FLORIDA TAX REVIEW

VOLUME 2 | 1994 | NUMBER 3

Rethinking Section 2702

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I. INTRODUCTION

In 1990, Congress added chapter 14 to the Code[1] to address several gift and estate tax avoidance techniques that flourished under prior law.[2] In general, those avoidance techniques involved fragmenting beneficial ownership into separate interests to facilitate transferring the underlying property in several stages. A donor utilizing one of these techniques initially transferred one interest while retaining another interest in the same property. Eventually, the interest retained in the initial transfer lapsed or was disposed of in a subsequent transfer. Especially where the underlying property was held in a closely-held business entity or family trust, the respective interests could be tailored to shift value from donor to donee in ways that proved extremely difficult to detect or measure.[3] Chapter 14 responds by adopting special valuation rules for certain types of transactions to ensure that such value shifts are included in the transfer tax base.[4]

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1. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388, 1388-491 (codified at IRC §§ 2701-2704).

2. In enacting chapter 14, Congress retroactively repealed its earlier, ill-fated attempt to deal with the same techniques under former § 2036(c). Omnibus Budget Reconciliation Act of 1990, supra note 1, § 11601, 104 Stat. at 1388-490. Section 2036(c) was enacted by the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10402, 101 Stat. 1330, 1330-430, and amended by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 3031, 102 Stat. 3342, 3634.

3. For overviews of estate freezing techniques under prior law, see Staff of Joint Comm. on Taxation, 101st Cong., 2d Sess., Present Law and Proposals Relating to Federal Transfer Tax Consequences of Estate Freezes (Comm. Print 1990); George Cooper, A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance, 77 Colum. L. Rev. 161 (1977); Symposium, The Estate Freezing Rage: A Practical Look at Planning Opportunities and Potential Problems, 15 Real Prop., Prob. & Tr. J. 21 (1980); see also Byrle M. Abbin, The Value-Capping Cafeteria—Selecting the Appropriate Freeze Technique, 15 Inst. on Est. Plan. ch. 20 (1981).

4. See IRC §§ 2701 (gift of subordinate equity interest in corporation or partnership), 2702 (gift of split interest in property), 2703 (restrictions on use or disposition of

Section 2702 of the Code applies to split-interest arrangements involving successive beneficial interests representing present and future rights to possess or enjoy the underlying property. When a donor transfers one interest to a family member while retaining another interest, the special valuation rules of section 2702 assign a value of zero to the retained interest unless it meets various statutory requirements. Since the value of the transferred interest is determined by subtracting the value of the retained interest from the value of the underlying property, section 2702 produces a correspondingly high value for the transferred interest, which is reflected in the donor's gift tax base.

For example, a parent who gratuitously transfers a remainder to a child while retaining an income interest for a limited term makes a completed gift of only the remainder. If the special valuation rules assign a zero value to the income interest, the donor makes a taxable gift of the full value of the underlying property. If the parent subsequently disposes of the retained interest in a transfer that attracts a gift or estate tax, a problem of double taxation may arise. The section 2702 regulations address this problem by providing a corrective adjustment at the time of the subsequent transfer.

This article examines the structure and operation of section 2702 in the context of the existing gift and estate tax system. Part II explains the abuses under prior law that led to the enactment of section 2702. Part III analyzes the impact of section 2702 in valuing the transferred and retained interests in the initial transfer, and critically examines the operation of the corrective adjustment under the regulations. Part IV argues that the approach of section 2702 is fundamentally misguided because it adds unnecessary complexity and exacerbates existing structural problems in the gift and estate tax system. Those problems, as well as the abuses targeted by section 2702, could be addressed more effectively by a uniform transfer tax base coupled with uniform rules for the completion and valuation of all lifetime and deathtime transfers.

II. Valuation Under General Principles

Section 2702 is aimed primarily at a few tax-driven techniques involving transfers with retained interests. A classic example is the so-called grantor retained income trust (a "GRIT"), by which the donor makes a gift

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property), 2704 (lapsing rights or restrictions). The split-interest transfers addressed by § 2702 differ materially in form, function, and tax treatment from the other estate freezing techniques addressed by §§ 2701, 2703, and 2704; the latter transactions fall outside the scope of this article. For an overview of chapter 14, see 5 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ch. 136 (2d ed. 1993).

of property subject to a retained income interest for a limited term.[5] During the 1980s when interest rates were high and property values appreciated rapidly (in nominal dollars), GRITs and similar techniques offered donors attractive opportunities to take advantage of annual increases in the unified credit.[6] The following overview of these techniques lays a foundation for understanding the scope and operation of section 2702 and for evaluating its effectiveness. Moreover, the techniques discussed below remain viable in situations where section 2702 does not apply.[7]

A. *Timing and Amount of Inclusion*

Under well-established gift tax principles, a donor carving beneficial ownership of property into separate interests may make a completed gift of some interests while retaining others, and no gift is made of a retained interest.[8] Even with respect to a transferred interest, the gift generally remains incomplete if the donor retains control over its beneficial enjoyment by others.[9] However, the possibility that beneficial enjoyment may return to the donor in the discretion of another person generally does not prevent

5. See Staff of Joint Comm. on Taxation, supra note 3, at 12-13, 15-16 (describing GRITs and similar techniques); U.S. Trust, Practical Drafting 397-430 (1984) (comprehensive analysis by Richard B. Covey). On the viability of split-interest arrangements after the enactment of § 2702, see Howard M. Zaritsky & Ronald D. Aucutt, Structuring Estate Freezes Under Chapter 14 chs. 10-13 (1993); Mitchell M. Gans, GRIT's, GRAT's and GRUT's: Planning and Policy, 11 Va. Tax Rev. 761 (1992); U.S. Trust, Practical Drafting 3325-457 (1993).

6. Between 1981 and 1987, the unified credit rose from $47,000 to $192,800. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 401(b), 95 Stat. 172, 299 (amending IRC § 2505). As a result, the amount of cumulative taxable transfers sheltered from gift and estate taxes by the unified credit rose from $175,625 to $600,000.

7. For example, a GRIT remains viable if the donee is not a member of the transferor's family, see IRC §§ 2702(a)(1), (e), 2704(c)(2), or if the underlying property is to be used as a personal residence by the holder of the term interest, see IRC § 2702(a)(3)(A)(ii).

8. Regs. § 25.2511-1(e); Smith v. Shaughnessy, 318 U.S. 176 (1943). The gift tax applies only to transfers of beneficial interests in property (i.e., the right to possess or enjoy the property or its income); for gift tax purposes, a transfer of bare legal title to a trustee is not a gift. Regs. § 25.2511-1(g)(1).

9. Estate of Sanford v. Commissioner, 308 U.S. 39, 44 (1939). A retained power which permits the donor to regain beneficial enjoyment or to change the beneficial enjoyment of others generally prevents completion. Regs. § 25.2511-2(b), (c). A retained power does not prevent completion, however, if it affects only "the manner or time of enjoyment," Regs. § 25.2511-2(d), is exercisable only in conjunction with a person having a substantial adverse interest, Regs. § 25.2511-2(e), or is exercisable in a fiduciary capacity and limited by a fixed or ascertainable standard, Regs. § 25.2511-2(g).

completion.[10] The donor thus enjoys considerable flexibility both in defining separate interests in the underlying property and in determining the time of completion of a gift of a particular interest.

The amount of a gift is its value at the time of completion.[11] Property generally is valued at "fair market value"—the price at which it would change hands in a hypothetical arm's-length transaction.[12] When beneficial enjoyment of property is split into a term interest[13] and a remainder,[14] the property's value is apportioned among the interests. Since the combined interests represent complete ownership of the property, the value of each interest generally is derived by subtracting the value of the other interests from the value of the entire property.[15] Thus, the values of the respective interests are interdependent, and any uncertainty or inaccuracy in the valuation of one interest indirectly affects the valuation of the other.

If the limitations and conditions affecting possession or enjoyment of the underlying property can be estimated reasonably,[16] the gift tax value of a term interest or remainder is determined by discounting the future payments to present value under Treasury tables based on prescribed discount rates and mortality assumptions.[17] The tables greatly simplify the valuation of split

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10. Regs. § 25.2511-2(g); *Shaughnessy*, 318 U.S. at 181. To the extent that the donor's creditors can reach the property under state law, however, the donor is treated as retaining the power to regain beneficial enjoyment. Outwin v. Commissioner, 76 T.C. 153, 186 (1981), acq. 1981-2 C.B. 2.

11. IRC § 2512(a). The value of any consideration in money or money's worth received by the donor reduces the amount of the gift. IRC § 2512(b). Moreover, the first $10,000 of present-interest transfers made by a donor to any donee in any calendar year is excluded from the donor's gifts for that calendar year. IRC § 2503(b).

12. The fair market value of property generally is "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Regs. § 25.2512-1.

13. For convenience, this article adopts the terminology of § 2702, which uses the phrase "term interest" to mean any present or future interest that confers a right to possess or enjoy property, or to receive income or annuity payments, for a definite period of time, such as the life of one or more individuals or a term of years. IRC § 2702(c)(3).

14. For convenience, this article uses the term "remainder" to mean any future interest that confers a right to possess or enjoy property at the expiration of a term interest, including an interest that would be classified as a reversionary interest or executory interest under state property law.

15. See Regs. § 25.2512-5.

16. Special problems arise if the duration of a term interest or the time for possession or enjoyment of a remainder depends on conditions that cannot be measured actuarially. See Prop. Regs. § 25.7520-3(b); infra notes 53-60 and accompanying text.

17. IRC § 7520 (valuation of annuities, interests for life or a term of years, remainders, and reversions); Regs. §§ 1.664-4, 25.2512-5; Prop. Regs. § 25.7520-1. The Treasury tables appear in I.R.S. Publication 1457, Actuarial Values—Alpha Volume (1989)

interests by sidestepping the need to resort to case-by-case investigations of factors affecting expected rates of return and life expectancies.

A simple GRIT illustrates the impact of the tables on the gift tax value of split interests. Assume that *A*, age 70, transfers property worth $100,000 in trust to pay income to herself for a term of 15 years with remainder at the end of the term to her nephew *B* or *B*'s estate.[18] If the applicable discount rate is 10%, the value under the tables of *A*'s retained interest is $76,061 (the present value of 15 annual payments of $10,000 each), and *A* has made a gift of $23,939, the value of the trust property less the value of *A*'s retained income interest.[19] *A* can reduce further the amount of the gift by retaining the right to receive the trust property at the end of the 15-year term in the event she is not then living.[20] Under the tables, the present value of this additional retained interest is $14,131, and the amount of the gift is only $9,808.[21]

In the example, the respective values of the interests in trust income and corpus are not necessarily unrealistic. If, in accordance with the assumptions built into the tables, the trust property actually has a constant value of $100,000 and generates income at an annual rate of 10%, *A*'s retained income interest is properly valued by discounting a 15-year stream of $10,000 annual payments at an annual rate of 10%.[22] Moreover, if *A* retains the right to receive the trust corpus at the end of the 15-year term in the event she is not then living and if the mortality tables accurately reflect *A*'s life expectancy, the value of *B*'s remainder is discounted properly to reflect the probability that *A* will die within 15 years.[23]

[hereinafter Actuarial Values (Alpha)] and I.R.S Publication 1458, Actuarial Values—Beta Volume (1989).

18. The special valuation rules of § 2702 do not apply because *B* is not a "member of [*A*]'s family" within the meaning of that section. IRC § 2702(a)(1). See infra note 76.

19. See Actuarial Values (Alpha), supra note 17, at Table B.

20. *A* might retain this additional interest because the trust corpus will be included in her gross estate for estate tax purposes in the event she dies before her retained income interest expires. Retention of the conditional interest in trust corpus therefore reduces the gift tax without significantly increasing the potential estate tax. See infra note 45.

21. *B*'s remainder will become possessory only if *A* survives the 15-year term. Accordingly, the present value of the interest transferred to *B* is the present value of the right to receive $100,000 in 15 years ($23,939) multiplied by the probability that *A* will survive the 15-year term (27,960/68,248), or $9,808. Similarly, the present value of *A*'s additional retained interest is the present value of the right to receive $100,000 in 15 years ($23,939) multiplied by the probability that *A* will not survive the 15-year term (1 - (27,960/68,248)), or $14,131. See Actuarial Values (Alpha), supra note 17, at Tables B, H, 80CNSMT.

22. In other words, the income distributed to *A* will replace the declining value of her interest in future trust income, leaving *A*'s net worth unchanged.

23. *A* may appear to be undertaxed if she survives the 15-year term because her retained interest in trust corpus will terminate without triggering any further inclusion in her

However, the values of the interests in trust income and corpus are only as accurate as the assumptions built into the tables. Three of those assumptions raise special concerns in the context of *A*'s GRIT. First, the tables assume that the trust corpus remains constant in value and that the trust's entire investment return takes the form of current income. Any assumption concerning the allocation of investment return to income or corpus is unreliable because that allocation normally depends on subsequent actions of the trustee in administering the trust.[24] For example, assume that the trustee of *A*'s GRIT properly invests the trust corpus of $100,000 in stock that generates $9,000 of capital appreciation and $1,000 of dividends annually.[25] Although *A* actually receives annual income of only $1,000, the tables value her retained income interest as a stream of $10,000 annual payments and produce a corresponding undervaluation of the remainder transferred to *B*.

A second, analytically distinct problem concerns the assumed discount rate (rate of return). In determining the present value of a split interest,[26] the tables apply a uniform discount rate indexed to the prevailing rate of return on federal obligations.[27] Since the expected return on an investment reflects the type and degree of risk of the investment,[28] the discount rate assumed

transfer tax base. Conversely, she may appear to be overtaxed if she dies during the term because the entire trust property will revert to her and be included in her gross estate. Without the benefit of hindsight, the tables apportion the value of the trust corpus at the end of the 15-year term between *A* and *B* based on the actuarial probability of *A*'s survival or death during the term. The accuracy of that apportionment depends on how closely the mortality tables reflect *A*'s actual life expectancy.

24. Section 2702 addresses this problem by valuing the retained interest at zero unless the trust is structured in a way that makes the trust accounting distinction between income and corpus largely irrelevant. See infra notes 82-94 and accompanying text.

25. In theory, the trustee may be constrained in its investment and allocation decisions by a duty of impartiality. As a practical matter, however, the shift of investment return from *A* to *B* may escape inclusion in *A*'s transfer tax base. See infra note 51 and accompanying text.

26. For a general introduction to risk, return, and present value, see William A. Klein & John C. Coffee, Jr., Business Organization and Finance 225-35, 303-24 (5th ed. 1993).

27. The discount rate is 120% of the federal midterm rate (determined monthly under § 1274(d)(1)), rounded to the nearest 0.2% and compounded annually. IRC § 7520(a)(2). The discount rate approximates a riskless rate plus a modest premium to compensate for volatility risk.

28. The expected return on an investment represents the arithmetic mean of probable outcomes and reflects the risk of loss (default risk). The variance or dispersion of probable outcomes (volatility risk), to the extent that it cannot be eliminated by diversification, commands a market risk premium. The market risk premium is reflected in a lower present value, and a correspondingly higher discount rate, for the investment. In theory, it is possible to adjust the expected return to eliminate volatility risk and discount the resulting certainty

by the tables is almost certainly unrealistic in any particular case.[29] For example, if the discount rate is unrealistically low, the tables distort the relative present values of split interests.[30] In the case of *A*'s GRIT, this distortion might benefit the government, since an understated discount rate produces an artificially low value for *A*'s retained income interest and thus overvalues the remainder transferred to *B*. The distortion would benefit *A*, however, if she retained a right to fixed payments rather than an income interest.[31]

Finally, the tables assume that each individual has a life expectancy consistent with the national mortality experience.[32] This assumption is unrealistic because it takes only age into account, and disregards other factors that indicate a longer or shorter life expectancy for a particular individual. As a result, the tables may produce distorted values for split interests conditioned on survival or nonsurvival.[33] For example, in the case of *A*'s GRIT, if *A* enjoys unusually robust health and expects to live longer than the average 70-year-old, the tables may produce an unrealistically high value for her retained interest in corpus (conditioned on her death within 15 years) and a correspondingly low value for the remainder transferred to *B*.[34]

In sum, the tables reflect assumptions about income and corpus allocations, rates of return, and mortality risks that diverge from actual

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equivalent at a riskless rate in calculating present value. See Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 201-04 (4th ed. 1991); Klein & Coffee, supra note 26, at 226-35, 323-24.

29. It might be argued that the probability of a low return should offset the probability of a high return and that all investments should have the same expected return. This argument ignores the fact that an increase in nondiversifiable volatility risk drives up the expected return if the present value of the investment is held constant. See Klein & Coffee, supra note 26, at 231-35.

30. In effect, the tables apportion the value of the underlying property among the respective split interests. If the value of the underlying property is understated, however, all of the interests will be undervalued. Section 2702 does not address the separate (and more serious) problem of ensuring accurate valuation of the underlying property. See Joseph Isenbergh, Simplifying Retained Life Interests, Revocable Transfers, and the Marital Deduction, 51 U. Chi. L. Rev. 1, 16 (1984) (noting the "ubiquitous and largely irreducible problem of valuation").

31. This problem, unlike the problem of allocating return to income or corpus, is not addressed by § 2702. As a result, opportunities for valuation abuse persist with respect to qualified interests under § 2702. See infra notes 93-98 and accompanying text.

32. The national mortality statistics are revised at least every 10 years. IRC § 7520(c)(3).

33. This problem is not addressed by § 2702. As a result, opportunities for valuation abuse persist with respect to qualified interests under § 2702. See infra notes 99-101 and accompanying text.

34. Under the tables, *A* has an actuarial life expectancy of 13.32 years. See Actuarial Values (Alpha), supra note 17, at Table 80CNSMT.

outcomes in particular cases. This does not raise serious concerns as long as valuation risks are allocated fairly between taxpayers and the government.[35] The opportunity for abuse arises when valuation risks are skewed systematically in favor of taxpayers. Inevitably, the tables reflect crude and rigid assumptions that bear little or no relation to the facts and circumstances of particular cases. Since the tables are almost always conclusive in valuing split interests,[36] taxpayers (who usually have superior information concerning the factors affecting value in particular cases) tend to structure transactions to exploit the tables and reduce the gift tax value of transferred interests.[37]

Whether a GRIT simply defers or permanently avoids transfer tax depends on what becomes of the donor's retained interests after the initial transfer. In the case of *A*'s GRIT, if *A* subsequently makes a completed gift of her retained interest in trust income or corpus, the gift will be valued under the tables in the same manner as the initial transfer. If she instead retains both interests, any trust income or corpus distributed to *A* will ultimately be reflected in the pool of assets constituting her transfer tax base.[38] If *A* survives the 15-year term, however, the trust property will

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35. In making an immediate gift of a future interest in the GRIT property (rather than waiting to transfer the property outright at the end of the 15-year term), *A* in effect engages in a wager with the government concerning the future value of the property. An analogous allocation of risk occurs in a short sale where a seller, *S*, agrees to deliver property (not presently owned by *S*) to *A* 15 years in the future. If the property appreciates, *A* benefits and *S* loses; if the property declines in value, *S* benefits and *A* loses. If the sale price accurately reflects the present value of the right to receive the property in 15 years, the allocation of risk is fair.

36. Section 7520 prescribes mandatory tables for valuing split interests where the valuation date occurs after April 30, 1989. Proposed regulations authorize departures from the tables where the terms of an income interest or remainder failed to provide substantially the same degree of beneficial enjoyment as general trust law principles, or where an individual who is a measuring life is terminally ill at the time of the gift. Prop. Regs. § 25.7520-3(b)(2), (3); cf. O'Reilly v. Commissioner, 973 F.2d 1403 (8th Cir. 1992) (permitting departure under prior law where GRIT was funded with low-dividend growth stock of closely-held corporation); Estate of McLendon v. Commissioner, T.C. Memo 1993-459 (CCH) (1993) (permitting departure under prior law where donor's actual life expectancy was less than one year); Rev. Rul. 80-80, 1980-1 C.B. 194 (permitting departure under prior law where death was "clearly imminent" or reasonably certain to occur within one year).

37. See S. Rep. No. 1001, 101st Cong., 2d Sess. 59-60 (1990), reprinted at 136 Cong. Rec. S15629, S15681 (Oct. 18, 1990) [hereinafter 1990 Senate Report] (noting problem of "adverse selection"); Staff of Joint Comm. on Taxation, supra note 3, at 18; see also Gans, supra note 5, at 766-76 (discussing disparities between assumed discount rate and expected rate of return).

38. With the lapse of time, *A*'s interest in trust income is gradually reduced to possession as each year's income is distributed to her. Any income distributed to *A* ultimately will be reflected in her transfer tax base unless consumed or dissipated by her during life. To the extent that *A* consumes her income distributions rather than other assets, the income

escape subsequent inclusion in her transfer tax base. Neither the termination of *A*'s retained interests in trust income and corpus at the end of the term, nor the simultaneous vesting in possession of *B*'s remainder, constitutes a transfer for gift or estate tax purposes.

If *A* dies during the 15-year term, the entire trust property is included in her gross estate at its deathtime value. This result makes good sense where *A* retains a reversion in trust corpus that becomes possessory at death, since property owned by a decedent forms the core of the gross estate.[39] The inclusion of the entire trust corpus in *A*'s gross estate may at first appear excessive, since the value of *B*'s remainder was previously included in *A*'s taxable gifts. However, the amount included in the gross estate is attributable solely to *A*'s reversion and not to *B*'s previously-taxed remainder. The apparent overtaxation where *A* dies during the 15-year term is the converse of the apparent undertaxation where *A* survives the term.

Even if *A* retains only the right to receive trust income and dies during the 15-year term, the entire trust property is included in her gross estate under the so-called "string" provisions.[40] The string provisions raise a problem of potential double taxation to the extent that they include in the gross estate property which already has been subjected in whole or in part to gift tax during the decedent's life.[41] To mitigate this problem, section 2001(b) of the Code excludes any previously-taxed interest from adjusted taxable gifts while allowing the previously-paid gift tax as an offset against the tentative estate tax.[42] As a result, the string provisions and section

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distributions indirectly enhance the value of the other assets. Any corpus distributable to *A*'s personal representative at death is included in her gross estate.

39. IRC § 2033.

40. IRC § 2036(a)(1). The same result occurs if *A* releases the income interest within three years of her death. IRC § 2035(a), (d). The term "string provisions" generally refers to the estate tax provisions that, in various circumstances, include property transferred during life in the gross estate. IRC §§ 2035-38.

41. Where applicable, the string provisions include property transferred during life in the gross estate based on the transferor's retained ownership or control with respect to an interest in the property, regardless of whether the lifetime transfer was a completed gift. Double taxation also may occur with respect to contractual survivorship arrangements, IRC § 2039(a), joint tenancies with survivorship rights, IRC § 2040(a), property subject to a general power of appointment, IRC § 2041(a), and life insurance on the decedent's life transferred within three years of death, IRC §§ 2035(a), (d), 2042.

42. Very generally, the gift and estate taxes are integrated by computing the estate tax as (1) a tentative tax on the sum of the taxable estate and "adjusted taxable gifts" (generally, all taxable gifts made after 1976), less (2) a hypothetical gift tax on all post-1976 taxable gifts, computed under the rate schedule in effect at the decedent's death. IRC § 2001(b). However, if property transferred by taxable gift is included in the gross estate, the gift is omitted from adjusted taxable gifts, but is included in computing the hypothetical gift tax. IRC § 2012 (providing estate tax credit for gift tax on pre-1977 gifts included in gross estate).

2001(b) generally ensure that reincluded property ultimately enters the transfer tax base only once, at its deathtime value, and treat any gift tax on a lifetime transfer of the same property as a prepayment of the resulting estate tax.[43]

A's GRIT produces the greatest transfer tax savings if the string provisions do not apply. The entire trust property is included in *A*'s gross estate if she dies during the 15-year term, due to her retained interest in trust income.[44] By retaining the additional interest in trust corpus conditioned on her death within the 15-year term, *A* achieves an immediate reduction in gift tax while avoiding any substantial increase in estate tax.[45] Moreover, if *A* survives the 15-year term, the expiration of her additional interest in trust corpus does not attract a subsequent transfer tax. Accordingly, if the 15-year term exceeds *A*'s actuarial life expectancy[46] but in fact ends before her death, a GRIT with a retained reversion permits *A* to transfer the underlying property at substantially less transfer tax cost than a single outright transfer made during life or at death.

If *A*'s actual life expectancy is less than her actuarial life expectancy, she may still be able to exploit the tables using either of two arrangements involving a simple life income interest with no reversion.[47] As in the case of a GRIT, the most dramatic opportunities for transfer tax avoidance occur where the underlying property is expected to appreciate substantially during *A*'s life while producing little current income.

The first of these arrangements is a sale of a remainder. Assume that *A*, age 70, transfers property in trust to pay income to herself for life with

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43. Although the net amount included in the transfer tax base may be the same as if the decedent simply had retained the underlying property until death, the tax cost of a split-interest transfer subject to the string provisions may be heavier or lighter than that of a single deathtime transfer of property owned at death. On one hand, the donor loses the return on amounts used to pay gift tax on the initial transfer. On the other hand, the amount of the gift tax paid is removed from the gross estate if the initial transfer occurs more than three years before death. See infra notes 163-66 and accompanying text.

44. If *A* retains an income interest for her life, the trust property is included in the gross estate no matter how long she lives, unless she disposes of the income interest more than three years before death. IRC §§ 2035(a), (d), 2036(a)(1).

45. The retained interest in trust corpus reduces *A*'s taxable gift by $14,131 (leaving a taxable gift of $9,808), and potentially increases her estate tax by the amount of the gift tax on the gift, which will not be allowed if the trust property is included in her gross estate under § 2033 rather than § 2036(a)(1). See supra note 21 and accompanying text. The reduced gift tax represents an immediate benefit to *A* that may well outweigh the discounted present value of the potential additional estate tax cost.

46. Under the tables, *A* has an actuarial life expectancy of 13.32 years. See Actuarial Values (Alpha), supra note 17, at Table 80CNSMT.

47. The tables may be inapplicable if *A* is terminally ill at the time of the gift. See supra note 36.

remainder at her death to *B* or *B*'s estate. In exchange, *A* receives money's-worth consideration from *B*. If the consideration is equal to the value of *B*'s remainder, there is no taxable gift.[48] Moreover, the same consideration may be sufficient to remove the arrangement from the reach of the string provisions, notwithstanding *A*'s retained life income interest.[49] If the consideration is adequate for gift and estate tax purposes, *A*'s transfer tax base will reflect the consideration received by *A* as well as any income actually distributed to her, but these amounts may be substantially less than the value of the trust property that they replace.[50] Conversely, any appreciation in the value of the trust property after the initial transfer may increase the value of *B*'s remainder while escaping inclusion in *A*'s transfer tax base.[51]

Alternatively, the arrangement might take the form of a joint purchase. Assume that *A* purchases a life income interest and *B* simultaneously purchases a remainder in the underlying property from a third party. If each purchaser furnishes money's-worth consideration equal to the value of the interest received, there is no taxable gift. Moreover, the string provisions should be inapplicable because *A* made no lifetime transfer; indeed, she never owned more than a life income interest in the underlying property. If the

48. For gift tax purposes, the consideration must at least equal the value of *B*'s remainder determined under the tables. IRC §§ 2512(b), 7520(a). If *A* is 70 years old, the trust property is worth $100,000, and the applicable discount rate is 10%, the values of *A*'s life income interest and *B*'s remainder under the tables are $64,093 and $35,907, respectively. See Actuarial Values (Alpha), supra note 17, at Table S. As in the original GRIT example, the special valuation rules of § 2702 do not apply because *B* (*A*'s nephew) is not a "member of [*A*]'s family" within the meaning of that section. IRC § 2702(a)(1). See infra note 76.

49. See IRC § 2036(a)(1) (providing exception for "bona fide sale for an adequate and full consideration in money or money's worth"). However, by analogy to the similar exception in § 2035(b)(1), one court has held that for estate tax purposes the adequacy of consideration must be measured by the value of the underlying trust property, which otherwise would be included in the gross estate, rather than by the value of the transferred interest. Gradow v. United States, 11 Cl. Ct. 808 (1987), aff'd, 897 F.2d 516 (Fed. Cir. 1990). See Charles L.B. Lowndes, Consideration and the Federal Estate and Gift Taxes: Transfers for Partial Consideration, Relinquishment of Marital Rights, Family Annuities, the Widow's Election, and Reciprocal Trusts, 35 Geo. Wash. L. Rev. 50, 81-82 (1966).

50. If the money's-worth consideration received by *A* is not adequate for estate tax purposes, the deathtime value of the trust property, reduced only by the amount of the consideration, is included in her gross estate. IRC §§ 2036(a)(1), 2043(a).

51. In theory, the trustee may be liable to *A* for making investment or allocation decisions that improperly favor *B* at *A*'s expense. Restatement (Second) of Trusts § 232 (1959) (duty of impartiality). Furthermore, if *A* consents to such investments or fails to pursue her remedies against the trustee, she may be treated as making an indirect gift to *B*. See Dickman v. Commissioner, 465 U.S. 330 (1984); Estate of Lang v. Commissioner, 613 F.2d 770 (9th Cir. 1980). As a practical matter, however, such a gift may be difficult to detect or measure. See Snyder v. Commissioner, 93 T.C. 529 (1989).

form of the transaction is respected,[52] *A*'s transfer tax base will reflect any income actually received by her, which may be substantially less than the compounded value of the consideration that she paid for her income interest. As in the previous example involving a sale of a remainder, substantial value may be shifted from *A* to *B* without entering *A*'s transfer tax base.

B. *Retained Interests Lacking an Ascertainable Value*

In apportioning value among term interests and remainders, the assumptions built into the tables concerning income and corpus allocations, discount rates, and mortality risks are normally conclusive. In some cases, the probability of an uncertain event, such as marriage or birth of issue, may be estimated based on actuarial or other evidence.[53] In other cases, however, no evidentiary basis exists for ascertaining the values of the various interests. In those cases, a donor bears the burden of proving the value of any retained interest in arriving at the value of a transferred interest.

Assume that, in the case of *A*'s GRIT, *A* retains the right to receive the trust property at the end of the 15-year term if neither *B* nor any of *B*'s issue is then living. In Robinette v. Helvering,[54] the Supreme Court refused to allow any reduction in the amount of a gift for a similarly conditioned retained interest because the donor failed to offer "any recognized method by which it would be possible to determine the value" of the interest.[55] Whether

52. To the extent that consideration furnished by *B* is traceable to *A*, the government may be able to recast the transaction as a purchase of the underlying property by *A* followed by a gift of a remainder to *B*. In that case, a corresponding portion of the underlying property is included in *A*'s gross estate under the string provisions. See Estate of Shafer v. Commissioner, 749 F.2d 1216 (6th Cir. 1984) (estate tax); Gordon v. Commissioner, 85 T.C. 309 (1985) (income tax); Priv. Let. Rul. 9206006 (Oct. 24, 1991) (estate tax).

53. See Commissioner v. Maresi, 156 F.2d 929 (2d Cir. 1946) (affirming Tax Court's reliance on remarriage statistics in determining estate tax value of claim for payments to divorced spouse until death or remarriage); Rev. Rul. 76-472, 1976-2 C.B. 264 (noting that decedent's vested remainder subject to open should be valued with "due regard" for probability that 53-year-old woman might bear or adopt additional children); Rev. Rul. 71-67, 1971-1 C.B. 271 (valuing claim for payments to surviving spouse until death or remarriage); Rev. Rul. 61-88, 1961-1 C.B. 417 (noting that decedent's remainder conditioned on death without issue of a childless 44-year-old married woman should be valued with regard to "all known circumstances relative to the particular life tenant, rather than to women aged 44 in general").

54. 318 U.S. 184 (1943).

55. Id. at 188. In *Robinette*, a 30-year-old woman created a trust, in contemplation of marriage, to pay income to herself for life, then to her parents for their lives, with remainder to her issue upon reaching age 21 or in the absence of issue to the appointees of the last surviving income beneficiary. Clearly, the settlor's taxable gift excluded the value of her retained income interest but included the value of her parents' secondary income interests. The dispute concerned the value of the settlor's reversionary interest, which was conditioned

viewed as announcing an evidentiary standard or a rule of valuation, *Robinette* imposes an outer limit on the technique of tailoring retained interests to reduce the gift tax value of transferred interests.[56]

The holding of *Robinette* is limited to cases where a donor retains one or more interests that have no ascertainable value while making a gift of other interests in the same underlying property.[57] Whether a retained interest has an ascertainable value is a question of fact.[58] If the retained interest has an ascertainable value,[59] or if the transferred interest represents the donor's entire interest in the underlying property,[60] there is no need to deviate from general valuation principles in valuing the transferred interest.

Although the impact of *Robinette* on the apportionment of value in the initial transfer is well settled, the subsequent treatment of a retained interest having no ascertainable value remains unclear. Specifically, a problem of double taxation arises if the value of the retained interest, having already been subjected to gift tax in the initial transfer, enters the transfer tax base

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not only on her surviving both parents but also on her dying without issue. Id. at 185-86.

56. See Regs. § 25.2511-1(e) (noting that if a donor retains a reversion conditioned on a 25-year-old beneficiary's death without issue, gift tax "normally" applies to the entire value of the property because the reversion is "not susceptible of measurement on the basis of generally accepted valuation principles").

57. Under *Robinette*, the value of a retained interest is taken into account only to the extent established by the taxpayer. 318 U.S. at 188-89. Thus, a retained interest with no ascertainable value is valued at zero; if the donor establishes some minimum value, only that value is taken into account. See, e.g., Rev. Rul. 72-571, 1972-2 C.B. 533 (noting that settlor who released control over reversion in stock worth $1,500X, while retaining reversion in $100X, made completed gift of discounted value of reversion in $1,400X; possibility that settlor might receive stock at termination had no ascertainable value); Rev. Rul. 77-99, 1977-1 C.B. 295 (noting that allocation of future capital gains to income and capital losses to corpus deprives retained reversionary interest of any ascertainable value).

58. See McHugh v. United States, 142 F. Supp. 927 (Ct. Cl. 1956) (denying summary judgment, and permitting taxpayer to introduce evidence concerning value of income beneficiary's limited power to invade corpus). Moreover, whether value is ascertainable may depend on whether a relevant condition (e.g., marriage or birth of issue) is within the control of an interested person. Assume that *A* creates a trust to pay income to *B* (who currently has no issue) for life, with remainder at *B*'s death to *B*'s issue or reversion to *A* if no issue of *B* are then living. *A*'s reversion may have no ascertainable value, whether or not the probability of death without issue is statistically unascertainable, if *B* has motive and opportunity to skew the outcome in *B*'s favor. See Estate of Cardeza v. United States, 261 F.2d 423, 426-27 (3d Cir. 1958); cf. Commissioner v. Estate of Sternberger, 348 U.S. 187, 197-98 (1955) (noting potential abuse where charitable interest was conditioned on event within private beneficiary's control).

59. See, e.g., Smith v. Shaughnessy, 318 U.S. 176 (1943) (holding amount of gift reduced by value of reversion where property was transferred in trust to pay income to settlor's wife for life, then reversion to settlor if living, otherwise remainder to wife's heirs).

60. See Regs. § 25.2511-1(f); cf. Rev. Rul. 76-472, 1976-2 C.B. 264; Rev. Rul. 61-88, 1961-1 C.B. 417.

again during life or at death. If the donor makes a subsequent lifetime gift of the retained interest, what little authority exists indicates that the subsequent gift should simply be disregarded, regardless of the value of the interest at that time.[61] This approach can be defended on grounds of consistency; since the interest retained in the initial transfer was valued at zero under *Robinette*, it is also valued at zero in the subsequent transfer.

Disregarding the subsequent transfer preserves symmetry in valuing the retained interest and prevents double taxation.[62] At the same time, this approach wreaks havoc with the general principle that a gift of an interest should be valued and included in the gift tax base when the gift becomes complete.[63] The disjunction between the time the gift tax is imposed on the retained interest (in the initial transfer) and the time the donor makes a completed gift of that interest (in the subsequent transfer) has its roots in the holding of *Robinette*. By imposing a gift tax on the combined value of the retained and transferred interests in the initial transfer, *Robinette* in effect telescopes the initial and subsequent transfers into a single taxable event. Though conceptually inelegant, this pragmatic approach sidesteps the problem of valuing an interest that has no ascertainable value. Moreover, once the retained interest has attracted a gift tax in the initial transfer, the same interest should not be subject to a second gift tax in the subsequent transfer.

The rationale for disregarding a subsequent transfer of the retained interest might appear equally persuasive where that transfer occurs at death rather than during life. However, if the donor still owns the retained interest at death, the interest generally is included in the gross estate.[64] Indeed, the

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61. See Estate of Kolb v. Commissioner, 5 T.C. 588 (1945) (holding that settlor who created trust with fixed equal shares for existing grandchildren, retaining power to add afterborn grandchildren, made gift of entire value of trust property, and that no additional gift occurred when settlor subsequently released retained power); Rev. Rul. 79-421, 1979-2 C.B. 347 (holding that gift included retained rights to extent value not ascertainable, where initial trustee relinquished general power of appointment, retaining rights conditioned on co-trustees dying or ceasing to act during his life; on subsequent release of remaining rights, gift excluded value of previously-taxed rights).

62. See Burnet v. Guggenheim, 288 U.S. 280, 285 (1933) (noting that gift tax requires "consistent choice" of rule governing time of completion).

63. See IRC §§ 2501(a)(1) (imposing gift tax on transfer of property by gift), 2511(a) (defining scope of transfer), 2512(a) (valuing gift of property at date of gift). Although the government occasionally has flirted with the notion of holding a completed gift "open" until valuation difficulties are resolved, see, e.g., Rev. Rul. 81-31, 1981-1 C.B. 475, it appears to have conceded that the issue of completion logically precedes the separate issue of valuation. See Rev. Rul. 92-68, 1992-2 C.B. 257 (revoking Rev. Rul. 81-31); see also Estate of DiMarco v. Commissioner, 87 T.C. 653 (1986), acq. in result 1990-2 C.B. 1.

64. IRC § 2033. An owned interest that expires at death is not transmissible and therefore has no includable value. However, a reversionary interest that expires at death may trigger inclusion of the underlying property under the string provisions. IRC § 2037(a)

controlling statute expressly requires that property owned at death be included in the gross estate at its deathtime fair market value.[65] Since the initial transfer, the retained interest may have changed substantially in value, and may have become more susceptible of valuation. If the interest is included in the gross estate at its fair market value, double taxation can be avoided only by making an adjustment to neutralize the initial inclusion in the gift tax base.

Section 2001(b) provides such an adjustment when a lifetime gift is included in the gross estate, ensuring that the gift ultimately enters the cumulative transfer tax base only once, at its deathtime value. Technically, this is accomplished by excluding the reincluded gift from the decedent's adjusted taxable gifts,[66] while reducing the estate tax by the amount of gift tax payable with respect to the lifetime transfer.[67] The section 2001(b) adjustment normally applies when the interest retained in the initial transfer is not directly included in the gross estate but is sufficient to trigger inclusion of a previously-taxed interest in the underlying property under the string provisions.[68]

Technical and practical problems arise in applying the section 2001(b) adjustment to a retained interest that was valued at zero in the initial transfer. When the retained interest is a reversion that becomes possessory at or before death, the underlying property is included in the gross estate without reference to the string provisions.[69] Even if such a reversion is valued at zero in

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(providing that property transferred during life, with retained reversionary interest worth more than 5% of underlying property immediately before death, is includable in gross estate if possession or enjoyment of property can be obtained only by surviving the decedent).

65. Fair market value generally is determined at death, unless the alternate valuation date is elected. IRC §§ 2031, 2032; Regs. § 20.2031-1(b). The value assigned to a reversionary interest for purposes of the 5% test under § 2037(a) is relevant to the question of includability, Regs. § 20.2037-1(c)(3), but not to the amount included in the gross estate, Regs. § 20.2037-1(e)(4). Cf. *Cardeza*, 261 F.2d at 424-25 (valuing reversionary interest at zero for purposes of 5% test under prior law).

66. IRC § 2001(b). See supra note 42.

67. If the lifetime gift occurred before 1977, the adjustment takes the form of a credit against the estate tax in the amount of the gift tax. IRC § 2012.

68. For example, if *A* creates a trust to pay income to herself for life with remainder at her death to *B* or *B*'s estate, the retained life income interest itself is not included in *A*'s gross estate, but it may trigger inclusion of the remainder. IRC § 2036(a)(1). Similarly, if *A* creates a trust to pay income to *B* for life with reversion at *B*'s death to *A* if living or to *C* or *C*'s estate if *A* is not living, and *A* dies before *B*, the retained reversion itself is not included in *A*'s gross estate, but it may trigger inclusion of the remainder. IRC § 2037(a).

69. Assume that *A* creates a trust to pay income to *B* (currently age 25, unmarried, and without issue) for life, with reversion at *B*'s death to *A* if *A* is then living and no issue of *B* are then living, otherwise remainder to *C* or *C*'s estate. If *A*'s reversion has no ascertainable value, the entire value of the trust property is subjected to gift tax under *Robinette*. If *B* dies

the initial transfer under *Robinette*, it is difficult to see how a completed gift can be made of a retained interest.[70] If no completed gift occurred with respect to the retained interest, the section 2001(b) adjustment may be unavailable because it applies only to "taxable gifts" that are included in the gross estate. Even if the section 2001(b) adjustment technically applies, it may prove unworkable. The adjustment consists of an exclusion from adjusted taxable gifts of the value of the taxable gift that is included in the gross estate, but this value could not be ascertained at the time of the gift. If the retained interest had no ascertainable value for gift tax purposes in the initial transfer, it similarly should generate no section 2001(b) adjustment for estate tax purposes.[71]

As a practical matter, the problem of double taxation resulting from the lack of a section 2001(b) adjustment seldom arose before the enactment of section 2702. Transfers in trust normally can be structured to avoid subjecting the same beneficial interest both to a gift tax in the initial transfer and to an estate tax at death. Where the string provisions draw a previously-taxed gift into the gross estate, section 2001(b) generally mitigates the risk of double taxation.[72] An acute problem of double taxation normally arises only where a donor subsequently transfers a retained interest that was valued at zero in the initial transfer. This troublesome situation is likely to become increasingly common as a result of section 2702.

III. VALUATION UNDER SECTION 2702

In response to valuation abuses involving split-interest transfers, Congress, in 1990, enacted section 2702, which provides special rules for apportioning the value of trust property between retained and transferred interests. A few defined types of retained interests continue to be valued under the tables. The special rules value most other retained interests at zero, thereby indirectly increasing the gift tax value of interests transferred in the

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without issue and *A* is still living, *A*'s reversion becomes possessory and is included in *A*'s gross estate under § 2033, presumably with no § 2001(b) adjustment.

70. The gift tax result of valuing a retained interest at zero is equivalent to finding a completed gift of that interest, but a completed gift is inconsistent with inclusion of the interest in the gross estate as property owned at death.

71. The value of the retained interest has probably changed, and may have become easier to measure, between the initial transfer and the donor's death. However, the deathtime value of that interest is irrelevant in calculating the § 2001(b) adjustment, which depends on the value of the retained interest at the time of the initial transfer.

72. In *Robinette*, for example, the donor retained a life income interest in addition to her reversion in the trust corpus. A life income interest, if retained until death, triggers inclusion of the entire trust property in the donor's gross estate under § 2036(a)(1), with a § 2001(b) adjustment for the value of the interests subjected to gift tax in the initial transfer.

initial transfer. Section 2702 thus may be viewed as an expanded application of the principle of *Robinette*. From this perspective, the following discussion focuses first on the effect of the special valuation rules in the initial transfer and then on related problems in the subsequent treatment of specially-valued retained interests.

A. *Initial Transfer*

The scope of section 2702 is defined by reference to three interrelated elements: a trust, a transfer, and a retained interest.[73] For purposes of section 2702, a trust includes any arrangement that splits beneficial ownership of property into successive interests, i.e. a term interest and remainder.[74] The statute applies when a living donor transfers a beneficial interest in trust property[75] to or for the benefit of a member of the donor's family.[76] The special rules apply for gift tax purposes in valuing interests retained by the donor (or an "applicable family member"[77]) in the underlying property.[78]

73. In determining the existence and amount of a gift resulting from a "transfer of an interest in trust to (or for the benefit of) a member of the transferor's family," § 2702 provides special rules governing the valuation of "any interest in such trust retained by the transferor or any applicable family member." IRC § 2702(a)(1). The regulations enumerate certain transfers that are not subject to § 2702. Regs. § 25.2702-1(c).

74. For purposes of § 2702, a term interest is a present or future interest that confers a right to possess or enjoy property, or to receive income or annuity payments, for a definite period of time, such as the life of one or more individuals, or a term of years. IRC § 2702(c)(3). A remainder is a future interest that confers a right to possess or enjoy property at the expiration of a term interest. See supra notes 13-14. Property is held in trust if there is at least one term interest (and, by implication, a remainder) with respect to the property. IRC § 2702(c)(1) (defining "transfer in trust"). Thus, the concept of a trust depends on the division of beneficial ownership of property into successive (as distinguished from concurrent) interests. See Regs. § 25.2702-4(a).

75. A transfer in trust includes a transfer of property to a new or existing trust, as well as a transfer of an interest in an existing trust. A transfer does not include a qualified disclaimer or an exercise, release, or lapse of a power of appointment that is not treated as a transfer for gift tax purposes. Regs. § 25.2702-2(a)(2).

76. "Member of the family" includes the donor's spouse, ancestors and lineal descendants of the donor or the donor's spouse, the donor's siblings, and spouses of the foregoing. IRC §§ 2702(e), 2704(c)(2). If the beneficiaries of a transfer in trust include family members and others, § 2702 presumably applies to the entire trust, excluding only any specified portion in which no family member has an actual or potential interest. Cf. IRC § 2702(d) (stating that in the case of a transfer of an income or remainder interest with respect to a "specified portion" of trust property, § 2702 applies only to such portion).

77. "Applicable family member" includes the donor's spouse, ancestors of the donor or the donor's spouse, and spouses of those ancestors. IRC §§ 2702(a)(1), 2701(e)(2).

78. An interest is "retained" if it is held by the same individual both before and after the transfer in trust. Regs. § 25.2702-2(a)(3). An individual who retains a power affecting beneficial enjoyment of property is treated as retaining an interest in the property to the extent

Accordingly, the special rules do not apply if the transfer in trust constitutes a completed gift of all interests in the property,[79] or if the donor's retained interests and powers ensure that no portion of the transfer is a completed gift.[80] In general, section 2702 reaches most types of GRITs and similar split-interest arrangements that exploited the valuation tables under prior law.[81]

Section 2702 serves a limited function of apportioning value for gift tax purposes between interests that are retained and transferred in the initial transfer.[82] Based on the notion that the aggregate value of all beneficial interests in the trust equals the value of the trust property, the regulations derive the value of transferred interests by subtracting the value of retained interests from the value of the trust property.[83] Thus, in focusing on the valuation of retained interests, the special rules indirectly control the valuation of transferred interests for gift tax purposes. By limiting the value of retained interests, the special rules set a floor on the amount of the gift in the initial transfer. The special rules have no effect, however, on general principles governing the timing or extent of gift completion.

Under section 2702, a "qualified" retained interest is valued under the tables, and any other retained interest is generally valued at zero.[84] A term interest is qualified only if it confers a right to receive payments in fixed amounts (an annuity interest)[85] or payments equal to a fixed percentage of

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that the retained power would prevent a transfer of the property from being a completed gift. Regs. § 25.2702-2(a)(4). Thus, a donor cannot avoid § 2702 simply by retaining a power to revoke or change beneficial interests rather than retaining beneficial ownership of the interests.

79. Regs. § 25.2702-2(d)(1) ex. 3. However, if a beneficiary of an existing trust transfers the beneficiary's entire interest to a family member, § 2702 applies if an applicable family member of the beneficiary owns an interest in the trust both before and after the transfer.

80. Regs. §§ 25.2702-1(c)(1), 25.2702-2(d)(1) ex. 4.

81. Personal residence trusts represent a glaring gap in the coverage of § 2702. See Regs. §§ 25.2702-1(c)(2), 25.2702-5. As the drafters of the regulations acknowledge, such trusts perpetuate precisely the valuation abuses that § 2702 is intended to curb. T.D. 8395, 1992-1 C.B. 316, 319.

82. Accordingly, § 2702 has no effect on valuation for income, estate, or generation-skipping-transfer tax purposes. I.R.S. Notice PS-92-90, 1991-1 C.B. 998, 999; T.D. 8395, 1992-1 C.B. 316, 318.

83. Regs. § 25.2702-1(b).

84. IRC § 2702(a)(2)(A), (B); Regs. § 25.2702-2(b)(1), (2). An exception applies where the nonexercise of rights under a retained term interest in tangible property has no substantial effect on the value of the remainder. IRC § 2702(c)(4); Regs. § 25.2702-2(c). In this case, the retained term interest is valued under an arm's-length standard that normally produces a value for the term interest that is lower than its value determined under the tables. This exception permits limited tax benefits from a GRIT with respect to tangible, nondepreciable property such as antiques, art works, jewelry, or unimproved land.

85. IRC § 2702(b)(1); Regs. § 25.2702-3(b).

the annually-determined value of the trust property (a unitrust interest);[86] in either case, the amounts must be payable at least annually, for a term equal to the holder's life, a specified term of years, or the shorter (but not the longer) of those periods.[87] A remainder is qualified only if it confers an unconditional right to receive property in which all other interests are qualified interests.[88] The requirements are intended to ensure that the holder of a qualified interest will actually receive distributions that can be valued realistically under the tables.[89] Conversely, denying value to nonqualified interests reduces opportunities for manipulating the tables.

To illustrate the impact of the special rules, assume that *A* transfers property worth $100,000 in trust to pay income to herself for a term of 15 years with remainder to her child *C* or *C*'s estate.[90] Under section 2702, the amount of *A*'s gift is $100,000; her retained income interest is valued at zero because it is not a qualified interest. The result is the same if *A* also retains a reversion conditioned on her death within the 15-year term. In view of the possibility that *A* might survive the 15-year term and never receive any distributions of income or corpus, the special rules treat her retained interests as having no ascertainable value in the initial transfer.

The special rules also curtail the gift tax advantages of a sale of a remainder or a joint purchase. Assume that *A*, age 70, transfers property worth $100,000 in trust to pay income to herself for life with remainder at her death to her child *C* or *C*'s estate, and in exchange *C* pays *A* the value of the remainder determined under the tables. Under section 2702, the amount

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86. IRC § 2702(b)(2); Regs. § 25.2702-3(c).

87. Regs. § 25.2702-3(d)(3). The § 2702 regulations impose no restrictions on the type of property that may be used to make the required payments. Nevertheless, § 2701 may apply if a donor creates a trust of subordinate equity interests in a corporation or partnership while retaining senior equity interests in the same entity. Regs. § 25.2701-3(b)(4)(iii) (incorporating § 2702 principles in valuation under § 2701). Under § 2701, payment in the form of an equity interest in the entity is not a qualified payment. Regs. § 25.2701-4(c)(5).

88. IRC § 2702(b)(3); Regs. § 25.2702-3(f).

89. Reflecting the same concern, the regulations prohibit any distribution to a person other than the holder during the term as well as any prepayment of the holder's interest. T.D. 8395, 1992-1 C.B. 316, 319; Regs. § 25.2702-3(d)(2), (4). If the holder does not receive the required payments, the interest apparently ceases to be qualified. See Regs. § 25.2702-3(d)(1), (f)(1)(ii) (noting that definitional and functional requirements apply from creation).

The definition of qualified interests under § 2702 is derived from the rules limiting charitable deductions for gifts of split interests, which reflect similar valuation concerns. See I.R.S. Notice PS-92-90, 1991-1 C.B. 998, 1001; cf. IRC § 2522(c)(2)(B); Regs. § 25.2522(c)-3(c). Indeed, certain transfers qualifying for a gift tax charitable deduction are exempt from § 2702. Regs. § 25.2702-1(c)(3)-(5).

90. This example is identical to the GRIT described in text accompanying note 18, supra, except that the remainder beneficiary is a member of *A*'s family and, as a result, § 2702 applies. See supra note 76.

of *A*'s gift is the difference between the value of the underlying property and the consideration furnished by *C*.[91] Alternatively, assume that *A* purchases a life income interest and *C* simultaneously purchases a remainder in the underlying property from an unrelated third party, each furnishing consideration in proportion to the value (determined under the tables) of the interest received. Section 2702 recasts the joint purchase as if *A* purchased the underlying property and then sold the remainder to *C* for the consideration actually furnished by *C*.[92] In both cases, section 2702 denies *A* the tax benefit of valuing her life income interest under the tables.

Section 2702 substantially reduces the gift tax advantages of retaining nonqualified interests in transfers subject to the special rules. Split-interest transfers remain viable as transfer tax avoidance techniques, however, where the special rules do not apply.[93] Even under section 2702, the mandatory use of the tables to value qualified interests offers substantial planning opportunities to the extent that the tables reflect unrealistic assumptions concerning actual rates of return and life expectancies. Assume that *A*, age 70, transfers property worth $100,000 in trust to pay a qualified annuity of $10,000 to herself for 15 years or until her prior death, with remainder to her child *C* or *C*'s estate. If the applicable discount rate is 10%, *A*'s retained annuity is valued at $60,307 and the amount of *A*'s gift to *C* is $39,693.[94]

The amount of the gift accurately reflects the present value of *C*'s remainder if the underlying assumptions of the tables coincide with realistic expectations concerning the rate of return on the trust's investments and *A*'s actual mortality risk. To the extent that those assumptions are unrealistic, however, the tables may distort the value of *C*'s remainder.[95] For example, the tables reflect an assumption that the trust property will produce a 10% annual return that will match precisely the $10,000 annuity payments to *A*,

91. Assuming a discount rate of 10%, the values of *A*'s life income interest and *C*'s remainder determined under the tables are $64,093 and $35,907, respectively. See Actuarial Values (Alpha), supra note 17, at Table S. Accordingly, the amount of *A*'s gift is $64,093. See Regs. § 25.2702-4(d) ex. 2.

92. IRC § 2702(c)(2); Regs. § 25.2702-4(c). Thus, if *A* pays $64,093 and *C* pays $35,907, in proportion to the values of their respective interests under the tables, the amount of *A*'s gift is $64,093 ($100,000 - $35,907). See Regs. § 25.2702-4(d) ex. 1. The amount of *A*'s gift, however, cannot exceed the amount of consideration furnished by *A*. Thus, if *A* pays only $20,000 and *C* pays $35,907, the amount of *A*'s gift is limited to $20,000. See Regs. § 25.2702-4(d) ex. 4. The bargain sale to *A* may trigger a separate gift by the third-party seller.

93. For example, the special rules do not apply if the donee is not a member of the donor's family, see supra note 76, or to certain transfers of property to be used as a personal residence. IRC § 2702(a)(3)(A)(ii); Regs. § 25.2702-5.

94. See Actuarial Values (Alpha), supra note 17, at Table H.

95. An even more serious distortion may arise if the trust property itself is undervalued. See supra note 30 and accompanying text.

leaving property worth $100,000 for *C* at the end of the term. If the property actually produces a 12% annual return and *A* survives the 15-year term, *C* will receive property worth $174,559 rather than $100,000 at the end of the trust term. If the interests were valued using the actual rate of return of 12%, rather than the 10% assumed return, *A*'s retained annuity would be valued at $54,791, and the gift to *C* would be $45,209, not $39,693.[96] The tables thus produce a substantial undervaluation of *A*'s gift, and this undervaluation increases in proportion to the length of the term. The effect is even more accentuated if the annuity payments increase in amount over the term.[97]

If the rate of return on trust investments is lower than the assumed rate, a donor can manipulate the special rules by retaining a qualified reversion. Assume that *A* transfers property worth $100,000 in trust to pay a qualified annuity of $10,000 to *C* for 15 years with reversion to *A* or *A*'s estate. If the applicable discount rate is 10%, *A*'s retained reversion is valued at $23,939 and the amount of *A*'s gift to *C* is $76,061.[98] If the property actually produces an annual return of only 5%, the annuity payments will exhaust the trust during the 15th year, leaving *A* with a worthless interest at the end of the term. Thus, a substantial portion of the value of the underlying property may escape inclusion in *A*'s transfer tax base.

A similar distortion may arise if *A* has an unusually short life expectancy, even if the underlying property actually produces precisely the assumed rate of return.[99] Assume that *A*, age 70, transfers property worth $100,000 in trust to pay a qualified annuity of $12,000 to herself for 15 years or until her prior death, with remainder to *C* or *C*'s estate. At a discount rate of 10%, the value of *C*'s remainder under the tables is $27,632 at the time of the initial transfer.[100] Since the $12,000 annuity exceeds the assumed annual income of $10,000, the tables reflect an assumption that the annuity payments will gradually consume the value of the underlying property. If the

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96. See Actuarial Values (Alpha), supra note 17, at Table H.

97. Backloading *A*'s annuity payments increases the risk and potential return for *B* by increasing the portion of the trust property locked into the trust's rate of return during the early years of the term. The § 2702 regulations permit noncumulative annual increases of up to 20% in the payments under a qualified term interest. Regs. § 25.2702-3(b)(1)(ii), (c)(1)(ii). The extent of permitted backloading thus increases in proportion to the length of the term. The holder of a qualified term interest may also have a right to receive any trust income in excess of the payments under the qualified interest, but the excess income is disregarded in valuing the qualified interest. Regs. § 25.2702-3(b)(1)(iii), (c)(1)(iii).

98. See Actuarial Values (Alpha), supra note 17, at Table B.

99. If *A* is terminally ill at the time of the initial transfer, the tables may be inapplicable in valuing her retained interest. See supra note 36.

100. Under the tables, *A* has a life expectancy of 13.32 years, and the present value of her retained annuity is $72,368. See Actuarial Values (Alpha), supra note 17, at Tables 80CNSMT, H.

property generates annual income of 10%, and *A* dies two years after the initial transfer, the trust property will be worth $95,800 at *A*'s death.[101] Thus, in overestimating *A*'s life expectancy, the tables may substantially undervalue *C*'s remainder in the initial transfer.

In theory, it is possible to fix the amount of a retained qualified annuity high enough to eliminate gift tax in the initial transfer. Such a "zero-out" arrangement, if permitted, would permit a donor to make a tax-free transfer of any return on the property in excess of the assumed rate without suffering any tax cost if the actual return fell below the assumed rate.[102] The section 2702 regulations prevent this result, however, by discounting the present value of each annuity payment by the probability of the holder's death. Thus, although a donor may retain a qualified annuity for a fixed term, the special rules in effect accord value only to annuity payments for the shorter of the fixed term or the donor's life.[103] Since there is always a possibility that the donor may die before receiving a particular payment, the gift tax value of the retained interest is always less than the value of the underlying property.[104]

Thus, despite their apparent harshness, the special rules leave room for planners to exploit the tables in apportioning value between retained and transferred interests in the initial transfer. To measure the impact of section

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101. The string provisions may include all or a portion of the trust property in *A*'s gross estate if *A* actually dies during the 15-year term. See IRC § 2036(a)(1); Rev. Rul. 82-105, 1982-1 C.B. 133 (retained annuity interest); Rev. Rul. 76-273, 1976-2 C.B. 268 (retained unitrust interest); Priv. Let. Rul. 9345035 (Aug. 13, 1993) (including entire trust property under § 2039).

102. Assume that *A* creates a trust to pay a qualified annuity to herself for a fixed term of years with remainder to her child *C* or *C*'s estate. If the present value of *A*'s retained annuity is exactly equal to the value of the underlying property at the time of the initial transfer, there is no taxable gift. Moreover, if *A* survives the 15-year term, there will be no further transfer tax consequences. If the property generates a return above the rate assumed under the tables, *C* will receive the excess value at the end of the term free of transfer tax; if the property generates less than the assumed rate, both *A* and *C* will be in the same position as if the transaction had never occurred.

103. Regs. §§ 25.2702-3(d)(3) (permitting fixed-term qualified interest), 25.2702-3(e) exs. 1, 5 (valuing fixed-term qualified interest as if for shorter of fixed term or holder's life).

104. This result cannot be circumvented by increasing the annuity amount, since annuity payments are taken into account only to the extent supported by the value of the underlying property. See Prop. Regs. § 25.7520-3(b)(2)(i), (v) ex. 5; Rev. Rul. 77-454, 1977-2 C.B. 351; see also Gans, supra note 5, at 833-37 (arguing that a donor who retains an annuity interest "confers a valuable right on the remainderman even where the annuity amount is set at a level that zeroes out the taxable gift"); U.S. Trust, Practical Drafting 3546-51 (1994) (tables assume underlying property sufficient to support annuity payments); but cf. Estate of Shapiro v. Commissioner, T.C. Memo 1993-483 (CCH) (1993) (disregarding possibility that annuity payments might exhaust underlying property).

2702 on split-interest transfers in trust, however, it is important to examine the subsequent treatment of retained interests after the initial transfer.

B. *Subsequent Treatment of Retained Interests*

After the initial transfer, the value of a retained interest is no longer determined under the special rules; in a subsequent transfer, the interest is valued under general principles. In the case of a retained qualified interest, the shift from one valuation method to another is innocuous because both methods value a qualified interest under the tables. In the case of a retained nonqualified interest, however, the two valuation methods raise a problem of potential double taxation. The special rules generally increase the amount of the gift in the initial transfer by disregarding the value of a retained nonqualified interest. In effect, the value of the retained interest is subject to gift tax in the initial transfer. If the same interest subsequently enters the transfer tax base at a value determined under general principles, an adjustment may be necessary to avoid double taxation.

As in *Robinette*, the problem stems from applying inconsistent valuation methods to the same interest at different times. One possible approach would be to eliminate the inconsistency by applying the special rules in the subsequent transfer. If a retained interest was valued at zero in the initial transfer, this would produce the same effect as simply excluding the interest from the transfer tax base in the subsequent transfer. Although this approach may achieve a pragmatic result in particular cases,[105] it exacerbates the inconsistency between the special rules and general principles concerning the timing and valuation of transfers, and offers no viable general solution to the problem of double taxation.

The section 2702 regulations provide a special adjustment to mitigate the problem of double taxation.[106] The adjustment takes the form of a reduction in the donor's cumulative taxable gifts[107] upon a subsequent transfer of a nonqualified interest that was valued under the special rules in the initial transfer (a "section 2702 interest").[108] In general, the adjustment

105. Cf. Rev. Rul. 79-421, 1979-2 C.B. 347; see supra note 61.

106. Regs. § 25.2702-6. In contrast to § 2701, the statutory language of § 2702 does not expressly provide for an adjustment. Cf. IRC § 2701(e)(6). Thus, in providing the adjustment, the Treasury has exercised its general regulatory authority. See I.R.S. Notice PS-30-91, 1991-2 C.B. 1118, 1120.

107. For convenience, this article uses the term "cumulative taxable gifts" to mean the aggregate sum of taxable gifts under § 2502(a) or the amount of adjusted taxable gifts under § 2001(b), as appropriate.

108. Regs. § 25.2702-6(a)(1), (2). The regulations properly provide no adjustment upon a subsequent transfer of a retained qualified interest. Since a qualified interest is valued under the tables in the initial transfer even under § 2702, the special rules create no risk of

is available only with respect to a section 2702 interest that was held by the donor at the time of the initial transfer.[109] Moreover, the adjustment becomes available only when the donor makes a subsequent transfer of the section 2702 interest during life or at death; if the donor simply retains the interest until it expires, the adjustment is lost.[110] The regulations limit the amount of the adjustment to ensure that the amount ultimately included in the transfer tax base on account of the section 2702 interest is at least equal to the value of that interest (determined under general principles) at the time of the initial transfer.[111] Predictably, the adjustment raises several technical and policy issues.

1. *Amount of Adjustment.*—The regulations limit the adjustment to the lesser of (1) the increase in taxable gifts resulting from applying the special rules to value the section 2702 interest in the initial transfer (the "first limitation") or (2) the increase in taxable gifts or gross estate resulting from the subsequent transfer of the section 2702 interest (the "second limitation").[112]

The first limitation is the difference, at the time of the initial transfer, between the value of the section 2702 interest determined without regard to the special rules and the value of the same interest under the special rules.[113] Typically, the section 2702 interest was valued at zero in the initial transfer, and the first limitation is accordingly equal to the value of the section 2702 interest at the time of the initial transfer determined without regard to the special rules.[114] Assume that *A* transfers property worth $100,000 in trust to pay income to herself for 15 years with remainder to her child *C* or *C*'s estate. Under the tables, assuming a 10% discount rate, the value of *A*'s retained income interest is $76,061,[115] but its value under the

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double taxation, and there is no need for a corrective adjustment. For similar reasons, the regulations provide no adjustment with respect to retained interests that were not valued under the special rules in the initial transfer.

109. On the unavailability of the adjustment with respect to interests held by applicable family members, see infra notes 138-44 and accompanying text.

110. See Regs. § 25.2702-6(a)(1), (2).

111. For a discussion of the amount of the adjustment, see infra notes 112-28 and accompanying text.

112. See Regs. § 25.2702-6(b)(1).

113. Under the subtraction method adopted by the § 2702 regulations, any value denied to the § 2702 interest by the special rules automatically increases the amount of the donor's gift.

114. The only situation in which the special rules accord positive value to a § 2702 interest involves certain tangible, nondepreciable property. See supra note 84. A conversion of the property during the term may trigger a deemed gift of the unexpired term interest and give rise to an adjustment under the § 2702 regulations. Regs. § 25.2702-2(c)(4).

115. See Actuarial Values (Alpha), supra note 17, at Table B.

special rules is zero. Any adjustment allowed in a subsequent transfer cannot exceed $76,061. In effect, the first limitation ensures that any appreciation in the section 2702 interest subsequent to the initial transfer is included in the transfer tax base.

The second limitation, which is normally equal to the value of the section 2702 interest at the time of the subsequent transfer, ensures that any decline in the value of the interest subsequent to the initial transfer does not reduce the amount included in the donor's gift tax base in the initial transfer. Thus, in the preceding example, if *A* makes a gift of her retained income interest two years after the initial transfer when the value of the interest (determined under the tables) is $71,034,[116] the adjustment is limited to $71,034. However, in the case of a lifetime transfer that is not fully includable in taxable gifts, the adjustment may be less than the value of the interest at the time of the subsequent transfer. This occurs, for example, if the subsequent transfer qualifies for a marital deduction[117] or (in some cases) an annual exclusion.[118] The adjustment may also be reduced in the case of a sale or exchange of the section 2702 interest for money's-worth consideration, since the consideration reduces the amount of the taxable gift.[119] Thus, if *A* sells her income interest two years after the initial transfer for its value (determined under the tables) of $71,034, no adjustment is allowed. To the extent that the second limitation actually reduces the amount of the adjustment below the value of the section 2702 interest, the adjustment is wasted.

The second limitation also raises a more subtle problem if the section 2702 interest is a term interest. The value of a term interest tends to decrease with the passage of time, producing a corresponding decrease in the amount

116. See Actuarial Values (Alpha), supra note 17, at Table B (value of right to receive $100,000 in 13 years, assuming 10% discount rate).

117. A § 2702 interest that qualifies for a gift tax marital deduction upon a subsequent transfer by the donor escapes inclusion in the donor's taxable gifts but is ultimately reflected in the spouse's transfer tax base. There is no apparent reason why the spouse should not be entitled to an adjustment upon a subsequent transfer of the interest. Cf. Regs. § 25.2702-6(a)(3) (adjustment assignable in connection with split gift of § 2702 interest to third party); but cf. T.D. 8536, 1994-21 I.R.B. 7 (rejecting assignability of analogous adjustment under § 2701 on grounds of "administrative complexity").

118. If the donor makes gifts of a § 2702 interest and of other property to the same donee in the same calendar year, and if both gifts qualify for the annual exclusion, a question arises concerning the amount of "taxable gifts" attributable to the § 2702 interest. For purposes of the second limitation, the regulations allocate the annual exclusion first to property other than the § 2702 interest. See Regs. § 25.2702-6(b)(2). This rule preserves the adjustment even if the gift of the § 2702 interest is excluded from taxable gifts under § 2503(b).

119. There is no apparent reason why the adjustment should not be preserved and allowed as a reduction in subsequent cumulative taxable gifts. Cf. Regs. § 25.2701-5(c)(3) (analogous adjustment under § 2701).

of the adjustment.[120] Assume that *A* transfers property worth $100,000 in trust to pay income to herself for 15 years with remainder to her child *C* or *C*'s estate. In the initial transfer, *A*'s retained income interest is valued at zero, producing a taxable gift of $100,000. If *A* subsequently makes a taxable gift of her remaining income interest, the income interest is valued under the tables, and the regulations allow an offsetting adjustment. Assuming a constant discount rate of 10% and a constant value of the trust property, the amount of the gift and the adjustment is $61,446 after 5 years, $37,908 after 10 years, and zero after 15 years.[121] If *A* retains the term interest for the full 15-year term, no adjustment is allowed.[122]

Although the adjustment matches the value of *A*'s remaining income interest, the gradual erosion of the adjustment over the 15-year term produces harsh results if *A* actually receives income distributions after the initial transfer. Whether or not *A* subsequently transfers the income interest, those distributions ultimately are reflected in her transfer tax base[123] and are not offset by any adjustment. Arguably, an adjustment should be allowed in connection with subsequent transfers of amounts traceable to income distributions received by *A*. However, the administrative problems of tracing distributions and discounting their value back to the time of the initial transfer[124] probably outweigh the increased accuracy that such an adjustment would

120. Some commentators argue that the decrease in the value of a term interest resulting from the passage of time should be ignored for purposes of the second limitation, whether or not the holder actually receives any distributions. American Bar Association, Section of Real Property, Probate, and Trust Law and Section of Taxation, Comments on Second Installment of Chapter 14 Proposed Regulations, Specific Comment B.3 (Oct. 16, 1991), 91 TNT 219-48 (LEXIS, Fedtax lib., TNT file). The § 2702 regulations properly reject this approach, which would threaten to revive the very abuses at which § 2702 is aimed. Cf. T.D. 8536, 1994-21 I.R.B. 7 (rejecting "purge" approach under § 2701).

121. See Regs. § 25.2702-6(b)(1)(ii) (second limitation); Actuarial Values (Alpha), supra note 17, at Table B.

122. The expiration of the income interest at the end of the 15-year term is not a transfer for gift tax purposes; even if it were, the amount of the adjustment would be limited to zero, the amount of *A*'s taxable gift in the subsequent transfer.

123. See supra note 38 and accompanying text.

124. In the preceding example in text, assume that *A* receives no income for the first 14 years and then in the 15th year receives an income distribution of $30,000, of which she immediately makes a taxable gift. Even if the subsequent transfer were valued at $30,000 for purposes of the second limitation, the $30,000 income distribution would in theory have to be discounted back to the time of the initial transfer for purposes of the first limitation. The present value of $30,000 payable in 15 years (assuming a 10% discount rate) is $7,182 ($30,000 x 0.239392). See Actuarial Values (Alpha), supra note 17, at Table B. Therefore, if an adjustment were allowed, the first limitation would presumably limit it to this amount.

provide.[125] Accordingly, the regulations permit the adjustment only if *A* assigns or releases her income interest during the term.[126]

The regulations draw a formalistic distinction between a transfer of an existing trust interest and a transfer of amounts received as distributions with respect to the trust interest. In the preceding example, assume that the income is payable to *C* for the 15-year term, subject to *A*'s retained power to revoke the income interest. In the initial transfer, *A*'s retained power is treated as a retained interest and valued at zero, producing a gift equal to the entire value of the trust property. Each year, as *A* allows her retained power to lapse with respect to current income, she is treated as making a completed gift of the income to *C*. Nevertheless, the regulations allow no adjustment because *A*'s annual gifts relate to amounts distributed as income rather than to the income interest itself.[127] By contrast, the adjustment would be available if *A* completely released her retained power (or exercised it in favor of another person) during the 15-year term.[128]

2. *Interaction with String Provisions.*—If the section 2702 interest is included in the donor's gross estate, the regulations generally allow a reduction in the donor's adjusted taxable gifts. If an interest transferred in the initial transfer is also included in the donor's gross estate under the string provisions, however, section 2001(b) provides an independent reduction in the donor's adjusted taxable gifts.[129] The section 2702 regulations resolve the potential overlap by giving precedence to the section 2001(b) adjustment.[130]

The section 2001(b) adjustment often applies in conjunction with section 2036(a) when the donor makes a lifetime transfer of a remainder

125. In some cases, however, the regulations do provide adjustments based on compounded or discounted values to reflect subsequent events inconsistent with assumptions made in the initial transfer. See, e.g., Regs. §§ 25.2701-4 (compounding rule for untimely qualified payments), 25.2702-2(c)(4) (valuing retained term interest in certain tangible property on conversion).

126. See T.D. 8395, 1992-1 C.B. 316, 320 (stating adjustment is available "only if the retained interest itself is taxed in a transfer subsequent to the [initial transfer]").

127. See Regs. § 25.2702-6(c) ex. 6.

128. See Regs. § 25.2702-6(c) ex. 7. Presumably, if *A* releases her retained power over a fractional or percentage portion of the entire income interest, a corresponding portion of the adjustment should be allowed. A partial adjustment may be allowed even if *A* releases her retained power over the income interest for specified future years. The regulations, however, do not address the problem of partial transfers. See infra notes 145-51 and accompanying text.

129. For a discussion of the string provisions, see supra notes 40-43 and accompanying text.

130. Regs. § 25.2702-6(b)(3) (denying reduction "to the extent section 2001 would apply to reduce the amount of an individual's adjusted taxable gifts with respect to the same [retained] interest").

while retaining an income interest for a period that does not end before death. In this situation, the underlying property is included in the gross estate, the gift tax value of the remainder is excluded from adjusted taxable gifts, and an offset is allowed against the estate tax for the gift tax payable with respect to the initial transfer.[131] The interaction of sections 2036(a) and 2001(b) produces approximately the same nominal amount of transfer taxes regardless of whether the special rules applied to the initial transfer.[132] If the special rules applied to the initial transfer and the section 2702 interest is a term interest, the adjustment under section 2702 is generally superfluous unless for some reason the string provisions do not trigger inclusion of the transferred interest in the gross estate. Accordingly, if the section 2702 interest is a term interest, the regulations allow a deathtime adjustment only in the unusual case where the string provisions do not apply.[133]

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131. IRC §§ 2036(a)(1), 2001(b).

132. For example, assume that *A* transfers $100,000 in trust to pay income to herself for 15 years, and dies during the trust term. Section 2702 applies to the initial transfer only if the remainder is transferred to a member of *A*'s family. Based on the simplifying assumptions of a 10% discount rate, a constant value of the trust property, and a flat transfer tax rate of 50% with no exclusions, deductions or credits, the following calculation shows that the total amount of transfer taxes is the same regardless of whether § 2702 applies to the initial transfer:

	General Principles	*Section 2702*
Initial transfer:		
taxable gift	$ 23,939	$100,000
gift tax	11,970	50,000
Subsequent transfer:		
gross estate	$100,000	$100,000
adjusted taxable gifts (§ 2001(b))	0	0
tentative estate tax	50,000	50,000
gift-tax offset	11,970	50,000
estate tax	38,030	0
Total transfer taxes	$ 50,000	$ 50,000

The total amount of transfer taxes in each case is the same. The economic cost is not identical, however, due to disparities in the transfer tax base and the completion rules of existing law. See infra notes 156-76 and accompanying text.

133. The § 2702 adjustment is available only if the retained term interest is included in the gross estate "solely by reason of section 2033." Regs. § 25.2702-6(a)(2)(i). For example, assume that *A* purchases a 15-year income interest in property and her child *C* simultaneously purchases the remainder in the same property, and that *A* dies during the 15-year term owning the unexpired income interest. In this case, the special rules apply to the joint purchase, IRC § 2702(c)(2), but the string provisions do not trigger inclusion of the underlying property in *A*'s gross estate as long as *A* is not treated as having made a lifetime "transfer" subject to a retained income interest. IRC § 2036(a). Under the §2702 regulations, *A*'s adjusted taxable gifts should be reduced by the lesser of the increase in her taxable gifts resulting from the application of the special rules in the initial transfer or the value of the term interest included in her gross estate under § 2033. See Regs. § 25.2702-6(c) ex. 8. This represents a liberaliza-

If the only section 2702 interest is a reversion that is included in the donor's gross estate, the section 2702 adjustment is available unless the string provisions trigger a section 2001(b) adjustment.[134] The section 2001(b) adjustment displaces the section 2702 adjustment where the string provisions trigger inclusion in the gross estate of a remainder that was transferred during life.[135] Often, however, a retained reversion does not trigger inclusion of any transferred interest under the string provisions, leaving the section 2702 adjustment intact.[136] If the special rules valued the retained reversion at zero in the initial transfer, the section 2702 adjustment is equal to the lesser of the value of the section 2702 interest at the time of the initial transfer or at death, determined in both cases under general principles.[137] If the retained reversion would have been valued at zero in the initial transfer under *Robinette*, even without regard to the special rules, the first limitation apparently produces a section 2702 adjustment of zero. In this case, section 2702 produces the same result as *Robinette* in the initial transfer, and offers no

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tion of the original proposed regulation, which allowed no adjustment in connection with a retained term interest. Prop. Regs. § 25.2702-6(a)(2), reprinted at 1991-2 C.B. 1118, 1122.

134. Regs. § 25.2702-6(a)(2)(ii).

135. For example, assume that *R* (age 40) creates a trust of $100,000 to pay income to *R*'s spouse *S* (age 42) for life with corpus at *S*'s death to *R* if living or if *R* is not then living to their child *T*. Assuming a constant discount rate of 10%, a constant value of the trust property, and no marital deduction under § 2523(f), if *R* dies 10 years later, survived by *S*, the deathtime value of *T*'s remainder ($14,780) is included in *R*'s gross estate. IRC § 2037(a); Regs. § 20.2037-1(e) ex. 3. The § 2001(b) adjustment is the value of *T*'s remainder (determined under the tables) at the creation of the trust ($3,681). This displaces the § 2702 adjustment, which is limited to the lesser of the value of *R*'s reversion determined under the tables at the time of the initial transfer ($4,360) or the value of *R*'s reversion included in *R*'s gross estate ($0). See Actuarial Values (Alpha), supra note 17, at Tables S, 80CNSMT.

136. If the only retained interest is a reversion, a donor normally can avoid the string provisions quite easily. Section 2037 does not apply if possession or enjoyment of the transferred interest might be obtained during the donor's life. Assume that *R* (age 40) creates a trust of $100,000 to pay income to *R*'s spouse *S* (age 42) for life with corpus at *S*'s death to their child *T* (age 20) if living or if *T* is not then living to *R*. If *R* dies 10 years later, survived by *S*, only the value of *R*'s reversion is included in *R*'s gross estate. IRC § 2033. Neither *S*'s income interest nor *T*'s remainder is included. IRC § 2037(a)(1); Regs. § 20.2037-1(e) ex. 1.

137. In the example in note 136, supra, assuming a constant discount rate of 10%, a constant value of the trust property, and no marital deduction, the first limitation is $1,134—the value of a remainder on the death of a 42-year-old ($8,041) multiplied by the probability that a 20-year-old will fail to survive a 42-year-old (.14105); the second limitation is $2,008—the value of a remainder on the death of a 52-year-old ($14,780) multiplied by the probability that a 30-year-old will fail to survive a 52-year-old (.13589). Under the first limitation, the amount of the § 2702 adjustment is $1,134. See Actuarial Values (Alpha), supra note 17, at Tables S, 80CNSMT.

better solution to the intractable problem of double taxation in the subsequent deathtime transfer.

3. *Special Problems.*—The regulations fail to address the availability and operation of the section 2702 adjustment in several special situations. One problem arises where the section 2702 interest was held by an applicable family member at the time of the initial transfer. Technically, the adjustment is potentially available, upon a subsequent transfer of a section 2702 interest, to the individual who held that interest at the time of the initial transfer.[138] In operation, however, the amount of the adjustment may not exceed the increase in the holder's taxable gifts resulting from applying the special rules to value the section 2702 interest in the initial transfer.[139] As a practical matter, in the usual case where the donor is the only individual who made a taxable gift in the initial transfer, the adjustment is unavailable with respect to any section 2702 interest that was held by an applicable family member[140] at the time of the initial transfer.[141] Thus, the donor's transfer tax base may include the value of an interest that the donor never actually owned or transferred.

The regulations provide some flexibility where the donor and the donor's spouse elect gift-splitting treatment with respect to a subsequent lifetime transfer of the section 2702 interest. Under the regulations, the donor, who would otherwise be entitled to the entire adjustment, may assign half of the adjustment to the consenting spouse.[142] Where the spouses elected gift-splitting in the initial transfer, however, half of the adjustment is apparently lost unless half of the retained interest is treated as "held" by the consenting spouse at the time of the initial transfer.[143] The regulations might easily be

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138. Regs. § 25.2702-6(a)(1), (2). By definition, the individual who held a § 2702 interest at the time of the initial transfer is either the donor or an applicable family member. IRC § 2702(a)(1).

139. Regs. § 25.2702-6(b)(1)(i).

140. The adjustment may be available with respect to a § 2702 interest held by the donor's spouse as a result of a gift-splitting election. See infra notes 142-44 and accompanying text.

141. By contrast, the analogous adjustment under § 2701 is allowed as a reduction in the donor's cumulative taxable gifts, even where the holder is an applicable family member. Regs. § 25.2701-5(a)-(c). There is no apparent reason for a more restrictive rule under § 2702.

142. Regs. § 25.2702-6(a)(3). If the gift-splitting election produces a second annual exclusion, the second limitation may produce a correspondingly smaller adjustment. See Regs. § 25.2702-6(c) ex. 4.

143. If the entire retained interest is treated as "held" by the donor at the time of the initial transfer, only the donor's half of the split gift is taken into account in calculating the § 2702 adjustment. Regs. § 25.2702-6(b)(1)(i) (first limitation). Moreover, if half of the retained interest is treated as held by each spouse at the time of the initial transfer, half of the adjustment may still be lost unless the spouses elect gift-splitting treatment with respect to the

clarified to allocate the adjustment equally between the spouses or permit the donor to assign half of the adjustment to the consenting spouse.[144]

A different problem arises where multiple initial transfers occur with respect to the same section 2702 interest. For example, assume that *A*, age 40, transfers property worth $100,000 in trust to pay income to herself for life, with remainder at her death to her child *C*, age 10. Under section 2702, the amount of *A*'s gift in this first initial transfer is $100,000. Three years later, *A* (now age 43) carves her life income interest into a 10-year term interest and a remainder, retaining the term interest and transferring the remainder to *C*. Under section 2702, the amount of *A*'s gift in this second initial transfer is apparently equal to the value (determined under the tables) of an income interest for *A*'s life.[145]

Apparently, no section 2702 adjustment is allowed as long as *A* retains any portion of her income interest.[146] Assume, however, that five years later *A* (now age 48) transfers the balance of her income interest to *C*. At that time, *A* becomes entitled to an adjustment,[147] arguably in a com-

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subsequent transfer. Regs. § 25.2702-6(b)(1)(ii) (second limitation). The need for a § 2702 adjustment may be obviated, however, if the transferred interest is subsequently included in the donor's gross estate under the string provisions. See supra notes 129-37 and accompanying text. In that case, § 2001(b) attributes the entire gift to the donor for purposes of the reduction in adjusted taxable gifts and the gift-tax offset. IRC § 2001(b), (d). Moreover, if the gift is included in the donor's gross estate under § 2035, half the value of the gift is removed from the spouse's adjusted taxable gifts, and the spouse's gift-tax offset is reduced by the amount shifted to the donor under § 2001(d). IRC § 2001(e). Thus, the gift may be removed from the adjusted taxable gifts of both spouses. See Regs. § 25.2702-6(c) ex. 5.

144. The original proposed § 2702 regulations allocated the adjustment equally between the spouses if they elected gift-splitting in the initial transfer, and permitted them to assign the adjustment to each other. Prop. Regs. § 25.2702-6(a)(3)(i), reprinted at 1991-2 C.B. 1118, 1122. The final regulations contain no such provision concerning gift-splitting in the initial transfer. See Regs. § 25.2702-6(a).

145. Assuming a discount rate of 10% and a constant value of the underlying property, *A*'s income interest is worth $91,424. See Actuarial Values (Alpha), supra note 17, at Table S. The amount of *A*'s gift is calculated by subtracting the value of the retained term interest (determined as zero under the special rules) from "the value of the transferred property." Regs. § 25.2702-1(b). Presumably, the value of the transferred property does not include the value of the remainder retained by *C*. Since *C* is not an applicable family member, the value of *C*'s retained remainder should be determined under the tables (rather than under the special rules). Accordingly, the value of the transferred property should be the difference between the value of the trust property ($100,000) and the value of *C*'s retained remainder ($8,576), or $91,424.

146. Cf. Regs. § 25.2702-6(c) ex. 6 (allowing no reduction on partial lapse of retained power).

147. Cf. Regs. § 25.2702-6(c) ex. 7 (allowing reduction on complete exercise of retained power).

bined amount based on the two initial transfers.[148] On the other hand, if *A* dies owning the carved-out term interest, the entire value of the underlying property is included in her gross estate and the combined amount of *A*'s taxable gifts in the two initial transfers is excluded from her adjusted taxable gifts.[149] The section 2001(b) adjustment more than compensates for the lack of a section 2702 adjustment.[150] If the first initial transfer took the form of a joint purchase rather than a gift of a remainder, however, the absence of a section 2702 adjustment might raise a serious problem of double taxation.[151]

A final problem may arise when a donor transfers a section 2702 interest at death in a manner qualifying for the estate tax marital deduction. If the section 2702 interest was valued at zero in the initial transfer, the donor's adjusted taxable gifts are reduced by the lesser of the value of that interest at the time of the initial transfer (determined under general principles) or its value in the donor's gross estate, unreduced by the amount of the marital deduction.[152] If the donor's taxable estate is sufficient to offset the full amount of the reduction in adjusted taxable gifts, the adjustment is fully effective. On the other hand, the adjustment is wasted to the extent that the taxable estate is less than the amount of the reduction. This could occur, for example, if the donor leaves a marital bequest determined under a formula that fails to take account of the adjustment. The problem could be avoided if the regulations provided a mandatory or elective mechanism for shifting the adjustment from the donor to the surviving spouse in connection with a

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148. Although the § 2702 regulations are silent on the matter, the analogous adjustment under § 2701 is equal to the sum of the separate adjustments for each initial transfer. Regs. § 25.2701-5(c)(3)(vi). Based on an assumed constant discount rate of 10% and a constant value of the underlying property, the combined amount of the adjustment is $74,866 ($37,433 + $37,433). With respect to the life income interest retained in the first initial transfer, the first limitation is $92,945 (the value of an income interest for the life of a 40-year-old), and the second limitation is $37,433 (the value of an income interest for five years or until the prior death of a 48-year-old). With respect to the carved-out term interest retained in the second initial transfer, the first limitation is $91,424 (the value of an income interest for the life of a 43-year-old), and the second limitation is again $37,433. See Actuarial Values (Alpha), supra note 17, at Tables S, H, 80CNSMT.

149. IRC §§ 2001(b), 2036(a)(1).

150. See Regs. § 25.2702-6(a)(2), (b)(3).

151. In that case, the expiration of *A*'s purchased income interest at death arguably would trigger no inclusion in her gross estate. See supra note 133. Accordingly, both the § 2702 adjustment and the § 2001(b) adjustment would be unavailable, and the value of *A*'s income interest, valued separately in both initial transfers, would be included twice in her transfer tax base.

152. Regs. § 25.2702-6(b)(1)(ii).

subsequent transfer of the section 2702 interest that qualifies for the estate tax marital deduction.[153]

In sum, the section 2702 adjustment attempts to compensate for the unfavorable valuation assumptions introduced by the special rules in the initial transfer. In determining the amount ultimately included in the transfer tax base with respect to the section 2702 interest, the adjustment raises several problems. The amount of the adjustment does not reflect distributions actually received by the donor, even though such distributions may replace all or part of the section 2702 interest in the transfer tax base. Moreover, the adjustment does not purport to compensate the donor for the lost return on any increase in gift tax caused by the special rules between the time of the initial transfer and the subsequent transfer.[154] At a more general level, the section 2702 adjustment introduces considerable complexity and uncertainty while failing to provide an adequate remedy for the distortions caused by the special rules in the initial transfer. Thus, section 2702 falls far short of its goals of simplicity, accuracy and fairness.[155]

IV. RETHINKING SECTION 2702

Conceptually, section 2702 carries the principle of *Robinette* to its logical extreme. In the initial transfer, the special rules in effect reapportion the value of the underlying property between nonqualified retained interests and transferred interests. The section 2702 adjustment, where it applies, offers limited relief from this unfavorable valuation approach. In addition to its internal shortcomings, section 2702 exacerbates tensions within the existing gift and estate tax system. The following discussion reexamines some proposals originally developed in the broader context of gift and estate tax reform that offer a simpler, more effective solution to the problems raised by split-interest transfers.

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153. The proposed regulations provided an automatic shift between spouses with respect to the analogous adjustment under § 2701. Prop. Regs. § 25.2701-5(a)(2), reprinted at 1992-1 C.B. 1239, 1241. However, this provision was eliminated in the final regulations. T.D. 8536, 1994-21 I.R.B. 7, 9.

154. Indeed, the timing effect is magnified where the increase in taxable gifts caused by the special rules pushes other taxable gifts made by the donor between the initial transfer and the subsequent transfer into higher brackets. Even if the amount of taxable gifts is subsequently adjusted, § 2702 may indirectly increase gift taxes payable with respect to interim gifts that are completely unrelated to the initial transfer.

155. The legislative history indicates that chapter 14 is intended "to assure more accurate gift tax valuation of the initial transfer" and to deter abuse through "a well defined and administrable set of rules," without hindering nonabusive "standard intrafamily transactions." 1990 Senate Report, supra note 37, at S15680-81.

A. *Section 2702 in Context*

Although section 2702 curbs many abusive valuation techniques involving split-interest transfers, it does nothing to resolve some basic structural weaknesses of the existing gift and estate tax system. Indeed, section 2702 superimposes new distortions that make reform of the existing system even more urgent.

The interaction of the gift and estate taxes produces anomalous results in the case of a split-interest transfer. If the donor retains sufficient ownership or control so that no completed gift occurs with respect to any interest during life, the string provisions pull the full deathtime value of the underlying property into the gross estate.[156] The transfer tax result is virtually the same as if the donor retained complete ownership of the underlying property until death.

On the other hand, if the donor retains ownership or control of an interest in income or corpus while making a completed gift of a remainder interest, the string provisions often draw the full deathtime value of the underlying property—including the previously-taxed remainder—into the gross estate.[157] For example, if *A* transfers property in trust to pay income to herself for life with corpus at her death to *B* or *B*'s estate, *A* makes a completed gift of the remainder.[158] If *A* retains the income interest until death, the deathtime value of the trust property is included in her gross estate.[159] Alternatively, if *A* transfers property in trust to pay income to *B* for life with corpus at *B*'s death to *A* if living or if *A* is not living to *C* or *C*'s estate, *A* makes completed gifts to *B* of an income interest and to *C* of a remainder.[160] If *A* dies before *B* and the value of her reversion (determined under the tables immediately before death) exceeds five percent of the deathtime value of the trust property, the deathtime value of *C*'s remainder is included in *A*'s gross estate.[161] Indeed, *A* may make a completed gift of

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156. A transmissible beneficial interest retained in the initial transfer and owned at death is included in the gross estate. IRC § 2033. Moreover, any retained control that prevents a completed gift from occurring during life with respect to an interest should trigger inclusion of the interest in the gross estate. See IRC § 2038 (estate tax); Regs. § 25.2511-2 (gift tax).

157. Although especially acute in the case of the string provisions, the same problem can arise under other provisions that include property in the gross estate. See IRC §§ 2039, 2040(a), 2041, 2042.

158. Regs. § 25.2511-1(e).

159. IRC § 2036(a)(1).

160. Regs. § 25.2511-1(e).

161. IRC § 2037.

the entire property while retaining certain powers which, if held at death, suffice to bring the entire property into the gross estate.[162]

When a taxable gift is included in the gross estate, section 2001(b) prevents the gift from being double-counted in the cumulative transfer tax base, and at the same time preserves an offset for any gift tax payable with respect to the gift. In conjunction with the string provisions, the section 2001(b) adjustment generally ensures that the total amount ultimately included in the transfer tax base with respect to a reincluded interest is the deathtime value of that interest. In effect, any gift tax imposed on the initial transfer counts as a prepayment of the estate tax imposed at death.[163]

The prepayment of tax represents an economic cost, since the donor loses the return that would otherwise have been earned on the amount used to pay the gift tax on the initial transfer. This cost is offset, at least in part, by the fact that the lost return is not included in the donor's gross estate. Accordingly, the cost of making a split-interest transfer subject to the string provisions, as compared to making a single deathtime transfer, depends in part on the rate of return on investments and the length of time between the initial transfer and death.

Assume that *A* transfers property worth $100,000 in trust to pay income to *A* for 15 years with remainder to her nephew *B* or *B*'s estate. To simplify the calculation, assume a flat transfer tax rate of 30%, a 10% discount rate under the tables, and a 10% annual rate of return (entirely in the form of capital appreciation) on all property. In the initial transfer, *A* makes a taxable gift of $23,939[164] and incurs a gift tax of $7,182 (30% x $23,939), which she pays from non-trust assets. If *A* dies holding the income interest during the 15-year term, the deathtime value of the trust property is included in her gross estate. For example, if *A*'s death occurs after four years, the includable value of the trust property is $146,410, generating an estate tax

162. For example, *A* may make a completed gift by a transfer of property in trust, even if the transfer is subject to a retained power that affects only the time or manner of enjoyment of the property, or that is exercisable only in conjunction with a person having a substantial adverse interest in the property. Regs. § 25.2511-2(d), (e). The same retained power that did not prevent a completed lifetime gift of the property may trigger inclusion of the property in *A*'s gross estate. IRC § 2038; Regs. § 20.2038-1(a).

163. To take account of any change in the rate schedule between the time of the initial transfer and the donor's death, the gift-tax offset is calculated using the rates in effect at the time of death, and thus may not equal the gift taxes actually paid. IRC § 2001(b)(2).

164. The tables apportion 23.9392% of the value of the underlying property to the remainder. See Actuarial Values (Alpha), supra note 17, at Table B. Section 2702 does not apply because *A*'s nephew *B* is not a "member of [*A*]'s family" within the meaning of that section. See supra note 76.

of $36,741 and leaving $109,669 after transfer taxes.[165] The after-tax value of the trust is less than if *A* made no completed gift in the initial transfer (for example, by retaining a power to revoke *B*'s remainder) and added the $7,182 gift tax savings to the trust in the initial transfer. In that case, the trust property would appreciate to $156,925 at *A*'s death, generating an estate tax of $47,078 and leaving $109,847 after transfer taxes.[166]

By avoiding a completed lifetime gift of the remainder, *A* is able to increase the deathtime value of her trust by $10,515 before transfer taxes ($156,925, rather than $146,410), but the estate tax increases by $10,337, leaving an increase of only $178 in the after-tax value of the trust.[167] This result highlights a further anomaly in the gift and estate tax system: the "tax-inclusive" estate tax base includes the amount of estate tax as well as the value of property transferred to successors, but the "tax-exclusive" gift tax base includes only the value of property transferred to donees.[168] Accord-

165. At a 10% annual rate of return in the form of capital appreciation, the trust property is worth $146,410 ($1.1^4$ x $100,000) at *A*'s death. That amount is included in her gross estate, generating a tentative estate tax of $43,923 (30% x $146,410) and, after a gift-tax offset of $7,182, an estate tax of $36,741. If the estate tax is paid from the trust property, the after-tax value of the trust property is $109,669 ($146,410 - $36,741).

166. At a 10% annual rate of return in the form of capital appreciation, the trust property is worth $156,925 ($1.1^4$ x $107,182) at *A*'s death. That amount is included in her gross estate, generating an estate tax of $47,078 (30% x $156,925); since *A* made no completed gift in the initial transfer, there is no gift-tax offset. The after-tax value of the trust is $109,847 ($156,925 - $47,078).

A longer period between the initial transfer and *A*'s death would magnify the difference in the value of the trust after transfer taxes. For example, if *A* dies after 14 years, the after-tax value of the trust is as follows, depending on whether the initial transfer is a completed gift:

	Completed gift	*No completed gift*
Initial transfer:		
pre-tax (and after-tax) value	$100,000	$107,182
taxable gift	23,939	0
gift tax	7,182	0
At death:		
gross estate	$379,750	$407,023
tentative estate tax	113,925	122,107
gift-tax offset	7,182	0
estate tax	106,743	122,107
after-tax value	273,007	284,916

167. The $10,337 increase in the estate tax results from a $3,155 increase in the tentative estate tax (30% x $10,515) combined with the elimination of a $7,182 gift-tax offset.

168. See generally Stanley S. Surrey et al., Federal Wealth Transfer Taxation 271-74 (1987). In the case of gifts made by a decedent (or the decedent's spouse) within three years of death, § 2035(c) eliminates most of the benefits of the tax-exclusive gift tax base by including in the gross estate any gift tax paid by the decedent (or the estate) with respect to

ingly, a prepayment of transfer tax in the initial transfer produces a tax benefit that offsets the tax cost of reinclusion, wholly or partially depending on the transfer tax rate, the rate of return on investments, and the length of time between the initial transfer and the date of death. With a flat transfer tax rate of 40% and a 10% rate of return, this benefit outweighs the cost of prepaying the transfer tax if *A* dies after four years[169] but not if she survives for 14 years.[170] The disparity between the gift and estate tax bases thus injects an element of arbitrariness into the interaction of the string provisions and section 2001(b).

Far from ameliorating the arbitrary effects of the reinclusion provisions, section 2702 aggravates them. If the special rules apply in the initial transfer and the string provisions include the underlying property in the gross estate, the after-tax value of the property still depends on the transfer tax rate, the rate of return on investments, and the length of time between the initial transfer and death. By increasing the amount of the taxable gift in the initial transfer, section 2702 accentuates both the tax cost of the lost return on the

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such gifts.

169. If *A* dies after four years, the after-tax value of the trust is as follows, depending on whether the initial transfer is a completed gift:

	Completed gift	*No completed gift*
Initial transfer:		
pre-tax (and after-tax) value	$ 97,815	$107,182
taxable gift	23,416	0
gift tax	9,367	0
At death:		
gross estate	$143,211	$156,925
tentative estate tax	57,285	62,770
gift-tax offset	9,367	0
estate tax	47,918	62,770
after-tax value	95,293	94,155

170. If *A* dies after 14 years, the after-tax value of the trust is as follows:

	Completed gift	*No completed gift*
Initial transfer:		
pre-tax (and after-tax) value	$ 97,815	$107,182
taxable gift	23,416	0
gift tax	9,367	0
At death:		
gross estate	$371,453	$407,023
tentative estate tax	148,581	162,809
gift-tax offset	9,367	0
estate tax	139,214	162,809
after-tax value	232,239	244,214

amount used to pay gift tax and the tax benefit of using pre-tax dollars to pay gift tax.

Assume that *A* transfers property worth $82,448 in trust to pay income to *A* for 15 years with remainder to her child *C* or *C*'s estate.[171] *A* makes a taxable gift of $82,448 in the initial transfer, and with a flat transfer tax rate of 30%, the gift tax is $24,734, which *A* pays from non-trust assets. If *A* dies holding the income interest during the 15-year term, the deathtime value of the trust property is included in her gross estate. If the trust property appreciates at a 10% annual rate and *A* dies after four years, the includable value of the trust in the gross estate is $120,711, generating an estate tax of $11,479 and leaving $109,232 after transfer taxes.[172] If *A* retained a power to revoke *C*'s remainder and added the $24,734 gift tax savings to the trust in the initial transfer, the includable value of the trust property in the gross estate would be $156,925, generating an estate tax of $47,078 and leaving $109,847 after transfer taxes.[173] The increase in the after-tax value of the trust would be magnified if *A* survived for a longer period.[174] Assuming a flat transfer tax rate of 40%, section 2702 accentuates the tax benefit of the

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171. In the present example, as in the preceding examples, *A* begins with $107,182. Section 2702 produces a larger gift tax in the initial transfer and a correspondingly smaller initial trust corpus than if the transfer were valued under general principles.

172. At a 10% annual rate of return in the form of capital appreciation, the trust property is worth $120,711 ($1.1^4$ x $82,448) at *A*'s death. That amount is included in her gross estate, generating a tentative estate tax of $36,213 (30% x $120,711) and, after a gift-tax offset of $24,734, an estate tax of $11,479. If the estate tax is paid from the trust property, the after-tax value of the trust property is $109,232 ($120,711 - $11,479).

173. See supra note 166.

174. For example, if *A* dies after 14 years, the after-tax value of the trust is as follows, depending on whether the initial transfer is a completed gift:

	Completed gift	*No completed gift*
Initial transfer:		
pre-tax (and after-tax) value	$ 82,448	$107,182
taxable	82,448	0
gift tax	24,734	0
At death:		
gross estate	$313,094	$407,023
tentative estate tax	93,928	122,107
gift-tax offset	24,734	0
estate tax	69,194	122,107
after-tax value	243,900	284,916

reinclusion provisions if *A* dies after four years[175] as well as their tax cost if she dies after 14 years.[176]

Ultimately, section 2702 serves a limited anti-abuse purpose at the cost of unwarranted complexity and inconsistency.[177] By adopting the gift tax valuation approach of *Robinette*, section 2702 accelerates gift tax and builds in the need for a subsequent adjustment to compensate for the distortion in valuing the retained and transferred interests in the initial transfer. The section 2702 adjustment in effect establishes a minimum value for the retained interest that eventually is included in the transfer tax base, but

175. If *A* dies after four years, the after-tax value of the trust is as follows, depending on whether the initial transfer is a completed gift:

	Completed gift	*No completed gift*
Initial transfer:		
pre-tax (and after-tax) value	$ 76,558	$107,182
taxable gift	76,558	0
gift tax	30,623	0
At death:		
gross estate	$112,089	$156,925
tentative estate tax	44,835	62,770
gift-tax offset	30,623	0
estate tax	14,212	62,770
after-tax value	97,877	94,155

176. If *A* dies after 14 years, the after-tax value of the trust is as follows:

	Completed gift	*No completed gift*
Initial transfer:		
pre-tax (and after-tax) value	$ 76,558	$107,182
taxable gift	76,558	0
gift tax	30,623	0
At death:		
gross estate	$290,730	$407,023
tentative estate tax	116,292	162,809
gift-tax offset	30,623	0
estate tax	85,669	162,809
after-tax value	205,061	244,214

177. Section 2702 affects the valuation of the retained and transferred interests only for gift tax purposes in the initial transfer. Thus, the value of the transferred interest must be determined independently under general principles for other purposes. For example, the special rules do not affect the donee's income tax basis in the transferred interest, see T.D. 8395, 1992-1 C.B. 316, 318, or the amount of a direct skip for generation-skipping transfer tax purposes. See I.R.S. Notice PS-92-90, 1991-1 C.B. 998, 999. Moreover, money's-worth consideration received by the donor may be sufficient to bring the initial transfer within an exception to the string provisions even though it does not produce a taxable gift of zero under the special rules.

does not purport to neutralize fully the distortions in the amount and timing of gift tax produced by the special rules.

If section 2702 simply discouraged abusive transactions by imposing uniformly unfavorable valuation assumptions on all retained nonqualified interests, its complexity might seem relatively harmless. After all, donors can readily avoid problems under section 2702 by retaining only qualified interests (or by transferring all interests in the underlying property at one time).[178] However, section 2702 does not apply uniformly to all split-interest transfers; instead, it redirects old valuation abuses into new channels involving certain types of retained interests, underlying property, and beneficiaries.[179] The problems of complexity, inconsistency, and continued transfer tax avoidance under section 2702 indicate a need for a simpler, more neutral solution.

B. *Eliminating the Need for Section 2702*

For many years, proponents of tax reform have recommended integrating the gift and estate taxes.[180] These proposals, while differing in

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178. In other words, as long as donors can use nonabusive techniques, they should not complain that GRITs and similar techniques produce harsh tax consequences under § 2702.

179. The special rules permit retained qualified interests to be valued under the tables, IRC § 2702(a)(2)(B), and permit nonqualified retained interests in certain tangible property to be valued under an arm's-length standard. IRC § 2702(c)(4). Section 2702 may be entirely inapplicable if the underlying property is to be used as a personal residence by the holder of the term interest, § 2702(a)(3)(A)(ii), or if the beneficiary of the initial transfer is not a member of the donor's family. IRC § 2702(a)(1).

180. The literature on integration is extensive. See House Comm. on Ways and Means and Senate Comm. on Finance, 91st Cong., 1st Sess., Tax Reform Studies and Proposals: U.S. Treasury Department 351-87 (Comm. Print 1969) [hereinafter 1969 Treasury Proposals]; Carl S. Shoup, Federal Estate and Gift Taxes (Greenwood Press 1980); 2 Dep't of the Treasury, Tax Reform for Fairness, Simplicity and Economic Growth 374-83 (1984) [hereinafter 1984 Treasury Proposals]; U.S. Dep't of the Treasury, Federal Estate and Gift Taxes: A Proposal for Integration and for Correlation With the Income Tax (1947); American Bar Association, Section on Taxation, Task Force on Transfer Tax Restructuring, Report on Transfer Tax Restructuring, 41 Tax Law. 395 (1988) [hereinafter ABA Report]; A. James Casner, American Law Institute, Federal Estate and Gift Taxation (1969) [hereinafter ALI Proposals]; A. James Casner, American Law Institute Federal Estate and Gift Tax Project, 22 Tax L. Rev. 515 (1967); Adrian W. DeWind, The Approaching Crisis in Federal Estate and Gift Taxation, 38 Cal. L. Rev. 79 (1950); Joseph M. Dodge, Redoing the Estate and Gift Taxes Along Easy-to-Value Lines, 43 Tax L. Rev. 241 (1988); John T. Gaubatz, The Unfinished Task of Estate and Gift Tax Reform, 63 Iowa L. Rev. 85 (1977); Erwin N. Griswold, A Plan for the Coordination of the Income, Estate and Gift Tax Provisions with Respect to Trusts and Other Transfers, 56 Harv. L. Rev. 337 (1942); Harry L. Gutman, A Comment on the ABA Tax Section Task Force Report on Transfer Tax Restructuring, 41 Tax Law. 653 (1988) [hereinafter Gutman, Comment]; Harry L. Gutman, Reforming Federal Wealth Transfer Taxes After

technical details, generally agree that economically equivalent wealth transfers should be taxed similarly. In an integrated system, the transfer tax consequences of a split-interest transfer should be essentially the same as those of an outright transfer of similar property during life or at death. If the after-tax value of a split-interest transfer were economically equivalent to that of an outright transfer of the same underlying property, the transfer tax incentives to carve beneficial ownership of property into separate interests would disappear. To the extent that integration would minimize disparities between split-interest transfers and outright transfers, it represents an attractive alternative to section 2702.

As a first step toward integrating the gift and estate taxes, the disparity between the tax-exclusive gift tax base and the tax-inclusive estate tax base should be eliminated. Systematically excluding gift tax from the gift tax base while including estate tax in the estate tax base in effect produces gift tax rates that are lower than the estate tax rates, notwithstanding the unified rate schedule.[181] The difference in effective rates generally provides an unwarranted incentive to structure transfers in a manner that attracts a gift tax rather than an estate tax.[182] In the case of a split-interest transfer, even

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ERTA, 69 Va. L. Rev. 1183 (1983) [hereinafter Gutman, Transfer Tax Reform]; Jerome Kurtz & Stanley S. Surrey, Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal, 70 Colum. L. Rev. 1365 (1970); Stanley S. Surrey, An Introduction to Revision of the Federal Estate and Gift Taxes, 38 Cal. L. Rev. 1 (1950).

181. For example, with a flat 25% transfer tax rate, both a taxable gift of $100 and a taxable estate of $100 trigger a $25 transfer tax. However, since the amount used to pay the gift tax is not itself taxed, the lifetime donor transfers an after-tax benefit of $100 at a total cost of $125, while the decedent transfers an after-tax benefit of $75 at a total cost of $100. In tax-inclusive terms, the effective gift tax rate is 20% (25/125), while the effective estate tax rate is 25% (25/100). More generally, a tax-exclusive rate r_{te} can be expressed as an equivalent tax-inclusive rate r_{ti} under a simple algebraic formula: $r_{ti} = r_{te}/(1 + r_{te})$. Michael J. Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575, 1583 n.25 (1979).

182. The standard arguments in favor of lower effective gift tax rates are not persuasive. There is no reason to believe that property given away during life is more productive than property transferred at death or that tax incentives favoring lifetime transfers enhance general welfare. The argument that a lower gift tax rate compensates for the donee's carryover income tax basis in the property misses the mark because the burden or benefit of a carryover basis depends on the donor's cost basis in the property, which plays no role in determining transfer taxes; moreover, this argument merely raises the question of why the income tax treatment of property acquired by gift differs so markedly from the treatment of property acquired from a decedent. Finally, a lower gift tax rate cannot be justified as a discount for early payment of an estate tax, since in theory the timing of a transfer tax payment does not affect its economic cost if the tax rate and base are constant and the rate of return on all investments is the same. See Gutman, Comment, supra note 180, at 656-57; see also ABA Report, supra note 180, at 403-05; Ronald D. Aucutt, Further Observations on Transfer Tax Restructuring: A Practitioner's Perspective, 42 Tax Law. 343, 345-48 (1989); Paul B. Stephan III, A Comment on Transfer Tax Reform, 72 Va. L. Rev. 1471, 1480-90 (1986).

if the string provisions include the underlying property in the gross estate, the gift-tax offset under section 2001(b) generally preserves the benefit of the tax-exclusive base with respect to the amount taxed in the initial transfer. If section 2702 applies, it accentuates the same tax benefit to the extent that it increases the amount of the taxable gift in the initial transfer.

These distortions could be avoided by including the amount of gift tax in the gift tax base, producing a tax-inclusive base consistent with the existing estate tax base.[183] Although conceptually simple, increasing the gift tax base requires an algebraic solution where the increase causes the total amount of the gift to span more than one rate bracket.[184] To avoid solving for interdependent variables (i.e., the tax-inclusive equivalent amount and the amount of gift tax), the same result could be achieved by applying nominally higher gift tax rates to a tax-exclusive base.[185] A uniform tax-inclusive base would remove a longstanding discontinuity between the gift and estate taxes and pave the way for further simplification.[186]

Even under a uniform tax-inclusive base, a progressive rate schedule provides an incentive to make lifetime gifts of property with substantial potential future appreciation because a gift completed before the property

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183. Recent reform proposals generally favor this "gross-up" approach. See 1969 Treasury Proposals, supra note 180, at 355, 369; "Discussion Draft" Relating to Estate Valuation Freezes: Hearings on Serial 101-102 Before the Comm. on Ways and Means, 101st Cong., 2d Sess. 36, 39, 41 n.4 (Apr. 24, 1990) (statement of Kenneth W. Gideon, Assistant Secretary (Tax Policy), Dep't of the Treasury); 1984 Treasury Proposals, supra note 180, at 377-78; Dodge, supra note 180, at 340; Gutman, Comment, supra note 180, at 656-57; Theodore S. Sims, Timing Under a Unified Wealth Transfer Tax, 51 U. Chi. L. Rev. 34, 59-69 (1984). A similar approach produces a tax-inclusive base for certain generation-skipping transfers. IRC § 2621(b) (taxable distribution). A uniform base could also be achieved by adopting a tax-exclusive estate tax, though rate increases might be necessary to compensate for the resulting revenue loss. See Gaubatz, supra note 180, at 87.

184. For example, under the existing unified rate schedule, a tax-exclusive transfer of $90,000 cannot be converted to a tax-inclusive equivalent simply by adding $21,000 (the tax on a tax-inclusive transfer of $90,000), because the marginal rate rises from 28% to 30% for cumulative transfers over $100,000. IRC § 2001(c)(1). Instead, the tax-exclusive amount must be bifurcated into two parts: the first $76,200 of the transfer generates a $23,800 tax, producing the equivalent of a $100,000 tax-inclusive transfer; the remaining $13,800 of the transfer is taxed at 30%, producing the equivalent of a tax-inclusive transfer of $19,714 ($13,800/(1 - .3)). Thus, the tax-exclusive transfer of $90,000 is equivalent to a tax-inclusive transfer of $119,714 ($76,200 + $23,800 + $19,714), including tax of $29,714.

185. Sims, supra note 183, at 70-74, 89-90 (deriving tax-exclusive rate equivalents).

186. A uniform tax-inclusive base would permit repeal of § 2035(c), which presently includes in the gross estate any gift tax paid by a decedent (or the decedent's estate) with respect to gifts made by the decedent (or the decedent's spouse) within three years of death. But cf. Isenbergh, supra note 30, at 14-15 (proposing expansion of § 2035(c) to include all gift taxes, instead of adopting tax-inclusive gift tax base); Joseph Isenbergh, Further Notes on Transfer Tax Rates, 51 U. Chi. L. Rev. 91, 91-96 (1984) (same).

appreciates often falls within lower rate brackets, whereas a later transfer of the same property at an appreciated value would often fall within higher rate brackets. Although this bracket effect presumably could be eliminated without compromising the progressivity of the rate schedule, the complexity of the solution probably outweighs its usefulness.[187]

Under the existing gift and estate tax system, however, the timing of taxable transfers produces more serious distortions that can and should be addressed.[188] Several problems arise from the overlap between the gift and estate taxes when the gross estate includes an interest that was previously transferred in a completed gift during life. Such an overlap often occurs, for example, in a split-interest transfer when a donor transfers a remainder while retaining ownership or control sufficient to trigger inclusion of the underlying property at death under the string provisions.[189] Although the string provisions include the deathtime value of the underlying property in the gross estate, the section 2001(b) adjustment removes the amount of the previously-taxed gift from adjusted taxable gifts, ensuring that the reincluded interest is counted only once in the estate tax base. In effect, only the appreciation in the property between the initial transfer and death increases the cumulative transfer tax base at death.

Quite apart from the amount included in the gross estate, the payment of gift tax in the initial transfer increases the economic cost of reinclusion. The amount of the gift-tax offset under section 2001(b) depends on the gift-tax value of the transferred remainder, which is fixed in the initial transfer. Section 2702, if applicable, may substantially increase the amount of gift tax payable with respect to the initial transfer. Whether or not section 2702 applies, the lost return on the gift tax payment represents an economic cost which increases in proportion to the length of time between the initial transfer and death.[190] The distortion caused by the early gift tax payment could be

187. Sims, supra note 183, at 75. Under existing law, the benefit of the low rate brackets cannot exceed $552,000 (i.e., the sum of the $192,800 unified credit and the $359,200 difference between the maximum 55% rate and the lower rates applied to the first $3,000,000 of cumulative transfers). See IRC §§ 2001(c)(1), 2010(a), 2505(a); Isenbergh, supra note 30, at 13 n.50. One commentator has proposed imposing transfer tax at a flat rate and allowing an exemption at death against transfers in reverse chronological order. Dodge, supra note 180, at 340-43.

188. For critical analyses of existing law, see Dodge, supra note 180, at 264-309; Isenbergh, supra note 30, at 2-16; Sims, supra note 183, at 39-52.

189. A similar overlap may arise in an outright transfer or a joint tenancy. See, e.g., IRC §§ 2035(a), (d), 2042 (transfer of life insurance policy on decedent's life within three years of death), 2040(a) (nonqualified joint tenancy to extent decedent furnished consideration).

190. See supra notes 164-66 and accompanying text. Disregarding the effects of credits, deductions, and progressive rate brackets, the economic cost of reinclusion may be

ameliorated by compounding the amount of the payment forward to the time of death at an appropriate rate of return.[191] Using a consistent deathtime value for both the gift tax payment and the includable value of the property would significantly reduce the distorting effect of the reinclusion provisions.

At a more fundamental level, however, the question arises why any transfer should ever enter the transfer tax base more than once. In a completely integrated gift and estate tax system, each transfer would be taxed only once, either during life or at death. Under a uniform completion rule, a completed gift of property would occur if the donor relinquished sufficient ownership and control during life; if the donor retained ownership or control sufficient to prevent a completed gift of the property from occurring during life, the property would be included in the gross estate.[192] Such a uniform rule would not only eliminate the overlap between the gift and estate taxes but also, if properly framed, minimize tax incentives to manipulate the timing of transfers.

In theory, the timing of a taxable transfer should not affect the economic cost of transfer tax, assuming a constant flat transfer tax rate and a uniform rate of return on all investments.[193] Assume that a donor intends to transfer property either during life or at death. The property is presently worth \$100, and transfer tax is imposed at a flat rate of 40% on a tax-inclusive base. If the donor makes an immediate lifetime transfer, the amount of the transfer is \$100, triggering a tax of \$40 and leaving an after-tax value of \$60. If instead the property is taxed at death when it has appreciated by 50%, the amount of the transfer is \$150, triggering a tax of \$60 and leaving an after-tax value of \$90. The economic cost of the transfer tax is the same in both cases if all property generates the same 50% return during the time between the two transfers. More generally, the amount of transfer tax and the after-tax value of the property bear a fixed ratio to each other and to the pre-

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expressed as $tA((1 - t)(1 + r)^y - 1)$, where t is the nominal gift tax rate, A is the amount of the gift in the initial transfer, r is the after-tax rate of return, and y is the number of compounding periods. Karen C. Burke, Valuation Freezes After the 1988 Act: The Impact of Section 2036(c) on Closely Held Businesses, 31 Wm. & Mary L. Rev. 67, 139 n.347 (1989).

191. For example, an appropriate rate might be defined by reference to the rate on federal obligations, approximating a riskless rate of return. Cf. IRC § 1274(d) (defining discount rate used in calculating issue price of certain debt instruments).

192. Technical details of various uniform completion proposals are discussed extensively in the integration literature. See 1969 Treasury Proposals, supra note 180, at 364-65, 384-87; 1984 Treasury Proposals, supra note 180, at 378-80; ABA Report, supra note 180, at 404-10; ALI Proposals, supra note 180, at 41-47; Dodge, supra note 180, at 267-79, 286-88, 300-04, 308-09, 313-16; Gaubatz, supra note 180, at 92-101; Gutman, Comment, supra note 180, at 674-81.

193. Alvin C. Warren, Jr., The Timing of Taxes, 39 Nat'l Tax J. 499, 500-01 (1986).

tax value of the property, regardless of the rate of return.[194] Stated differently, the lost return on an early tax payment exactly offsets the exclusion of subsequent appreciation from the transfer tax base.[195]

A uniform completion rule, if practicable, would eliminate the cumbersome mechanics and arbitrary effects of the existing reinclusion provisions. Under an "easy-to-complete" rule, a donor may make a completed gift while retaining a substantial degree of control over the transferred property. By contrast, a "hard-to-complete" rule prevents a completed gift from occurring until the donor relinquishes substantially all control over the transferred property. The existing gift tax rules represent a hybrid approach which offers a donor considerable flexibility in determining the time of completion with respect to separate interests in the underlying property.[196] Those rules, however, operate without regard to ease or difficulty of valuation.[197] Indeed, most of the abuses at which section 2702 is aimed involve exploiting the tables to apportion value unrealistically between transferred and retained interests in the initial transfer. Any choice between an easy-to-complete rule and a hard-to-complete rule should reflect the need for a consistent, accurate, and administrable valuation method.

In general, a uniform hard-to-complete rule would minimize uncertainty in valuing separate interests in the underlying property.[198] Indeed,

194. Assuming a uniform tax-inclusive base, a flat 40% tax rate, and a constant rate of return on all investments, the following table illustrates the fixed ratio between the pre-tax value of property, the amount of transfer tax, and the after-tax value of the property:

Rate of return	*None*	*20%*	*50%*	*100%*	*Ratio*
Pre-tax value	$100	$120	$150	$200	100%
Amount of tax	40	48	60	80	40%
After-tax value	60	72	90	120	60%

195. As a practical matter, the rate of return is not the same for all investments. To the extent that the rate of return on donated property exceeds the rate of return on the property used to pay transfer tax, the donor has an incentive to pay the tax sooner rather than later.

196. For example, a donor generally can prevent gift completion with respect to an interest simply by retaining a power affecting beneficial enjoyment of the interest. Regs. § 25.2511-2(b), (c). On the other hand, a retained power affecting beneficial enjoyment does not prevent completion if the power is limited by an "ascertainable standard" and is held by the donor in a fiduciary capacity. Regs. § 25.2511-2(c), (g).

197. The government appears to have rejected an "open" transaction approach in the gift tax context. See supra note 63.

198. By contrast, an easy-to-complete rule tends to require valuation of separate transferred interests at a time when the degree of beneficial enjoyment they represent remains speculative. On the implications of easy-to-complete and hard-to-complete rules, see 1969 Treasury Proposals, supra note 180, at 361-68, 372-73, 384-87; 1984 Treasury Proposals, supra note 180, at 378-83; ABA Report, supra note 180, at 404-10; ALI Proposals, supra note 180, at 41-47; Dodge, supra note 180, at 281-304; Gaubatz, supra note 180, at 92-101; Gutman, Comment, supra note 180, at 674-81; Gutman, Transfer Tax Reform, supra note 180, at 1256-59.

under a strong version of a hard-to-complete rule, a split-interest transfer would trigger no completed gift as long as the donor retained any interest (or control of any interest) in the underlying property. Upon the expiration or disposition of the retained interest during life or at death, the entire property could be valued under general principles without apportioning value between retained and transferred interests. Thus, for example, if a donor transferred property in trust retaining only an income interest for a fixed term of years, a completed transfer of the underlying property would occur at the expiration of the term or at the donor's prior death. In effect, a hard-to-complete rule would hold split-interest transfers "open" until the retained interest ceased to have any significance for valuation purposes.[199] As a result, the need for special valuation rules and subsequent adjustments would disappear.

One possible objection to a hard-to-complete rule is that some interests may be valued and included in the transfer tax base long after the donor relinquished ownership and control of them. In the case of a GRIT, for example, the remainder transferred in the initial transfer may appreciate substantially in value by the time all retained interests expire.[200] There is no reason, however, why common-law property concepts should determine the timing or extent of a transfer for federal tax purposes.[201] In effect, a hard-to-complete rule ignores the fragmentation of beneficial ownership in the initial transfer and treats the donor as making a completed transfer of the entire property upon the termination of all retained ownership and control. This represents a systematic extension of existing rules concerning the time of completion in the context of retained powers over a particular transferred interest.[202]

A more serious problem with the strong version of a hard-to-complete rule stems from the treatment of retained future interests. If a donor transfers a term interest while retaining a reversion, any distributions with respect to the transferred interest would trigger completed gifts.[203] Although periodic

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199. Cf. IRC §§ 2612(a), 2622 (timing and amount of taxable termination for generation-skipping transfer tax purposes); IRC § 2642(f) (timing and amount of direct skip determined at expiration of "estate tax inclusion period").

200. Presumably, most donors who create GRITs expect that the underlying property will appreciate and structure the transaction to maximize the probability that future appreciation will escape gift and estate tax.

201. The same term often refers to fundamentally different concepts, depending on whether it appears in a federal gift tax context or a common-law property context. See, e.g., Dickman v. Commissioner, 465 U.S. 330, 333-38 (1984) ("gift"); Jewett v. Commissioner, 455 U.S. 305 (1982) ("disclaimer"); Commissioner v. Disston, 325 U.S. 442, 446 (1945) ("future interest").

202. See Regs. § 25.2511-2(b), (f).

203. Regs. § 25.2511-2(f); cf. IRC §§ 2612(b), 2621 (timing and amount of taxable distribution for generation-skipping transfer tax purposes).

gifts present no conceptual difficulty, they raise administrative concerns, especially if the only retained interest represents a remote possibility that possession or enjoyment of the underlying property might return to the donor.[204] In such a case, a more practical solution would be to modify the hard-to-complete rule to disregard remote interests.[205] Obviously, some bright-line rules would be necessary to define remote interests and to determine when the donor would be treated as retaining powers actually held by other persons.[206] Furthermore, an adjustment to mitigate double taxation might be necessary if the remote interest became possessory or if the donor transferred the interest.[207] With such modifications, a hard-to-complete rule would represent a substantial improvement over the provisions of existing law concerning timing and valuation.

A hard-to-complete rule, coupled with a uniform tax-inclusive base, would remove the most troublesome transfer tax disparities between a split-interest transfer and a single deferred outright transfer. Under such a rule, by contrast with existing law, the transfer tax base would include the full value of the underlying property at the time of completion, obviating the need to apportion value between transferred and retained interests in the initial transfer.[208] Moreover, a hard-to-complete rule would eliminate the vexing overlap between the gift tax and the estate tax rules concerning the timing and extent of completion.[209] The special attraction of a hard-to-complete

204. Donors might welcome the prospect of periodic distributions, despite the burden of filing frequent gift tax returns, if the distributions qualified for one or more annual exclusions. A strong argument can be made for curtailing the annual exclusion with respect to transfers in trust and trust distributions. See Gutman, Comment, supra note 180, at 657-60; Gutman, Transfer Tax Reform, supra note 180, at 1244-49; see also Robert B. Smith, Should We Give Away the Annual Exclusion?, 1 Fla. Tax Rev. 361, 431-33 (1993).

205. See Gutman, Comment, supra note 180, at 676-79.

206. For specific proposals of such rules, see 1969 Treasury Proposals, supra note 180, at 365, 386-87; 1984 Treasury Proposals, supra note 180, at 379; ABA Report, supra note 180, at 405-07; ALI Proposals, supra note 180, at 41-43, 46; Gaubatz, supra note 180, at 98-101; Gutman, Comment, supra note 180, at 680-81.

207. The same problem arises under existing law where a donor retains an interest having no ascertainable value in the initial transfer and subsequently transfers the same interest. See supra notes 61-71 and accompanying text.

208. A strong easy-to-complete rule represents a mirror image of the hard-to-complete rule discussed in text. Including the underlying value of the entire property in the transfer tax base at the time of the initial transfer similarly would avoid the problem of unrealistic assumptions in valuing split interests; any retained interests could simply be disregarded in a subsequent transfer. This approach, combined with a uniform tax-inclusive base, would remove most of the transfer tax incentives for making split-interest transfers rather than outright transfers.

209. A hard-to-complete approach would leave the string provisions essentially intact, while limiting the range of transfers treated as completed gifts under existing law. Alternatively, under an easy-to-complete approach, most of the string provisions could be

rule—in addition to improving the general structure of the gift and estate tax system—stems from its role as a viable substitute for section 2702.[210]

V. CONCLUSION

The need for structural reform of the gift and estate tax system remains just as urgent after the enactment of section 2702 as before. Under prior law, disparities between the gift and estate taxes created strong incentives for structuring transfers to attract a single gift tax while avoiding the estate tax. To be sure, split-interest trusts represented a special variety of available techniques for reducing transfer taxes by carving beneficial ownership of property into separate interests. In contrast to techniques addressed by other provisions of chapter 14,[211] the split-interest trusts at which section 2702 is aimed combined the advantages of a single completed lifetime transfer with the unrealistically favorable valuation assumptions of the tables. As a result, GRITs and similar techniques permitted donors to transfer property at unrealistically low gift tax values.

Section 2702 responds to those abuses by sharply limiting the availability of the tables and imposing an unfavorable zero-value assumption on many retained interests. This approach, however, is flawed in concept and implementation. On one hand, the zero-value assumption builds in fresh valuation distortions which often remain uncorrected, notwithstanding the elaborate compensating adjustments provided in the regulations. On the other hand, the continued use of the tables in valuing qualified retained interests, personal residence trusts and gifts to nonfamily members leaves considerable room for sophisticated transfer tax avoidance. Thus, section 2702 has redirected many of the old abuses into new channels.

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eliminated. See Isenbergh, supra note 30, at 12, 14, 16-19.

210. The major obstacle to enacting a hard-to-complete approach is rooted in politics rather than policy. The experience with former § 2036(c), which extended the reinclusion provisions to a broad range of estate freezing techniques for a brief period before 1990, offers a sobering lesson. In 1990, Congress responded to sustained opposition from "small business" interests and their lawyers by retroactively repealing § 2036(c) simultaneously with the enactment of chapter 14. See supra note 2. For discussions of the politics of transfer tax reform, see Michael J. Graetz, To Praise the Estate Tax, Not To Bury It, 93 Yale L.J. 259, 259-73 (1983); Gutman, Transfer Tax Reform, supra note 180, at 1197-1207; see also Byrle M. Abbin, The Politics of Transfer Taxation or Watching Sausage Being Made—is Anyone in Charge?, 25 Inst. on Est. Plan. ch. 4 (1991).

211. See IRC §§ 2701 (gift of subordinate equity interest in corporation or partnership), 2703 (restrictions on use or disposition of property), 2704 (lapsing rights or restrictions); see also Estate of Bright v. United States, 658 F.2d 999, 1001-02 (5th Cir. 1981) (deathtime transfer of interest in community property); Rev. Rul. 93-12, 1993-1 C.B. 202 (simultaneous gifts of separate minority blocks of closely-held stock to different family members).

At a more fundamental level, section 2702 injects complexity and inconsistency into a gift and estate tax system already badly in need of reform. By focusing narrowly on valuation in the initial transfer, section 2702 exacerbates preexisting disparities between the gift and estate taxes. The use of split-interest trusts to avoid transfer taxes could be curbed far more effectively by moving toward an integrated gift and estate tax system. Specifically, a uniform tax-inclusive base and consistent rules governing completion and valuation would eliminate most of the differences in transfer tax cost between split-interest transfers and outright transfers made during life or at death. Although these reforms would represent only a first step toward full integration,[212] they would render section 2702 obsolete while making the gift and estate tax system simpler, fairer, and more neutral.

212. Integrating the gift and estate taxes represents an especially easy solution to the problem of valuation abuses in the context of split-interest transfers. Provisions addressing other techniques might require further refinement even in a completely integrated system. See John T. Gaubatz, A Generation-Shifting Transfer Tax, 12 Va. Tax Rev. 1 (1992) (proposing integration of gift, estate, and generation-skipping transfer taxes).