maximized by spreading gifts to a particular donee over a number of years rather than concentrating them in a single year. *See* 26 U.S.C. § 2503(b) ("In the case of gifts (other than gifts of future interest in property) made to any person by the donor during the calendar year, the first [$12,000] of such gifts to such person shall not . . . be included in the total amount of gifts made during such year.").

45. *Id.* § 2037(a) ("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, if (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent and (2) the decedent has retained a reversionary interest in the property . . . , and the value of such reversionary interest immediately before the death of the decedent exceeds 5 percent of the value of such property.").

46. Technical Changes Act of 1949, Pub. L. No. 81-378, § 7, 63 Stat. 891, 894-896.

47. Spiegel's Estate v. Comm'r, 335 U.S. 701 (1949).

48. *See supra* text accompanying notes 25-26.

least from Congress' perspective – gave the phrase an overly *broad* construction when it held that inclusion was required even though the transferor possessed a *de minimis* reversionary interest by operation of state law and not by express reservation in the trust instrument.[49] The estate tax consequence was significant – the reversionary interest possessed an actuarial value of $4,000 (or less than one-half of one percent of the trust corpus) yet caused a net increase in estate tax of more than $450,000.[50]

Congress responded even more swiftly than it did to *May v. Heiner*, amending the statute nine months later to provide for estate taxation of reversionary interests but, with respect to pre-enactment transfers (such as the one involved in *Spiegel's Estate*), only when the interest was expressly retained in the trust instrument and, even then, only when the value of the reversionary interest immediately before the transferor's death exceeded five percent of the value of the trust property.[51] The statute thus reversed the outcome in *Spiegel's Estate*.

Congress took an altogether different tack with respect to post-enactment transfers, however, and imposed inclusion without regard to whether the transferor expressly retained a reversionary interest in the trust property. This is so as long as someone other than the transferor could obtain possession or enjoyment by surviving the transferor or, alternatively, by surviving some specified event and the specified event did not occur during the decedent's lifetime.[52] Congress melded these competing provisions five years later and established a uniform standard for inclusion of property transfers taking effect at death.[53]

49. The trust instrument provided the trust income should be divided among the transferor's three children during his life but, if they predeceased him, then to any of their surviving children. *Spiegel's Estate*, 335 U.S. at 703. The trust instrument also provided that the corpus should be distributed in the same manner at the transferor's death. *Id.* The trust instrument did not provide for the distribution of the corpus in the event the transferor survived his children and grandchildren. *Id.* The failure to provide expressly for this contingency gave rise to a right of reversion under state law and thus estate taxation under federal law. *Id.*

50. *Id.* at 727 (Burton, J., dissenting).

51. Technical Changes Act of 1949, § 7(a), 63 Stat. at 895.

52. *Id.*

53. One commentator explains that the statute "does not restrict the term 'reversionary interest' to its common law meaning. The term includes any possibility that property might return to the decedent or his estate and any possibility that the property might become subject to a power of disposition by him." LEWIS, *supra* note 11, § 7.5.2, at 160; *see also* STEPHENS ET AL., *supra* note 11, ¶ 4.09[4][a], at 4-244 ("[T]his requirement is satisfied by the existence of the possibility; it is not necessary to show the property will return. Even if the possibility ends with the decedent's death, he has retained the requisite interest long enough within the statutory concept."). Section 2037(b) thus provides in pertinent part: "[t]he term 'reversionary interest' includes a possibility that property transferred by the decedent – (1) may return to him or his estate, or (2) may be subject to a

Section 2037, as currently written, requires inclusion only when the value of the reversionary interest immediately before the transferor's death exceeds five percent of the value of the transferred property.[54] The reversionary interest is valued for this purpose by taking into consideration (a) the mathematical chance – based on age – that the transferor will survive the contingency upon which the reversionary interest rests; (b) the fact that the transferor's interest cannot take effect in any event until the contingency is fulfilled; and (c) the value of the transferred property.[55] For example, a sixty-year-old irrevocably transfers IBM stock valued at $1 million to a trust. The trust instrument requires payment of dividend income for life to the transferor's golf instructor, who is twenty-five years old, and then, upon the golf instructor's passing, the stock returns to the transferor if she is living but, if she is not, then to her tennis instructor. The transferor dies four years later. The value of the reversionary interest will be established as of the date of death by first determining the statistical likelihood that the transferor (now age sixty-four) will survive the golf instructor (now age twenty-nine), and then multiplying the resulting percentage by the discounted present value of the stock immediately before death (because the transferor cannot obtain the property until the golf instructor reaches her actuarial death age, hence the need to calculate a present value). The value of the reversionary interest on these extreme facts is probably well below five percent, but it illustrates the purpose of the threshold: to exempt from estate taxation property with very little chance of finding its way back to the transferor and thus, as two commentators colorfully explain, "put an end to a saturnalia of litigation involving alleged or actual reversionary interests of monumental trivia."[56]

Once this threshold requirement is satisfied, the amount included in the gross estate is the value of the interests that are dependent upon surviving the transferor – or, put differently, the value of the property less the value of those interests that are not dependent upon surviving the transferor.[57] Altering the facts slightly, in which the value of the

power of disposition by him, but such term does not include a possibility that income alone from such property may return to him or become subject to a power of disposition by him." 26 U.S.C. § 2037(b) (2012). The breadth of this language is sufficient to justify inclusion, for example, when the putative survivor contracts to bequeath the transferred property back to the original transferor. *See* Estate of Gilbert v. Comm'r, 14 T.C. 349 (1950).

54. 26 U.S.C. § 2037(a)(2).

55. 26 C.F.R. § 20.2031-7(d)(2)(ii) (2014).

56. BITTKER & LOKKEN, *supra* note 3, ¶ 126.7.4, at 126-109.

57. Treas. Reg. § 20.2037-1(b) (1958) ("[T]he value of an interest in transferred property is not included in a decedent's gross estate . . . unless possession or enjoyment of the property

reversionary interest exceeds five percent of the value of the trust property, the amount that would be included in the gross estate would be the value of the IBM stock discounted to present value to reflect the time that the tennis instructor will be expected to wait to obtain possession of the property based on the golf instructor's actuarial death age.

As one might expect, Section 2037 is a moribund provision within the estate tax. A Westlaw search for cases involving Section 2037 since 1949 generated only twenty-one "hits," and of these, only twelve involved any substantive treatment of it.[58] Consistent with this, two commentators explain that Section 2037 "has probably functioned primarily as a trap for the unwary because the reversionary interests that bring it into force are usually retained more by mistake than by design."[59] The lack of significance may be a function of its origin: as a hastily-drawn response to an improvident judicial decision, Section 2037 provided little more than immediate relief to the losing party in a single case. Its presence in the estate tax is thus more a matter of historical accident than principled draftsmanship.

The status of Section 2037 as a separate provision, rather than part of Section 2036, is difficult to justify. To be sure, the two sections focus on different retained interests: the former involves future contingent interests while the latter involves present possessory interests.[60] They also impact estate valuation differently: the former draws into the gross estate the value of the individual interest that is contingent on surviving the transferor while the latter draws in the value of the entire property to which the interest attaches.[61] These differences – however important they may be from a substantive or economic perspective – are relatively modest from the perspective of drafting technique. Indeed, one cannot imagine a legislator, who is drafting on a clean slate, concluding that the statute dealing with the beneficial interests covered by these two sections should do so separately rather than uniformly. To the contrary, one would expect the legislator to recognize the similarity between the retained interests covered and meld and harmonize them into a single provision.

---

could . . . have been obtained . . . by any beneficiary either by surviving the decedent or through the occurrence of some other event such as the expiration of a term of years.").

58. The terms and connectors search that generated these results was "(26 /5 2037!) & 'estate tax'"; the database was "all federal courts." The "hits" determination involved mere verification that the statutory provision was cited in a case; the "substantive application" determination required some indication that the court relied upon the provision in resolving at least one issue in the case.

59. BITTKER & LOKKEN, *supra* note 3, ¶ 126.7.1, at 126-104.

60. 26 U.S.C. §§ 2036-2037 (2012).

61. *Id.*

Nor would one expect a threshold valuation requirement in one but not the other. The two sections apply to retained interests that the transferor expressly included in the trust instrument. As such, it is difficult to understand why one of the transferors would receive differential (and preferential) treatment for purposes of estate valuation on the apparent assumption that retained reversionary interests of modest value should not result in dramatic economic consequences to the estate when retained powers can result in such consequences. The two cannot be harmonized on this point in any meaningful fashion – both should have the same valuation threshold or neither should have any threshold. These provisions may or may not have continued utility, either in whole or in part, but at a minimum those portions that are retained should be included in a single statutory provision.

C. Overview of Section 2038

Section 2038 of the Internal Revenue Code[62] traces its origin to Section 202(d) of the Revenue Act of 1924.[63] This provision drew into the gross estate property transferred by the decedent under circumstances in which the transferee's "enjoyment thereof was subject at the date of [the decedent's] death to any change through the exercise of a power, either alone or in conjunction with any person, to alter, amend or revoke, or where decedent relinquished any such power in contemplation of his death."[64] Congress later amended this statutory language in response to *White v. Poor* in which the Supreme Court held that a power to alter, amend, modify or revoke must be retained expressly by the transferor and not conferred upon her by another.[65] The Court also raised, but did not decide, whether a power to "terminate" a

62. *Id.* § 2038(a)(1) ("The value of the gross estate shall include the value of all property . . . [t]o the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.").

63. Revenue Act of 1924, Pub. L. 68-176, § 202(d), 43 Stat. 253, 304. Section 202(d) provided in full: "To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power in contemplation of his death, except in case of a bona fide sale for a fair consideration in money or money's worth." *Id.*

64. *Id.*

65. White v. Poor, 296 U.S. 98 (1935).

trust was among the powers to which the statute applied.[66] Congress promptly added an express reference to the power to "terminate" a trust and also added language making clear that inclusion was necessary when the transferor transferred property and later acquired from another a power to alter, amend, modify, revoke or terminate.[67]

Section 2038, like Section 2036, is based on the notion that a power to control another's interest in property is a significant attribute of ownership and should therefore be taxed as such at death. The Senate Finance Committee explained:

> If the decedent had the power at the time of his death to change the enjoyment of a property interest, which he had transferred, or with respect to which he had created a trust, such interest is to be included for estate tax purposes in his gross estate. . . . Even though the decedent has made the transfers specified in this subdivision, he has retained substantial control over the disposition of the property through the power to change the enjoyment thereof. Such property interests should therefore fairly be taxed as part of the decedent's estate, particularly since, by virtue of his death, the substantial interest which he had has been wiped out, and to the same extent the property interest of the legal title holder, his transferee, has been increased. This provision is in accord with the principle which taxes to the grantor the income of a revocable trust.[68]

Given the similarity of purpose, it is not surprising that Section 2038 and Section 2036 overlap to a great extent.

The similarities (and differences) between the two can be subtle. On the one hand, both apply to powers or controls over other people's beneficial interests; they apply to powers and controls that exist at death without regard to whether any were exercised during life; and they require inclusion even when the power cannot be exercised unilaterally but only in conjunction with another. On the other hand, Section 2038 applies exclusively to reserved powers over remainder interests (such as the power to change the identities or relative shares of remaindermen),[69]

66. *Id.* at 101.

67. Revenue Act of 1936, Pub. L. No. 74-740, § 805(a), 49 Stat. 1648, 1744-45.

68. S. REP. NO. 68-398, at 34-35 (1924).

69. *See* Estate of Bowgren v. Comm'r, 105 F.3d 1156, 1160 (7th Cir. 1997) ("Section 2038(a)(1) requires inclusion of the value of the property transferred in trust in the settlor's gross estate if, at the time of his death, the settlor retains the discretionary power to terminate the trust. The settlor's power to terminate the beneficiaries' rights to enjoyment of the trust is a power to 'alter, amend, revoke or terminate' for purposes of I.R.C. § 2038(a)(1)."); Kisling v. Comm'r, 32 F.3d 1222, 1225 (8th Cir. 1994) ("Under Section 2038, transfers made during the life of the decedent are includable in the gross estate if enjoyment of the transferred property is limited or

while Section 2036 applies exclusively to retained powers over present interests measured in relation to the transferor's life (such as the retained power, for life, to change the identities or relative shares of those who may use or enjoy trust property).[70]

The subtle differences between these provisions are especially manifest with respect to the amounts drawn into the gross estate when both are applicable. Section 2036 draws into the gross estate the value of the property to which the interest attaches[71] (typically, the entirety of the property unless the interest attaches to a smaller portion of the property), while Section 2038 draws into the gross estate the value of the interest that is subject to alteration, amendment, modification, revocation or termination.[72] This seemingly modest difference can have enormous financial consequences. For example, suppose transferor transfers $1 million of IBM stock to a trust. The trust instrument provides that dividend income will be paid to transferor's golf instructor for the duration of transferor's life; that the stock will pass to transferor's tennis instructor upon transferor's death; and that transferor retains the right to name additional or different beneficiaries with respect to dividend income. Section 2036(a)(2) and Section 2038 apply to the transfer but they diverge quite dramatically on the transferor's death because the former causes inclusion of the date of death value *of the entire property* (because the decedent's power attached to the entirety of the property) while the latter does not cause any inclusion (because the interest to which the power attached, the golf instructor's income interest, extinguished along with the transferor's life).

The outcome flips when the facts change only slightly. Transferor again transfers $1 million of IBM stock to a trust. The trust instrument again provides that dividend income will be paid to transferor's golf instructor for the duration of transferor's life; that the stock will pass to transferor's tennis instructor upon transferor's death; and that transferor reserves the right to name additional or different remaindermen. In this changed scenario in which the reserved power attaches to the remainder interest rather than a present interest, Section 2036(a)(2) does not apply

subject to change, because the decedent retained power to alter, amend, revoke, or terminate the transfer or relinquished that power within three years of her death - even if the decedent does not exercise those powers.").

70. Section 2038 also applies in the unique situation in which the transferor divests herself of every power or control over the property but then reacquires one of these powers through some twist of fate (such as an appointment to serve as trustee). As noted above, Congress specifically intended inclusion in this circumstance, however rare it may be.

71. 26 U.S.C. § 2036(a) (2012).

72. *Id.* § 2038(a).

(because it concerns retained powers over present possessory interests alone), while Section 2038 draws into the gross estate the entire property (because the transferor-decedent held a power at death that could affect the remainder interest, which at death is valued at the property's entire value).[73]

The justification for two provisions that apply to retained powers appears to be lost in history. The legislative record is unclear, and one is hard-pressed to discern why a rational legislator would proceed in this fashion. One possibility is that adding new provisions, to confront new situations as they arise, is easier than continuing to reflect upon existing law and then modifying that law in relation to the new and unanticipated exigencies. Another possibility is that new and additional provisions, while leaving existing provisions intact, provide better protection against evasive tax strategies than reworking existing law which, in so doing, might unwittingly open other avenues for avoidance. A third possibility is that repeated overhauls of existing law creates uncertainty about existing estate planning strategies and that this will be unnecessarily expensive as those earlier strategies must be evaluated for continued compliance.

Nonetheless, the combination of overlap between Sections 2036 and 2037 on the one hand, as well as the overlap between Sections 2036 and 2038 on the other, strongly suggests that legislative reform should be pursued to provide a single set of governing rules applicable to lifetime transfers with retained interests and controls that can be easily understood and readily applied and, just as importantly, make sense in relation to one another. The policy of protecting expectations is uniquely important in this area given that individuals must frequently make choices about lifetime and deathtime giving long before the event that precipitates the gift. This might suggest that some amount of untidiness in drafting technique or organizational form must be accepted because change (even positive change for purposes of good order) is preferable to imposing substantial costs on taxpayers who must then confirm that their prior decisions about giving remain valid and not subject to

73. This situation is more complicated when the duration of the trust is measured by a term of years or by the life of someone other than the transferor. For example, transferor transfers $1 million of IBM stock in trust. The trust instrument provides that dividend income is payable to her golf instructor for the duration of her husband's life, with the stock passing upon husband's death to transferor's tennis instructor. Transferor retains the ability to name new or additional dividend income beneficiaries. In this changed scenario, Section 2036 applies and draws into the gross estate the value of the entire property (because this is the value of the property to which the interest attached); Section 2038 also applies and draws into the gross estate the value of the income interest alone (because this is the interest that is subject to the retained interest).

Reiber: Untangling the Strings

differing tax outcomes.

Any reform effort must therefore be sensitive to existing expectations and draft with an eye toward retaining those portions of the statutory scheme that work well while simultaneously jettisoning those that are unnecessary and redundant. The present environment presents such an opportunity to evaluate the continued need for three separate provisions that, to varying degrees, address the same problems as the other two: the gift tax and estate tax are largely unified,[74] the same rate structure applies to transfers during life and at death, and the tax ultimately applies to cumulative transfers whether made during life or at death. The time is therefore ripe for reform.

III. A SIMPLE RULE FOR TAXATION OF RETAINED INTERESTS

Sections 2036, 2037 and 2038 of the Internal Revenue Code are "quick fixes" to perceived mistakes by the judiciary when construing and applying the original estate tax.[75] It is not surprising, therefore, that the resulting statutory language – drawn and re-drawn in response to the judicial decision *du jour*[76] – does not constitute an integrated whole. To ameliorate this situation, and to provide sensible, easy to follow rules, the statutory reform recommended in this Article retains the best of these provisions while jettisoning those portions that are duplicative or unnecessary. Section A introduces the proposed statutory reform and identifies the policy justifications upon which the proposal rests. Section B next discusses the scope of property included in the gross estate under the proposed statutory reform. Section C then identifies three exceptions from inclusion in the gross estate: (1) qualified interests; (2) qualified personal residence trusts; and (3) optional valuation for gift tax purposes.

74. The estate and gift taxes are not fully "integrated," and lifetime transfers have some advantages over deathtime transfers. For example, an individual can gift $14,000 to as many different people as she wants without incurring any gift tax on any or all of the transfers. 26 U.S.C. § 2503(b)(1). Moreover, lifetime giving is taxed on a tax exclusive basis, whereas deathtime giving is taxed on a tax inclusive basis – meaning that the gift tax is calculated solely in reference to the gift itself, whereas the estate tax is calculated on the gift plus the amount necessary to pay the tax on the gift. Assume taxpayer has $1.5 million to give away, either during life or at death, in an environment in which gift and estate taxation is at a flat 50% rate. If taxpayer makes a lifetime gift, she can give $1 million and use the remaining $500,000 to pay gift tax. If, in contrast, taxpayer makes a deathtime gift, she can only give $750,000 because she will need the same amount to pay estate tax.

75. *See supra* Part II.

76. May v. Heiner, 281 U.S. 238 (1930); Spiegel's Estate v. Comm'r, 335 U.S. 701 (1949); White v. Poor, 296 U.S. 98 (1935).

A. Suggested Statutory Reform

The statutory reform recommended in this Article rests on two assumptions. First, estate taxation of retained interests is justified when the transferor retains a beneficial interest in the transferred property – namely, one that puts money in her pocket directly (such as the right to receive income from trust property) or indirectly (such as the right to use the trust property). In this circumstance, the imposition of estate taxation seems fair and reasonable. Second, estate taxation of retained controls is not justified when the transferor-decedent retains control over others' beneficial interests in trust property but washes her hands of the ability to reclaim the property for her own use or possession. The retention of the ability to choose who gets what may appear to some as "one of the most pleasurable aspects of ownership" (a proposition that is not self-evident), but it does not follow that estate taxation is justified.[77] In this circumstance, the imposition of estate taxation seems unfair and unreasonable because there is no relationship (whether logical or otherwise) between the value of the property drawn into the gross estate – in some instances the full fair market value of the entire property – and the actual subjective value of the power to the transferor-decedent.[78]

Consistent with these assumptions, this Article recommends replacing Sections 2036, 2037 and 2038 with a stand-alone provision that melds Section 2036(a)(1) and Section 2037(a) and imposes transfer tax obligations at the time of the transfer and/or at the time of death depending upon (a) the nature of the retained beneficial interest and (b) the base against which gift tax was imposed at the time of the initial transfer. In particular, a transferor who retains a "qualified interest" or who transfers a personal residence in trust would pay gift tax on the remainder interest using traditional valuation principles based on the actuarial tables contained in the Treasury Regulations.[79] A transferor who proceeds in this fashion would insulate her estate from potential additional estate taxation at death. In addition, a transferor who retains

77. The rationale may be that additional taxation at death is justified because subsequent appreciation in value provided the transferor with the ability to direct the distribution of a larger amount of property. But, if true, then one could credibly argue that the transferor should receive a deathtime refund of some portion of the previously paid gift tax because there was less for her to spread around due to a subsequent decline in value.

78. A change along these lines would not require any additional statutory language and could be implemented simply by adding an additional paragraph in the existing gift tax regulations making clear that a completed gift exists when the transferor *irrevocably* transfers property in trust, *even though* she retains a power or control over subsequent distributions to others, *so long as* she fully and finally disclaims any actual or potential economic benefit from the property.

79. *See* Treas. Reg. § 20.2031-7 (as amended in 2011).

any other beneficial interest (other than a reversionary interest) would be permitted to insulate her estate from additional taxation following death by paying gift tax at the time of the transfer on the full fair market value of the transferred property. A transferor who proceeds in either of these fashions would pay gift tax but not estate tax. Conversely, a transferor who does not proceed in either of these fashions would remain subject to the possibility of additional estate taxation upon death, and by extension, a transferor who retains a reversionary interest of any kind that is then followed by a possessory interest in favor of another would be ineligible for this sort of estate tax "insurance" and would pay transfer tax at the time of the initial transfer and then again at the time of death.

The suggested text for a statutory provision that would accomplish these goals is as follows:

> (a) The value of the gross estate shall include the value of any property irrevocably transferred by the decedent prior to death, whether by trust or otherwise, in which the decedent retained an interest for her life, or for any period not ascertainable without reference to her death, or for any period that does not in fact end before the decedent's death, that (1) allows her to use or possess the transferred property or (2) allows her to receive the income from the transferred property. This section shall not apply to any retained interest that satisfies the definition of a "qualified interest" in Section 2702(b), to any retained interest in a "personal residence" of the type described in Section 2702(a)(3)(A)(ii), or to any retained interest that is valued at zero for purposes of determining the amount of tax payable under Chapter 12 of this subtitle.
>
> (b) 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, in which (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent and (2) the decedent expressly retained a reversionary interest in the property. Notwithstanding the foregoing, an interest so transferred shall not be included in the decedent's gross estate under this section if possession or enjoyment of the property could have been obtained by any beneficiary during the decedent's life through the exercise of a general power of appointment (as defined in Section 2041) which in fact was exercisable immediately before the decedent's death.

This suggested text resembles Sections 2036(a)(1) and 2037(a) (and, in fact, retains the entirety of Section 2037(a) except for the limitation on inclusion for modestly-sized reversionary interests), but there are several differences from the existing statutory text that do not fall under the rubric of "word-smithing" and therefore require explanation.[80]

B. *Scope of Potential Inclusion for Estate Taxation*

The suggested text draws within the gross estate the date of death value[81] of property irrevocably transferred in trust under circumstances in which the transferor retained a beneficial interest in the property. The suggested text thus operates like the current version of Section 2036(a)(1).[82] If a retained beneficial interest attaches to the property, then the entire date of death value of the property is drawn back into the gross estate for estate tax purposes.[83]

The suggested text also retains Section 2037(a) in its current form but eliminates the threshold valuation requirement for retained reversionary interests.[84] The suggested text eliminates this threshold valuation requirement for two reasons. First, this threshold valuation requirement cannot be squared with the absence of any similar valuation

80. The existing parenthetical in Section 2036(a)(1), exempting transfers involving "a bona fide sale for an adequate and full consideration in money or money's worth," is eliminated because the principle is already covered in Section 2043(a). *See* 26 U.S.C. § 2043(a) (2012) ("If any of the transfers, trusts, interests, rights, or powers enumerated and described in sections 2035 to 2038, inclusive, and section 2041 is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.").

81. An express reference to the valuation date is unnecessary because that is already provided in the statute. *See id.* § 2031(a) ("The value of the gross estate of the decedent shall be determined by including . . . the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."). An alternate valuation date can be elected in limited circumstances. *See id.* § 2032(a) ("The value of the gross estate may be determined, if the executor so elects, by valuing all the property included in the gross estate as follows: (1) In the case of property distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date of distribution, sale, exchange, or other disposition. (2) In the case of property not distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date 6 months after the decedent's death.").

82. The current regulations make clear that the amount included in the gross estate will be reduced when the scope of the property to which the interest attached is less than the entirety of the transfer (such as a retained interest in one-half of the dividend income from stock held in trust). *See, e.g.*, Treas. Reg. § 20.2036-1(a) (as amended in 2011). The suggested statutory provision would apply to proportionate interests in the same fashion.

83. The amount actually included, however, may be affected by the exemptions to inclusion provided in the suggested text (as described in Part III.A, *supra*): specifically, exclusion from estate taxation when the transferor retains a qualified interest or places a residence in trust and values the remainder interest for gift tax purposes consistently with the methodology described in Section 7520 or, alternatively, values the retained interest at zero for purposes of calculating the value of the remainder for gift tax purposes.

84. *See supra* Part III.A.

requirement in other situations involving retained interests. Congress plainly was troubled by the outcome in *Spiegel's Estate*[85] (a case that purported to require inclusion of a significant amount for estate tax purposes notwithstanding the *de minimis* nature of the reversionary interest and the absence of any affirmative step on Mr. Spiegel's part to retain such an interest). Congress responded by establishing a threshold valuation requirement in which the transferred property would not be included in the gross estate unless the value of the reversionary interest, immediately before the transferor's death, exceeded five percent of the value of the property.[86] A valuation threshold of this sort may (or may not) be appropriate – but it certainly cannot be justified in one context when other retained interests, in other contexts, are not treated similarly.

Second, the threshold valuation requirement provides relief in some circumstances in which none is justified because it applies indiscriminately to all situations in which the transferor retains a reversionary interest and another person takes in the event the transferor predeceases the event upon which the interest is contingent. These situations include the one confronted in *Spiegel's Estate* in which the transferor did not expressly retain a reversionary interest but one was imposed under state law.[87] They also include the situation in which the transferor expressly retained such an interest. Relief may be justified in the former on fairness grounds but cannot be justified in the latter on any ground. Mr. Spiegel's estate was required to pay estate tax on the value of the previously transferred property because of a quirk in state law and not because of anything Mr. Spiegel affirmatively chose to do. In fact, Mr. Spiegel presumably did not want any such interest given that he did not retain one expressly. In contrast, a transferor who expressly retains a contingent reversionary interest in the trust instrument should not receive a "pass" from estate taxation simply because the actuarial value of the interest is small.[88] The absence of differential estate tax treatment

85. Spiegel's Estate v. Comm'r, 335 U.S. 701 (1949).

86. 26 U.S.C. § 2037(a)(2).

87. *Spiegel's Estate*, 335 U.S. 701.

88. This departure from existing law would probably not impose any meaningful burden given the moribund state of Section 2037. *See supra* text accompanying notes 59-62. And, of course, protection can be provided to existing estate plans by making any such change applicable only to transfers that post-date enactment, as has been done in a variety of provisions in the estate tax. *See, e.g.*, 26 U.S.C. § 2036(c) ("This section shall not apply to a transfer made before March 4, 1931; nor to a transfer made after March 3, 1931, and before June 7, 1932 . . . ."); *id.* § 2038(a)(1)-(2) (differential treatment for inclusion within gross estate due to the presence of certain retained powers when transfer occurs before or after June 22, 1936); *id.* § 2039 (annuity contracts included in gross estate in certain circumstances but only so long as they were entered in to after March 3, 1931); *id.* § 2041 (differential treatment for inclusion within gross estate when creation of general

in these radically different circumstances cannot be justified on any principled basis. As such, the suggested text eliminates this threshold valuation issue.[89]

C. *Suggested Exceptions to Inclusion from Gross Estate and Estate Taxation*

The suggested text provides three exceptions to inclusion in the gross estate (and thus from estate taxation) even when the transferor retains a beneficial interest in the transferred property. The exceptions are based on the principles underlying Section 2702 and involve situations in which a transferor can avoid estate taxation by (a) retaining particular kinds of beneficial interests that can be valued accurately using traditional valuation techniques based on the transferor's life expectancy or, in other circumstances, by (b) valuing the retained interest at zero for purposes of determining the amount of her gift to the remaindermen).[90]

In 1990, Congress enacted Section 2702 in response to certain estate freeze techniques that allowed individuals to transfer property to

---

power of appointment occurred before or after October 21, 1942).

89. Transferors in Mr. Spiegel's situation would be protected under the suggested text because inclusion occurs only when the transferor expressly retains a contingent reversionary interest and provides for the property to pass to another in the event he does not survive the occurrence of the contingency. Mr. Spiegel's estate would thus be spared from inclusion because he did not expressly retain any reversionary interest and, instead, one was imposed as a matter of state law. *See Spiegel's Estate*, 335 U.S. at 703-04.

90. The "premium" paid by the transferor for this "insurance" against estate taxation will frequently result in the government receiving larger payments sooner than would otherwise be the case. It may also, on a present value basis, result in the government receiving greater aggregate transfer tax payments than would have been the case if it received some amount of gift tax at the time of transfer and some additional amount of estate tax following the transferor's death. The present system imposes immediate gift taxation on the full value of the remainder interest when the transferor and remainderman are members of the same family while reserving the potential for additional estate taxation should the value of the property increase between the date of the gift and the date of death. This, of course, assumes that the property appreciates in value and that the rate of appreciation exceeds 120% of the federal mid-term rate, the default discount rate for valuing retained fixed payment income interests under Section 2702. 26 U.S.C. § 2702(a)(2)(b); *see also id.* § 7502(a)(2). In the absence of such appreciation, the government will, at a minimum, break even from a revenue perspective on a present value basis.

Beyond this, Section 2702 principles should be extended to other situations in which the transferor retains a beneficial interest in trust property. Congress attempted to limit estate freeze opportunities when it enacted this section and, by virtue of its application in the family setting alone, presumably believed that the motivation for mischief and evasion existed among family members. As society changes, however, the concept of traditional families changes with it, and there is not any reason to believe that similar motivations may not exist between individuals in non-traditional settings. As a result, Section 2702 principles should be extended beyond their current reach as suggested in the reform proposal outlined in this Article.

subsequent generations in such a way that the property would be valued at an artificially low level for transfer tax purposes. This created the possibility that some of the existing value of the property would never be taxed, and any subsequent appreciation would also escape taxation.[91] Congress responded by legislatively valuing retained interests at zero in the family context, thus meaning that the transferor would pay gift tax on the full value of the property at the time of the transfer.[92] Section 2702 includes certain exceptions. One permits transferors to value retained beneficial interests using traditional valuation tools (and thus pay gift tax on a lower-valued remainder interest) when the transferor retains a "qualified interest" – defined in Section 2702 as an interest in which the transferor will receive an income distribution, at least annually, on a fixed, previously determined amount or a fixed percentage of the value of the property in trust. Another permits transferors to value their retained interests using traditional techniques when they transfer homes to a trust and continue to reside in them.[93] Section 2702 principles, along with its exceptions, can be extended to retained beneficial interests arising out of all irrevocable transfers and, as a result, can lead to a fairly simple and efficient transfer tax regime.[94]

1. Qualified Interests

The suggested text exempts from deathtime taxation any portion of property transferred during life in which the transferor retained a beneficial interest that constitutes a "qualified interest" under Section 2702.[95] These are interests in which the transferor-decedent receives a

91. One method used frequently in the retained interest context involved transfers of growth ostensibly with income payable to the transferor and the remainder payable to another. The remainder interest was valued for gift tax purposes by reducing the value of the property by the present value of the retained interest, taking into consideration the transferor's age and life expectancy, and applying a discount rate based on 120% of the federal mid-term rate. This method of valuation resulted in undervaluation of the retained interest (and thus payment of less gift tax) because of the assumption the transferor would receive income from the property, something that was obviously not intended or likely given the transfer of growth stock to the trust.

92. 26 U.S.C. § 2702(2)(A).

93. Congress imposed these valuation rules when the transferor and remainderman were members of the same family; meaning, a transferor who retains an interest but ultimately intends to benefit a non-family member at death may continue to value her interest using traditional methods and pay the applicable gift tax based on the present value of the remainder interest.

94. A transferor who chose not to "purchase" insurance by valuing her interest at zero for purposes of valuing the remainder for gift tax purposes, and who did not retain a qualified interest, would subject her estate to taxation on the appreciated value of the property during the interim between initial transfer and death. This outcome is identical to that which obtains under current law with respect to transfers with retained interests.

95. The term "qualified interest" is defined as "(1) any interest which consists of the right to

fixed amount each year or a fixed percentage of the property's fair market value as calculated each year. Congress determined that traditional valuation methods generate reasonably accurate values in this context and reduce (if not eliminate) the sort of manipulations that underlie the estate freeze.[96] Congress' recognition of the propriety of valuing retained interests of fixed amounts or fixed percentages of an established amount in the family context[97] implies that the same approach can be used effectively outside the family context. A transferor who retains one of these qualified interests would insulate her estate from additional deathtime taxation even when the underlying property continues to appreciate in value.

2. Personal Residence Trusts and Qualified Personal Residence Trusts

The suggested text also exempts from deathtime taxation lifetime transfers in trust of a personal residence in which the transferor retains the right to continue living there.[98] A transferor in this circumstance will pay gift tax on the remainder interest, which will be calculated at the

receive fixed amounts payable not less frequently than annually, (2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and (3) any noncontingent remainder interest if all of the other interests in the trust consist of interests described in paragraph (1) or (2)." 26 U.S.C. § 2702(b)(1)-(3).

96. The ordinary methodology for valuing interest is described in Section 7520, which provides that these interests "shall be determined (1) under tables prescribed by the Secretary, and (2) by using an interest rate (rounded to the nearest 2/10ths of 1 percent) equal to 120 percent of the Federal midterm rate in effect under section 1274(d)(1) for the month in which the valuation date falls." *Id.* § 7520(a). The actuarial tables to which Section 7520 refers can be located at Treas. Reg. § 20.2031-7 (as amended in 2011).

97. Congress promulgated Section 2702 to combat estate freeze techniques in the family context and expressly provided that the valuation rules described in the provision were applicable only when the transferor made a transfer in trust for the benefit of a member of her family and she retained for herself an interest in the trust. *See* 26 U.S.C. § 2702(a)(1) ("Solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member (as described in section 2701(e)(2)) shall be determined as provided in paragraph (2)."). Section 2701(e)(2), in turn, defines the term "member of the family" as the transferor's spouse, a lineal descendent of the transferor or the transferor's spouse, and the spouse of any such descendent. *See id.* § 2701(e)(1)(A)-(C).

98. The Treasury Regulations explain that these trusts can take two different forms: the personal residence trust and the qualified personal residence trust. *See* Treas. Reg. § 25.2702-5(b)-(c) (as amended in 1997). The two trusts are largely indistinguishable, although the latter provides greater flexibility than the former because the trust can hold money that can be used to maintain the residence. For a general overview of these two types of trusts, see BITTKER & LOKKEN, *supra* note 3, ¶ 136.4.6, at 136-62.

house's fair market value less the actuarial value of the retained interest. Congress again determined that this was an appropriate method for valuing trust property comprised of a personal residence and, as a result, that determination should be extended to all other similar situations. A transferor who places her home in a trust, and retains the ability to live in it, would insulate her estate from additional deathtime taxation.

3. Optional Valuation for Gift Tax Purposes

The suggested text also exempts from deathtime taxation lifetime transfers in which the transferor retains a beneficial interest but values that interest at zero – meaning that she pays gift tax on the full fair market value of the property at the time of the transfer. Having valued her retained interest at zero for gift tax purposes, her estate would be protected from subsequent deathtime taxation. In contrast, her estate would be subject to potential additional estate taxation if she valued her interest at an amount other than zero for purposes of calculating gift tax on the remainder interest. This portion of the proposal possesses the salutary benefit of simplicity without necessarily providing transferors or their estates with a windfall – indeed, a choice either way in situations in which a choice is available may (or may) not prove financially beneficial to the transferor, to her estate or to the government depending upon how subsequent events unfold.

IV. CONCLUSION

The current statutory scheme for gift and estate taxation of retained interests and powers is confused and confusing. The existing statutory provisions that apply to such interests and powers are the result of hurried, legislative efforts to respond to judicial decisions with which it disagreed. As a result, the existing statutory scheme represents seriatim fixes rather than a comprehensive solution. To ameliorate this situation, the estate tax can be (and should be) amended to provide a single, stand-alone provision that covers all such interests and powers and that provides a simple, straight-forward approach to transfer taxation. Such a provision should impose gift taxation on the full value of the transferred property when the transferor retains a non-beneficial interest in the property and when the transferor retains a beneficial interest but values that interest at zero for gift tax purposes. This single reform would establish a coherent, easy to administer scheme for transfer taxation in this context.